Business Owners Beware of Taxable Death Benefit

by Terri Getman, J.D.*, CLU, ChFC, RICP, AEP (Distinguished)

Situation: Many businesses own life insurance to cover losses that will be incurred at the untimely death of their owners and employees. In general, proceeds from life insurance are income tax-free under the IRC Section 101(a). However, this general rule changed when Section 101(j) was enacted as part of the Pension Protection Act of 2006.

In general, IRC Section 101(j) provides that for *employer-owned life insurance (EOLI) contracts* issued after August 17, 2006, death benefits will be taxed as ordinary income to the extent the amounts paid under the contract exceed premiums and other amounts paid by the employer.[1] Congress wrote the rules into the tax code in order to prevent perceived abuses where a few businesses were insuring rank-and-file employees.

At first glance, the Section 101(j) rules seem to negatively impact many common business uses of life insurance such as key person coverage, non-qualified deferred compensation, entity buy-sell arrangements, and endorsement split dollar agreements. Fortunately, the rules provide an exception which when followed preserves the income tax-free character of the death proceeds. In this *Counselor's Corner* we describe when the EOLI rules apply and how to qualify for the exception.

Solution: Let's start by looking at when the rules apply.

Definition of an Employer-Owned Life Insurance Contract. An employer-owned contract is a life insurance contract:

- That is owned by a person engaged in a trade or business (applicable policyholder, as defined by law)
- Under which, the applicable policyholder, or related person (as defined by the law), is directly or indirectly a beneficiary, and
- That covers an insured who is an employee of the trade or business of the applicable policyholder on the date the contract is issued.

It's clear that this definition includes policies where a business is the owner and beneficiary, such as key person coverage, entity purchase buy-sell arrangements, and endorsement split dollar arrangements. What's not so obvious is that under the *applicable policyholder* and *related party* definitions, the legislation expands its reach to a broad group of individuals and entities such as family members, trusts, and estates.

Applicable Policyholder and Related Party. The term *applicable policyholder* includes a trade or business that owns the contract, but also includes any individual who bears a relationship to the applicable policyholder if that relationship is described under any of the following sets of *related party* rules:

- IRC § 267(b), the constructive ownership rules,
- IRC § 707(b)(1), dealing with transactions between a partner and a partnership, or
- IRC §52(a), (b), the common control rules applicable to corporations.

The related party provision is important because it broadens the reach of the rules beyond policies owned by a trade or business. The question is how far was it meant to reach?

In Notice 2009-48, the IRS clarified that to be an employer-owned contract the person owning the policy must be engaged in a trade or business. Thus, the Notice indicated that contracts owned by qualified plans or a VEBA that is sponsored by an entity engaged in a trade or business is not subject to the EOLI rules. Likewise, the Notice provided contracts owned by the owner of an entity engaged in a trade or business is not subject to the EOLI rules. However, a contract that is owned by a grantor trust, the assets of which are treated as assets of a grantor that is engaged in a trade or business, may be an employer-owned contract – such as a Rabbi trust.

Despite the clarification provided in the Notice, there is still a great deal of confusion and inconsistency in what insurance carriers consider employer-owned contracts. Consequently, it's likely that carriers may treat the same situation differently. For example, one carrier may consider a cross purchase buy-sell arrangement as an arrangement subject to the EOLI rules based on the strict language of the Internal Revenue Code, while another carrier may point to the Notice and not apply the EOLI rules. In light of the confusion regarding the application of these rules, it is important that business owners work with their tax and legal counsel to determine if the policy is subject to the employer-owned life insurance rules prior to implementing and placing a life insurance policy on an employee.

Once it's determined that the policy is an employer-owned life insurance contract, the next step is to follow the rules that have been established to avoid taxation. The rules provide that if certain notice and consent requirements are met and if certain "safe harbor" exceptions apply, the death benefits will pass income tax-free. Thus, the death benefit on an employer-owned life insurance policy is generally subject to income tax, but the tax can be avoided. So, let's turn our attention to a review of the rules which preserve the tax-free character of the death proceeds.

