Advisor Guide to IRC §(j) Compliance

Avoiding Potential Taxation of Employer–Owned Life Insurance

Employer Owned Life Insurance

Compliance with IRC Sections 101(j) and 6039I

IRC Sec. 101(j) applies to policies issued after August 17, 2006 (or issued pursuant to a 1035 exchange with material increases to the death benefit or material changes to the policy) in which a business is the owner of the policy, the business is directly or indirectly the beneficiary, and an employee is the insured.

The general rule is that death benefits paid from a life insurance policy subject to IRC Sec. 101(j) are taxable when received. In order to avoid taxation of the death benefits you must qualify for one of the following **exceptions.**

- The insured is a director or highly compensated employee[1]
- The employee/insured was employed by the business no later than 12 months prior to death
- The death benefits are payable to the employee's heirs (family members, trust, estate)
- The death benefits are used to purchase an interest in the business

In addition to qualifying for an exception, the employer must provide the insured employee with **written notice** stating –

- That the business intends to insure the life of the employee and that coverage may continue after the employee terminates employment,
- That the business will be the beneficiary of the life insurance policy, and
- The maximum amount of life insurance coverage the business will obtain on the employee.

The insured employee needs to **consent in writing** to being insured and to having coverage continue after they terminate their employment **PRIOR TO ISSUANCE OF THE POLICY**.

In order to avoid taxation of the death benefits the business also must **report to the IRS** (on IRS Form 8925):

- The number of employees of the applicable policyholder at the end of the year,
- The number of such employees insured under such contracts at the end of the year,
- The total amount of insurance in force at the end of the year under such contracts,
- The name, address, and taxpayer identification number of the applicable policyholder and the type of business in which the policyholder is engaged, and
- That the applicable policyholder has a valid consent for each insured employee (or, if all such consents are not obtained, the number of insured employees for whom such consent was not obtained).

1 The highly compensated requirement can be met by **any** of the following:
- Insured employee has compensation in excess of the 414(q) limit ($105,000 in 2008)
- Insured employee is among the top 35% in pay – IRC Sec. 105(h)
- Insured employee owns 5% or more of the business

IRS Notice 2009-48

In June of 2009 the IRS published additional guidance on IRC 101(j) in the form of IRS Notice 2009-48. The Notice provides guidance in five different areas:

1 The definition of employer owned life insurance

2 Exceptions to the application of 101(j)(1) – timing of the notice and consent requirement

3 Satisfaction of the notice and consent requirement

4 Transition rules and 1035 exchanges

5 Information Reporting under §6039I and Form 8925

One of the most frequently asked questions has been whether or not any relief is available for inadvertently failing to comply with the notice and consent requirements. With regards to that question the Notice stated the following:

> Q-13. How can an inadvertent failure to satisfy the notice and consent requirements of §101(j)(4) be corrected?
>
> A-13. Section 101(j) does not contain a provision for correcting an inadvertent failure to satisfy the notice and consent requirements of §101(j)(4). The Service will not, however, challenge the applicability of an exception under §101(j)(2) based on an inadvertent failure to satisfy the notice and consent requirements if the following conditions are met:
>
> (1) the applicable policyholder made a good faith effort to satisfy those requirements, such as by maintaining a formal system for providing notice and securing consents from new employees;
>
> (2) the failure to satisfy the requirements was inadvertent; AND
>
> (3) the failure to obtain the requisite notice and consent was discovered and corrected no later than the due date of the tax return for the taxable year of the applicable policyholder in which the employer-owned life insurance contract was issued. Because § 101(j)(4)(B) requires that the employee's consent be written, failure to obtain such consent cannot be corrected after the insured employee has died.

While Notice 2009-48 is effective June 15, 2009, the IRS will not challenge a taxpayer who made a good faith effort to comply with IRC §101(j) based on a reasonable interpretation of the statutory provision prior to the effective date.

