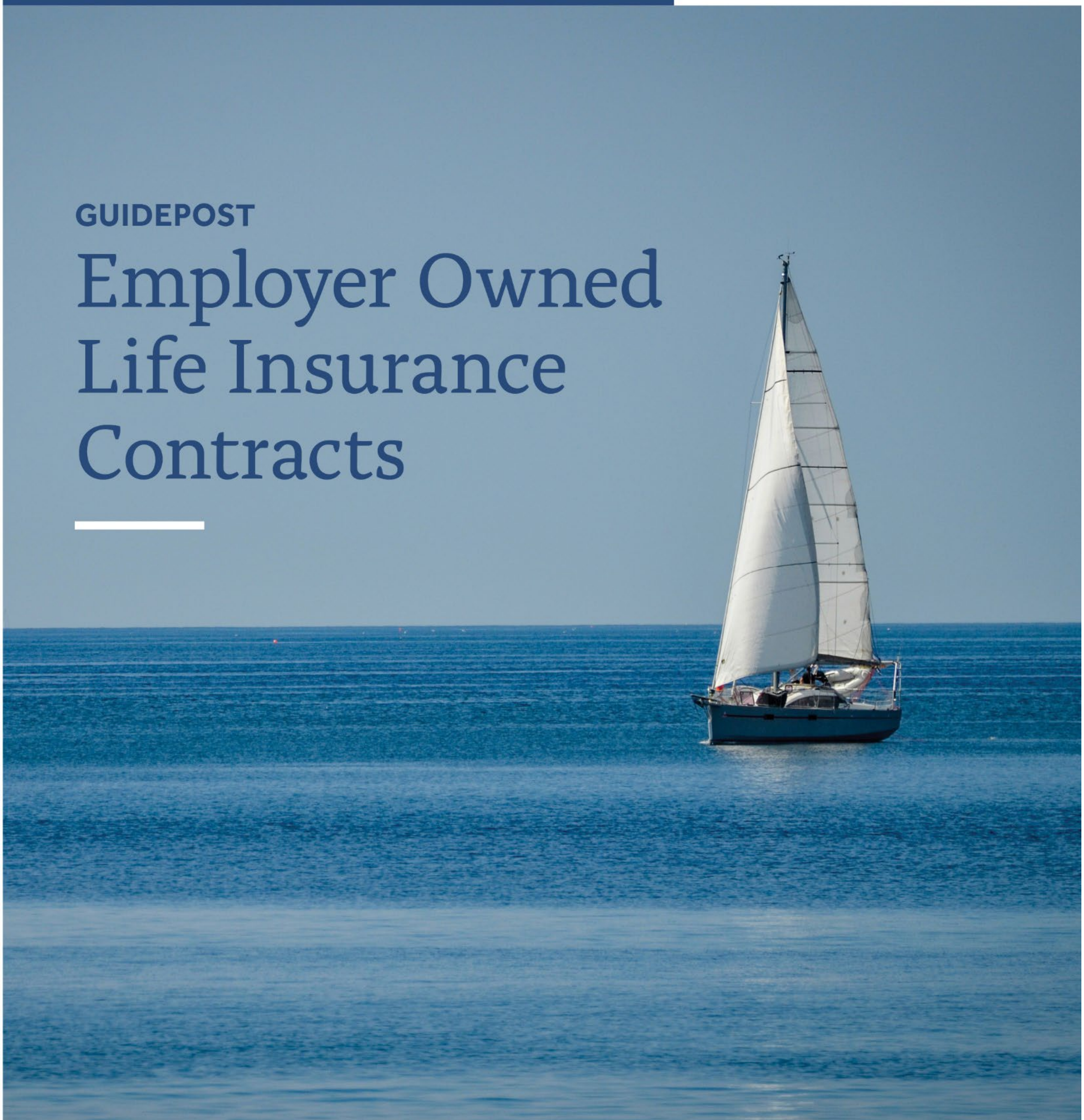
THE NAUTILUS GROUP®

GUIDEPOST

Employer Owned Life Insurance Contracts



Employer Owned Life Insurance Contracts

For businesses, life insurance can provide protection against the risk of losing a key employee, life insurance can fund a deferred compensation plan or a succession plan, or life insurance can be utilized as part of a split-dollar arrangement. For the business to receive the life insurance death benefit federal income tax-free, the business must comply with the notice and consent requirements outlined in Internal Revenue Code (IRC) §101(j). This requirement for employer-owned life insurance (EOLI) applies to all policies that were either issued or materially changed any time following August 17, 2006. An important consequence is that if the IRC §101(j) notice and consent requirements are not met, the difference between the death benefit and the premiums paid may be subject to income tax when paid to the business. IRC §101(j) generally applies to life insurance policies issued after August 17, 2006, where a business is the policy owner, that business is directly or indirectly the policy beneficiary, and an employee of that business is the insured. For a life insurance policy subject to IRC §101(j), the death benefit paid is taxable when received. Exceptions to this general rule, however, do exist. Therefore, it is crucial for business owners and their advisors to understand and comply with the requirements of IRC §101(j) if income taxation is to be avoided.

