

June 2, 2009

## IRS Provides Guidance on PPA Rules for Employer-Owned Life Insurance

The Internal Revenue Service has published guidance, in question-and-answer format, on a number of outstanding issues arising under the new rules for certain employer-owned life insurance contracts enacted in the Pension Protection Act of 2006 (PPA). New [Notice 2009-48](#) provides the first substantive guidance on these provisions.

By way of background, for certain employer-owned life insurance contracts issued (or subjected to certain material changes) after August 17, 2006, the PPA both:

- Imposed new substantive tax requirements in Internal Revenue Code § 101(j). That section provides that, in the case of an employer-owned life insurance contract, the amount of death benefits excluded from the gross income of the “applicable policyholder” under § 101(a)(1) is limited to the sum of the premiums and other amounts paid by the policyholder for the contract. For this purpose, an employer-owned life insurance contract is a life insurance contract that is owned by a person engaged in a trade or business and under which such person is directly or indirectly a beneficiary under the contract, and covers the life of an insured who is an employee with respect to the trade or business on the date the contract is issued. (An “applicable policyholder” is generally the person that owns an employer-owned life insurance contract, or a related person as described in § 101(j)(3).) Section 101(j)(2) provides exceptions for certain employer-owned life insurance contracts if specified notice and consent requirements are met. Those exceptions depend on either (i) the insured’s status as an employee within 12 months of death, or as a highly compensated employee or highly compensated individual at contract issuance, or (ii) the extent to which death benefits are paid to a family member, trust or estate of the insured employee, or are used to purchase an equity interest in the applicable policyholder from a family member, trust or estate; and,
- In § 6039I, required the applicable policyholder to file an information return for each year the contracts are owned.

These provisions are generally described in a [prior alert](#) on the PPA. In addition, previously the Treasury promulgated [regulations implementing § 6039I](#) and the Service published [Form 8925](#) pursuant to those regulations, effective for tax years ending on or after November 14, 2007.

Effective June 15, 2009 (and without taking issue with reasonable positions taken by taxpayers in good faith prior to that date), Notice 2008-49:

- Addresses a number of issues under the definition of employer-owned life insurance, the exceptions to that definition, and the transition rules;
- Fills in details about the notice and consent process; and
- Clarifies that only the “applicable policyholder” that owns the contract, and not related persons included in the applicable policyholder definition, has the Form 8925 reporting obligation.

© 2009 Sutherland. All Rights Reserved.

This communication is for general informational purposes only and is not intended to constitute legal advice or a recommended course of action in any given situation. This communication is not intended to be, and should not be, relied upon by the recipient in making decisions of a legal nature with respect to the issues discussed herein. The recipient is encouraged to consult independent counsel before making any decisions or taking any action concerning the matters in this communication. This communication does not create an attorney-client relationship between Sutherland and the recipient.

## Definitional and Transition Issues

Notice 2009-48 provides generally helpful elaborations of the definition of employer-owned life insurance for these purposes, and the exceptions to that definition. In general, the Notice concludes that these rules are applicable if:

The owner <b>and</b> direct or indirect beneficiary of the contract (“applicable policyholder”) is:	And the policy insures an individual who is, with respect to that applicable policyholder:	And the insured has that status on the date the contract is “issued.”
<p>An entity engaged in a trade or business, including a partnership or sole proprietorship.</p> <ul style="list-style-type: none"> <li>▪ Includes certain related persons to such an entity.</li> <li>▪ Includes a grantor trust (e.g., a rabbi trust) taxed to such an entity.</li> <li>▪ Does not include owners of such entities (as opposed to the business itself), e.g., to finance a cross buy-sell agreement with another owner.</li> <li>▪ Does not include qualified plans or VEBAs sponsored by such entities.</li> </ul>	<ul style="list-style-type: none"> <li>▪ Common law employee;</li> <li>▪ Officer;</li> <li>▪ Director; or</li> <li>▪ “Highly compensated employee” as defined in § 414(q). This picks up:               <ul style="list-style-type: none"> <li>▪ A former employee who was “highly compensated” at the time of separation from service, and</li> <li>▪ A self-employed individual treated as an employee under § 401(c)(1), such as a partner or LLC member.</li> </ul> </li> </ul>	<p>Contract issuance is the later of:</p> <ul style="list-style-type: none"> <li>▪ Date of application for coverage,</li> <li>▪ Effective date of coverage, or</li> <li>▪ Formal issuance of contract.</li> </ul>

The Notice relies on the same “contract issuance” rule to determine if notice and consent was timely provided prior to contract issuance.

- The Notice also includes a “general rule” that the issue date is the date (on or after the date the application is signed) assigned to the contract by the insurance company. While that general rule is useful to supply comprehensive guidance on this timing issue, it is unclear whether any outcome under these provisions will actually be governed by the general rule.

The insured’s status must be redetermined, and notice and consent generally renewed, in the event of a material increase in the contract’s death benefit or other material change in the contract. The following are not material changes:

- Death benefit increases resulting from § 7702 (the statutory definition of “life insurance contract”) or existing contract terms, provided insurer consent to the increase is not required;
- Administrative changes;
- Changes between the general account and separate account of the insurer; and
- Changes resulting from the exercise of a contract option or right granted at original issuance.

The Notice also looks to these principles to determine whether a change in a grandfathered contract is “material,” and thus causes it to be treated as newly “issued” after August 17, 2006, and subject to these provisions. For this purpose, the addition of more covered lives to a master contract is a new “issuance”

only as to new insureds, and a § 1035 exchange does not vitiate grandfathered status unless it results in a material increase in death benefit or other material change (other than the change in insurer).