PLR 201217017

In Private Letter Ruling 201217017 the taxpayer requested a ruling from the IRS that the taxpayer did not violate the notice and consent requirement of IRC 101(j) because they had made a good faith effort to comply pursuant to Notice 2009-48.

The taxpayer (an employer) purchased insurance policies on shareholders of the business in order to fund a buy-sell agreement. The facts state that the taxpayer did NOT provide each insured with a separate document that contained all of the necessary notice and consent information. However, the IRS looked at the application for insurance along with the buy-sell agreement and determined that:

1. Through the Buy-Sell agreement and the life insurance application, each shareholder was notified in writing that the taxpayer (employer) intended to insure their lives;
2. Through the application, each shareholder was notified in writing of the maximum face amount for which the shareholder could be insured at the time the contract was issued, in dollars;
3. By signing both the buy-sell agreement and the life insurance application, each shareholder consented to being insured under the contract;
4. By signing the agreement, each shareholder consented that such coverage may continue after the shareholder terminates employment; and,
5. Through the agreement and the application, each shareholder was informed in writing that the taxpayer will be a beneficiary of any proceeds payable upon the death of the shareholder.

Due to these findings of fact the IRS ruled that the taxpayer had satisfied the notice and consent requirements of 101(j) **before** the policies were issued.

It is important to consider a number of important facts regarding this guidance from the IRS –

1. There were specific provisions in the buy-sell agreement that lead the IRS to determine that the shareholders consented that the coverage could be continued by the employer after they terminated employment [which is a requirement under 101(j)]. Many buy-sell agreements do not contain the language used in this buy-sell agreement and would therefore fail to meet this particular requirement.
2. While the employer did not obtain separate documentation from each shareholder that expressly complied with the notice and consent requirements PRIOR to the issuance of the policies, they did in fact obtain separate documentation after the policies were issued (but not before the due date of the taxpayer's federal income tax return). The fact that they did obtain the separate documentation most certainly helped the taxpayer in this case argue that they had acted in "good faith".
3. Private letter rulings are directed only to the taxpayer requesting them and cannot be used or cited as precedent for other taxpayers.

Based on these facts, in order to avoid having the death benefits on employer owned policies subjected to income taxes, it is still highly recommended that employers comply with all of the notice and consent requirements of 101(j) **prior** to having life insurance policies covering the lives of employees issued.

Exhibit 1
IRS Form 8925

Form **8925** (Rev. January 2010) Department of the Treasury Internal Revenue Service (99)

Report of Employer-Owned Life Insurance Contracts

▶ Attach to the policyholder's tax return—See instructions.

OMB No. 1545-2089

Attachment Sequence No. 160

Name(s) shown on return	Identifying number
Name of policyholder, if different from above	Identifying number, if different from above
Type of business	

1	Enter the number of employees the policyholder had at the end of the tax year	1	
2	Enter the number of employees included on line 1 who were insured at the end of the tax year under the policyholder's employer-owned life insurance contract(s) issued after August 17, 2006. See *Section 1035 exchanges* on page 2 for an exception	2	
3	Enter the total amount of employer-owned life insurance in force at the end of the tax year for employees who were insured under the contract(s) specified on line 2	3	
4a	Does the policyholder have a valid consent (see instructions) for each employee included on line 2? ☐ Yes ☐ No		
b	If "No," enter the number of employees included on line 2 for whom the policyholder does not have a valid consent	4b	

General Instructions

Section references are to the Internal Revenue Code unless otherwise noted.

Purpose of Form

Use Form 8925 to report the *number of* employees covered by employer-owned *life insurance contracts issued after* August 17, 2006, and the total amount of employer-owned life insurance in force on those employees at the end of the tax year. Policyholders must also indicate whether a valid consent has been received from each covered employee, and the number of covered employees for which a valid consent has not been received.

See sections 101(j) and 6039I, and Notice 2009-48, 2009-24 I.R.B. 1085, for more information.

