

The Pension Protection Act of 2006 and Corporate- or Employer-Owned Life Insurance (COLI or EOLI Best Practices)

The Pension Protection Act of 2006 (PPA), which became law on August 17, 2006 (“the date of enactment”), includes new rules on employer-owned life insurance that are effective for all new policies issued after the date of enactment. These new rules are known as “COLI Best Practices,” and they effectively limit employer- or corporate-owned life insurance (EOLI or COLI) to highly compensated individuals and require the consent of the insured (the new rules also impact Bank-Owned Life Insurance, or BOLI). The new rules under PPA have been incorporated into the provisions of Sections 101(j) and 6039I of the Internal Revenue Code (IRC).

GENERAL RULE

Under Section 101(j), unless the EOLI/COLI policies meet the notice and consent provisions, as well as the highly compensated employee or highly compensated individual requirement (as outlined below in items 1-2), ***the death benefit on a COLI policy will be included in the employer’s income in excess of premiums and other amounts paid on the contract.*** An “employer-owned life insurance contract” is defined as a life insurance contract which: 1) 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 under the contract and 2) covers the life of an insured who is an employee with respect to the trade or business of the applicable policy owner on the date that the contract is issued. The specific requirements of Section 101(j) are as follows:

1. NOTICE

The employee must receive written notice of the policy, the maximum possible face amount of the policy, and that the employer will be the beneficiary of the policy death benefit; and

2. CONSENT

The employee must provide written consent to being insured even after he/she terminates employment.

3. EXCEPTIONS TO THE GENERAL RULE/THREE CATEGORIES OF EMPLOYEES

There are several possible categories of employees that can meet the applicable exceptions under Section 101(j). If the notice and consent requirements outlined on the previous page are met *before the policy* is issued and the insured falls into one of the following categories *at the time that the policy is issued*, then the death benefit proceeds received by the employer from a COLI contract will be income tax free.

- 1) Is an employee at any time during the 12 months preceding his/her death (a “**recent employee**”),
or
- 2) Is a director or among the highest paid 35% of all employees (“a **highly compensated individual**” as defined in IRC Section 105(h)(5)), or
- 3) Is “a **highly compensated employee**” as defined by IRC Section 414(q).

4. EXCEPTION FOR FAMILY BENEFICIARIES AND STOCK REDEMPTION

The only other exceptions to the new income inclusion rule for COLI policies is if the notice and consent requirements are met before the policy is issued and the death benefit is:

- 1) Paid to a member of the insured’s immediate family, to the insured’s designated beneficiary under the policy, to a trust for the benefit of a family member or designated beneficiary or to the estate of the insured; or
- 2) Used to purchase an equity interest in the policyholder (employer) from a family member, beneficiary, trust or estate.

5. EFFECTIVE DATE AND POLICY CHANGES

Section 101(j) applies to contracts issued after the date of enactment of PPA (August 17, 2006), except for contracts issued after that date due to a 1035 exchange. In addition, material increases in the death benefit or other material changes will cause a policy to be treated as a new contract. Exceptions to the rule for material increases include existing lives under a master contract, increases in the death benefit that occur as a result of Section 7702, death benefit increases due to normal operation of the contract and death benefit increases as a result of market performance or contract design (for variable and universal life contracts). Section 101(j) also does not apply to policies on the lives of nonresident aliens (individuals who are neither U.S. citizens nor U.S. residents).

6. EMPLOYER REPORTING AND RECORDKEEPING REQUIREMENTS

Under IRC Section 6039I, employers who own one or more COLI contracts issued after August 17, 2006 are now required to file Form 8925 with their tax return with the IRS for each year that the contracts are owned. The return must state the following:

- The number of employees at the end of the year;
- The number of employees insured under the COLI contracts at the end of the year;
- The total amount of insurance in force under the COLI contracts at the end of the year;
- The employer’s name, address and taxpayer identification number (TIN) and the employer’s business; and

- That the employer has a valid consent form for each insured employee and the number of insured employees (if any) from whom a consent form was not obtained.

In addition, employers that own COLI contracts subject to these new rules must maintain annual records to demonstrate and determine whether the requirements of Section 101(j), such as the notice and consent requirements, are met.

ADDITIONAL IRS GUIDANCE: IRS NOTICE 2009-48 (MAY 22, 2009)

On May 22, 2009, the IRS issued Notice 2009-48 (the Notice), which addresses several questions surrounding the treatment of employer-owned life insurance contracts under IRC §§101(j) and 6039I.

