ASSOCIATION FOR ADVANCED LIFE UNDERWRITING
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Section 101(j) Review

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Internal Revenue Code section 101(j) establishes rules for the taxation of employer-owned life insurance. Since its enactment in 2006 as part of the Pension Protection Act, a number of questions have been raised regarding the types of insurance arrangements to which section 101(j) may apply. Previous Washington Reports have touched on some of these issues. (See, e.g., our Bulletins Nos. 06 93 and 06 121.) We will here summarize, consolidate and (to some extent) repeat an analysis of the situations to which the section is applicable. We will also review potential problems that have arisen in connection with section 101(j)'s notice and consent requirements. Given the potential scope of 101(j)'s coverage, as described further herein, the notice and consent requirements may apply more broadly than initially assumed. In addition, because the consequences of noncompliance are so harsh (i.e., taxable death benefits), it is generally advisable to comply with the notice and consent requirements (as well as the other requirements) whenever there is a reasonable possibility that section 101(j) may apply.

Section 101(j) provides that the death benefit proceeds paid on an “employer-owned life insurance contract” will remain tax-free under section 101(a) if the statutorily prescribed notice and consent requirements are satisfied and the contract fits within one of the statutorily designated coverage conditions. The coverage conditions are (i) the insured was an employee of the policyholder during the 12-month period before the insured’s death, or (ii) at the time the contract was issued the insured was a director, a highly compensated employee (within the meaning of section 414(q), with certain modifications) or a highly compensated individual (within the meaning of section 105(h)(5)).

An “employer-owned life insurance contract” is a life insurance contract which (i) is owned by a person

engaged in a trade or business and under which such person (or a related person) is directly or indirectly a beneficiary and (ii) covers the life of an insured who is an employee with respect to the trade or business of the applicable policyholder on the date the contract is issued. The term "related person" is defined to include any person who (i) bears a relationship specified in section 267(b) or section 707(b)(1); or (ii) is engaged in trades or businesses with such person which are under common control within the meaning of section 52(a) or (b).[1] The term "employee" includes officers, directors and highly compensated employees (under section 414(q)).

The broad nature of these terms raises questions of the extent to which section 101(j) applies to various types of arrangements. Although the IRS has not to-date brought substantial clarity to this issue, we would not be surprised if the Service publishes relevant guidance in the not too distant future now that it has released IRS form 8925 and has issued proposed and temporary regulations under section 6039I. (See our Bulletins Nos. 07−101 and 08−06.)

The balance of this Bulletin will consider the application of section 101(j) to various types of arrangements and will address aspects of the pivotal notice and consent standards. In this regard, it is important to keep in mind that failure to comply with the section will cause the death benefits under the policy to be taxable (instead of tax-free). Compliance with section 101(j) (and avoidance of the harsh consequences of noncompliance -- potential taxable income recognition) requires full satisfaction with the broad notice and consent standards. In general, it is therefore advisable to comply with these standards (as well as the other requirements) whenever there is any reasonable possibility that the section may apply.

The section generally applies only to life insurance contracts issued after August 17, 2006 (subject to the material-change rules).

COLI

Corporate-owned life insurance (COLI), although not a statutory term, is generally understood to be an arrangement in which the employer purchases life insurance on one or more of its employees. It certainly is a type of arrangement to which section 101(j) is directed. In many cases COLI is used in conjunction with deferred compensation arrangements, but it also may be used to provide welfare and other benefits.

Key Man Life Insurance

Key man life insurance is a form of COLI in which an employer takes out a life insurance policy to protect it against the premature death of an executive who is of major importance to the employee's financial success.

It has come to our attention that some people do not realize that key man life insurance is subject to section 101(j). Because the policy is taken out by the employer on the life of an employee, key man life insurance fits squarely within the definition of employer-owned life insurance. As a consequence, it is very important that the life insurance policy comply with the requirements of section 101(j) and, if it was issued before August 17, 2006, that careful attention be paid to any type of modification to the contract which might cause loss of grandfather treatment.

Cross Ownership

In many situations business life insurance is not taken out in standard COLI form, but may be issued in some type of cross-ownership arrangement. For example, in a company that has two principal

stockholder/executives, those persons may cross insure each other's lives. In this type of arrangement, the employer does not itself own the life insurance. Therefore, it does not appear that section 101(j) applies.

The key term that must be examined is "employer-owned life insurance contract." One of its requirements (i.e., a prerequisite for application of the section) is that the contract be owned by a person engaged in a trade or business and that such person (i.e., the employer) be (directly or indirectly) the beneficiary of the policy. The statute also provides that a "related person" may be the beneficiary, but it does not say that the section will apply if the related person is the owner of the policy. In a cross-ownership situation, the policy is simply not owned by the employer. It may in fact be owned by a related person (such as an owner in a cross ownership situation), but ownership by such a person is by itself insufficient to trigger the reach of section 101(j).

