

ADVANCED MARKET INSIGHTS

EMPLOYER-OWNED LIFE INSURANCE AND IRC 101(J) AND 6039I

IRC §101(j)¹ requires the **presumption** that all corporate-owned life insurance (COLI) and employer-owned life insurance (EOLI) policies are taxable investment contracts.² Businesses buying life insurance on their employees must treat the policy death benefits in excess of the businesses' costs as taxable income **unless** the employer meets certain "notice and consent" and IRS filing requirements. This paper examines the technical aspects of 101(j) and provides guidance for successful implementation.

What is an EOLI Contract?

EOLI is a life insurance contract, owned by a person engaged in a trade or business and under which a U.S. citizen or resident employee, or related party, is the insured on the date the policy is issued.³ Related parties include, but are not limited to, partners in a partnership, family members, grantors and fiduciaries of trusts, controlled groups, or related businesses and corporations.^{4,5}

IRC 101(j) presumes that all COLI and EOLI policies are taxable investment contracts.

Since 1913, Congress deemed life insurance death benefits income tax-free, and under current law, policy cash values grow tax deferred. This combination

provides a powerful accumulation tool for buyers of permanent life insurance policies. Over time, through the Internal Revenue Code (IRC), Congress has put reasonable restraints on how individuals and businesses can buy, own, and transfer life insurance policies to ensure only those with an insurable interest (the owner and beneficiary stand to be financially harmed by the insured's death) would receive income tax-free treatment of the death benefit. Otherwise, such parties would be taxed on the policy's gains as income, just like other investment contracts. The total sum of the premiums and other amounts paid by the policy holder would not be taxable.

TAX-FREE LIFE INSURANCE DEATH BENEFITS FOR BUSINESSES START WITH NOTICE AND CONSENT

Personal and trust-owned life insurance death benefit proceeds are generally paid income tax-free to the policy beneficiaries.⁶ In order for EOLI death benefits to avoid income tax, the business must meet a number of statutory exemptions and satisfy a notice and consent requirement. The employee must be notified of the policy application and the maximum amount of insurance, and the employee's consent to be insured must be received with the express understanding that such coverage may continue after the insured leaves the company. Notice and consent is also required if there are material changes (including 1035 exchanges) to any policy issued *before* August 17, 2006.^{7, 8, 9}

Taxpayers that buy life insurance on employees after August 17, 2006, must also annually file an informational form (IRS Form 8925) along with the business income tax return providing information on each policy.¹⁰

Why Insure an Employee?

Employers purchase life insurance on the life of an employee when the business has an insurable interest in the insureds, generally the lives of the owners, officers, and key employees. There are many reasons to purchase a policy including to:

- Fund a stock redemption arrangement.
- Mitigate loss of a key employee.
- Informally save for a nonqualified deferred compensation arrangement.
- Provide excess death benefit coverage to employees (split-dollar).
- Act as a corporate savings vehicle (COLI/bank-owned life insurance (BOLI)).

MEETING THE NOTICE AND CONSENT REQUIREMENT

Compliance with notice and consent is the employer/EOLI policyowner's responsibility.¹¹ IRC §101(j)(4) establishes notice and consent requirements for all new policies and material changes to existing policies issued after August 17, 2006. A single consent may apply to more than one policy if all of the following criteria are met:¹²

- The employee must be notified in writing:
 - That the employer intends to buy life insurance on the life of the employee either in dollars or multiples of salary.
 - Of the maximum face amount/death benefit that the employer might buy.
 - That the employer will be a beneficiary of some or all of the policy death benefit.

- The employee must give written consent to:
 - Being insured by the employer.
 - Coverage continuing after the employment relationship ends.

It is a corporate best practice to have an employee sign a stand-alone notice and consent form prior to, or at the time of, any application for life insurance, and at the time of any material change to the policy. Both the company and the employee should keep the records. Although a life insurance carrier's application may include a notice and consent, it doesn't guarantee required disclosures will be provided.

MEETING THE STATUTORY EXCEPTIONS TO 101(J)

The employer must meet the notice and consent requirements to avoid investment contract income tax treatment under an exception to 101(j).¹³ The death benefits of policies that meet one of the following exceptions (and the notice and consent requirements) are excluded from gross income — "income tax-free."

