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IRS RULES ON NOTICE AND CONSENT REQUIREMENTS FOR EMPLOYER-OWNED LIFE INSURANCE POLICIES

*By Kyla Grogan and Frederic Gelfond**

In LTR 201217017, the Internal Revenue Service (IRS) issued guidance regarding the application of the employer-owned life insurance notice and consent requirements contained in Internal Revenue Code section 101(j).[1] That section generally provides that the exclusion of death benefits under an employer-owned life insurance contract is limited to the aggregate premiums or other consideration paid for the contract. Such limit on excludability would not operate, however, if the insured or the payments under the contract qualify for one of the exceptions set forth in section 101(j)(2). In order for the exceptions in section 101(j)(2) to apply, however, the notice and consent requirements contained in section 101(j)(4) must be satisfied.

The taxpayer in LTR 201217017 requested a ruling that, pursuant to Notice 2009-48,[2] the IRS would not challenge the application of section 101(j)(2) to its employer-owned life insurance contracts because the taxpayer made a good faith effort to comply with the section 101(j)(4) notice and consent requirements. In considering the information provided, however, the IRS determined that the taxpayer had actually satisfied, and not merely made a good faith effort to comply with, the notice and consent requirements of section 101(j)(4).

Background on the Law and Current Guidance under Notice 2009-48

Section 101(j) was added to the Internal Revenue Code by the Pension Protection Act of 2006,[3] and generally applies to employer-owned life insurance contracts issued after August 17, 2006. Section 101(j) provides that the exclusion of employer-owned life insurance proceeds from income is generally limited to the aggregate premiums or other consideration paid, unless one of the following exceptions set forth in section 101(j)(2) is met and the notice and consent requirements of section 101(j)(4) are satisfied:

- The insured was an employee of the taxpayer at any time during the 12 months before death;
- The insured was a director, highly compensated employee, or highly compensated individual at the time the contract was issued; or
- The amount received upon the insured's death was distributed as follows:
    - Paid to a member of the insured's family, the insured's designated beneficiary (other than the taxpayer), a trust established to benefit a member of the insured's family or the designated beneficiary, or the insured's estate; or
    - Used to purchase an equity, capital, or profits interest in the taxpayer from any of these persons (described immediately above).

The notice and consent requirements of section 101(j)(4) that the employer must satisfy before the issuance of the contract include the following:

- The taxpayer must notify the employee in writing that it intends to insure the employee's life and of the maximum face amount for which the employee could be insured;
- The taxpayer must notify the employee in writing that the taxpayer will be the beneficiary upon the employee's death; and
- The employee must provide written consent to being insured and that the coverage may continue after employment terminates.

In Notice 2009-48, the IRS provided guidance on section 101(j), including the notice and consent requirements of section 101(j)(4), in a series of questions and answers. In question and answer 13, the IRS provided that it will not challenge an exception under section 101(j)(2) if the taxpayer satisfies the following three conditions:

(1) The taxpayer made a good faith effort to satisfy the notice and consent requirements;
(2) The taxpayer inadvertently failed to satisfy the requirements; and
(3) The taxpayer discovered and corrected the failure no later than the due date of its federal tax return for the taxable year in which the contract was issued.

The Facts of This Matter . . .

As discussed in the ruling, the taxpayer, a closely-held corporation, entered into a signed agreement with each of its employee shareholders that provided that the taxpayer would purchase the shareholder's interest in the taxpayer in the event that the shareholder died or terminated employment with the taxpayer. The agreement provided that the taxpayer intended to obtain life insurance on each shareholder's life in order to facilitate such a purchase and that the taxpayer would be the owner and beneficiary of the life insurance. The agreement also provided that if the agreement was terminated or the shareholder disposed of its interest in the taxpayer, the shareholder would have the right to purchase the life insurance policy from the taxpayer; if the insurance contract was not purchased, the taxpayer would retain the right to surrender or dispose of the insurance.

In order for the taxpayer to purchase the life insurance contracts, each shareholder completed a signed application that indicated that the taxpayer would be the beneficiary of the insurance contract and provided the amount of coverage that would be obtained. The taxpayer provided and obtained separate documentation from each shareholder that was intended to satisfy the notice and consent requirements of section 101(j)(4), but not until after it purchased the contracts and after the due date of its federal income tax return for the year of purchase.

The taxpayer requested a ruling that, pursuant to Notice 2009-48, the IRS would not challenge the application of section 101(j)(2) to the life insurance contracts because it made a good faith effort to comply with the notice and consent requirements of section 101(j)(4).

The IRS Conclusion

The IRS considered the taxpayer's documentation as a whole and determined that all of the notice and consent requirements of section 101(j)(4) were satisfied before the contracts were issued. Although no one separate document satisfied all the notice and consent requirements, the taxpayer provided all the required information to shareholders through the combination of the agreement and the application, both of which the shareholders signed before the contracts were issued and the taxpayer filed its return for the year of purchase of the contracts. Nevertheless the taxpayer appears to have sought relief through guidance that it acted in good faith in accordance with the provisions of Notice 2009-48 question and answer 13. Despite the specific ruling request made by the taxpayer, however, the IRS did not need to consider whether the taxpayer's facts satisfied the good faith criteria set forth in the notice. This is because there was no failure in the first instance, as the provisions of section 101(j) had already been satisfied.

