APPLIED KNOWLEDGE | LIFE INSURANCE

Tax guidance for employer-owned life insurance

Helping you stay informed while maximizing your solutions for business and key employee protection.

Summary

If your clients need employer-owned life insurance for key person protection, buy-sell funding, or other business needs, you will need to help them meet the requirements of 101(j). Compliance with IRC Section 101(j) is necessary to protect the income tax-free treatment of death proceeds from employer-owned life insurance. That means your clients will have more cash to help meet business needs, such as recovering from the loss of top talent and creating liquidity for key employee benefit programs.

What is IRC Section 101(j)?

The general rule is that employer-owned life insurance death proceeds are taxable, to the extent they exceed cost basis, unless the requirements of Section 101(j) are met. The overall framework of IRC Section 101(j) imposes certain requirements, which if met, will generally allow death benefits of employer-owned life insurance to be received income tax-free.

How it works

Q1 **If the general rule of Section 101(j) is that employer-owned life insurance death proceeds are taxable, then how do death proceeds that are payable to an employer, from employer-owned contracts, qualify as tax-free under the general rule of IRC Section 101(a)?**

The first condition is that the employer must comply with the notice and consent requirement. In general, the insured will need to sign a written notice and consent form prior to the policy issue date. Notice and consent details are provided in questions 12, 13, and 14.

The second condition is that one of two specific conditions must be met:

(1) the insured's status with the employer meets the conditions described in Q 2, *or*

(2) the death proceeds must be payable to, or for the benefit of, the insured's heirs, including for the purchase of an insured's equity interest in the business(Q 7).

Q2 **What are the conditions based on an insured's status?**

The insured's status with the employer qualifies it for income tax-free treatment if:

1. The insured was an employee within the twelve-month period preceding his or her death, *or*
2. The status of the insured at the time the policy is issued is one of the following:
   - A highly compensated employee (HCE) under IRC 414(q)

- A highly compensated individual (HCI) as defined under IRC Section 105(h)(5) (as slightly modified by Section 101(j)), or
- A director of the employer.

Q3 **What is the definition of a highly compensated employee (HCE) under IRC Section 414(q)?**

Under IRC Section 414(q), an HCE is someone who was either:

- A 5% owner during the current or preceding year (defined as a person who owns, including stock ownership attributed under Section 318, more than 5% of the outstanding stock or voting stock of a corporation or, if the employer isn't a corporation, any person who owns more than 5% of the capital or profits interest in the employer), or
- An employee with at least $135,000 (2022) of compensation for the preceding year. The income figure is adjusted annually for inflation. A former employee may be considered an HCE if he or she separated from service as an HCE or was an HCE at any time after attaining age 55.

Q4 **What is the definition of a highly compensated individual (HCI) under IRC Section 105(h)(5) as applicable to Section 101(j)?**

For purposes of IRC Section 101(j), an HCI is generally an employee who ranks among the highest paid 35% of an employer's employees. For this purpose, certain employees may be excluded from consideration, such as employees who are part of a collective bargaining unit. In addition, the five highest paid officers of the employer are considered HCIs. Applying the requirements of Section 105(h)(5) to Section 101(j), it would appear that the level of compensation would be determined on the basis of the employee's compensation for the current year.

Q5 **If an insured employee doesn't qualify under one of the previously discussed status exceptions, and the employer is the beneficiary under the employer owned policy, can the death benefit still be received income tax-free under the framework of IRC Section 101(j)?**

Yes. If the insured employee dies while currently employed, or within 12 months from the last day of employment, and the employer has met the notice and consent requirements, then the death proceeds of employer-owned life insurance should be received income tax-free based on the first status condition (Q 2), even if the insured is not a director, an HCE or an HCI at policy issue.

Q6 **How do the definitions for HCEs and HCIs interact with the guidelines for determining who is a top-hat employee for ERISA purposes?**

Determining whether an employee qualifies under the top-hat guidelines for ERISA purposes is separate and distinct from the requirements of IRC Section 101(j). It's important to keep in mind that Section 101(j) has only one primary purpose: To impose requirements on employers that must be met in order for an employer to get a tax-free death benefit from a life insurance policy it owns. It is purely an income tax matter. Top-hat status for participants of employer benefit plans is necessary for the employer benefit plans to be exempt from certain ERISA requirements. It appears most top-hat employees would meet one of the status exceptions of 101(j) described above. However, that doesn't mean everyone who meets one of the status exceptions would necessarily qualify as a top-hat employee.

