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IRS ANSWERS QUESTIONS ON EMPLOYER-OWNED LIFE INSURANCE CONTRACTS BUT TAX TRAPS REMAIN

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The IRS recently issued guidance in connection with employer-owned life insurance contracts ("EOLI"). Notice 2009-48 clarifies a number of administrative questions. It does not eliminate the loss of tax benefits applicable to EOLI or the need to satisfy notice and consent formality in order to quality for exception from these rules. An inadvertent failure to satisfy the notice and consent requirements could result in the loss of a significant tax exclusion.

BASIC RULES

In 2006, Congress limited the income tax benefits of EOLI. Generally, death proceeds of a life insurance contract are received tax free. However, unless an exception applies, the death proceeds of EOLI are tax free only up to the amounts paid to acquire the policy. The rest is taxed as ordinary income.

A policy is EOLI if all of the following factors apply:

- The owner is a trade or business.
- The owner (or a related person) is directly or indirectly a beneficiary under the policy.
- At the time the policy is issued, the insured is an employee of the "applicable policyholder" (the owner or a related person).
- The policy is issued after 8/17/2006. An older policy will be treated as newly issued if there is a material increase in the death benefit or other material change.
- The insured is a U. S. citizen or resident.

Thus, EOLI may include key-man life insurance, creditor life insurance, split-dollar life insurance, entity buy-sell life insurance and insurance to fund employer-paid compensation arrangements.

EXCEPTION TO THE BASIC RULES

The Internal Revenue Code provides an exception to the general rule (allowing for the tax free receipt of the full death benefits) where *certain written notice and consent requirements are satisfied* and the insured falls within one of the following categories:

(1) The insured is an employee at any time during the 12-month period before the insured's death.

(2) At the time the policy is issued, the insured was a director, a highly compensated employee or a highly compensated individual.

(3) Sale of equity interest: The death proceeds are used to purchase an equity interest in the applicable policyholder from a family member of the insured, the designated beneficiary of the insured under the policy, a trust established for the benefit of a family member or designated beneficiary, or the estate of the insured.

Notice and Consent Requirements

To qualify for the exception, before the issuance of the policy, the employee must:

- Be notified in writing that the applicable policyholder intends to insure the employee's life and be advised of the maximum face amount for which the employee could be insured at the time the policy is issued;
- Be informed in writing that the applicable policyholder will be a beneficiary of any proceeds payable upon the death of the employee; and
- Provide written consent to being insured under the policy and allow such coverage to continue after the employee terminates employment.

The applicable policyholder of an EOLI policy must also file a return each year on Form 8925, setting forth specific information with respect to the contracts.

NEW GUIDANCE

Notice 2009-48 addresses a number of questions in connection with EOLI:

- EOLI restrictions do not apply where the policy is owned by a related party, such as a shareholder, rather than the trade or business entity itself. Thus, policies used for cross-purchase under buy-sell arrangements are not subject. In addition, policies owned by qualified plans or VEBAs are also excluded.
- A policy owned by a partnership or a sole proprietorship may qualify as EOLI. The definition of "employee" includes a partner or LLC member. However, this result does not apply to a sole proprietor with respect to a life insurance policy on his own life.
- In order to qualify for the exception on the purchase of an equity interest in the applicable policyholder, the death proceeds must be used for this purpose within a limited time--by the due date, including extensions, of the tax return of the applicable policyholder for the taxable year in which the death benefits are received.
- The "issue" date on which the notice and consent requirements are satisfied is the later of (1) the date of application, (2) the effective date of coverage, or (3) the formal issuance date of the policy. The employee consent form will be operative for one year after being signed unless the insured's employment terminates before then.
- A single notice and consent document may be used for multiple policies.
- A policy that is subject to a split-dollar life insurance arrangement is an EOLI if it is owned by the trade or business. This would include endorsement split-dollar arrangements and certain collateral assignment split-dollar under which the trade or business entity is deemed to be the owner.
- The requirement for written notice and consent will apply even in the context of a wholly-owned business entity in which the sole owner is the covered employee.
- The notice and consent requirements do not apply to an existing policy which an employee irrevocably transfers to the business entity.
- An inadvertent failure to comply with the notice and consent requirements may be fixed only within a limited window. It must be discovered and corrected no later than the due date of the tax return of the business entity for the taxable year in which the policy was issued. Also, correction is not possible after the insured employee has died.
- EOLI applies to policies issued after 8/17/2006. However, older policies may lose their grandfathered status if there is a material increase in the death benefit (other than under the original terms of the insurance contract) or any other material change. A Section 1035 exchange does not protect the grandfathered status if there is a material increase in the death benefit or other material change in terms.

Please contact Arthur Zatz if you have any questions.

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