Employer-Owned Life Insurance

Employers buy life insurance to protect the business, family, partners and key employees from the financial consequences of an unexpected death. They also use life insurance to provide a valuable benefit designed to attract top talent and build loyalty. In some cases, individual owners buy and own needed insurance; in others, the business entity itself buys and owns the needed insurance.

Employers purchasing insurance policies for legitimate business needs must heed the requirements under IRC §101(j) for disclosure, consent, and reporting. The financial stakes are high—failure to comply with these requirements results in the death benefit being included in the employer's gross income, where it is subject to tax.

Employer-Owned Life Insurance Defined

In essence, employer-owned life insurance (EOLI) is a policy owned by the business on the life of a current employee (at the date of policy issuance) where the business is the beneficiary of the policy. It is also referred to as "company-owned life insurance" (COLI) or "corporate-owned life insurance" (also COLI).

In more formal terms, EOLI is:

(1) A life insurance contract 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 under the policy. The "related person" rules are very broadly defined and include family members and business associates in corporations and partnerships under common control, as noted in IRC §101(j)(3).

(2) A policy that covers the life of an insured who is an employee of the applicable policyholder on the date the policy was issued. The term "applicable policyholder" also includes any person who bears a relationship specified in Secs. 267(b), 707(b)(1), or 52(a) or (b).

The term "employee" includes officers, directors, highly compensated employees, or highly compensated individuals.

The term "insured" refers to an individual covered by an employer-owned life insurance contract who is a United States citizen or resident. If the policy covers the joint lives of two individuals, references to an insured includes both of the individuals.

Exceptions to the Application of Sec. 101(j)(1)

The IRC §101(j)(1) exclusion rule provides that when a business receives the death benefit from an EOLI policy, it can only exclude from income the amount paid for the life insurance contract (all premiums and other amounts paid). The balance of the death proceeds is included in gross income, and therefore taxable.

However, there are several exceptions to this income inclusion rule, provided the business meets the notice and consent requirements (defined in the next section):

(1) **Exception for a recent employee:** The insured was an employee of the employer at any time during the 12-month period before the insured's death.

(2) **Exception for a highly compensated individual:** The insured was a director or highly compensated employee or individual at the time the policy was issued. This would include:

- a director

- a 5%-or-greater owner of the employer at any time during the current year or the preceding year

- a highly compensated employee or highly compensated individual with compensation of at least $150,000 for 2023 (adjusted annually for cost-of-living)

- one of the five highest paid officers

- among the highest paid 35% of all employees

(3) **Exception for death proceeds paid to heirs:** The death proceeds are paid to:

- a member of the insured's family, which includes brothers and sisters (including half brothers and half sisters), spouse, ancestors, and lineal descendants

- any individual who is the designated beneficiary of the insured under the contract (other than the employer)

- a trust established for any family member or designated beneficiary, as just described

- the estate of the insured

The exception for proceeds paid to heirs also includes death proceeds used to purchase an equity (or partnership capital or profits) interest in the employer by any family member, beneficiary, trust, or estate. It is intended that death proceeds used to purchase an interest in the employer be paid or used by the due date of the employer's tax return for the tax year in which the proceeds are received as a death benefit. This is necessary to be able to determine if the payment of proceeds or the use of the death proceeds is known in the taxable year for which the exception from the income inclusion rule is claimed.

Notice and Consent Requirements

Since the employer and the insured must comply with the notice and consent requirements to make use of any exception and avoid the general rule of income inclusion, it is important to understand all three elements that the employer must meet before the policy is issued:

(1) Notify the employee in writing that the employer intends to insure the employee's life. The notice must state the maximum face amount for which the employee could be insured at the time the policy is issued. The face amount must be either in dollars or as a multiple of salary.

(2) Obtain the employee's written consent to being insured under the policy (including the possible continuance of the insurance after the insured terminates employment).

(3) Inform the employee in writing that the employer will be directly or indirectly a beneficiary of any proceeds payable on the employee's death.