The ruling reflects a reasonable approach towards determining whether a taxpayer has satisfied the statutory notice and consent requirements of section 101(j)(4).

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END NOTES

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[1] Section references contained herein are to the Internal Revenue Code of 1986, as amended (the "Code").
[2] 2009-1 C.B. 1085.
[3] P.L. 109-280.

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THE IRS RULES AGAIN ON AN ANNUITY-LTC COMBINATION PRODUCT

By Brian King

On Dec. 20, 2011, the Internal Revenue Service (IRS) released PLR 201213016, which addresses whether a noncancellable long-term care (LTC) rider offered with a single premium deferred annuity contract is an "insurance contract" for purposes of section 7702B(b)(1) of the Internal Revenue Code. This ruling is the third private letter ruling issued by the IRS that addresses certain federal income tax aspects of LTC annuity combinations. The IRS previously issued PLR 200919011 dealing with a coinsurance design[1] (see September 2009 issue of *Taxing Times*) and PLR 201105011 dealing with a tail design[2] (see May 2011 issue of *Taxing Times*) (the *Prior Rulings*). What is noteworthy with PLR 201213016 is that the IRS declined to rule on the insurance company's request that the investment in the contract (within the meaning of section 72) of the annuity contract not be reduced by the payment of an LTC benefit.

Facts of the Ruling

Similar to the LTC annuity combination that was the subject of PLR 201105011, the LTC Rider that is the subject of this ruling is also a tail design LTC rider. All LTC benefits during the initial benefit payment period (subject to elimination and waiting period requirements) are offset dollar for dollar by reductions to the annuity contract's cash value, referred to as Phase I in the ruling request. A second benefit period, Phase II, begins once the benefits during Phase I have been exhausted, assuming the insured is still eligible for benefits. Regardless of whether benefits are payable during Phase I or II, the contract limits the monthly benefit payment to the lesser of a defined monthly benefit cap or actual expenses incurred for qualified long-term care services during the period the insured is chronically ill.

The insurer imposes a monthly charge for the LTC Rider that is expressed as a percentage of the contract value of the annuity. The rate of the rider charge cannot be increased, and will decrease if the imposition of the charge would cause the value of the annuity contract at the end of the month to be less than the value at the end of the prior month. The rider charge is paid with after-tax dollars and reflects an arm's length charge for the LTC Rider.

Requested Rulings

The insurer requested the following rulings from the IRS:

1. The LTC Rider constitutes an insurance contract within the meaning of section 7702B(b)(1);
2. All LTC benefits will be excludable from the policy owner's gross income under section 104(a)(3); and
3. The investment in the contract (within the meaning of section 72) of the annuity contract to which the LTC Rider is attached will not be reduced by the payment of LTC benefits.

With respect to the first ruling request, the IRS concluded that the LTC Rider constitutes an "insurance contract" within the meaning of section 7702B(b)(1). The analysis presented by the IRS was largely consistent with the Prior Rulings, focusing on the presence of the risk shifting and risk distribution, and that the LTC Rider conforms to the definition of insurance in the commonly accepted sense.

The second ruling request deals with the tax treatment of LTC benefits received by the policy owner. Because the LTC Rider constitutes an insurance contract under section 7702B(b)(1) (based on the first ruling request) and the insurer requesting the ruling represented that the LTC Rider otherwise satisfies the requirements for a QLTCI contract under section 7702B, the IRS ruled that the LTC benefits would be excludable from gross income under section 104(a)(3).

While there is nothing surprising with the first two rulings, the IRS declined to issue a ruling on the third request, dealing with the effect that the payment of the LTC benefit has on the section 72 "investment in the contract" for the annuity contract. Interestingly, the IRS did rule on a similar request in PLR 200919011. In LTR 200919011, the IRS concluded that "payment of LTC Benefits under the Rider will reduce the 'investment in the contract' of the [annuity contract] for purposes of § 72," without elaborating on how the investment in the contract would be reduced. The ruling was not received favorably by the industry, prompting responses by industry groups to the IRS to reconsider the position taken in the ruling. The IRS may still be formulating its thoughts on this matter as evidenced by the release of Notice 2011-68 in August of 2011. Notice 2011-68 addressed certain aspects of the tax treatment of stand-alone and combination LTC insurance products, providing interim guidance on certain issues relating to the determination of the investment in the contract for annuity-LTC combinations. The Notice was silent, however, on how the

tax-free LTC benefits received under the QLTCI portion of an annuity-LTC combination product affect the investment in the contract for the annuity portion of the contract. (The same issue also exists for life-LTC combination products.) Perhaps the IRS's decision not to issue a ruling on the effect of an LTC benefit payment on the annuity portion's investment in the contract provides an indication that more formal guidance on this matter may be forthcoming.

END NOTES

[1] Under a coinsurance design, each LTC benefit results in a reduction in the annuity cash value but in part consists of net amount at risk. The reduction in the annuity cash value is typically a predetermined percentage (less than 100 percent) of the LTC benefit payment.

[2] Under a tail design, all LTC benefits that are payable during an initial period result in a dollar for dollar reduction in the annuity cash value. When the benefits during the initial period are exhausted, LTC benefits continue for a period of time, without reduction to the annuity cash value, *i.e.*, they consist solely of net amounts at risk.

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