Q7 **Are death benefits from employer-owned policies payable to an insured-employee's heirs eligible for tax-free treatment under 101(j)?**

Yes, assuming the notice and consent requirements of IRC 101(j) are met, death benefits that are 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) are subject to an exception from Section 101(j). And, life insurance death benefits used to purchase an equity (or capital or profits) interest in the employer from any of these persons, would also qualify if the death proceeds are used to purchase the interest no later than the employer's tax return due date, including extensions. It's worth noting that if any portion of the death benefit is intended for the employer (for instance, under an endorsement split dollar arrangement) then that portion of the death benefit would need to meet the notice and consent requirements and qualify under one of the insured's status exceptions for the death proceeds to be income tax-free under Section 101(j). If an exception isn't available, the death proceeds would be taxable to the employer to the extent they exceed the employer's cost basis.

Q8 **How does IRC Section 101(j) define "employer- owned life insurance contract" and why is this definition important?**

An employer-owned life insurance contract is one that is generally owned by a "person" engaged in a trade or business where the same person, or a related person, is also a direct or indirect beneficiary under the contract. For purposes of this definition, a "person" may include a:

- Corporation (including a sole-owner corporation)
- Partnership
- LLC (including a single member LLC)
- Sole proprietorship or similar business entity

However, a life contract owned by a sole proprietor on his or her own life isn't an employer-owned life insurance contract. Furthermore, a life contract owned by a co-owner to fund a cross purchase buy-sell agreement should not be considered employer- owned life insurance (as further discussed below). Generally, the insured must also be an employee of the "applicable policyholder" on the day the policy is issued. The purpose of this definition is to cast a wide net with respect to business-owned policies so that as many ownership arrangements as reasonably possible are brought within the scope of this Code section. If a life insurance policy isn't an "employer-owned contract," the rules of Section 101(j) don't appear to apply.

Q9 **How does IRC Section 101(j) define "applicable policyholder"?**

The term "applicable policyholder" generally refers to the person who owns the life insurance contract or a "related person." However, under Notice 2009-48, a contract owned by a related person won't be considered employer-owned life insurance unless the related person is engaged in a trade or business. Thus, according to the IRS, a life contract owned by the owner of a business entity (such as for purposes of financing the purchase of an equity interest of another owner) is not an employer-owned life insurance contract. This should mean that a life contract owned by a co-owner to fund a cross purchase buy-sell agreement is not an employer-owned life insurance contract. This is an IRS interpretation of confusing statutory language, and is favorable to the taxpayer.

Q10 **How does IRC Section 101(j) define "related person"?**

For purposes of Section 101(j), a related person is anyone, with a relationship to the applicable policyholder, who is described in either IRC Sections 267(b) or 707(b)(1). Controlled partnerships as defined in IRC 707(b)(1), and a long list of other relationships, including family members and fiduciary relationships, are identified as being within the meaning of related person.

Q11 **Are policies owned by a Rabbi trust exempt from the requirements of IRC Section 101(j) because they aren't employer-owned?**

The grantor of a grantor trust (including a Rabbi trust) is considered the owner of property in the trust for income tax purposes. Therefore, policies owned by a grantor trust are considered to be owned by the trust grantor and would subject the grantor to the rules and requirements of Section 101(j). Grantor trusts are often used in conjunction with nonqualified deferred compensation plans to hold employer assets, including life insurance policies, that are earmarked to pay deferred compensation benefits.

Administrative requirements

Q12 **What life policies require notice and consent?**

Notice and consent must generally be received for all employer-owned life insurance contracts issued or materially changed after August 17, 2006. See the answer to Q 22 for details on grandfathering rules.

