SOCIETY OF ACTUARIES

Article from:

Taxing Times

September 2009 – Volume 5, Issue 3

GUIDANCE RELEASED ON COLI BEST PRACTICES RULES

By John T. Adney, Bryan W. Keene, and Joel W. Mann

On May 22, 2009, the Internal Revenue Service ("IRS") released Notice 2009-48 (the "IRS Notice"), which provides significant clarification in question-and-answer format on several provisions of the corporate-owned life insurance ("COLI") "best practices" rules that were codified in section 101(j)[1] by the Pension Protection Act of 2006 (the "PPA").[2] The IRS Notice became effective June 15, 2009, but it states that 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 section before the effective date. The IRS released the new guidance at least in part in response to a request by the American Council of Life Insurers ("ACLI") in 2007. In its request for guidance, the ACLI brought to the Treasury Department's ("Treasury") attention several areas of uncertainty regarding section 101(j). Agreeing that these areas merited further clarification, Treasury and the IRS placed the matter on their combined 2008-2009 Priority Guidance Plan and subsequently released the IRS Notice. This article provides a brief review of the rules of section 101(j) and then summarizes the guidance contained in the IRS Notice.

REVIEW OF SECTION 101(J)

Subject to certain transition rules, section 101(j) generally denies the exclusion from income under section 101(a)(1) for death benefits under an "employer-owned life insurance contract" to the extent they exceed the premiums and other amounts paid for the contract. An employer-owned life insurance contract is a life insurance contract that 1) is owned by a trade or business, 2) directly or indirectly designates that trade or business as the beneficiary, 3) covers the life of an insured who is an employee of the "applicable policyholder" when the contract is issued, and 4) is issued or "materially changed" after Aug. 17, 2006. An applicable policyholder is a person who engages in a trade or business and owns an employer-owned life insurance contract, or is a related person.[3]

Several exceptions to the general exclusion disallowance rule are available. One set of exceptions is based on whether amounts are paid to the insured's heirs.[4] The other set is based on the insured's status with the applicable policyholder, namely, insureds who were employees within 12 months of their death and insureds who were directors or "highly compensated" at the time the contract was issued.[5] None of the exceptions applies unless the employer, before the contract is issued, 1) notifies the insured in writing that the employer intends to procure the coverage, including the maximum face value for which the person could be insured; 2) obtains the insured's written consent to the coverage and to the possible continuation of the coverage after the insured terminates employment; and 3) informs the insured in writing that the employer will be the contract beneficiary.[6]

GUIDANCE ON NOTICE AND CONSENT REQUIREMENTS

One of the concerns that the ACLI raised in its request for guidance was the lack of any mechanism to correct inadvertent "foot faults" made in attempting to comply with the notice and consent requirements before a contract was issued. The IRS Notice provides, in response, that the IRS will not challenge an inadvertent failure to satisfy those requirements if 1) the employer made a good faith effort to satisfy them, 2) the failure was inadvertent, and 3) the employer corrects the error by the due date of its tax return for the year the contract was issued.[7] This "self-help" correction mechanism gives employers acting in good faith considerable leeway and should alleviate concerns that innocent and inevitable human errors would have harsh consequences. The key to effective utilization of this self-help mechanism is prompt discovery and correction of the error. In the absence of prompt action, there is no means under section 101(j) of correcting an inadvertent failure to comply with the notice and consent requirements. Hence, in the case of a failure discovered beyond the timeframe permitted under the IRS Notice, the only recourse would seem to be surrender of the affected contracts or, possibly, seeking a closing agreement with the IRS coupled with belated compliance with the statute's requirements.

Another question that arose when taxpayers began implementing the notice and consent requirements was how long an employee's consent remains valid. In other words, could

CONTINUED ON **PAGE 38**

an otherwise valid consent become "stale" if there was some delay in issuing the contract after the consent was obtained? This could occur, for example, if outside events delayed the plan moving forward after consents were obtained, or if a plan was implemented in multiple steps. With regard to the latter possibility, a related question became whether a single consent with respect to a given face amount could be used to purchase two or more smaller contracts that totaled to the amount for which the consent was given. The IRS Notice answers both of these questions. It provides that consent remains valid up to one year from when it was obtained, or up to the date the employment relationship ends—whichever occurs earlier.[8] It also provides that a single consent may apply to multiple contracts covering the life of the same insured, so long as the maximum face value to which the employee consented is not surpassed.[9] Taken together, these two rules suggest that if an employer plans to purchase multiple contracts based on a single consent, it should do so within a year of the consent or else the consent will expire. (The stale consent issue is discussed further below.)

Still another question that arose soon after section 101(j) was added to the Code was whether the "written" notice and consent requirements could be met *via* electronic means. The IRS Notice clarifies that they can, as long as the electronic notification and consent system has elements in place similar to the administrative requirements in the case of electronically filed Forms W-4.[10] It is our understanding that some employers have already been providing notice and obtaining consent electronically, based in part on the general applicability of the federal "E-SIGN" statute.[11] Those employers will likely want to review the IRS Notice to ensure that their current electronic system complies with the new guidance.

