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Subject: **IRS Issues Significant New COLI Guidance on Revenue Code Sections 101(j) and 6039I**

Major References: [IRS Notice 2009-48](#)

Prior AALU Washington Reports: 08-102; 08-22; 08-06; 07-101; 06-132; 06-127; 06-121; 06-93; 06-92; 06-87

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The Internal Revenue Service has issued Notice 2009-48 to provide significant new guidance under Revenue Code sections 101(j) and 6039I which address the tax treatment and impose annual reporting requirements for employer-owned life insurance contracts, more commonly referred to as corporate-owned life insurance or COLI. Section 101(j) provides that any death proceeds paid under an "employer-owned life insurance contract" generally are not excludible from taxable income under section 101(a) unless specific notice and consent requirements are satisfied and certain exceptions apply. In addition, under section 6039I every "applicable policyholder" that owns an employer-owned life insurance contract must file an annual return with the IRS on Form 8925. Sections 101(j) and 6039I were added by the Pension Protection Act of 2006. Since their enactment, there have been many questions regarding the scope of the new rules and other compliance matters. AALU has been actively seeking additional guidance from the Revenue Service on many of these issues and Notice 2009-48 was issued, at least in part, in response to those efforts.

Notice 2009-48 provides new guidance in the form of seventeen questions and answers, which are divided into five separate categories. Each category and question are addressed separately below, with the numbered paragraphs below corresponding to the questions and answers that appear in the notice.

Definition of Employer-Owned Life Insurance Contract

"Employer-owned life insurance contract" is defined in section 101(j)(3) as a life insurance contract (i) which 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) which covers the life of an insured who is an employee of the applicable policyholder on the date the contract is issued. In addition, the term "applicable policyholder" generally means the person who owns the employer-owned life insurance contract and any person who bears a relationship specified in sections 267(b) or 707(b)(1) to the owner of the contract or who is engaged in trades or businesses with the owner of the contract which trades or businesses are under common control within the meaning of Code sections 52(a) or (b).

(1) Q & A - 1 - 101(j) Does Not Apply if Contract Owner Not Engaged in a Trade or Business: A contract cannot be an employer-owned life insurance contract if it is owned by a person who is not engaged in a trade or business. The notice includes two specific examples. The first involves a contract, that is owned by the owner of an entity engaged in a trade or business (such as for the purpose of financing the purchase of an equity interest of another owner). The second example involves a contract that is owned by a qualified retirement plan or VEBA that is sponsored by an entity engaged in a trade or business. The IRS concludes that in each example the contract is not an employer-owned life insurance contract because the actual owner of the contract is not itself engaged in a trade or business. The notice provides further, however, that a contract that is owned by a grantor trust (such as a Rabbi trust), the assets of which are treated as assets of a grantor that is engaged in a trade or business, may be an employer-owned life insurance contract.

(2) Q&A - 2 - Application to Split-Dollar Arrangements: A contract that is subject to a split-dollar arrangement is an employer-owned life insurance contract if it is owned by a person engaged in a trade or business (a usual circumstance for a split dollar contract) and otherwise meets the statutory conditions. However, section 101(j) generally does not apply to the extent any amount received by reason of the death of the insured is paid to a family member of the insured, to an individual who is a designated beneficiary, or to a trust established for the benefit of a family member or designated beneficiary. This exception may apply to many, if not most, split-dollar arrangements. In addition, to the extent the employer receives a portion of the death proceeds that does not exceed the premiums it paid, such amount would be excludible from taxable income under section 101(j)(1).

(3) Q&A - 3 - Contracts Owned by Partnerships and Sole Proprietorships May Still be Subject to 101(j): The ownership of a life insurance contract by a partnership or sole proprietorship does not prevent the contract from being treated as an employer-owned life insurance contract if it otherwise would meet the conditions to be treated as such. However, the IRS notes that a contract that is owned by a sole proprietor on his or her own life (and not the life of an employee) is not an employer-owned life insurance contract.

Exceptions to the Application of Section 101(j)

There are two exceptions to the application of section 101(j)(1) if the notice and consent requirements are satisfied. First, that section does not apply if the insured either was an employee at any time during the 12-month period before death, or was a director, highly compensated employee or highly compensated individual at the time the contract was issued. Second, section 101(j)(1) does not apply to

any amount received by reason of the death of an insured to the extent the amount is paid to or used to purchase an equity (or capital or profits) interest from a family member of the insured, an individual who is a designated beneficiary, a trust established for the benefit of a family member or designated beneficiary, or the estate of the insured.

(4) Q&A - 4 - When A Contract is Considered Issued for Purposes of 101(j): For purposes of determining whether the notice and consent are timely, or whether the insured is a director, a highly compensated employee, or highly compensated individual at the time the contract is issued, issuance is on the later of:

- (i) the date of application for coverage,
- (ii) the effective date of coverage, or
- (iii) the formal issuance of the contract.