Definitions

Employer-owned life insurance contract. For purposes of Form 8925, an insurance contract is an employer-owned life insurance contract if it is owned by a policyholder as defined below, and covers the life of the policyholder's employee(s) on the date the life insurance contract is issued. If you have master contracts, see section 101(j)(3) for additional information.

Policyholder. For purposes of Form 8925 and these instructions, a policyholder is an "applicable policyholder" as defined in section 101(j)(3)(B). Generally, a policyholder is the person who owns the employer-owned life insurance contract, and who is (a) engaged in a trade or business that employs the person insured under the employer-owned life insurance contract and (b) the direct or indirect beneficiary of the employer-owned life insurance contract.

Related person. A related person is considered a policyholder if that person is (a) related to the policyholder (defined earlier) under sections 267(b) or 707(b)(1), or (b) engaged in a trade or business under common control with policyholder. See sections

Employee. Employee inclu officer, director, or highly c employee under section 41

Insured. An individual mus citizen or resident to be co insured under an employer insurance contract. Both in covered by a contract cove lives of two individuals are insured.

Notice and consent requi qualify as an employer-own insurance contract, the pol must meet the notice and c requirements listed below b issuance of the contract.

1. Provide written notific employee stating the policy *intends* to insure the emplo the maximum face amount employee could be insured the contract was issued.

The written notification a disclosure of the face am insurance, either in dollars multiple of salary, that the

reasonably expects to purchase with regard to the employee during the course of the employee's tenure. Additional notice and consent are required if the aggregate face amount of the employer-owned life insurance contracts with regard to an employee exceeds the amount of which the employee was given notice and to which the employee consented. See Q&A-9

For Paperwork Reduction Act Notice, see page 2.

Exhibit 2
Sample Notice and Consent Form

NOTICE AND CONSENT TO EMPLOYERS APPLICATION FOR LIFE INSURANCE

NAME AND ADDRESS OF CARRIER:

1. EMPLOYEE (PROPOSED INSURED) INFORMATION

Full Name (First, Middle, Last. Include maiden name in parentheses)	Gender ☐ F ☐ M	Date of Birth MM/DD/CCYY	Social Security Number
Street Address	City	State	Zip Code
Occupation			

2. EMPLOYER (OWNER) INFORMATION

Full Legal Name			
Street Address	City	State	Zip Code

3. NOTICE BY EMPLOYER (OWNER)

a. Employer intends to apply for insurance on the life of the Employee (Proposed Insured).

b. The maximum face amount the Employee (Proposed Insured) could be insured for at the time the contract is issued is $________

c. The Employer will be the Owner of any policy issued and a beneficiary of any proceeds payable upon the Employee's (Proposed Insured's) death.

4. CONSENT OF EMPLOYEE (PROPOSED INSURED)

a. I consent to being an insured under the life insurance policy for which my Employer intends to apply.

b. I consent to my Employer continuing coverage, after my employment ends, under any policy issued.

c. I understand that my Employer will own the policy. Unless provided in a separate agreement, my Employer will receive all of the death proceeds, and my personal representative, next of kin, and heirs at law will have no beneficial interest in the policy or its death proceeds.

AGREEMENT AND AUTHORIZATION

This form is provided as a convenience to the Employer and to obtain information that may be needed for information reporting services. By providing this form, the carrier makes no representation that completing it will constitute compliance with any law or regulation, tax or otherwise. Federal tax law specifies that the death benefits of certain employer-owned life insurance contracts will not be completely excluded from federal gross income of the Employer unless notice-and-consent requirements and other requirements specified in the law are fulfilled.

The carrier and its representatives and distributors do not provide tax or legal advice. The carrier did not accept this form for use by any taxpayer to avoid any Internal Revenue Service penalty. You should ask your independent tax and legal advisors for advice based on your particular situation.

A photocopy of this form shall be as valid as the original.

