# Employer-Owned Life Insurance

Consent and Reporting Requirements of IRC SECTION 101(J) (applies to life insurance policies issued after August 17, 2006)

Internal Revenue Code Section 101(j), enacted as part of the Pension Protection Act of 2006, addresses the taxation of death benefit proceeds of an employer-owned life insurance policy. Under this new code section, death benefits of employer-owned policies are subject to income taxation to the extent they exceed the employer's basis in the policy, unless certain conditions are met. This law applies to all employer-owned life insurance policies issued after August 17, 2006.

## What is an Employer-Owned Contract?

While there is some uncertainty in the law as written, at the very least, employer-owned life insurance includes policies used for key-person, stock redemption, endorsement split dollar, non-qualified deferred compensation, COLI and BOLI. It may also extend to other designs where the employer may not be the policy applicant but may be considered a policy owner, such as collateral assignment (economic benefit and loan regimes) split dollar or where a trust or other entity owns the policy for the benefit of the employer.

Income taxation of the death benefit may be avoided, however, if: (1) a valid exception applies, such as the insured being a member of an exempted class or the policy being exempted by use, and (2) certain notice and consent requirements are satisfied.

The first exception is for employees, who, at the time of death, were employed by the employer within the last twelve months, or, at the time the policy was issued, were either a director, or a highly compensated employee. A highly compensated employee is one who was:

- a 5% or more owner of the business at any time during the preceding year; or
- earned compensation of $95,000 (for 2005, indexed for inflation) in the preceding year; or
- one of the five highest paid officers; or
- among the highest-paid 35% of all employees.

The second exception is if the notice and consent requirements are met before the policy is issued and the death benefit is paid to:

- A member of the insured's immediate family, to the insured's designated beneficiary under the policy, to a trust for the benefit of a family member or designated beneficiary or to the estate of the insured; or
- Used to purchase an equity interest in the policyholder (employer) from a family member, beneficiary, trust, or estate.

## Notice and Consent (Prior to Issue) Requirement

The notice and consent requirement applies to all life insurance policies involving an employer, other than those related to a qualified plan, that are issued after August 17, 2006, including add-ons to existing cases. The insured must be given written notice of and provide consent to the life insurance coverage. This notice and consent is in addition to what is currently required under state insurance law. The notice must inform the insured that the employer intends to insure the employee's life and the maximum life insurance face amount for which the employee could be insured at the time the policy is issued. It is unclear if the maximum face amount requirement refers to the maximum initial face amount of the policy or whether it refers to a future maximum face amount the policy is expected to have as of the policy issue date.

The notice must also clearly state that the employer will be the beneficiary of the life insurance death benefit and the coverage may continue after the insured terminates employment. The insured must then provide written consent to such life insurance coverage.

**If the notice and consent requirement is not met, the life insurance death benefit will be income taxable to the employer to the extent it exceeds the employer's basis in the policy.**

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## Recording & Record Keeping Requirements

The legislation also mandates annual reporting of employer-owned contracts for each year the contracts are owned. Employers must complete Form 8925 (to fulfill the reporting requirement under Internal Revenue Code (IRC) Section 6039I established in conjunction with IRC Section 101(j). The form requires any employer that owns life insurance policies issued or materially changed after August 17, 2006 to provide the following information:

- The total number of employees the employer had at the end of the tax year.
- The number of employees who were insured at the end of the tax year under the employer's employer-owned life insurance contracts issued or materially changed after August 17, 2006.
- The total amount of employer-owned life insurance in force for the employees covered on the form.
- An attestation that valid consent from each of the insureds has been obtained and if not, the number of employees for whom a valid consent does not exist.

Form 8925 must be attached to the employer's form 1120 (or other tax form) on which it will be reporting its income taxes - for each tax year ending after November 13, 2007, during which the policyholder has employer-owned life insurance contract(s) in force.

In light of these reporting rules, it is extremely important that the employer maintain documentation that proves that the employer has met the notice and consent requirements in a timely manner.

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*For federal income tax purposes, life insurance death benefits generally pay income tax-free to beneficiaries pursuant to IRC Sec. 101(a)(1). In certain situations, however, life insurance death benefits may be partially or wholly taxable. Situations include, but are not limited to: the transfer of a life insurance policy for valuable consideration unless the transfer qualifies for an exception under IRC Sec. 101(a)(2) (i.e., the transfer-for-value rule); arrangements that lack an insurable interest based on state law; and an employer-owned policy unless the policy qualifies for an exception under IRC Sec. 101(j).*

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