It should also be noted by way of analogy that IRS Form 8925, which is used to report the ownership of employer-owned life insurance arrangements, does not appear to be designed to cover cross ownership situations.

Independent Contractors

As noted above, the term "employer-owned life insurance" is defined in part as life insurance that is owned by a business and that covers an insured who is an employee. The term "employee" is defined to include officers, directors and highly compensated employees under section 414(q).

Thus, the term "employee" is used to determine (i) when section 101(j) applies and (ii) what types of arrangements are covered. While an intuitive definition of "employee" would include only common law and statutory employees, the definition of "employee" in section 101(j), by reference to section 414(q), creates some uncertainty. (Directors, who are often independent contractors, are definitely included). The temporary regulations under section 414(q) (at Q&A 7) expressly state that the term "employee" refers to individuals who perform services for the employer and are either common-law employees or self-employed individuals who are treated as employees pursuant to section 401(c)(1). Because the definition of "employee" in section 414(q) includes self-employed individuals, one possible reading is that section 101(j) could also apply to life insurance on the lives of independent contractors. Note, however, that an independent contractor, in order to be covered by these rules, would still have to be "highly compensated" under section 414(q) and would have to perform services for the employer.

Split-Dollar Arrangements

Although split-dollar arrangements can be established in a number of different situations, we will here simply refer to employee/employer arrangements.

Because the employee owns the insurance contract in the case of collateral assignment split-dollar arrangements, it appears that such an arrangement should not encompass an employer-owned life insurance contract under section 101(j). This should be true even if the contract holder (and the person insured) is a related person under the statutory rules discussed above. If the employer is, however, a co-owner of the policy in any fashion, then the collateral assignment arrangement may be covered by the section.

The analysis is different, however, with respect to endorsement split-dollar arrangements. There the life insurance contract is literally owned by the employer, who is a direct beneficiary along with the insured employee. These arrangements would appear to fit within the definition of employer-owned life

insurance contracts and therefore should be subject to the requirements of section 101(j).

While some split-dollar arrangements may constitute section 101(j) contracts, the failure to comply with the new notice and consent requirements will not necessarily create adverse tax consequences. Section 101(j) denies an exclusion to the extent the death proceeds exceed the sum of the premiums and other amounts paid by the employer for the contract. In many split-dollar arrangements, the employer is entitled to a return of only the premiums it paid under the split-dollar arrangement, in which case the death proceeds received by the employer should be excludable under section 101(a) regardless of whether the notice and consent requirements are satisfied. However, to the extent the death proceeds received by the employer exceed the premiums paid by it, the notice and consent (and other) requirements would need to be satisfied in order to exclude the excess amounts from income.

VEBAs

Life insurance contracts may be held by VEBAs in certain situations to fund benefits. In those situations are we faced with employer-owned life insurance? For example, a VEBA may be "related" to an employer under section 267(b)(9), which provides that an organization to which section 501 applies (a VEBA is covered by section 501(c)(9)) is related to a person who controls such organization (whether directly or indirectly).

However, again the employer ownership rule (as contrasted to ownership by a related person) becomes decisive to protect the circumstance from application of section 101(j).

Further doubt on whether life insurance held by a VEBA could constitute an employer-owned life insurance contract is created by the other part of the definition of "employer-owned life insurance contract" which requires that the policy cover the life of an insured who is an employee "with respect to the trade or business of the applicable policyholder on the date the contract is issued." If the VEBA is the applicable policyholder and the insured is an employee of the employer that creates the VEBA, then it is doubtful that this requirement is literally satisfied since the employee is not an employee "with respect to" the employer's trade or business (unless, of course, the individual is an employee of the VEBA, which would be unusual).

Even if section 101(j) were to apply and deny an exclusion under section 101(a) for proceeds received by a VEBA, a question remains whether any tax would be due in view of the fact that VEBAs are tax-exempt under section 501(c)(9). However, VEBAs are taxable to the extent they receive unrelated business taxable income. There are special rules that apply for purposes of determining a VEBA's unrelated business income (see section 512(a)(3)). Essentially, the income received by a VEBA will constitute unrelated business income to the extent the assets set aside exceed the account limits under section 419A (excluding any funding reserves for post-retirement medical benefits). Thus, if the death proceeds are retained in the plan and the assets exceed the account limits under section 419A as of the end of the year, the death proceeds may be taxed as unrelated business income. Nevertheless, it appears unlikely that section 101(j) applies to VEBAs in any event.