• Appropriate insured

The "appropriate insured" exception saves policies purchased on the lives of certain officers or highly compensated employees who are or will be (1) an employee at any time during the 12 months prior to the employee's death or (2) who are or will be a director of the employer or a highly compensated employee or individual at the time of policy issue.^{14,15}

• Permitted Purpose

The "permitted purpose" exception safeguards from taxation amounts paid outright or in trust to an insured's heirs including the insured's estate, or to a family member. The definition of family includes the insured's spouse, lineal descendants, brothers and sisters, and ancestors. The second exception also applies if the policy proceeds are used to purchase an equity interest in the employer from any of the insured's heirs.¹⁶

REPORTING REQUIREMENTS OF IRC §6039I

IRC §6039I requires that an employer purchasing life insurance that insures the lives of one or more employees after August 17, 2006, annually report the following on IRS Form 8925:

- Both the number of employees and the number of those employees insured under EOLI policies at the end of the tax year.
- The total amount of EOLI death benefit in force at the end of the tax year.
- The name, address, and EIN of the business and a declaration of the type of business it is engaged in.
- A statement that the business has a valid consent for each insured employee or a declaration of the number of insured employees from whom consent has not been obtained.
- Form 8925 must be attached to the taxpayer's regular income tax return for all policy years going forward.

CURING NONCOMPLIANT EOLI CONTRACTS FOR FAVORABLE INCOME TAX TREATMENT

The general rule of 101(j) is that you cannot cure a policy that does not meet the requirements at the time the policy is originally issued. However, a 1035 exchange to a new policy with an increased death benefit or any other material change would cause the policy to be newly issued and give the employer a new opportunity to satisfy the requirements.

A policy may be cured if:

- The original policy is canceled or surrendered and a newly-issued policy is obtained.
- The carrier is willing and able to reissue the policy to a date that gives the parties time to meet the notice and consent requirements prior to the reissue date.
- There is a newly-issued policy under IRC §7702 that meets the notice and consent requirements prior to that date. To be newly-issued there would need to be an increase in the death benefit or other material change (such as the addition of a rider) to the existing policy which would likely involve additional underwriting.
- A transfer to the employee would remove the 101(j) requirements and would also meet the transfer-for-value exception required as a transfer to the insured.

The employee could then transfer the policy back to the employer. This second transfer would need to still meet an exception to the transfer-for-value rules in order to obtain the death benefits exclusion from gross income under IRC 101(a)(2).¹⁷ The policy would also need to meet one of the statutory exemptions (appropriate insured or permitted purpose) outlined above, to avoid taxable investment contract treatment.

- If a notice and consent is inadvertently missed, it can be corrected by the tax return's due date for the taxable year in which the policies were issued if there is good faith, and practices in place to generally satisfy the requirements.¹⁸

IDENTIFYING POTENTIAL 101(J) ISSUES

When reviewing the following fact patterns, look out for potential 101(j) violations.

- Changes or exchanges of policies issued prior to August 17, 2006: any change to such a policy may fall under the ambit of 101(j) if the death benefit increased materially or other material changes were made to the policy.
- Split-dollar arrangements between the employer and the employee: any split-dollar arrangement in which the employer owns a policy issued after August 17, 2006, and the employer is the owner of any split-dollar receivable secured by the policy's death benefit. Loan regime arrangements in which the owner of the policy is the insured, or an individual or trust unrelated to the business, are not subject to 101(j) because they are not generally "employer owned."
- Stock Redemption Arrangements: In these arrangements the business generally owns the policies and receives the death benefits to purchase the owner's interests. Determine if the owner is an employee for the purposes of 101(j).
- Key Person Life Insurance: The business may own policies insuring key employees to mitigate against the loss of a key person.
- Nonqualified Plans: A business may own life insurance as a general asset to reserve for future nonqualified deferred compensation arrangements.
- Family Limited Partnerships and Buy/Sell, LLC Arrangements: In both of these arrangements the facts and circumstances may rise to the level of engaging in a trade or business and require compliance with 101(j).

