Income Tax Newsletter

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Recent Changes To Section 101

By Robert Nemzin

The Pension Protection Act of 2006 recently amended the Internal Revenue Code with the enactment of §101(j), defining the income tax treatment of proceeds from employer-owned life insurance (EOLI) contracts issued after August 17, 2006. EOLI contracts are typically used as a mechanism to provide a source of income to an employer upon the loss of a key employee and are often seen in the form of a "buy-sell" agreement. To limit the amount an employer may exclude from gross income under an EOLI contract, §101(j) was enacted to provide a general rule of income recognition for the employer for receipt of EOLI proceeds unless the employer falls into one of two permitted exceptions.

Under the first exception, life insurance proceeds under an EOLI contract will be excluded from the gross income of the employer if the insured employee was, at the time the contract was issued, a director or a "highly compensated" employee of the employer within the meaning of §101(j). The purpose of requiring the insured employee to be a director or highly compensated employee is designed to discourage employers from taking out life insurance policies on the lives of employees who are not indispensable to the employer's activities.

Under the second exception, life insurance proceeds are also excludable the from gross income of the employer to the extent the proceeds are paid to the members of the family of the insured employee, to a trust established for the benefit of a member of the family of the insured, to an individual designated beneficiary of the insured under the contract (other than the employer-policyholder), or to the estate of the insured employee.

In addition to fitting into one of the above exceptions, §101(j) also requires notice to and consent of the insured employee of the insurance arrangement to avoid inclusion of EOLI proceeds in the employer's gross income. The notice and consent requirements of §101(j) will be satisfied if, prior to the issuance of the policy: (1) the employee receives written notice that the employer intends to insure the employee's life and the maximum amount for which the employee could be insured at the time policy is issued; (2) the employee is informed that the employer will be the beneficiary of the policy; and (3) the employee provides written consent to being insured under the contract and that such coverage may continue after the employment relationship terminates. These notice and consent requirements can be satisfied in the provisions of the "buy-sell" agreement itself.

In addition, employers that own one or more EOLI contracts issued after the enactment of §101(j) are subject to the annual reporting requirements under new §6039I with the filing of new Form 8925. Under §6039I and Form 8925, employers with EOLI contracts must annually report: (1) the total number of employees of the employer 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 insurance in force at the end of the year under such contracts; (4) the name, address and taxpayer identification number of the employer and the type of business in which it is engaged; and (5) a statement that the employer has a valid consent for each insured employee in accordance with §101(j), or if such consent was not obtained, the number of insured employees for whom such consent was not obtained. Furthermore, §6039I requires policyholders to keep records to demonstrate whether the reporting requirements under §6039I and the general provisions under §101(j) have been satisfied.

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