Finally, the Notice comments on three more particularized definitional issues:

- In the case of a sole proprietorship, a contract insuring the sole proprietor's life is not subject to these rules—thereby avoiding the exercise in futility of distinguishing whether life insurance owned by a sole proprietor on his or her own life is held in a “business” or “personal” capacity.
- To take advantage of the exception for death proceeds used to purchase an equity (including a capital or profits) interest in the applicable policyholder from the insured's heirs, the Notice takes the position that purchase or use must occur by the tax return due date, including extensions, of the applicable policyholder for the year it is treated as receiving those proceeds.
- A contract subject to a split-dollar arrangement is subject to these rules if, *inter alia*, the contract owner (using the rule of ownership in the split-dollar regulations at Treas. Reg. § 1.61-22(c)(1)) is described above, but may qualify for an exception to the extent death proceeds are paid to the insured's specified heirs or beneficiary *and* the notice and consent requirements are satisfied.

## Notice and Consent

Given the language of the statute, the Notice also takes a largely pragmatic approach to a range of issues arising under the notice and consent requirement:

- The “issue” date definition noted above means that, even if coverage takes effect (conditionally or unconditionally) on submission of the application, notice and consent can be effected during the processing and/or underwriting period, so long as that is completed prior to formal contract issuance. This is intended as a helpful rule. The Service did not explain what constitutes the “effective date” of coverage or “formal issuance” of the contract for these purposes, however, so:
  - The conservative planning practice would be to complete notice and consent with the execution of the insurance application, but
  - Even that practice does not necessarily resolve issues that can arise if the status of the insured with the business changes between (i) the application date and (ii) the date of contract delivery or payment of the initial premium or other final step in the formal formation of the insurance contract (i.e., possible outside dates for “formal issuance”). Given the overall tenor of the Notice, however, it seems unlikely the Service intended a trap for the unwary on this point.
- Except as noted below, written notice and consent is required; demonstrable actual knowledge on the part of the insured is not sufficient.
- The notice must specify the maximum face amount of life insurance, by dollar amount or multiple of salary, the applicable policyholder reasonably expects to purchase with respect to the employee during the employee's tenure. This disclosure must be more specific than “the maximum amount for which the employee can be insured,” e.g., the insurer's underwriting limit.
- Notice and consent can apply to more than one contract, although consent expires (i.e., the contract must be issued before) one year after the date of execution by the employee (or, if earlier, termination

of the employee's employment). Thus, if valid notice and consent is provided for coverage up to a specified amount, the employer may, for example, (i) immediately purchase one contract up to the maximum coverage amount, (ii) immediately purchase multiple contracts aggregating up to the maximum coverage amount, or (iii) immediately purchase one contract for part of the maximum coverage amount, and defer purchasing additional coverage up to the balance so long as that additional coverage is issued prior to expiration of the insured's consent.

- Transfer of an existing life insurance contract owned by an employee to the employer automatically satisfies the notice and consent requirement, although notice and consent must be renewed in written form for any subsequent increase in the face amount of coverage.
- Similarly, notice and consent need not be renewed upon exchange of a contract for which notice and consent was previously provided, so long as either (i) the original consent has not expired or (ii) there is no material change in the death benefit or otherwise under the new contract (applying the same principles discussed above).
- Otherwise, however, a material increase in the death benefit or other material change does trigger a new notice and consent requirement.
- Written notice and consent is required even for the owner-employee of a wholly owned corporation.
- Notice and consent may be performed through an electronic delivery system meeting certain requirements (generally, the rules for electronic Forms W-4).
- Inadvertent defects in the notice and consent process can be corrected prior to the tax return due date (presumably, including extensions) of the applicable policyholder for the year in which the contract was issued, provided that (i) the applicable policyholder is maintaining a formal system for meeting the notice and consent requirements for new employees or otherwise is making a good faith effort to comply and (ii) the insured is still living.



*If you have any questions about this development, please feel free to contact any of the attorneys listed below or the Sutherland attorney with whom you regularly work.*

George H. Bostick	202.383.0127	<a href="mailto:george.bostick@sutherland.com">george.bostick@sutherland.com</a>
Daniel M. Buchner	202.383.0869	<a href="mailto:daniel.buchner@sutherland.com">daniel.buchner@sutherland.com</a>
Adam B. Cohen	202.383.0167	<a href="mailto:adam.cohen@sutherland.com">adam.cohen@sutherland.com</a>
Thomas A. Gick	202.383.0191	<a href="mailto:tom.gick@sutherland.com">tom.gick@sutherland.com</a>
James V. Heffernan	202.383.0141	<a href="mailto:james.heffernan@sutherland.com">james.heffernan@sutherland.com</a>
Michael R. Miles	202.383.0204	<a href="mailto:michael.miles@sutherland.com">michael.miles@sutherland.com</a>
Alice Murtos	404.853.8410	<a href="mailto:alice.murtos@sutherland.com">alice.murtos@sutherland.com</a>
Robert J. Neis	404.853.8270	<a href="mailto:robert.neis@sutherland.com">robert.neis@sutherland.com</a>
Christopher Ocasal	202.383.0818	<a href="mailto:chris.ocasal@sutherland.com">chris.ocasal@sutherland.com</a>
Vanessa A. Scott	202.383.0215	<a href="mailto:vanessa.scott@sutherland.com">vanessa.scott@sutherland.com</a>
W. Mark Smith	202.383.0221	<a href="mailto:mark.smith@sutherland.com">mark.smith@sutherland.com</a>
Carol P. Tello	202.383.0769	<a href="mailto:carol.tello@sutherland.com">carol.tello@sutherland.com</a>
William J. Walderman	202.383.0243	<a href="mailto:william.walderman@sutherland.com">william.walderman@sutherland.com</a>
Carol A. Weiser	202.383.0728	<a href="mailto:carol.weiser@sutherland.com">carol.weiser@sutherland.com</a>