Qualified Retirement Plans

A analysis similar to that appropriate to VEBAs seems to apply to life insurance contracts held under qualified retirement plans. Such contracts generally would not appear to fit literally within the applicable definitions and even if they did, the proceeds may still be tax-exempt to the qualified plans.

Note that while qualified retirement plans are also potentially subject to the unrelated business income

tax, the rules for determining unrelated business income with respect to such plans are different from the rules for VEBAs. A qualified retirement plan will have unrelated business income only to the extent that it receives non-excluded income from a trade or business that is regularly carried on by the organization or to the extent it has unrelated debt-financed income. The unrelated business income tax rules exclude certain types of passive income (e.g., interest and dividends), but death proceeds from life insurance contracts are not expressly addressed. Consequently, if section 101(j) were to apply, which seems unlikely, any death proceeds received by a qualified retirement plan might be taxable unless excluded from income by reason of compliance with the notice and consent (and other requirements) of section 101 (j).

Rabbi Trusts

Rabbi trusts are used in conjunction with nonqualified deferred compensation arrangements. To avoid current income tax recognition in the hands of the employee, the assets held in a rabbi trust must remain subject to the claims of the employer's general creditors and are generally treated as assets of the employer. They, therefore, are thought to be covered by section 101(j). Accordingly, consideration should be given to complying with the notice and consent (and other) requirements with respect to any life insurance contracts held in a rabbi trust.

Secular Trusts

Secular trusts are also used in conjunction with nonqualified deferred compensation arrangements. They differ from rabbi trusts because the assets do not remain subject to the claims of the employer's general creditors. As a result, the assets are generally not treated as owned by the employer for tax purposes. Secular trusts are not exempt under section 501 so the analysis discussed above for VEBAs and qualified retirement plans should not apply. Further, it would appear that life insurance contracts held in a secular trust should not be covered by section 101(j) since the secular trust arguably is not a person engaged in the trade or business and the employee arguably is not an employee "with respect to" that trade or business (even if it does exist). In a normal situation, secular trusts would not appear to be in any trade or business but instead are simply passive investment vehicles.

It should be kept in mind that the IRS has not so far issued any guidance on the interpretation of these issues under section 101(j). Finally, the IRS has further indicated informally that, if it is called upon by taxpayers to address these issues, it is likely to take a broader, rather than a narrower, interpretation of the application of section 101(j).

Notice and Consent

As a cautionary note, given any degree of uncertainty it is probably advisable, as emphassized above, to comply with the notice, consent and other requirements of section 101(j) if at all possible, rather than to risk an adverse interpretation by the IRS.

Further as to notice and consent issues, in its proposed regulations under section 6039I the Internal Revenue Service requested comments on issues under section 101(j) that may need guidance. It specifically asked about the notice and consent rules. AALU is preparing and intends to submit comments to the Service that may address the following issues:

1. Once an employer obtains the necessary section 101(j) consent from an employee, how long does that consent remain valid? AALU is likely to suggest a bright-line rule of approximately 12 months in which the consent will remain valid and the employer can purchase life insurance

consistent with that consent.

2. Once a written consent is obtained, can the employer purchase (during the period the consent is valid) more than one policy, the total face values of which do not exceed the maximum amount specified in the consent? In many cases, employers may wish to purchase policies from more than one insurer or may wish to have different features in separate policies.

3. Will the IRS provide a correction mechanism in situations where the requirements of section 101(j) have not in all cases been properly satisfied by taxpayers? For example, there may be situations in which an employer has not obtained a timely consent in circumstances that could be readily corrected without prejudice to either employer or employee.

4. What types of modifications will cause a policy to lose its grandfather status? Because such a loss of status will occur if material changes are now made to a contract that was issued before the effective date of section 101(j), further IRS clarification may be appropriate.

5. Whether former employees who were highly compensated employees when they separated from service or at any time after attaining age 55 have to be treated as employees for purposes of satisfying the annual reporting requirements on IRS Form 8925?

6. Whether former employees are covered by the special 1035 exchange rule, which provides that Code section 101(j) generally does not apply to contracts issued after August 17, 2006 pursuant to an exchange described in Code section 1035 for a contract issued on or before that date?

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[1] Among the parties that section 267(b) designates "related parties" are:

1. family members such as brothers, sisters, spouses, ancestors, and lineal descendants;

2. an individual and a corporation more than 50% of the value of the outstanding stock of which is owned directly or indirectly by or for such individual;

3. a grantor and a fiduciary of any trust;

4. a tax-exempt organization which is controlled indirectly or directly by the person or by members of the family of that individual; or

5. a corporation and a partnership if the same persons own more than 50% of the value of the stock of the corporation and more than 50% of the capital or profits interests in the partnership.

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