It may not be clear when the date of application for coverage (item (i) above) occurs. For example, is it the date the application is completed and signed or is it the date the application is submitted or received by the insurance company? The IRS also notes that an employer-owned life insurance contract may be treated as a new contract, and thus newly issued, by reason of a material increase in death benefit or other material change in the contract (see Q&As 14 and 15 below).

(5) Q&A - 5 - Term "Employee" Can Include More Than Common Law Employees: The term "employee" can include service providers other than common law employees, such as (per section 101(j)(5)(A)) an officer, director, and highly compensated employee (within the meaning of section 414(q)). A director is an independent contractor in his or her capacity as a director. In addition, section 414(q) contains special rules relating to certain former employees and self-employed individuals who can be considered employees for purposes of section 101(j).

(6) Q&A - 6 - Exception for Death Proceeds Used To Purchase Equity Interest: To qualify for the exception for death proceeds used to purchase an equity (or capital or profits) interest in the applicable policyholder, the death proceeds must be so used by the due date, including extensions, of the tax return for the applicable policyholder's taxable year in which it is treated as receiving a death benefit under the contract.

Satisfaction of Notice and Consent Requirement

The notice and consent requirements are satisfied only if, before the issuance of the policy, the employee:

- (i) is notified in writing that the applicable policyholder intends to insure the employee's life and of the maximum face amount for which the employee could be insured at the time the contract was issued;
- (ii) provides written consent to being insured under the contract and that such coverage may continue after the insured terminates employment; and
- (iii) is informed in writing that an applicable policyholder will be a beneficiary of any proceeds payable upon the death of the employee.

(7) Q&A-7 - Notice and Consent Required by Owner-Employee of Wholly-Owned Corporation: The statute does not provide an exception for this situation. Therefore, the Service confirmed that a notice and consent is required of an owner-employee of a wholly-owned corporation.

(8) Q&A - 8 - No Notice and Consent for Contracts Irrevocably Transferred to Employers: No notice and consent is required in connection with the actual transfer of an existing life insurance contract by an employee to an employer. However, if the employer subsequently increases the face amount of the contract, written notice and consent must be obtained for the new face amount.

(9) Q&A - 9 - How Far In Advance Can Written Notice and Consent Be Provided: The contract must be issued before the earlier of:

- (i) the expiration of the one-year period beginning on the date the consent was executed, or
- (ii) the termination of the employee's employment with respect to the trade or business of the applicable policyholder.

It is not necessary to provide further notice or to renew an employee's consent with regard to an existing contract unless, for example, the total face amount of the employer-owned life insurance contracts for that employee exceeds the amount for which there was previous consent.

(10) Q&A - 10 - A Single Consent Can Be Provided for Multiple Contracts: A single consent can be obtained for multiple contracts so long as the notice and consent requirements are otherwise satisfied. Where an employee is appropriately notified that an applicable policyholder intends to insure the employee's life for a maximum \$1 million face amount and the employee consents in writing, the applicable policyholder could purchase two employer-owned life insurance contracts, each with a face amount of \$500,000.

(11) Q&A - 11 - Notice and Consent Can Be Satisfied Electronically: The notice and consent requirements can be satisfied electronically if the system for electronic notification and consent includes all of the required elements and the system:

- (i) ensures that the information received by the employee is the same as the information sent by the employer;
- (ii) makes it reasonably certain that the person accessing the system is the employee for whom notice and consent is required;
- (iii) includes a process for electronic signature or other means of formally recording the employee's consent to being insured; and
- (iv) permits the production of a hardcopy of the electronic notice and consent upon request by the IRS and a statement that, to the best of the employer's knowledge, the required notice was provided to the employee and the employee consented to being insured.

(12) Q&A - 12 - Cannot Obtain Consent For Maximum Face Amount Possible: The notice and consent requirements are not satisfied if the employee is notified that the face amount of the life insurance may be "the maximum face amount for which the employee could be insured" at the time the contract is issued.

An adequate notification requires the disclosure of a face amount of life insurance, either in dollars or as a multiple of salary, that the applicable policyholder reasonably expects to purchase with regard to the employee during the course of the employee's tenure.

(13) Q&A - 13 - Correcting Inadvertent Notice and Consent Failures: Although the statute does not authorize the correction of inadvertent notice and consent failures, the IRS will not challenge the applicability of one of the exceptions based on an inadvertent failure to satisfy the notice and consent requirements if the following conditions are met:

- (i) the applicable policyholder made a good faith effort to satisfy those requirements, such as by maintaining a formal system for providing notice and securing consents from new employees;
- (ii) the failure to satisfy the requirement was inadvertent; and
- (iii) the failure to obtain the requisite notice and consent was discovered and corrected no later than the due date of the tax return for the taxable year of the applicable policyholder in which the employer-owned life insurance contract was issued.