ANALYZING 101(J) ISSUES

The following analysis tree is one way to consider any 101(j)-related issue.¹⁹

1. Query — Does 101(j) apply?

- Is the policy EOLI?
 - Is the policy owned by the employer or the employer's related party?
 - Is the beneficiary the employer or the employer's related party?
- Was the policy issued after August 17, 2006?
 - If yes, then the policy is subject to 101(j) and notice and consent are required.
- Was a policy issued before August 17, 2006?
 - If “yes” the policy is not subject to 101(j) unless the policy has had a material modification after this date, which would cause it to be subject to 101(j) and treated as a newly-issued policy.

2. Did the employer provide written notice and obtain written consent from the employee?

- Did the employer provide written or electronic notice to the employee that:
 - Was prior to policy issue?
 - Declared the employer's intent to insure the employee even after the employer/employee relationship ended?
 - Declared the maximum death benefit the employer intended to purchase on the employee's life?
 - Declared that the employer would be a beneficiary of some or all of the contract?
- Did the employee provide written consent to all of the above?²⁰

3. Does a 101(j)(2) exception apply?

- Assuming 101(j) applies, query whether the appropriate insured or permitted purpose exception applies:
 - Was the insured an “appropriate insured?” Was the employee:
 - Employed at any time during the 12-month period prior to the insured's death?

- A director of the company or a highly compensated individual as defined by IRC 414(q) or 101(j)(2)(A)(ii)(III) at the time the policy was issued?

An affirmative answer to either question suggests that the appropriate insured exception is met.

- Was the death benefit paid to an insured's heirs?
 - Was the death benefit paid to an ancestor of the employee, their spouse, their brothers or sisters, their descendants, their estate, either outright or in trust?
 - Was the amount used to purchase an equity interest in the employer, previously held by the insured employee, from the insured's heir(s)?

An affirmative answer to either question suggests the permitted purpose exception is met.

4. Were the reporting requirements of IRC 6039I met on IRS Form 8925?

- Form 8925 includes the:
 - Number of employees of the applicable policyholder at the end of the year.
 - Number of contracts insuring employees.
 - Total year-end amount of insurance in force under such contracts.
 - Name, address, and identifying number of the applicable policyholder and the type of business in which the policyholder is engaged.
 - Valid consent for each insured employee by the applicable policyholder, or, if all such consents are not obtained, the number of employees that did not consent.
- Form 8925 has been filed for all relevant tax years.

5. The policy death benefit proceeds may be excluded from the employer's gross income if 101(j) applies, both the notice and consent requirement and an applicable exemption apply, and the policies are accurately reported on IRS Form 8925.

SPECIMEN FORM: 101(J) "NOTICE & CONSENT"

The following annotated form is an example of the type of notice and consent form a company can use in an EOLI transaction. This specimen form is for educational and reference purposes only and may not be used in this form for any transactions. Any notice and consent form should be prepared by the client's licensed counsel.

Additionally, a life insurance carrier may also provide a notice and consent form as part of the application package. M Advanced Markets suggests taking a "belt-and-suspenders" approach and using both a stand-alone form and the carrier form. Not all carrier forms meet the requirement of 101(j).

NOTICE & CONSENT FORM FOR EOLI POLICY

RETAIN A COPY OF THIS FORM IN COMPANY INSURANCE RECORDS AND EMPLOYEE RECORDS

APPLICABLE POLICY OWNER: _____
(Employer or Related Person)

EMPLOYEE NAME: _____

NOTICE TO EMPLOYEE

Your Employer intends to purchase a life insurance contract or make a material change modifying an existing life insurance policy insuring your, the Employee's, life. The maximum face amount on the date of policy issue is \$ _____ or a _____ multiple of the Employee salary of _____.

The Employer intends to be a beneficiary of all, or a portion of, the death benefit proceeds payable from the life insurance contract upon your, the Employee's, death.

EMPLOYEE CONSENT

I, _____, hereby consent to the application for, and purchase of, the life insurance coverage described above and consent to the coverage continuing after our Employer/Employee relationship is terminated. I also understand, and hereby consent to, the Employer being a beneficiary of all, or a portion, of the death benefits payable from the policy upon my death.

Employee Signature

Date

Employee Name (please print)

Employer Representative Signature

Date

Employer Representative (please print)

For Company Use

Policy Carrier:

Policy Number:

Policy Issue Date:

ENDNOTES

¹ Unless otherwise indicated, all section references are to the Internal Revenue Code of 1986 (hereinafter "IRC").