Signature of Employee (Proposed Insured) Date

Signature of Employer (Owner) Date

Title

IRC Sections 101(j) and 6039I
Worksheet

The Pension Protection Act of 2006 contained a number of provisions dealing with the taxation of employer-owned life insurance. The Act added Internal Revenue Code (IRC) Sections 101(j) and 6039I to the IRC in an attempt to curtail what they perceived to be abuses by businesses of the favorable tax treatment afforded life insurance death benefits. In November of 2007, the Internal Revenue Service (IRS) issued temporary regulations regarding employer-owned life insurance (effective November 13th, 2007). The Service released final regulations November 6, 2008, specifying reporting requirements under Code § 6039I. The final regulations provide guidance as to how the requirements of § 6039I should be applied. If you are uncertain whether or not IRC Sections 101(j) and 6039I apply to a particular life insurance policy, or if you are uncertain what must be done to assure the death benefits are received tax-free, please follow the steps below.

Step 1: Do IRC Sections 101(j) and 6039I apply to your case?

Was the policy issued after August 17, 2006? **OR** Was the policy issued pursuant to a 1035 exchange with material increases to the death benefit or material changes to the policy?[1]	❑ Yes	❑ No
Is the business (or a "related party")[2] the owner of the policy?	❑ Yes	❑ No
Is the business (or a "related party") directly or indirectly the beneficiary?	❑ Yes	❑ No
Is the insured an employee of the business (on the date the policy is issued)?	❑ Yes	❑ No

If you answered **YES** to EACH question above, then IRC sections 101(j) and 6039I **do** apply to your life insurance case — **Move on to Step 2.**

If you answered **NO** to ANY question above, then IRC sections 101(j) and 6039I **do not** apply to your life insurance case.

Step 2: Income tax treatment of employer-owned life insurance death proceeds.

General Rule: *Death benefits (in excess of the cumulative premiums paid) are included as income for* income tax purposes unless you qualify for one of the exceptions.

Is the insured a director or highly compensated employee?[3]	❑ Yes	❑ No
Was the employee employed by the business no later than 12 months prior to death?	❑ Yes	❑ No
Are the policy death benefits payable to the employee's heirs (family members, trust, their estate)?	❑ Yes	❑ No
Will the policy death benefits be used to purchase an interest in the business from the insured's family, estate or trust?	❑ Yes	❑ No

If you answered **YES** to ANY of the questions above, you have met one of the exceptions to the general rule of taxing employer-owned life insurance death benefits. You must comply with notice and consent requirements as well as reporting and recordkeeping requirements — **Move on to Step 3.**

If you answered **NO** to EACH question above, then the insured employee **does not** qualify for an exception from the general rule of taxing employer-owned life insurance death benefits:
The death proceeds may be subject to income tax when paid.

Step 3: Notice and Consent Requirements

In order to avoid taxation of employer owned life insurance death benefits, you are required to meet the following notice and consent requirements *prior to the issuance of the policy*:

Notice required:

The business must provide the insured employee with written notice stating —

- That the business intends to insure the life of the employee and that coverage may continue after the employee terminates employment,
- That the business will be the beneficiary of the life insurance policy, and
- The maximum amount of life insurance coverage the business will obtain on the employee.

Consent required:

- The insured employee needs to consent in writing to be insured and to having coverage continue after they terminate their employment.

Move on to Step 4.

Step 4: Reporting and Recordkeeping Requirements

In order to avoid taxation of employer-owned life insurance death benefits, you are required to meet the following reporting and recordkeeping requirements:

Reporting Requirements:

Annually, the applicable policyholder (the employer) shall report to the IRS (via IRS Form 8925) —

- The number of employees of the applicable policyholder at the end of the year
- The number of such employees insured under such contracts at the end of the year
- The total amount of insurance in force at the end of the year under such contracts
- The name, address, and taxpayer identification number of the applicable policyholder and the type of business in which the policyholder is engaged
- That the applicable policyholder has a valid consent for each insured employee (or, if all such consents are not obtained, the number of insured employees for whom such consent was not obtained)

Recordkeeping:

Each applicable policyholder owning one or more employer-owned life insurance contracts during any year shall keep such records as may be necessary for purposes of determining whether the requirements of Sections 101(j) and 6039I are met.