However, an inadvertent notice and consent failure cannot be corrected after the insured employee has died. Therefore, taxpayers will have to develop policies and procedures to ensure compliance and to periodically review their operations in order to be able to correct any such inadvertent failures within the applicable time limits.

Transition Rule and Section 1035 Exchanges

Section 101(j) applies to contracts issued after August 17, 2006, except for a contract issued after that date pursuant to a section 1035 exchange for a contract issued on or before that date. For this purpose, any material increase in the death benefit or other material change causes the contract to be treated as a new contract and thus subject to section 101(j).

(14) Q&A - 14 - What Changes Are Not Material Changes For Purpose of the Transition Rule?: The IRS indicates that the following are not material changes for this purpose:

- (i) increases in death benefit that occur as a result of either the operation of section 7702 (definition of a life insurance contract) or the terms of the existing contract (provided the insurer's consent to the increase is not required);
- (ii) administrative changes;
- (iii) changes from general to separate account (and vice versa); or
- (iv) changes as a result of the exercise of an option or right granted under the contract as originally issued.

The notice includes the following examples of such changes:

- (a) a death benefit increase necessary to keep the contract in compliance with section 7702;

- (b) a death benefit increase resulting from the application of policyholder dividends to purchase paid-up additions; or
- (c) a death benefit increase resulting from market performance or contract design with regard to a variable contract.

It is not clear whether the potential increases in death benefits that may occur must be taken into account in complying with the notice and consent requirements and, if so, how they must be communicated. Presumably, these features for potential death benefit increases would have to be disclosed, but it is not clear whether they will have to be quantified in some manner and, if so, how.

(15) Q&A - 15 - When Does The Transition Rule Not Apply to a Section 1035 Exchange?: Section 101(j) generally does not apply to a contract issued after August 17, 2006 in an exchange described in Code section 1035 for a contract issued on or before that date. However, a section 1035 exchange that results in a material increase in death benefit or other material change (other than a change in issuer) (see Q&A - 14) is treated as the issuance of a new contract after August 17, 2006.

(16) Q&A - 16 - New Notice and Consent Requirements for Certain 1035 Exchanges for Contracts Originally Issued After August 17, 2006: No further notice and consent are required with regard to a contract received in a section 1035 exchange for an employer-provide life insurance contract which was issued after August 17, 2006, and for which the notice and consent requirement was previously satisfied, if either:

- (i) the existing consent remains valid (see Q&A - 9), or
- (ii) the exchange does not result in a material change in the death benefit or other material change in the contract (see Q&A - 14).

Information Reporting Under Section 6039I and Form 8925

Section 6039I and IRS Form 8925 require that every applicable policyholder owning one or more employer-owned life insurance contracts issued after August 17, 2006, provide the following information showing for each year the contracts are owned:

- (i) the number of employees of the applicable policyholder at the end of the year;
- (ii) the number of such employees insured under such contracts;
- (iii) the total amount of insurance in force at the end of the year under such contracts;
- (iv) the name, address, and identifying number of the applicable policyholder and the type of business in which the policyholder is engaged; and
- (v) a statement that the applicable policyholder has a valid consent for each insured employee or, if all such consents are not obtained, the number of employees for whom such consent was not obtained (see Bulletin Nos. 08-102; 08-06; 07-101).

(17) Q&A - 17 - Only One Taxpayer Required to File Form 8925 for Each Contract: Although the term "applicable policyholder" includes certain persons related to the owner of an employer-owned life

insurance contract, only the applicable policyholder that actually owns the contract is required to file a Form 8925 with respect to such contract.

Effective Date

The notice is effective June 15, 2009. In addition, the IRS will not challenge a taxpayer who made a good faith effort to comply with section 101(j) based on a reasonable interpretation of that provision before that date. It is not clear whether this good faith standard applies to a determination by a taxpayer that an exception to section 101(j) applies. The language references only good faith efforts to comply, which could be interpreted literally to apply only to efforts to comply and not necessarily to good faith determinations that particular contracts are not subject to section 101(j). We may have to await further clarification from the IRS on this point. However, taxpayers should, in general, seek to have all their relevant actions satisfy good faith standards.

Any AALU member who wishes to obtain a copy of IRS Notice 2009-48 may do so through the following means: (1) use hyperlink above next to “Major References,” (2) log onto the AALU website at www.aalu.org and enter the *Member Portal* by entering your last name and birth date and select *Current Washington Report* for linkage to source material or (3) email Anthony Raglani at raglani@aalu.org and include a reference to this *Washington Report*.

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