Notice and Consent Requirements. Meeting the **notice and consent requirements is the critical first step** to avoiding taxation of death benefits applicable to employer-owned contracts. Specifically, under the notice and consent rules, the following actions must be taken by the policy owner before a life insurance contract is issued:

- The employee must receive **written notification** of the applicable policyholder's **intention to insure** the employee's life, and such notification must **specify the maximum face amount** for which the employee could be insured at time of issue;
- The employee must provide **written consent** that he or she is **aware of the insurance** coverage and that the **coverage may continue after he or she terminates employment**; and
- The applicable policyholder must inform the employee in writing that the **policyholder will be the beneficiary of any death benefits paid.**

Failure to meet the notice and consent requirements prior to policy issue will result in the death benefits being subject to ordinary income tax.[2] So, when is a policy considered issued? Notice 2009-48 provided the following explanation. For purposes of determining whether the notice and consent are timely, "issue" is considered the later of:

- Date of application of coverage,
- Effective date of coverage, or
- Formal issuance of the contract.

It should be noted that it is not the insurance carrier's responsibility to see that the notice and consent requirements are met – it's the business owner's responsibility. While insurance carriers are not required to see that the notice and consent requirements are met, some carriers have established new business submission processes to make insureds and business owners aware of the requirements. For example, some carriers require that business owners that business owners sign an acknowledgement form indicating that the business owner is aware of the requirement, other carriers' applications contain a disclosure, and some carriers do nothing. This wide difference in carrier treatment has caused confusion.

Adding to the confusion, a few state insurance departments established notice requirements prior to the enactment of the EOLI rules. Insurance carriers doing business in these states are mandated to establish state notice forms. Often the state notice form does not meet the specific notice required by the EOLI rules. Consequently, it's easy for a business owner to mistakenly believe that the state notice form is the EOLI notice.

While it is presumed that an employee will receive a separate form to meet the notice and consent requirements, a recently issued private letter ruling (PLR 201217017) held that a separate document was not required where the totality of the applicable policyholder's documentation in connection with the policy evidenced that all the notice and consent requirements were met prior to the contract issuance. In this case a buy-sell agreement and a life insurance application, both executed by the insured employee prior to issuance of the contract, which together contained all the required notice and consent information was determined to adequate to meet the requirement. Hopefully, this illustrates some leniency on the part of the IRS.

If the business owner does not comply with the written notice and consent requirements, or if notice is given, but it does not meet the specific terms required by Section 101(j), the death benefit will be subject to income tax.[3] Proper notice and consent is not the only requirement imposed by the legislation. As indicated earlier, to avoid being subject to income taxation, employer-owned contracts must also comply with a **critical second step - meet the terms of one of the following safe harbor exceptions.**

Safe Harbor Exception Based on an Insured's Status. This exception provides that the death benefit will not be subject to income tax provided that proper notice and consent is given and the insured individual was either:

- An employee at any time during the 12-month period before the insured's death, or
- A director, a highly compensated employee, or a highly compensated individual **at the time the contract was issued.**

Highly compensated employees are defined using the rules found in IRC § 414(q) and include employees who, during the preceding year, were 5% owners of the business or had compensation in excess of a specified dollar amount ($135,000 if prior year is 2022 and $150,000 for 2023, increased for inflation in future years). Note: Because of the reference to IRC § 414(q) and wording in that Internal Revenue Code section, employees include independent contractors, self employed individuals and former employees. *Highly compensated individuals* are defined under IRC § 105(h)(5) to include the five highest-paid officers or to be among the highest paid 35 percent of all employees.[4]

Safe Harbor Exception Based on the Individuals Who Receive the Death Benefit Proceeds. This exception states that, provided proper notice and consent is given, the income inclusion rule will not apply to an amount received at the death of an insured to the extent the amount is paid:

- To a family member of the insured,
- To an individual, other than an applicable policyholder, who is the designated beneficiary of the insured,
- To a trust established for the benefit of any such member of the family or designated beneficiary,
- To the estate of the insured, or
- Where the policy proceeds are used to purchase an interest in the applicable policyholder from such family member, beneficiary, trust, or estate.

In light of the need to satisfy one of the exceptions as well as the notice and consent requirement, it is extremely important that the business maintain records documenting that they have timely met both aspects of the Section 101(j) rules.