Employer Owned Life Insurance Defined

An employer owned life insurance policy is:

- A policy owned by a person engaged in a trade or business under which that person (or a related person[1]) is directly or indirectly a beneficiary of the policy, and the policy insures an employee in the trade or business of the policy owner or a related person on the date the contract is issued.

Typical examples of EOLI include key person life insurance policies, business owned policies to fund a stock redemption plan, and split-dollar arrangements. Insurance policies owned by a qualified plan or voluntary employee benefits association (VEBA) are not considered EOLI under IRC §101(j). Insurance policies held in a rabbi trust that are considered the grantor employer's asset may be considered EOLI under IRC §101(j). Insurance policies held in a secular trust that are not treated as owned by the employer for tax purposes may not be considered EOLI under IRC §101(j).

Notice and Consent Requirements

The notice and consent requirements must be met **BEFORE** the life insurance policy is issued. Although a life insurance application may be submitted, and underwriting commenced, the "Notice and Consent" must be signed and dated by the employee prior to the policy being issued.

- The employee must be notified in writing that the employer intends to insure the employee's life;
- The employee must be notified in writing of the maximum face amount for which the employee could be insured at the time the insurance policy is issued, either in dollars or in multiples of salary that the employer reasonably expects to purchase on the employee;
- The employee must be notified in writing that the employer (or a related person to the employer) will be a beneficiary of any proceeds payable upon the death of the employee;
- The employee must provide written consent to being insured under the insurance contract; and
- The employee must provide written consent that the coverage may continue following any termination of employment of the employee.

1 A "related person" is a person who bears a certain relationship to the policy owner or is engaged in a trade or business with persons under common control with the policy owner, anyone related to the policyholder under the family or entity attribution rules of IRC §267(b) and IRC §707(b)(1). See IRC § 101(j)(3)(B).

Annual Filing Requirements

Employers owning life insurance on their employees must also comply with the ongoing requirement outlined in IRC §6039I, which requires an annual report of EOLI contracts.

The employer must report the following to the IRS annually:

- The total number of employees of the employer at the end of the year;
- The number of those employees insured under EOLI contracts at the end of the year;
- The total dollar amount of insurance in force at the end of the year under those contracts;
- The name, address, and taxpayer identification number of the employer, and the type of business in which the employer is engaged; and
- Verification that the employer has a valid consent for each insured employee, or, if all required consents are not obtained, the number of insured employees for whom consent was not obtained.

Employers are required to keep records that demonstrate requirements of both IRC §§101(j) and 6039I have been met for all applicable tax years. This requirement is met by attaching Form 8925 to the employer's income tax return for the year.

Insights and Caveats

Guidance concerning the treatment of certain EOLI contracts is provided in IRS Notice 2009-48 via a question-and-answer format. Highlights include:

Date of Issue

An EOLI contract is determined to be "issued" at the latest of the following:

- The date of application for coverage;
- The effective date of coverage; or
- The date of formal issuance of the contract.

Inadvertent Failure to Satisfy

The notice and consent requirements can be corrected if the policyholder made a good faith effort to satisfy those requirements, such as maintaining a formal system to do so, the failure to satisfy the requirements was inadvertent, and the failure to satisfy the notice and consent was discovered and corrected no later than the due date of the tax return of the policyholder for the year in which the policy was issued.

Valid Consent

For the notice and consent to be valid, the life insurance policy must be issued before the expiration of the one-year period starting on the date the consent was executed, or termination of the employee's employment with the employer (or related person).

Multiple EOLI Contracts on One Employee

A single consent can apply to more than one EOLI contract as long as IRC §101(j)(4) requirements are met (i.e., all contracts do not exceed aggregate face amount to which the employee consented).

IRC §1035 Exchanges

No further notice and consent is required if either the existing consent remains valid or the exchange does not result in a material change (e.g., increase in death benefit) in the contract.

Irrevocable Transfer of an Existing Policy from Employee to Employer

Notice and consent will not be necessary if an employee irrevocably transfers an existing life insurance contract to an employer unless the employer later increases the face amount of the contract.

Electronic Notice and Consent

Notice and consent can be satisfied electronically if the employer's system:

- Ensures that the information received by the employee is the same as what was sent by the employer;
- Makes it reasonably certain that the person accessing the system is the employee;
- Includes an electronic signature process or other means to formally record the employee's consent; and
- Permits production of a hardcopy of the electronic notice and consent upon IRS request and a statement that to the best of the employer's knowledge the employee was notified and consented to being insured.

Entity Structure

- A wholly owned corporation and its employer-owner must comply with written notice and consent requirements.
- A life insurance policy owned by a sole proprietor on his/her own life is not an EOLI contract.
- Guidance is not clear regarding treatment of an employee-owner of a single member limited liability company; therefore, compliance is prudent.