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Understanding Employer-Owned Life Insurance (EOLI) and 101(j)

The Pension Protection Act of 2006 (PPA '06), which became law on August 17, 2006, included new rules on employer-owned life insurance that became effective for all new life insurance policies issued after August 17, 2006. If the EOLI rules are not complied with, the death benefit received on the EOLI policy will be subject to income taxes. The EOLI rules created by the PPA '06 were incorporated into the provisions of Sections 101(j) and 6039I of the Internal Revenue Code.

What is §101(j) and how does it impact EOLI?

Under §101(j), to receive an income tax free death benefit, the notice and consent provisions of §101(j) have to be met before the policy is issued AND the insured has to fall into one of the exceptions. If these two requirements are not satisfied, ***the death benefit on an EOLI policy will be included in the employer's income in excess of the premiums and other amounts paid on the contract.***

An employer-owned life insurance contract is defined as a life insurance contract which:

1. Is owned by a person (or entity) engaged in a trade or business and under which such person (the contract owner) is directly or indirectly a beneficiary under the contract; and
2. The contract covers the life of an insured who is an employee with respect to the trade or business of the applicable policy owner on the date that the contract is issued.

How does an employer comply with §101(j)?

As mentioned above, to ensure the employer/contract owner will receive the policy income tax free under §101(j), the notice and consent has to be put in place before the policy is issued. The employer must include an informational filing, Form 8925, with its annual income tax return, listing the number of employees, the number of EOLI policies, the total amount of EOLI death benefit, and the number of EOLI policies for which the employer has a valid Notice & Consent on file. Employers that own EOLI contracts subject to §101(j) must maintain annual records to demonstrate that the requirements of §101(j) are met.

What are the requirements for the Notice & Consent?

The **Notice** provisions require that the employee/insured receive written notice of the policy, the maximum death benefit possible under the policy, and that the employer will be the beneficiary of the policy's death benefit. The employee then has to provide **Consent**, in writing, that he or she agrees to be the insured *even* after he or she terminates employment.

What are the exceptions for the employees?

There are several possible categories of employees that can meet the applicable exceptions under §101(j). If the notice and consent requirements are met *before* the policy is issued, and the insured falls into one of the following categories *at the time the policy is issued*, then the death benefit proceeds received by the employer from the EOLI contract will be income tax free. The exceptions are:

1. Is an employee at any time during the 12 months preceding the insured's death (i.e. a **recent employee**);
2. Is a director of among the highest paid 35% of all employees (i.e. a **highly compensated individual**, as defined in §105(h)(5)); or
3. Is a **highly compensated employee**, as defined in §414(q).

Are there any other possible exceptions under §101(j)?

Section 101(j) also provides an exception, where the notice and consent requirements are met prior to the policy being issued, if the death benefit is:

1. 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
2. Used to purchase an equity interest in the policyholder (employer) from a family member, beneficiary, trust, or estate.

What is the effective date for §101(j) and what if I make changes to a pre-101(j) policy?

Section 101(j) applies to contracts issued after the date of enactment of PPA (August 17, 2006), except for contracts issued after that date due to a §1035 exchange of the contract. In addition, material increases in the death benefit or other material changes will cause a policy to be treated as a new contract. Exceptions to the rule for material increases include existing lives under a master contract, increases in the death benefit that occur as a result of §7702, death benefit increases due to normal operation of the contract and death benefit increases as a result of market performance or contract design (for Variable and Universal Life contracts). §101(j) also does not apply to policies on the lives of nonresident aliens (individuals who are neither U.S. citizens nor U.S. residents).

Has there been any additional guidance concerning the application of §101(j)?

On May 22, 2009, the IRS issued Notice 2009-48 (the Notice), which was designed to address several outstanding questions surrounding the treatment of employer-owned life insurance contracts under IRC §§101(j) and 6039I (requiring annual reporting on Form 8925). The following discussion outlines the clarifications made by the Notice:

What constitutes an "Employer-Owned Life Insurance Contract"?

The Notice states that a policy is "employer-owned" for §101(j) purposes only if it is owned by a person engaged in a trade or business; a policy that is owned by a business owner or a qualified plan (or VEBA) of an employer is not an EOLI contract for §101(j) purposes. An employer-owned policy subject to a split-dollar arrangement is subject to the provisions of §101(j), as is a life insurance policy owned by a partnership or a sole proprietorship.

Exceptions to the Application of §101(j)

There are two exceptions that the Notice outlines, the first is under §§101(j)(2)(A) and (j)(4), which provide exceptions that relate to "the time the contract is issued." The Notice makes it clear that for these purposes, the policy is "issued" on the later of: (1) application, (2) the effective date of coverage, or (3) the formal issuance of the contract.

The other exception provided by the Notice is for policies that the insured transfers to the employer. In that situation, the Notice states that the notice and consent requirements of §101(j) are waived if the employee irrevocably transfers an existing contract to the employer, presumably because the IRS figures that an employee who is transferring an existing contract to the employer already knows that the employer is going to own the policy. It is important to note that while the notice and consent requirements are waived in this situation, the exceptions for possible insureds are not also waived. Therefore, for the employer to receive the death benefit income tax free, the insured would have to fall into one of the categories listed above. If the employer, subsequent to the irrevocable transfer, increases the policy's face value, then the notice and consent requirements must be satisfied with respect to the additional insurance.

"Grandfathering" under §101(j)

The Notice sets for a list of changes to a policy that are not considered to be material for purposes of determining whether a new policy has been issued under §101(j). This list is particularly important when the changes are being made to a policy that was issued prior to §101(j)'s **effective date of August 17, 2006**. Policies issued *prior to* August 17, 2006 are *not* subject to the provisions of §101(j), however, if there has been a material change to the policy, then the policy will be subject to the requirements of §101(j).

Those changes that are not considered material for purposes of §101(j) include: (1) increases in death benefit resulting from the terms of the contract requiring no consent from the insurer or operation of §7702; (2) administrative changes; (3) changes between general and separate accounts; or (4) changes resulting from exercise of an option or right under the original contract.

Split Dollar and §101(j)

The Notice also addresses those situations in which §101(j) intersects with split dollar agreements. Specifically, a contract that is subject to a split dollar agreement is an EOLI contract if the contract is owned by a person engaged in a trade or business. The obvious situation in which §101(j) would apply is the standard endorsement split dollar arrangement in which the employer owns the life insurance contract and endorses the death benefit to the insured employee (or the employee's family). Less obviously, the Notice makes it clear that §101(j) also applies to collateral assignment split dollar agreements between the employer and the employee (or the employee's trust) where the employee or the employee's trust owns the policy. This is because of the split dollar rules of §61 that say that the premium payor of a collateral assignment split dollar agreement is deemed to be the owner of that split dollar life insurance contract. This means that §61 makes the employer the owner of the split dollar life insurance contract, bringing that split dollar contract with the purview of §101(j).

Potential Impact

As has been discussed above, the provisions of §101(j) will potentially impact life insurance policies that are used in a variety of employee benefit and business planning arrangements, including nonqualified deferred compensation, key person insurance, some buy-sell agreements, certain types of split dollar agreements, §475(f) plans, and BOLI. Care should be taken to make sure that the requirements of §101(j) are met for any potentially applicable case.

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