Q13 **When must the notice and consent requirements be completed?**

In general, the employee must complete the written notice and given signed consent prior to a policy being "issued." Generally, for purposes of Section 101(j), the issue date is the later of:

- The date of application for coverage
- The effective date of coverage, or
- The "formal" issuance of the contract

In addition, an employer-owned life insurance contract may be treated as a new contract, and thus newly "issued," by reason of a material increase in the death benefit or other material change in the contract. Presumably, this would mean the notice and consent would need to be reviewed and signed by the employee before the later of the date the adjustment application is signed or the adjustment date of the policy.

The policy must also be issued before the earlier of:

-One year from the date of the notice and consent, or

-Termination of the employee's employment

For an inadvertent failure that meets certain “good faith” compliance requirements, the IRS won’t challenge the notice and consent requirement if the failure is discovered and corrected no later than the due date of the employer’s tax return for the year the policy was issued. The inadvertent failure corrective relief doesn’t appear to be available for policies issued where the notice and consent requirements were completely overlooked.

It’s important to keep in mind that the employer is responsible to maintain the necessary records which show compliance with the notice and consent requirement. In addition, the employer should document the HCE, HCI, or director status of any insured at the time employer-owned life insurance is purchased. Failure to do so may jeopardize the tax-free status of the death benefit.

Q14 **What information must be included in the notice and consent form?**

The notice must inform the employee that the employer, as policy owner and beneficiary, intends to insure the life of the employee. In addition, Section 101(j) requires that the notice provide the maximum face amount for which the employee could be insured at the time the contract is issued. In response to question 12 of Notice 2009-48, the IRS states that the maximum face amount, expressed in dollars or as a multiple of salary, should be what the employer “reasonably expects to purchase with regard to the employee during the course of the employee’s tenure.” The Consent to be Insured form from Principal permits the employer to select a maximum face amount and should be completed in a manner consistent with Notice 2009-48. An additional notice and consent is required by the IRS if the aggregate face amount of the employer-owned life insurance contracts with regard to an employee exceeds the amount of which the employee was given notice and to which the employee consented.

Q15 **What information must be furnished to the IRS to meet the information return requirements under IRC Section 6039I?**

Every employer with one or more employer- owned life insurance policies must annually file a completed IRS Form 8925 with the employer tax return. Information required for employer-owned policies issued after August 17, 2006 includes the number of employees of the employer and the number of insured employees. However, an employer isn’t required to complete Form 8925 for a life policy issued after August 17, 2006 as part of a Section 1035 exchange for a contract issued before August 18, 2006 (unless the new contract has a material increase in death benefit or other material change).

In addition, the form asks for the total amount of employer-owned life insurance coverage in force at the end of the tax year. It also asks if a valid consent form has been received for each policy and, if not, the number of employees for whom the employer doesn’t have a valid consent.

Q16 **How does Principal Life Insurance Company support employers who face these information-reporting requirements?**

For in-force life insurance coverage administered under an established business plan (such as key person, endorsement split dollar, nonqualified deferred compensation, entity purchase buy-sell, etc.), Principal provides annual reporting to the employer listing all the policies under the plan, including each insured's name and corresponding death benefit. This information will be helpful to the employer in completing IRS Form 8925.

Additional details

Q17 **Does IRC Section 101(j) apply to tax-exempt employers?**

In some cases (as noted in the instructions to the IRS Form 990-T Exempt Organization Business Income Tax Return), nonprofits may be considered engaged in a trade or business. This "trade or business" activity may make policies owned by the tax-exempt organization subject to Section 101(j). Therefore, we'll require a notice and consent for all insureds who are employees or former employees of nonprofits if the policies are owned by the nonprofit.

Q18 **In what circumstances may an insured who isn't a common law employee be covered under the rules of IRC Section 101(j)?**

The 101(j) definition of "employee" includes directors and Section 414(q) HCEs. Both of these classifications may include individuals who aren't considered common law employees. A director is an independent contractor in his or her capacity as a director. Section 414(q) HCEs include former employees if the individual separated from service as a HCE, or was a HCE at any time after attaining age 55. In addition, a self- employed individual, such as a partner or LLC member who is considered an employee under Section 401(c)(1) (qualified plan rules), will be considered an employee for purposes of Section 101(j). On the other hand, a life insurance contract that is owned by a sole proprietor on his or her own life isn't considered an employer-owned policy life insurance contract.

