Avoiding a New Tax Trap in Business Owned Life Insurance

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Everyone knows that the death benefit on life insurance is income tax free, right? That is the general rule, but sometimes the general rule does not hold. There are two major exceptions to income tax free life insurance death benefits: (1) the transfer for value rule, and (2) business owned life insurance (BOLI). This article reviews a recent Internal Revenue Service notice concerning the second exception—business owned life insurance and, in particular, the effect of Internal Revenue Code (I.R.C.) Section 101(j) rules on insured buy-sell agreements.

Federal Income Tax Treatment of Life Insurance

Life insurance is one of the few assets that receives preferential treatment for tax purposes. Over the past 10–15 years, however, proposals to subject the inside build-up or death benefits of life insurance to income taxation have been raised by members of Congress and the Treasury as a means of increasing governmental revenue. To date, proposals to subject individual life insurance policies to income tax have not engendered widespread support, but over that same period, Congress and the IRS have attacked business uses of life insurance.

In some instances, the death benefit received on life insurance owned by a corporation is subject to the Alternative Minimum Tax. In the early 2000s, the IRS successfully attacked the prevailing tax treatment of split-dollar life insurance, a commonly used structure that splits the policy ownership between a company and an employee. In 2006, Congress amended the I.R.C. by adding a new subsection, I.R.C. 101(j), which simply states that the death benefit of employer owned life insurance contracts issued after August 17, 2006, will be subject to income tax to the extent the death benefit exceeds the sum of the premiums and other amounts paid by the policyholder for the contract. Death benefit taxation of employer owned policies can be avoided if (1) notice and consent requirements are met, and (2) a safe harbor exemption exists. The safe harbor exemptions are based on either the insured's status (detailed below) or who receives the death benefit (generally, the exemptions apply if the death benefit is received by someone other than the employer). The 2006 amendments to Section 101 left open many questions, some of which were addressed by the IRS in June 2009 in Notice 2009-48.

Significance of IRS Notice 2009-48

To avoid death benefit taxation on business owned life insurance, the notice and consent requirement must be complied with *prior* to contract issue. Under Notice 2009-48, a life insurance policy is considered to be issued upon the later of: (1) the date of application for coverage, (2) the effective date of coverage, or (3) the formal issuance of the contract. Essentially, if a policy meets the definition of BOLI, the "applicable policyholder" must give written notice to the employee indicating (1) an intention to insure the

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employee's life, (2) the maximum face amount of intended coverage at time of policy issuance, and (3) a disclosure that the applicable policyholder will be the beneficiary of any death benefits paid. The employee must then give written consent permitting the employer to purchase the policy. The employee's consent must indicate awareness of the coverage amount and the fact that the coverage may extend beyond termination of his or her employment. The death benefit may escape income taxation provided that (1) the

notice and consent requirements are satisfied before policy issuance, (2) the policy is issued within the shorter of one year beginning on the date the consent was executed or before termination of the employee's employment with the applicable policyholder, and (3) one of two safe harbor exemptions applies.

The first safe harbor exemption creates a de facto class of key employees and applies when the insured was (1) an employee at any time during the 12-month period before death, or (2) a director, highly compensated employee, or highly compensated individual at the time the contract was issued. The second safe harbor exemption applies when the death benefit on the policy is received (1) by a family member or estate of the insured, (2) by an individual who is the designated beneficiary of the insured (other than an applicable policyholder), (3) by a trust established for the benefit of a member of the family or designated beneficiary, and (4) for use in purchasing an equity interest in the applicable policyholder. Notice 2009-48 additionally states that for this last safe harbor rule to apply, the life insurance death benefit must be used to purchase an equity interest in the applicable policyholder no later than the due date, including extensions, of the income tax return for the taxable year in which the death benefit is paid. Provided that the notice and consent requirements are met and one of the above exemptions applies, the death benefit remains income tax free.

It seems clear from statutory language of Section 101(j) that entity-purchase buy-sell agreements are subject to the BOLI rules. The death benefit on such a policy will avoid income taxation if notice requirements are met and the safe harbor exemption concerning use of the death benefit to purchase an equity interest in the applicable policyholder applies. Planners wishing to preserve the income tax free death benefit of life insurance used to fund entity-purchase buy-sell agreements must strictly comply with the notice and consent requirements before the policy is issued. Failure to strictly comply with these requirements is likely to result in partial death benefit taxation.

Under the original statutory language of Section 101, the question of whether or not cross-purchase buy-sell agreements would be subject to the BOLI rules was not as clear cut. The definition of business owned contracts included attribution and related party rules that could have potentially classified life insurance policies owned by one business owner on the life of fellow owners as BOLI, even though the business itself was neither the owner nor the beneficiary of the policy. This issue has been clarified by the IRS in Notice 2009-48. IRC Sec. 101(j) defines an employer/business owned life insurance contract as a contract (1) owned by a person engaged in a trade or business, (2) under which such person or a related person is directly or indirectly a beneficiary, and (3) the insured is an employee of the trade or business on the date the policy is issued. Notice 2009-48 clarified that contracts owned directly by the owner of an entity engaged in a trade or business (not by the entity itself) are not subject to the BOLI rules. Although a sole proprietorship is not, itself, a business entity, the IRS further specified that a life insurance policy owned by a sole proprietor on his or her own life (rather than under the trade name of the business) will not be considered BOLI. Consequently, Notice 2009-48 implies that the attribution rules will not apply to life insurance purchased by business owners in their own names to fund cross-purchase buy-sell agreements, thereby avoiding application of the BOLI rules. Thus, the death benefit on those policies will be received by the owners free of federal income tax, provided, of course, that there has been no transfer for value.

Planning Implications of IRS Notice 2009-48

When engaging in entity purchase buy-sell planning with clients, keeping the 101(j) rules in mind is important. Entity buy-sell agreements must strictly meet all of the requirements to preserve an income tax free death benefit. Furthermore, if a material change is made in a policy (even a policy that was originally issued prior to August 17, 2006), the Section 101(j) rules apply. While the IRS will not permit taxpayers to retroactively satisfy the notice and consent requirements after policy issuance, the service has announced that it will not challenge a good faith effort to "fix" the problem, provided that the following conditions are met: (1) the business made a good faith effort to comply with the requirements, (2) the failure to satisfy the requirements was inadvertent, and (3) the mistake is corrected before the due date of the business's tax return for the year the policy was issued. A taxpayer could, for example, use Section 1035 to exchange the existing non-compliant policy to a larger death benefit or a policy that results in a material modification from the current arrangement and, if the notice and consent requirements are met prior to the new policy's issuance, the income tax free death benefit will be preserved.

In Notice 2009-48, the IRS preserved traditional cross-purchase buy-sell planning for business owners, and announced that it would not impose the more complex 101(j) requirements to policies purchased for that purpose. Traditional corporate redemption agreements can preserve income tax free death benefits if the 101(j) requirements are met. While these rules do place a few additional obstacles in the planner's path, the benefits of using life insurance to fund buy-sell agreements has not yet been eliminated. The enactment of Section 101(j), and the IRS's subsequent announcement concerning its application, however, is yet another harbinger of increased governmental scrutiny of the use of life insurance to obtain tax-free benefits. The obvious implication is that financial planners and the life insurance industry must be especially vigilant in a time during which government expenditures, and the resultant need for increased revenues, are rising.