In addition to the foregoing, the IRS Notice also clarifies that 1) notice and consent is required of an owner-employee of a wholly-owned corporation; 2) notice and consent is not required with regard to an existing life insurance contract that an employee irrevocably transfers to an employer, because the transfer itself is sufficient to satisfy the notice and consent requirements; and 3) the notification to the employee of the maximum face amount for which the employee could be insured must be satisfied by using either a dollar amount or a multiple of salary, and not a general statement such as "the maximum face amount for which you can be insured."[12]

GUIDANCE ON THE ISSUE DATE OF A CONTRACT

There also has been general concern over what date a contract will be considered "issued" for purposes of section 101(j). The concern arises because the new rules apply only to contracts "issued" after Aug. 17, 2006, and because the notice and consent requirements must be met before the contract is "issued." For example, it is common for large purchases of employer-owned life insurance to be accomplished using a binding premium receipt, which provides immediate coverage for a specific amount of time, such as until the underwriting process is complete. If a contract was deemed "issued" before this binding premium receipt became effective, notice and consent would not be timely if accomplished after that time, which would often be the case.

The IRS Notice provides a reasonable and flexible response to this type of concern by clarifying that a contract's "issue" date is the latest of 1) the date of application for coverage, 2) the effective date of coverage, or 3) the formal issuance of the contract.[13] Thus, for example, the fact that a binder is effective before notice and consent are obtained will not necessarily cause a violation. As discussed below, this definition of "issue" date also has implications for the transition rules governing section 101(j)'s application and for determining the insured's status as a director or as "highly compensated."

GUIDANCE ON TRANSITION RULES

Section 101(j) applies only to contracts issued after Aug. 17, 2006, "except for a contract issued after such date pursuant to an exchange described in section 1035 … for a contract issued on or prior to that date."[14] For this purpose, "any material increase in the death benefit or other material change shall cause the contract to be treated as a new contract."[15] While it is common for statutory enactments to treat a material change to a life insurance contract as giving rise to a new contract,[16] the

exception for contracts exchanged pursuant to section 1035 was somewhat novel. This novelty has created confusion over the interaction between the two provisions.

The confusion stems from the appearance that the two rules, taken together, suggest that a deemed exchange resulting from a material change will trigger the rule's effective date, whereas an actual exchange of contracts will not—*i.e.*, the section 1035 exchange rule could be read to "swallow" the material change rule. The IRS Notice interprets these rules by retaining some meaning for each, stating that an actual exchange "that results in a material increase in death benefit or other material change *(other than a change in issuer)* is treated as the issuance of a new contract."[17] In effect, this interpretation adds a change in the identity of the contract's issuer to the list of items that will not be considered a "material change" for purposes of the transition rules.

In that regard, the IRS Notice also lists specific changes that are not treated as material for purposes of the transition rules. These largely track a similar list that was set forth in the only legislative history for section 101(j).[18] They are: 1) increases in death benefit due to the operation of section 7702 or the terms of the contract (provided the insurer's consent is not required); 2) administrative changes; 3) changes from general to separate account or from separate to general account (the latter being somewhat of an expansion, given that the legislative history referred only to changes from general account to separate account); and 4) changes as a result of an option or a right under the contract as originally issued.[19] With respect to contracts already subject to section 101(j), the IRS Notice also provides that a material change to the contract—whether through a modification to the contract or an actual exchange—will require a new notice and consent unless one remains in effect under the "expiration" provisions summarized above (*e.g.*, the change occurs within a year of the original notice and consent).[20]

Although this guidance on the perennially thorny issue of material changes is quite helpful, some questions are bound to remain. By way of example, as noted above the IRS Notice provides that a section 1035 exchange which also results in a material change, other than a change in the issuer of the contract, gives rise to a new contract for section 101(j) purposes. State law generally requires contracts issued after 2008, including those issued in an exchange, to base their mortality charge guarantees on the 2001 CSO mortality tables rather than the 1980 CSO tables. Normally, a change to a life insurance contract's guaranteed mortality charges is treated as a material change for tax purposes.[21] While the IRS Notice does not speak directly to this point, it may not be correct to read it as voiding the section 101(j) grandfather in this instance, for to do so could seem to swallow the section 1035 exchange relief Congress provided in the transition rule.

OTHER GUIDANCE

In its 2007 request for guidance, the ACLI noted that significant uncertainty existed with respect to the application of section 101(j) to various traditional insurance arrangements. The IRS Notice responds by clarifying whether 101(j) applies in several circumstances. First, it states that a contract is an employer-owned life insurance contract only if it is owned by a person who engages in a trade or business, and not when it is owned by a person who does not engage in one.[22] The IRS Notice gives the example of a life insurance contract owned by a qualified plan or VEBA that is sponsored by a business, and notes that such an arrangement is not subject to section 101(j).[23] Second, the IRS Notice states that a contract involved in a split-dollar arrangement can constitute an employer-owned life insurance contract, but any death benefits received under the contract that are paid to a family member or designated beneficiary of the insured are excluded from income due to section 101(j)(2)(B).[24] Finally, the IRS Notice provides that a life insurance contract owned by a partnership or sole proprietorship may still constitute an employer-owned life insurance contract, but not if the contract is owned by a sole proprietor and covers his or her own life.[25]

> Although this guidance on the perennially thorny issue of material changes is quite helpful, some questions are bound to remain.