A sample Notice and Consent form includes these requirements. Click here to view sample (Appendix A).

Effective Date

The effective date of these provisions was August 17, 2006. The income inclusion rule does not apply to contracts issued before that date or contracts issued after that date pursuant to an IRC §1035 exchange.

In addition, if a life insurance policy issued before the effective date experiences certain material increases in the death benefit or other material changes, the policy will generally be treated as a new

contract, and will therefore be subject to the income inclusion rule. However, certain death benefit increases that do not require the insurers' consent will not be considered material death benefit increases that cause a contract to be treated as a new contract. These death benefit increases include:

(1) **Changes required to meet the definition of life insurance.** IRC §7702 requires a mathematical relationship between the contract cash value and the death benefit. As the cash value increases, the death benefit must increase to meet the definition of life insurance tests. Death benefit increases required by the corridor test or cash value accumulation test do not require the insurer's consent, and will not cause the contract to be treated as a new contract.

(2) **Changes due to the normal operation of the contract.** For example, a whole life policyholder may have dividends purchase paid-up additions, which increase the death benefit.

(3) **Changes due to market performance or contract design.** This applies to variable contracts, universal life contracts, and indexed universal life contracts. For example, some contracts provide that the death benefit will equal the original death benefit plus the cash value. With these contracts, the total death benefit will vary depending on the cash value of the policy.

Reporting Requirements

In addition to the notice and consent requirements, every employer that owns one or more employer-owned life insurance contracts issued after August 17, 2006, is required to file a return with the IRS. According to IRC §60391 (part of the Pension Protection Act of 2006), the employer must report the following information:

(1) the total number of employees at the end of the year

(2) the number of employees insured under EOLI contracts at the end of the year

(3) the total amount of EOLI in force at the end of the year

(4) the name, address, and taxpayer identification number of the employer and the type of business being conducted

(5) a statement that the employer has a valid consent for each insured employee or, if valid consents were not obtained, the total number of insured employees for whom valid consents were not obtained

Reporting is done on IRS Form 8925 (Report of Employer-Owned Life Insurance Contracts), which is filed annually with the employer's income tax return.

Recordkeeping Requirements

Each employer owning one or more employer-owned life insurance policies must also keep the records necessary to determine whether the requirements of the reporting rules of IRC §6039 and the income inclusion rules of IRC §101(j) are met. The IRS has issued regulations to guide employers in complying with the reporting and recordkeeping requirements of IRC §6039. See Reg. Sec. 1.6039-1.

Observations and Cautions

Where an EOLI policy has been issued on an employee after August 17, 2006 without compliance with the notice and consent requirements, the death proceeds will be ordinary income to the company. The only corrective measure is for the employer to cancel the existing policy, give notice to the employee, obtain the employee’s written consent, and apply for a new policy.

The IRS has clarified a couple situations where the employer can avoid the inclusion of death proceeds:

- **Policy transfer.** When an employee transfers an existing policy to the employer, the actual transfer of the policy satisfies the notice and consent requirements.
- **Inadvertent failure correction.** An employer who inadvertently fails to satisfy the notice and consent requirements can correct the failure under very limited circumstances. The employer must have: (1) made a good faith effort to satisfy those requirements, such as by maintaining a formal system for providing notice and securing consent from new employees, (2) failed to satisfy the notice and consent requirements inadvertently, and (3) discovered and corrected the failure no later than the due date of the employer's tax return for the tax year in which the policy was issued.

A final issue is the broad definition of "related person." The legislation refers to the employer as the applicable policyholder or "a related person," and defines this term as anyone related to the employer under the family or entity attribution rules. This complicates compliance with the notice and consent requirements. Therefore, the best course may be to comply with the notice and consent requirements at any time an employee is to be the insured, whether or not the employer is to be the owner and beneficiary.

See Notice 2009-48, I.R.B. 2009-24 for additional guidance concerning the treatment and reporting of employer-owned life insurance.

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