A Timely Analysis of Legal Developments

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The IRS has issued new rules implementing a new statutory requirement that employers holding certain life insurance policies on their employees or directors notify the insureds of this coverage. The new rules are effective June 15, 2009.

IRS Mandates New Reporting and Notice Obligations for Employer-Owned Life Insurance

By Susan Katz Hoffman

The IRS has issued Notice 2009-48 outlining the reporting and notice obligations for employer-owned life insurance policies. The new rules become effective June 15, 2009.

The Pension Protection Act of 2006 (PPA) added Internal Revenue Code sections 101(j) and 6039I, to require employers holding certain life insurance policies on employees and directors (commonly known as "COLI" or "BOLI" policies – corporate-owned or bank-owned life insurance), to provide notice of certain policies' existence to the insured employees and directors and also to provide notice of certain policies to the IRS. Notice 2009-48 implements these requirements for policies issued after August 17, 2006. Code section 101(j) also restricts the tax exclusion for amounts received from these policies where employee consent is not obtained.

What Life Insurance Policies Are Subject to These New Rules?

If a life insurance contract is owned by a business, or a person engaged in a trade or business, if the owner is a beneficiary of the life insurance contract (directly or indirectly), and if the individual whose life is insured is an employee (or officer, director, or independent contractor) of the owner (or of a related business) at the time the policy is issued, the contract is potentially subject to the new rules.

The new rules do *not* cover contracts owned by a qualified plan or welfare benefit trust, but they *do* cover contracts held in a grantor trust, if the assets are treated as owned by the employer. The new rules also do not cover contracts owned by the owner of a business (for example, for the purpose of financing the purchase of another owner's equity interest in the event of the other owner's death), or contracts held by a sole proprietor on his or her own life.

Split-dollar life insurance contracts may be subject to the new rules if the contract is owned by the employer. Even though the restriction on tax exclusion does not apply to amounts paid to a family member of the insured (as is common under a split-dollar arrangement), the notice and consent requirements described below must be satisfied in order for this exception to be satisfied.

What Are the New Notice and Consent Requirements?

The general rule is that the "applicable policyholder" must provide an annual notice to the IRS (on Form 8925) showing the number of employees employed by the policyholder at the end of the year, the number of such employees insured under the contract, the total amount of insurance in force at the end of the year, the type of business in which the policyholder is engaged, and certifying that a valid consent was obtained from each insured employee (or the number of employees for whom such consent was not obtained).

If the insured individual was an employee at any time during the 12-month period before death, or if the insured was a director, highly compensated employee, or highly compensated individual when the contract was issued, the restriction on the tax exclusion will not apply if the notice and consent requirements described below are met. Similarly, the restriction will not apply to insurance proceeds paid to a family member or beneficiary designated by the insured, or to amounts used to purchase the insured's interest in the business, provided the notice and consent requirements described below are met. Thus, it is important for employers holding such contracts to implement appropriate procedures to ensure compliance with the notice and consent requirements.

Notice and Consent Requirements:

Before the policy is issued on the life of an employee (or director or independent contractor), the following must occur:

- the employee is given notice in writing, that the employer intends to insure the employee's life; and that the employer (or other applicable policyholder) will be a beneficiary of the proceeds;
- the employee is given notice of the maximum face value of the insurance (as of the date the policy is issued); *and*
- the employee provides written consent to being insured under the contract and acknowledges that the coverage may continue after the insured terminates employment.

Additional requirements include:

- The insurance contract must be issued within one year after the date the employee's consent was obtained or, if earlier, before termination of the employee's employment.
- If the amount of the insurance is increased above the amount initially contained in the notice, new consent must be obtained, but the original notice must be limited to the amount (either in dollars or a multiple of compensation) that the employer reasonably expects to purchase during the course of the employee's employment.
- Inadvertent failures can be corrected before the due date of the employer's tax return, but they cannot be corrected after the death of the employee.
- If an employee irrevocably transfers an existing policy to the employer, the transfer is considered equivalent to the required notice and consent.
- Notice and consent can be provided electronically, subject to the general rules applicable to electronic notifications and signatures.

A contract is considered "issued" on the date shown on the policy, which must be on or after the latest of: (a) the date the application was signed; (b) the effective date of coverage; or (c) the formal issuance of the contract. Because the notice and consent requirements must be satisfied before the issue date, this provision is actually helpful to employers.

A material increase in the death benefit, or any other material change in the contract, results in a new "issue date," and new consent is required. Notice 2009-48 contains a detailed list of non-material changes. If an employer holds a master contract, the addition of new covered lives is considered a newly issued contract only with respect to the additional covered lives.

A section 1035 exchange of an old contract for a substantially similar contract does not create a new issue date – either for purposes of the notice requirement or for purposes of the effective date of the new provisions.

The new rules will be effective June 15, 2009. The IRS will not challenge a taxpayer who made a good faith effort to comply with the notice and consent requirements between the effective date of section 101(j) and the effective date of the new rules.

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