Q19 **Are there other parts of IRC Section 101 that may cause life insurance death proceeds to be taxable?**

Yes. The transfer for value rule is still part of Code Section 101. In general, unless a specific exception can be applied to a transaction, when a life insurance policy is transferred to a party in exchange for money or other valuable consideration, that policy's death benefit is taxable as ordinary income to the extent it exceeds the policy's cost basis. Some of the exceptions include:

- Transfers to the insured
- Transfers to a partner of the insured, or to a partnership in which the insured is a partner
- Transfers to a corporation in which the insured is an officer or stockholder

In addition, life insurance death proceeds may be taxable if there is a reportable policy sale as defined in Section 101 and regulations. A reportable policy sale is generally a direct or indirect acquisition of an interest in a life insurance contract if the acquirer has, at the time of acquisition, no substantial business, financial or family relationship to the insured (as defined in regulations) apart from the interest in the policy. Details, definitions and exceptions are explained in “Transfer for value/reportable policy sale regulations Q&A,” BB12408. An example of a potential reportable policy sale that could result in a taxable death benefit would be the acquisition of a business that owns life insurance on a former key person who is no longer employed and has no ownership in the acquired (or acquiring) business.

Q20 **What life insurance sales concepts are impacted by Section 101(j)?**

As discussed, a nonqualified deferred compensation arrangement (including Deferred Comp-Select Reward and Deferred Comp-SERP) is often informally funded with employer-owned life insurance and may be impacted by Section 101(j) even if policies are owned by a Rabbi trust. In addition, the portion of an endorsement split dollar death benefit paid to the employer may be impacted by Section 101(j) to the extent the return to the employer exceeds the employer’s basis in the policy. Additional sales concepts that may be subject to Section 101(j) include Key Person insurance, Death Benefit Only (DBO) plans, Entity Purchase Buy-Sell funding, and Corporate ESOP Repurchase Liability funding. In addition, Family Limited Partnerships and Family Limited Liability Companies may, in some cases, be considered as engaging in a trade or business, thereby subjecting insurance on employees (as previously defined) to Section 101(j).

Q21 **What’s the effective date of Section 101(j)?**

Section 101(j) became effective August 18, 2006, subject to the grandfathering discussed in the next question.

Q22 **Does Section 101(j) affect employer-owned life insurance contracts issued prior to August 18, 2006?**

As long as these “grandfathered” policies aren’t materially changed (as discussed in the next question) after August 17, 2006, they will not be subject to the rules of IRC Section 101(j). However, a material change of a grandfathered policy after August 17, 2006 will cause the policy to be treated as a new contract subject to Section 101(j), including notice and consent requirements.
Employer-owned life insurance issued prior to August 18, 2006 may be exchanged under IRC Section 1035 and the new policies will retain grandfathered status, as long as such new policies aren’t materially changed as part of the exchange. A loss of grandfathering status means that a notice and consent form should be completed before the new policy is issued, and an exception based on insured status or beneficiary must be found to avoid taxation of the death benefit (in excess of cost basis). As a best practice, employers may wish to require a notice and consent any time a grandfathered policy is exchanged. In addition, the employer will be subject to the recordkeeping and information reporting requirements.

Q23 **What does “materially changed” mean?**

The answer to question 14 of Notice 2009- 48 provides the following list of changes not treated as material changes for purposes of Section 101(j):

- Increases in death benefit required under Section 7702 of the Code
- Administrative changes
- Changes from general to separate accounts (or vice versa)
- Changes resulting from the exercise of a contractually guaranteed option or right

A “material increase in the death benefit” is identified as a material change.

Q24 **Is the transfer of a policy by an employee to an employer subject to Section 101(j)?**

Generally, it isn’t. However, a subsequent material change would cause the employer- owned contract to be subject to Section 101(j). Also, the transfer may be subject to the transfer for value rules discussed in question 19.

Q25 **Why did Congress adopt these changes to the tax code?**

In general, Congress was concerned about businesses purchasing life insurance policies on the lives of employees without any specific, legitimate business purpose other than a profit motive. Working with life insurance industry representatives, Congress was supportive of adopting an insurance industry best practices approach to preserving tax-free death benefits in legitimate situations.

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