Employer-Owned Life Insurance

Businesses own life insurance on their employees for a number of reasons. For small businesses, life insurance is usually connected with executive and succession planning arrangements. For larger businesses, it is often used to fund employee benefit plans.

All of these plans depend on the tax-free nature of the death benefit. However, in 2006, Congress changed the rules with respect to some business-owned policies after certain "janitor" insurance arrangements were widely reported in the press.

Under these (legal) arrangements, companies purchased life insurance on all their employees (including rank and file, such as janitors) without the consent or knowledge of the employees. The death benefits, or in some cases, the cash accumulation, would be used to fund various employee benefit plans.

When survivors of deceased former employees found out about the life insurance paid to the employer, they sued to try to collect the death benefit. Although the survivors lost in court, the outcry was sufficient to cause Congress to investigate and impose new rules that reach far wider than the original perceived abuse.

The new rules apply to employer-owned life insurance (EOLI) and are contained in Internal Revenue Code section 101(j) .

IRC Section 101(j)

Although the code refers to employer-owned policies, the IRS interprets the employer-employee relationship very broadly so any policy owned by any business entity (corporation, partnership, LLC, sole proprietor, etc.) is potentially covered. The starting point is any policy owned by the employer on the life of an employee where the death benefit is payable to the employer.

Common arrangements that are not affected by the new rules are buy-sell arrangements that are structured as cross purchase and executive bonus plans. In these cases, the policies are owned by an individual, not the business.

EOLI and Small Businesses

The small business owner is often regarded as the most desirable client for the life insurance producer. Business owners need life insurance for personal needs, business succession planning and executive compensation or retirement planning. All of these strategies typically are funded with life insurance and depend on the death benefit being income tax-free.

But to ensure this result, new employer-owned policies must comply with additional requirements. Many producers are unaware of these requirements, and the producer can establish credibility with business owners and their producers by being familiar with the new rules.

Requirements Under the Code

IRC Section 101(j) requires that, for the death benefit of a life insurance contract owned by a business to be income tax-free, all three conditions must be satisfied:

- A Notice and Consent form must be obtained prior to the issuance of the policy.
- The employee must meet the specified status requirement.
- The employer must meet reporting requirements.

The rules are effective for all policies issued after August 17, 2006. Policies in effect prior to August 18, 2006, are not subject to the new rules unless there is a material change to the policy.

Notice and Consent Requirement

The business must give notice to the proposed insured and obtain consent to the coverage prior to the issuance of the policy. Since the provisions of the notice and the consent are specific, this has led to the development of Notice and Consent forms for this purpose.

The Notice and Consent form must specify the amount of insurance that is being applied for, and that the business will continue to own and be the beneficiary of the policy after the insured ceases to be employed or associated with the business. The insured must sign the notice and return it to the business. It is the responsibility of the business to obtain the form and to keep it with its records. Signing the insurance application is NOT sufficient to meet this requirement.

Employee Status Requirement

The employee must fall into one of three categories. The first category is any employee (including rank and file) provided that the death benefit is received while the employee is employed or within one year of leaving the business. The second category is employees who are more than 5% owners. The third category is key persons who are defined as the five highest paid officers or individuals among the highest paid 35% of all employees, in both cases at the time of issuance of the policy. The second and third categories will cover nearly all small business planning cases.

Employer Reporting Requirement

The employer must maintain written records and file IRS Form 8925 with the business income tax return. This is a short information form that lists the number of employees, the number of employees on whom the employer has life insurance and the number who have signed a Notice and Consent form.

What Happens if the Business Didn't Get the Notice and Consent Form?

The IRS has not provided any way to remedy the situation. If the failure to obtain the Notice and Consent occurred in the current year and was inadvertent, then IRS Notice 2009-48 states that the Notice and Consent can be obtained before the income tax return is filed for the tax year in which the policy was issued (including extensions but only if requested). For older cases, the best solution may be to obtain a new policy.

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