² The Pension Protection Act of 2006 (Pub. L. 109-280, 120 Stat 780) (PPA), passed on August 17, 2006, was intended to improve retirement security by providing greater access to savings plans and IRA transfers to a surviving spouse. It was also an attempt to shore up private company pensions through government protections. Section 863 of the PPA amended Section 101 of the Internal Revenue Code, setting forth rules and exceptions for EOLI in part as a reaction to certain companies purchasing life insurance on employees without the employee's knowledge and keeping the death benefits for the benefit of the company.

³ IRC 101(j)(3),(5)(B).

⁴ EOLI contracts arise whenever the employer is both the owner and the beneficiary of a policy insuring the life of an employee. Examples include life insurance owned inside a single shareholder LLC (a disregarded entity), sole proprietorships (on the lives of employees), partnerships or wholly-owned/closely held companies insuring the owner, key person arrangements, COLI generally, stock redemption arrangements, and split-dollar arrangements where any interest in the arrangement is retained by the employer such as the "split-dollar receivable."

Rabbi Trusts owning life insurance as part of a nonqualified deferred compensation arrangements are considered EOLI because the assets held inside the Rabbi Trust are attachable by the sponsoring employer's creditors. (Private Letter Ruling 8113107, Rev. Proc. 92-64)

Charitable organizations which are otherwise tax exempt may be still be subject to 101(j) if the tax exempt employer fails to meet an exception to 101(j) because the life insurance death benefits may be treated as unrelated business taxable income, "UBTI." See IRC 267(b),(f), and IRC 707(b) for more examples.

⁵ IRS Notice 2009-48. There are certain types of arrangements that are generally not subject to 101(j) because the policies are personally owned regardless of a business purpose. Examples include policies used in pure cross purchase buy/sell arrangements, life insurance used as a personal savings vehicle, properly accounting for personal income tax treatment, policies owned by a VEBA (Voluntary Employee Beneficiary Association), and life insurance owned inside an employee's qualified plan.

⁶ IRC §101 generally excludes benefits paid by reason of death of the insured from gross income. IRC §101(a).

⁷ IRS Notice 09-48, Q/A-13

⁸ Id., Q/A-14; A material change to a life insurance policy is any new change which increases the benefits of the policy. However, material changes do not include increases in death benefit occurring due to the operation of the contract or by the operation of IRC §7702, administrative changes, changes in allocation among the general accounts and separate accounts, or the exercise of an option or right granted by the contract as originally issued.

⁹ Reinsurance related transfers or assumptions have generally not been determined to be material changes. PLR 201443015, PLR 201736019, PLR 202018003.

¹⁰ IRC §6039I.

¹¹ Generally, IRS Notice 09-48 presumes that each employee will receive a separate notice and consent form. However, in PLR 201217017 the service held that a separate document was not explicitly required when the totality of the applicable policyholder's documentation in connection with the EOLI contract demonstrated that all the notice and consent requirements were met prior to the policy's issue. In that case a buy/sell agreement and life insurance application together contained all of the notice and consent requirements. A PLR (private letter ruling) is unique to the taxpayer who requested the ruling and is not to be relied upon as authority for other taxpayers.

¹² IRS Notice 09-48 Q/A-10.

¹³ IRC 101(j)(2).

¹⁴ IRC 101(j)(2)(A).

¹⁵ Highly compensated individuals are defined in IRC 414(q) and include 5% or greater shareholders of company stock, those earning at least \$110,000 (indexed for inflation) in the preceding year, those among the highest paid 35% of all employees, or is one of the five highest paid officers of the company. For 2021, an HCE is an employee who earns more than \$130,000.

¹⁶ IRC 101(j)(2)(B).

¹⁷ IRC Notice 09-48, Q/A-8.

¹⁸ IRS Notice 09-48, Q/A-13.

¹⁹ This analysis tree is neither legal nor accounting advice, and any party facing a taxable death benefit due to 101(j) or for any other purpose is advised to seek competent counsel.

²⁰ IRS Notice 09-48 Q/A-11 provides a framework on how an employer may construct an electronic notice and consent program to electronically gather employee consent.

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