Corporate-owned life insurance—taxation and reporting

Nonqualified deferred compensation plans are unfunded contractual promises from an employer to an employee. Although unfunded, some employers choose to purchase corporate-owned assets to informally finance the plan, including corporate-owned life insurance (COLI). Entities using employer-owned life insurance will need to meet the requirements of Internal Revenue Code Section 101(j) (IRS Section 101(j)).[1] Compliance with IRC Section 101(j) is necessary to protect the income tax-free treatment of death proceeds.

Taxation of COLI

IRC Section 101(j) applies to employer-owned life insurance contracts. This section generally provides that death benefits from COLI are taxable (in excess of premiums paid) to the employer. However, tax-free treatment of death benefits is still permitted if notice and consent requirements, and qualifying conditions with respect to the insured, are met.

Notice and consent requirements

The notice must inform the prospective insured that the employer intends to insure the employee's life, that the employer is the beneficiary of the policy, and the maximum amount of coverage the employer could purchase on the employee's life. The employer must also obtain written consent from the employee giving permission to be insured and providing approval for coverage to continue after the employee terminates employment.

Qualifying conditions with respect to the insured

One of these qualifying conditions that must be met in order to qualify the death benefit as income tax- free:

- The insured is (1) a director, (2) a highly compensated employee (as defined in IRC Section 414(q), see Key Federal Tax Rates and Amounts), or (3) an employee whose compensation is in the top 35% of employees at the time the policy is issued (most nonqualified deferred compensation plans financed with COLI will be able to rely on one of these three categories); or
- The insured employee dies while employed or within 12 months after separation from service; or
- Death proceeds are paid to the insured's heirs or are used to purchase an equity interest in the entity owning the policy.

Reporting and recordkeeping requirements

Policyowners who hold COLI contracts must file Form 8925 with their corporate income-tax return for each year their employer-owned life insurance is in force. This return includes:

- The name, address, taxpayer ID, and type of business of the employer.
- The total number of employees of the employer.

- The number of employees insured under the COLI contracts.
- The total amount of insurance in force.
- A statement that valid consent has been obtained from each insured, and the number of insureds who did not provide consent.

In order to meet the annual reporting and record retention requirements of IRC Section 6039, this Form 8925 is reported annually as an attachment to the policyowner's tax return.

Grandfathering

Policies with issue dates prior to August 17, 2006, are fully grandfathered and not subject to the provisions of IRC Section 101(j). In addition, grandfathered policies that are exchanged for new policies under IRC Section 1035 are eligible to have their grandfathering status continued. If there's any "material" change to a policy (for example, an increase to the death benefit), then grandfathering will be lost, and the policy will be subject to IRC Section 101(j).

COLI and nonqualified deferred compensation plans

When COLI is used for informally financing nonqualified deferred compensation plans, it's important to discuss the qualifying conditions and notice and consent requirements with the employer. In most situations, the income tax-free nature of the death proceeds should be retained, assuming these requirements are followed. With careful planning, these requirements shouldn't be difficult for employers to meet. When any one of several somewhat typical fact patterns are met, and if the notice and consent requirements are complied with, death benefits of employer-owned policies should retain their tax-free status for income-tax and cost-recovery purposes.

[1] Code Section 101(j) was signed into law on August 17, 2006, as part of the Pension Protect Act of 2006.