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1 Technical Explanation of H.R. 4, August 3, 2006 - Material increase in death benefit/Material changes in the contract: *Increases in the death benefit that occur as a result of the operation of section 7702 of the Code or the terms of the existing contract, provided that the insurer's consent to the increase is not required, will not cause a contract to be treated as a new contract. In addition, certain changes to a contract will not be considered material changes so as to cause a contract to be treated as a new contract. These changes include administrative changes, changes from general to separate account, or changes as a result of the exercise of an option or right granted under the contract as originally issued.*

2 A related person is either a person who is engaged in business having a common control (within the meaning of IRC Secs. 52(a) or (b)) or a person having a relationship defined in IRC Secs. 267(b) or 707(b)(1).

3 The highly compensated requirement can be met by any of the following:
- Insured employee has compensation in excess of the 414(q) limit ($105,000 in 2008)
- Insured employee is among the top 35 percent in pay – IRC Sec. 105(h)
- Insured employee owns 5 percent or more of the business
- Insured employee is among the top 5 highest paid officers of the business

Relevant IRC Sections

IRC Sec. 267(b) - Relationships

The persons referred to in subsection (a) are:

(1) Members of a family, as defined in subsection (c)(4);
(2) An individual and a corporation more than 50 percent in value of the outstanding stock of which is owned, directly or indirectly, by or for such individual;
(3) Two corporations which are members of the same controlled group (as defined in subsection (f));
(4) A grantor and a fiduciary of any trust;
(5) A fiduciary of a trust and a fiduciary of another trust, if the same person is a grantor of both trusts;
(6) A fiduciary of a trust and a beneficiary of such trust;
(7) A fiduciary of a trust and a beneficiary of another trust, if the same person is a grantor of both trusts;
(8) A fiduciary of a trust and a corporation more than 50 percent in value of the outstanding stock of which is owned, directly or indirectly, by or for the trust or by or for a person who is a grantor of the trust;
(9) A person and an organization to which section 501 (relating to certain educational and charitable organizations which are exempt from tax) applies and which is controlled directly or indirectly by such person or (if such person is an individual) by members of the family of such individual;
(10) A corporation and a partnership if the same persons own—
 (A) more than 50 percent in value of the outstanding stock of the corporation, and
 (B) more than 50 percent of the capital interest, or the profits interest, in the partnership;
(11) An S corporation and another S corporation if the same persons own more than 50 percent in value of the outstanding stock of each corporation;
(12) An S corporation and a C corporation, if the same persons own more than 50 percent in value of the outstanding stock of each corporation; or
(13) Except in the case of a sale or exchange in satisfaction of a pecuniary bequest, an executor of an estate and a beneficiary of such estate.

IRC Sec. 267(c)(4) – Family Defined

The family of an individual shall include only his brothers and sisters (whether by the whole or half blood), spouse, ancestors and lineal descendants.

IRC Sec. 707(b)(1) – Partner Relationships

(A) A partnership and a person owning, directly or indirectly, more than 50 percent of the capital interest, or the profits interest, in such partnership, or
(B) Two partnerships in which the same persons own, directly or indirectly, more than 50 percent of the capital interests or profits interests.

IRC Sec. 101(j)(3)(A)(i) – Employer Owned Life Insurance Defined

The term 'employer-owned life insurance contract' means a life insurance contract which is owned by a person engaged in a trade or business and under which such person (or a related person described in subparagraph (B)(ii)) is directly or indirectly a beneficiary under the contract, and (ii) covers the life of an insured who is an employee with respect to the trade or business of the applicable policyholder on the date the contract is issued.