ADVISOR UPDATE | January 2011

IRC Section 101(j) and Notice 2009-48

New IRC Section 101(j) was adopted as part of the Pension Protection Act of 2006. In a prior upate we focused on the general taxation framework for this new code section and its application to life insurance death benefits. Recently, the Internal Revenue Service issued Notice 2009-48 which provides interpretation and clarification on the application of 101(j). A stark reversal of prior tax law, this new approach to taxation of life insurance death benefits can be easily overcome if proper procedures are followed.

FOR MORE INFORMATION

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Taxation of Employer-owned Life Insurance

Under the general rule of Internal Revenue Code section 101(j), life insurance death proceeds of employer-owned policies are taxable, to the extent they exceed cost basis, unless the requirements of 101(j) are met. If code section requirements are met, then the life insurance death proceeds may be received by the business income tax free.

Notice and Consent Required

The first major requirement is that an employer must document that it has obtained a valid notice and consent from the proposed insured. Basically, a proposed insured must agree to the new coverage. In addition, the proposed insured must acknowledge that they have been informed about certain aspects of the new coverage.

Under 101(j), the employer is tasked with keeping a written copy of the notice and consent from the proposed insured as evidence that compliance with the notice and consent procedure has been completed.

Status Exceptions

The other major requirement of 101(j) to obtain tax free treatment of death proceeds is that at least one of the several exceptions included in the code section must be met. These exceptions are generally based on either the insured's status with the employer or the fact that death proceeds are payable to the insured's heirs.

The insured's status may be used as an exception under two different sets of circumstances. The first circumstance is that the insured was an employee of the entity owning the policy during the twelve-month period preceding his or her death. The salary or position of the employee is immaterial for this exception. The other circumstance focuses on the status of the insured at the time the policy is issued. Under this exception, the insured may be (1) a highly-compensated employee (HCE) under IRC 414(q), (2) a highly-compensated individual (HCI) as generally defined under IRC 105(h)(5) or, (3) a director of the employer.

Exceptions Based on Use of the Death Proceeds

Death benefits payable to the insured's heirs such as a family member, a designated personal beneficiary, a trust for the benefit of such people or the insured's estate can qualify as tax-free. In addition, life insurance death benefits used to purchase an equity interest in the employer from any of these persons, would also qualify for tax-free treatment.

Information Reporting Requirement

An information reporting requirement related to employer-owned policies has been added with new IRC Section 6039I. Form 8925 has been published to help employer's meet this requirement.

Grandfathering

Grandfathering was generally provided to contracts issued prior to the effective date of the Pension Protection Act (August 18, 2006). In addition, such policies may be exchanged under IRC Section 1035 and will generally still retain their grandfathered status as long as the face amount of the new policy is not increased.

Notice 2009-48

Notice 2009-48 has provided additional guidance sought by the insurance industry. Some of the key points of this guidance include:

- Notice and consent requirements apply to 100% owners of a business, except those operating as sole proprietors

- A policy transfer from an insured employee/owner to a business does not create an employer-owned contract.
- Policies must be issued within twelve months following acquisition of the employee's initial notice and consent
- A single consent form may be valid for policies issued by multiple carriers if all policies are issued in a timely manner
- "Inadvertent" notice and consent failures may be corrected. Completely overlooking the notice and consent requirement will not be considered "inadvertent".
- A "reasonable" process must be used to determine the "maximum face amount" for the notice requirement. Simply stating the "the maximum face amount for which the employee could be insured" is not a reasonable approach.
- A life insurance contract is generally considered "issued" on the date assigned by the insurance company
- Endorsement split dollar arrangements are generally considered to be employer-owned contracts

In Conclusion

Advisors should take extra care to communicate with clients about these new requirements so that any employer-owned coverage is handled in a manner consistent with 101(j)'s requirements and the new guidance provided under Notice 2009-48. Extra communication is also warranted with the insurance carrier/third-party administrator to determine the extent to which it assists business owners in achieving compliance.

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