

Taxes: IRS Guidance on Employer-Owned Life Insurance

It used to be relatively easy to understand the income taxation of death proceeds of life insurance.

As a general rule, under IRC Section 101(a) (1) death proceeds were income tax free, unless the policy was transferred for a valuable consideration during the insured's lifetime. In those cases, the amount of the death proceeds excluded from income was limited to the consideration paid for the policy plus subsequent premium payments made by the transferee. The balance of the death proceeds were includable in the beneficiary's income and taxed at ordinary income tax rates.

The underlying rationale of the "transfer-for-value-rule" was to discourage speculation on lives for gain and the creation of a secondary market in life insurance policies. Consequently, certain transfers that do not create the risk the rule sought to protect against are exempted. Exempted transfers for value include:

- The insured;
- A partner of the insured;
- A partnership in which the insured is a partner;
- A corporation in which the insured is a shareholder or officer; and
- Any person, when the transfer is determined to be a gift with reference to the transferor's basis.

An Historical Perspective

Prior to 2006, the general rule excluding death proceeds from income applied to individually-owned, trust-owned, and employer-owned policies. In the context of employer-owned policies, employers often applied for, owned, and named themselves beneficiaries of policies insuring the lives of highly-compensated executives and shareholders. Policies on executives were often used

to reimburse employers for non-qualified deferred compensation benefits paid to executives or their survivors. Policies on shareholders were often used to provide the employer with liquidity to redeem stock from a deceased shareholder's estate pursuant to a "buy-sell" agreement. The redemption proceeds were in turn used by the executor to satisfy creditors, pay administrative expenses and taxes, and fund bequests to heirs.

It was generally believed that the life insurance proceeds were income tax free to the employer under Section 101(a). It was also generally believed that such employer-owned insurance satisfied State law requirements that a third-party purchaser of life insurance have an "insurable interest" in the insured at the time the policy was purchased. The insurable interest was evidenced by the pecuniary loss an employer would suffer from the loss of a major shareholder or executive.

Concerns arose when in the late 1980s and early 1990s employers began purchasing large numbers of relatively small policies insuring rank-and-file policies to informally fund post-retirement health insurance and other large liabilities. In some cases employees were unaware of the purchase of the insurance, waived their rights to the insurance unwittingly by signing confusing legal documents, or agreed to the purchase of the insurance in consideration of the employer's promise to provide a modest death benefit to the insured's survivors. Such insurance was sometimes derided as "janitor insurance," law suits were filed by heirs or deceased employees, and the IRS raised the issue as to whether the employer possessed the requisite insurable interest under State law.

If no insurable interest existed, the policies would be considered "wagering contracts," not life insurance contracts. Consequently, the Section 101 exclusion would not apply.

The Pension Protection Act of 2006

Following several years of skirmishes among insurers, agents groups, insureds beneficiaries, and the IRS, Congress enacted Section 863 of the Pension Protection Act of 2006.

Section 863 amends IRC Section 101, by adding Section 101(j), which relates to Employer-Owned Life Insurance.

Employer-Owned Life Insurance is defined as:

"A life insurance contract that is owned by a person engaged in a trade or business and under which that person is a beneficiary under the contract, and that covers the life of an insured who is an employee on the date the contract is issued."

Section 101(j)(1) provides that, in the case of an employer-owned life insurance contract, the amount excluded from gross income of an applicable policyholder under § 101(a)(1) shall not

exceed an amount equal to the sum of the premiums and other amounts paid by the policyholder for the contract.

Section 101(j)(2) provides exceptions to the general rule of § 101(j)(1) in the case of certain employer-owned life insurance contracts with respect to which certain notice and consent requirements are met. Those exceptions are based either on (1) the insured's status as an employee at any time during the 12-month period before the insured's death or as a director, a highly compensated employee or highly compensated individual at the time the contract is issued, or (2) the extent to which death benefits are paid to (or used to purchase an equity interest in the applicable policyholder from) a family member, trust, or estate of the insured employee.

The notice and consent requirements of Section 101(j)(4) are met if, before the issuance of the policy, the employee (1) is notified in writing that the applicable policyholder intends to insure the employee's life and of the maximum face amount for which the employee could be insured at the time the contract was issued; (2) provides written consent to being insured under the contract and that such coverage may continue after the insured terminates employment; and (3) is informed in writing that an applicable policyholder will be a beneficiary of any proceeds payable upon the death of the employee.

IRB 2009-24

IRB 2009-24, issued June 15, 2009, contains guidance concerning the application of Section 101(j).

Some important points emerging from the guidance include the following:

- ✓ Policies owned by "Rabbi Trusts," which are sometimes used to facilitate benefit payments under non-qualified deferred compensation plans, will be considered "employer-owned life insurance," provided the trust is a grantor trust (which is nearly always the case). On the other hand, policies owned by VEBAs or qualified retirement plans are not considered to be employer-owned life insurance.
- ✓ For purposes of the Section 101(j) exception relating to employees insured during the last 12-months prior to death, "employee" is not limited to the common law meaning of that term. Instead, "employee" includes an officer, director, and highly compensated employee (within the meaning of Section 414(q)). A director is an independent contractor in his or her capacity as a director. Section 414(q) contains special rules relating to certain former employees and self-employed individuals. For example, a former employee is treated as a highly-compensated employee (within the meaning of Section 414(q)) if the individual was a highly-compensated employee when he separated from service, or was a highly-compensated employee at any time after attaining age 55. In addition, the term "employee" for purposes of Section 414(q) includes an individual who

is a self-employed individual who is treated as an employee pursuant to Section 401(c) (1).

- ✓ For purposes of the exception relating to insurance proceeds used to purchase an equity interest of the employer from the insured's estate, trust, or family member, the purchase must be made the due date, including extensions, of the tax return for the employer's taxable year.
- ✓ Transfer of an existing policy from an employee to an employer constitutes sufficient notice and consent under Section 101(j) (4). In the event the employer subsequently increases the face amount of the contract, however, written notice and consent must be secured to establish the requisite notice to the employee and consent to the new face amount.
- ✓ Section 101(j) applies to life insurance contracts issued after August 17, 2006, except for a contract issued after that date pursuant to a Section 1035 exchange for a contract issued on or before that date. In the case of such a Section 1035 exchange, the new policy is effectively "grandfathered," unless there is a "material change to the contract. The following changes are not considered "material changes":
 1. Increases in death benefits that occur as a result of either the operation of Section 7702 or the terms of the existing contract (provided the insurer's consent to the increase is not required);
 2. Administrative changes;
 3. Changes from general account to separate account or from separate account to general account; or
 4. Changes as a result of the exercise of an option or right granted under the contract as originally issued.

Bottom Line

Employer-owned life insurance policies must meet the notice and consent and other requirements of Section 101(j) in order for the death benefit to be entirely income tax free to the employer.

The good news is that with a little planning, life insurance to informally fund non-qualified deferred compensation plans and to provide liquidity for stock redemptions from the insured's estate or family members remains a viable and important planning tool.

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