# Employer-Owned Life Insurance Rules May Unintentionally 'Clean Up' More Than Just Wal-Mart 'Janitor Policies'

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**Related Services**

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The Pension Protection Act of 2006 (the PPA) added Section 101 (j) to the Internal Revenue Code (the Code). Although life insurance proceeds are normally excluded from a taxpayer's gross income under Code Section 101(a), unless certain conditions are met, Code Section 101(j) denies this exclusion for amounts exceeding the premiums and other amounts paid by the policyowner of an "employer-owned life insurance contract."

**Employer-Owned Life Insurance Contract.**

Code Section 101(j)(3)(A) defines an "employer-owned life insurance contract" to mean a life insurance contract owned by an employer that covers the life of an officer, director, or employee of the employer (determined as of the date the policy is issued) and under which the employer (or a related person) is a direct or indirect beneficiary.

**Notice and Consent Requirements.**

To fall within the gross income exclusion under Code Section 101 (a), an employer must first meet the following notice and consent requirements. Code Section 101(j)(4) requires that the insured employee must, before the insurance policy is issued:

1. be notified in writing that the applicable policyowner intends to insure the employee's life and the maximum face amount for which the employee could be insured at the time the contract was issued;
2. provide written consent to being insured under the contract and that such coverage may continue after the insured terminates employment; and

3. be informed in writing that the applicable policyowner will be a beneficiary of any proceeds payable upon the death of the employee.

If these three requirements are not met, the insurance proceeds, less the premiums and other amounts paid by the employer for the policy, will be subject to income taxation.

**Gross Income Exclusion — Exception Based Upon Insured's Status; Exception for Payments Made to Insured's Heirs.**

If the notice and consent requirements are met, Code Section 101(j)(2) provides that under the following conditions the proceeds of an employer-owned life insurance contract may be excluded from the gross income of the employer:

1. if an insured was an employee of the policyowner at any time during the 12-month period before the insured's death;
2. if at the time the insurance policy is issued, the insured is:
    1. a director of the policyowner;
    2. a "highly compensated employee" of the policyowner (defined as a 5 percent owner or an employee earning over $110,000), or
    3. a "highly compensated individual" of the policyowner (defined as the five highest-paid officers, 10 percent shareholders, or the highest-paid 35 percent of employees);
3. or to the extent that:
    1. proceeds are paid to a family member of the insured, a designated beneficiary of the insured under the policy (other than the policyowner), a trust established for the benefit of any family member or designated beneficiary of the insured, or the insured's estate; or
    2. proceeds are used to purchase an equity (or capital or profits) interest in the policyowner from a family member of the insured, a designated beneficiary of the insured, a trust established for the benefit of any family member or designated beneficiary of the insured, or the insured's estate.

**Reporting Requirements.**

Code Section 6039I requires policyowners owning one or more employer-owned life insurance contracts issued after the enactment of the PPA (August 17, 2006) to file an annual information return showing for each year such contracts are owned. Such policyowners must report the following information on Form 8925 (Report of Employer-Owned Life Insurance Contracts):

1. the number of employees of the employer at the end of the year;

2. the number of such employees insured under such contracts at the end of the year;
3. the total amount of insurance in force at the end of the year under such contracts;
4. the name, address, and taxpayer identification number of the applicable employer and the type of business in which the employer is engaged; and
5. that the applicable policyowner has a valid consent for each insured employee (or, if all such consents are not obtained, the number of insured employees for whom such consent was not obtained).

**Grandfathered Policies; Exceptions.**

Insurance policies that predate the enactment of the PPA (August 17, 2006) are generally exempt from the provisions of Code Sections 101(j) and 6039I. See Notice 2008-42, 2008-15 I. R.B. 747 (March 23, 2008); T.D. 9431 (March 5, 2008). Such contracts may, however, fall within the scope of these Code Sections, if there is a material increase in the death benefit or other material change in the policy provisions that would cause the insurance contract to be treated as a new contract. See id.

**S Corporations as Policyowners.**

Revenue Ruling 2008-42, 2008-30 I.R.B. 175 (July 1, 2008) provides guidance with respect to employer-owned life insurance contracts owned by S corporations. First, insurance premiums paid by the S corporation on employer-owned life insurance contracts will not reduce the corporation's AAA. Second, death benefits received by the corporation will not increase the corporation's AAA if the insurance proceeds are exempt from income taxation under Code Section 101(j)(2).

**Conclusion.**

As you can see, Code Section 101(j) is exclusionary—policies not falling within the exceptions lose their tax-free treatment. This exclusionary rule was meant to cure abuses by employers that insured many or all of their non-key employees, giving rise to the term "janitor policies;" however, it also may trap unwary employers and companies that own life insurance for the purpose of funding buy-sell agreements.

Employers should review all life insurance policies taken out on the lives of officers, directors, and employees. Policies that predate the enactment of the PPA (August 17, 2006) may be grandfathered. With respect to policies purchased on or after August 18, 2006, employers should ensure that the necessary consents have been obtained from the employees being insured and that annual reporting requirements of Code Section 6039I are being met.