Correcting a Violation. When the legislation was initially enacted there was no means to correct a violation other than to start over. However, in Notice 2009-48 the IRS indicated that by doing a Section 1035 exchange to a larger face amount (or other material modification), it's possible to correct a violation by complying with the rules prior to the issue of the new policy.[5]

In addition to the above requirements which must be met to avoid income tax on the death proceeds, there is an annual reporting requirement.

Reporting and Record Maintenance Requirements. Under the new rules, applicable policyholders who have employer-owned contracts are required to file Form 8925 with the Internal Revenue Service (IRS) for each year the contracts are owned. Form 8925 requires the following information:

- The number of employees the policyholder had at the end of the year;
- The number of those employees who were insured under such contracts at the end of the year;
- The total amount of employer-owned insurance in force at the end of the tax year under such contracts;
- The name, address, taxpayer identification number of the applicable policyholder and the type of business in which the policyholder is engaged; and
- Attestation that the applicable policyholder has obtained valid consent from each insured, or where all consents are not obtained, the number of insureds from whom such consent was not obtained.

Effective Date of the New Rules. The rules apply to contracts issued after August 17, 2006. The legislation provided that the rules do not apply to an IRC § 1035 exchange of a contract issued on or before August 17, 2006. However, any material increase in the death benefit or material change will cause the contract to be treated as a new contract subject to the employer-owned life insurance rules (except with respect to a master contract, where the addition of covered lives is treated as a new contract only with respect to the added lives).

Because of the uncertainty about what is considered a *material change*, fewer IRC § 1035 exchanges than originally thought may be grandfathered. Notice 2009-48 shed some light on the subject by stating that none of the following will be considered a *material change:*

- Administrative changes;
- Changes from general to separate account;
- Changes resulting from the exercise of an option or right granted under the contract as originally issued; and
- Increases in the death benefit occurring as a result of the operation of IRC § 7702.

The Notice does not address any other situation. For example, is a change of carrier as part of a Section 1035 exchange considered a *material change*?

In Summary. It's still possible for an employer-owned life insurance policy to provide income tax-free death benefits; however, specific requirements must be met. Specifically, the employer must now meet notice and consent requirements prior to policy issue and limit coverage to certain individuals or restrict who receives policy benefits. In addition, the business must file Form 8925 annually with the IRS when such policies are in place.

[1]It should be noted that there are other sections of the Internal Revenue Code which can result in death benefit being subject to tax. For example, violation of the reportable policy sale and transfer-for-value rules under IRC Section 101(a)(2) & (3), will result in a portion of the death benefit being subject to income taxation.

[2]Notice 2009-48 answered a number of questions concerning the notice and consent requirement, including that it can be satisfied electronically. The owner of a sole proprietorship does not need to give himself/herself notice; however, a 100% owner of a corporation must give himself/herself notice.

[3]While Section 101(j) does not contain a provision for correcting a failure to satisfy the notice and consent requirements, Notice 2009-48 provides that the notice and consent failure can be corrected if the business made a good faith effort to satisfy the notice requirement such as by maintaining a formal system; and the failure to satisfy the requirements was inadvertent; and the failure was ***discovered and corrected by the due date for the filing of the tax return for the tax year in which the policy was issued.***

[4] Note that 35% has been substituted for the 25% generally applicable under IRC § 105(h)(5).

[5]In addition, inadvertent notice violations can be corrected if they meet the terms discussed in footnote 3.

For the Education of Financial Professionals. Not for use with the General Public.

This material has been prepared to assist our licensed financial professionals and clients' advisors. It is designed to provide general information in regard to the subject matter covered. It should be used with the understanding that we are not rendering legal, accounting or tax advice. Such services must be provided by the client's own advisors. Accordingly, any information in this document cannot be used by any taxpayer for purposes of avoiding penalties under the Internal Revenue Code. Insurance policies contain exclusions, limitations, reductions of benefits and terms for keeping them in force. Policies and or features may not be available in all states.

Securities and Insurance Products: Not insured by FDIC or any federal government agency. May lose value. Not a deposit or guaranteed by any bank or bank affiliate.