I. Definition of Employer-Owned Life Insurance Contract

The Notice states that a policy is “employer-owned” for §101(j) purposes only if it is owned by a person engaged in a trade or business; a policy that is owned by a business owner or a qualified plan (or VEBA) of an employer is *not* an employer-owned contract for §101(j) purposes. An employer-owned policy subject to a Split Dollar arrangement is subject to the provisions of §101(j), as is a life insurance policy owned by a partnership or sole proprietorship.

Exceptions to the Application of IRC §101(j)

IRC §101(j)(2)(A) and (j)(4) provide exceptions that relate to “the time the contract is issued.” The Notice makes clear that, for these purposes, the policy is “issued” on the later of (1) application, (2) the effective date of coverage or (3) the formal issuance of the contract.

Satisfaction of Notice and Consent Requirements

After noting that the statute does not provide for any cure, the Notice states that the IRS will not challenge an exception based on a failure to satisfy notice and consent requirements if:

- 1) The policyholder made a good faith effort to satisfy the requirements *such as* by maintaining a formal system to do so;
- 2) The failure to satisfy the requirements was inadvertent; and
- 3) The failure to satisfy the requirements was discovered and corrected no later than the due date of the tax return of the policyholder for the year the policy was issued.

The Notice makes clear that notice and consent requirements may be satisfied electronically, notwithstanding the requirement in the statute that they be in writing, so long as the notice and consent meet the content requirements (*e.g.*, intent to insure, maximum amount, consent, etc.). Such an electronic system must also (1) ensure the employee receives the information transmitted; (2) make reasonably certain that the person accessing the system is the relevant employee; (3) provide for electronic signature indicating the employee’s consent; and (4) provide for hard copy upon request of the IRS with the employer’s statement that required notice was given and consent received.

Also of particular interest is the limited shelf life of valid notice and consent: to qualify for an exception under IRC §101(j) an employer-owned policy must be issued before the earlier of (1) the one-year anniversary of the execution of the consent and (2) termination of the insured employee’s employment with the policyholder. If an employee irrevocably transfers a policy to its employer, no written notice and consent is required. However, if the employer subsequently increases the face amount of the insurance, notice and consent are required with respect to the additional insurance.

In addition, the Notice observes that IRC §101(j) provides no exception to the notice and consent requirements for a policy insuring the life of an owner-employee of a wholly owned corporation. Furthermore, a single consent can apply to more than one life insurance policy, so long as the notice of maximum amount is not exceeded.

Transition Rule and Section 1035 Exchanges

The Notice sets forth a list of changes to a policy which are *not* considered to be material for purposes of determining whether a new policy has been issued under IRC §101(j): (1) increases in death benefit resulting from the terms of the contract requiring no consent from the insurer or operation of IRC §7702; (2) administrative changes; (3) changes between general and separate accounts; or (4) changes resulting from exercise of an option or right under the original contract.

Information Reporting under Section 6039I and Form 8925

The Notice states that only policyholders “owning 1 or more employer-owned life insurance contracts” are required to file IRS Form 8925 under IRC §6039I. Thus, “related persons” referred to by the definition under §101(j) of “applicable policyholder” are not anticipated to be required to file, because such persons would not actually own an employer-owned policy.

Effective Date

The Notice is effective June 15, 2009, and asserts that the Service will not challenge a taxpayer who made a good faith effort to comply with §101(j) based on a reasonable interpretation of its provisions before June 15, 2009.

POTENTIAL IMPACT

The provisions of Section 101(j) will potentially impact life insurance policies that are used in a variety of employee benefit and business planning arrangements, including Non-Qualified Deferred Compensation, Key Person insurance, some Buy-Sell arrangements, some Split Dollar arrangements, Section 457(f) plans and BOLI. Significant care should be taken to make sure that the requirements of Section 101(j) are met for any potentially applicable case.

This material does not constitute tax, legal or accounting advice and neither John Hancock nor any of its agents, employees or registered representatives are in the business of offering such advice. It was not intended or written for use and cannot be used by any taxpayer for the purpose of avoiding any IRS penalty. It was written to support the marketing of the transactions or topics it addresses. Comments on taxation are based on John Hancock's understanding of current tax law, which is subject to change. Anyone interested in these transactions or topics should seek advice based on his or her particular circumstances from independent professional advisors.

Insurance products are issued by John Hancock Life Insurance Company (U.S.A.), Boston, MA 02116 (not licensed in New York) and John Hancock Life Insurance Company of New York, Valhalla, NY 10595.

© John Hancock 2009. All rights reserved.

MLINY01271012147 AB



INSURANCE PRODUCTS:		
Not FDIC Insured	Not Bank Guaranteed	May Lose Value
Not a Deposit	Not Insured by Any Government Agency	