In addition to the foregoing, the IRS Notice provides several other clarifications. First, it specifies that for purposes of section 101(j), the term "employee" is not limited to common law employees. Second, the IRS Notice provides that in order to qualify for the exception in section 101(j)(2)(B)(ii) that allows death benefits to remain tax free when they are used to purchase an equity (or capital or profits) interest in the employer (technically, the applicable policyholder) from family members or designated beneficiaries of the insured, the death benefits must be so used by the due date, including extensions, of the tax return for the taxable year in which the employer is treated as receiving them under the contract.[26]

CONTINUED ON **PAGE 40**

John T. Adney is a partner with the Washington, D.C. law firm of Davis & Harman LLP and may be reached at *jtadney@davis-harman.com.*

Bryan W. Keene is a partner in the Washington, D.C. law firm of Davis & Harman LLP and may be reached at *bwkeene@davis-harman.com.*

Joel W. Mann is an associate with the Washington, D.C. law firm of Davis & Harman LLP and may be reached at *jwmann@davis-harman.com.*

The final item on which the IRS Notice provides guidance is the information reporting requirements of section 6039I, which was also added to the Code by the PPA, and Form 8925, which is the IRS form used to implement the reporting requirements. Section 6039I and Form 8925 require each applicable policyholder owning one or more employer-owned life insurance contracts issued after Aug. 17, 2006, to provide certain information to the IRS. The ACLI had inquired in its request for guidance whether multiple taxpayers could be required to file Form 8925 by reason of the same employer-owned life insurance contract, since an "applicable policyholder" could possibly include both owners of the contracts and other related parties. The IRS Notice responds by saying that only the applicable policyholder that owns one or more employer-owned life insurance contracts is required to file the information return.[27]

CONCLUSION

The IRS Notice responds to the concerns of the ACLI and others in the industry quite thoroughly, and should be commended. The correction mechanism for inadvertent failures to satisfy the notice and consent requirements is particularly favorable to taxpayers. Despite the thoroughness of the IRS Notice, however, no doubt other questions will arise in the future. In light of the comprehensive guidance provided under the Notice, such remaining questions likely can be answered adequately through the private letter ruling process.

END NOTES

[1] All references to "section" are to sections of the Internal Revenue Code of 1986, as amended (the "Code").
[2] Pub. L. No. 109-280, 120 Stat. 780 (2006).
[3] *See* sections 267(b) and 707(b)(1).
[4] *See* section 101(j)(2)(B). This includes an amount paid to purchase an equity (or capital or profits) interest in the applicable policyholder from the insured's family members or certain others.
[5] *See* section 101(j)(2)(A).
[6] *See* section 101(j)(4).
[7] *See* Q&A-13 of Notice 2009-48.
[8] *See* Q&A-9 of Notice 2009-48.
[9] *See* Q&A-10 of Notice 2009-48.
[10] See Q&A-11 of Notice 2009-48; Treas. Reg. § 31.3402(f)(5)-1(c)(2).
[11] E-SIGN stands for the Electronic Signatures in Global and National Commerce Act, Pub. L. No. 106-229 (2004), which generally facilitates the use of electronic signatures in various instances where federal law requires a signature or communication to be "in writing."
[12] *See* Q&A-7, -8, and -12 of Notice 2009-48, respectively.
[13] *See* Q&A-4 of Notice 2009-48.
[14] Pub. L. No. 109-280 § 863(d).
[15] Id.
[16] *See* S. Prt. No. 98-169, at 579 (1984) (discussing the treatment of exchanged contracts as new contracts for purposes of the effective date of section 7702).
[17] *See* Q&A-15 of Notice 2009-48 (emphasis added).
[18] *See* Staff of J. Comm. on Tax'n, 109th Cong., Technical Explanation of H.R. 4, the "Pension Protection Act of 2006," as Passed by the House on July 28, 2006, and as Considered by the Senate on August 3, 2006, at 212–13 (J. Comm. Print 2006).
[19] *See* Q&A-14 of Notice 2009-48.
[20] *See* Q&A-16 of Notice 2009-48.
[21] *See, e.g.*, S. Prt. No. 98-169, at 579 (1984); H.R. Conf. Rep. No. 98-861, at 1076 (1984) (stating that the conference report follows the Senate report); Staff of J. Comm. on Tax'n, 98th Cong., General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984, at 656 (J. Comm. Print 1984).
[22] See Q&A-1 of Notice 2009-48.
[23] However, a contract owned by a grantor trust, the assets of which are treated as assets of a grantor that is engaged in a trade or business, constitutes an employer-owned life insurance contract and is subject to section 101(j).
[24] *See* Q&A-2 of Notice 2009-48. The statement in the IRS Notice is true, of course, only if the statute's notice and consent requirements are met.
[25] *See* Q&A-3 of Notice 2009-48.
[26] *See* Q&A-5 and -6 of Notice 2009-48, respectively.
[27] *See* Q&A-17 of Notice 2009-48.