John Hancock
LIFE INSURANCE

Advanced Markets
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New Guidance on COLI Best Practices

COMPLIANCE BY JUNE 15, 2009 ADVISED

IRS NOTICE 2009-48 (MAY 22, 2009)

Section 101(j) (also known as "COLI Best Practices") of the Internal Revenue Code (IRC) was created by §863 of the Pension Protection Act of 2006. Its provisions are applicable to "employer-owned life insurance contracts," as defined therein, issued after August 17, 2006 (except for a contract issued after that date pursuant to a §1035 exchange for a contract issued on or before that date) and to contracts increased or changed materially after that date. Stated broadly, IRC §101(j) provides that the amount of death benefit received from an employer-owned policy is excluded from gross income of the policyholder only to the extent of premiums and other amounts paid by the policyholder for the contract, except in enumerated circumstances. The section provides exceptions to this rule based on either (1) the status of the insured with respect to the employer or (2) the purpose of the death benefit. These exceptions are available *only if* notice and consent requirements set forth in the section are met before the life insurance policy is issued.

After its creation, the Internal Revenue Service (IRS) issued IRS Notice 2008-42, to provide guidance regarding the application of IRC §§101(j) and 264(f) to life insurance contracts subject to split-dollar arrangements. Subsequently, the IRS released IRS Reg. §1.6039I-1, providing regulatory guidance for the reporting requirements for employer-owned policies. Aside from these pronouncements, tax-payers have received no other guidance for applying the provisions of IRC §101(j).

On May 22, 2009, the IRS issued IRS Notice 2009-48 (the Notice), which addresses several questions surrounding the treatment of employer-owned life insurance contracts under IRC §§101(j) and 6039I. The Notice is in "Q&A" format, with 17 questions grouped under five major headings: (1) Definition of Employer-Owned Life Insurance Contract; (2) Exceptions to the Application of IRC §101(j); (3) Satisfaction of Notice and Consent Requirement; (4) Transition Rule and Section 1035 Exchanges; and (5) Information Reporting under Section 6039I and Form 8925. For the most part, there is nothing surprising in the answers to the questions in the Notice.

I. Definition Of Employer-Owned Life Insurance Contract

The Notice puts to rest some of the more bizarre scenarios that some taxpayers and advisors had contemplated under the "related persons" provisions of IRC §101(j). The first answer 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 an owner of a business entity 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. (But, a word of caution about subtle differences: a later part of the Notice concludes that an employer owning life insurance on the life of an employee that is the sole owner of the employer must satisfy the notice and consent requirements.) This would suggest that employee-owned policies purchased as part of traditional cross-purchase buy-sell planning should not be subject to the provisions of §101(j). However, while the Notice reduces some uncertainty as to which contracts §101(j) applies, it does not make the answer clear. Because the requirements are relatively easy and inexpensive to meet, the prudent taxpayer will err on the side of compliance.

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. Also, not surprisingly, in order to qualify for the exception based on the use of the policy death benefit to purchase an equity interest in the employer from an heir, trust or beneficiary of the insured (e.g., entity redemption buy-sell), the death benefit must be actually used for such purpose not later than the due date for the tax return (including extensions) of the policyholder for the year it received the death benefit.

Satisfaction of Notice and Consent Requirements

More than 40% of the questions addressed in the Notice fall under this heading, including some that have received a lot of attention from taxpayers and advisors. Arguably of most interest is the answer to the question whether an inadvertent failure to satisfy the notice and consent requirements can be corrected. 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 the 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.

Obviously, the questions created here are almost as large as the ones answered: what constitutes "good faith effort" and "inadvertent"? With regard to the third and last requirement, policies issued in 2006 and 2007 for which the notice and consent requirements have not yet been satisfied would appear to be beyond cure.

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 hardcopy 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. (Presumably, this is not a comprehensive list, but the Notice makes no representation in this regard.) The Notice reiterates that IRC §101(j) does not consider a policy received after August 17, 2006, under a §1035 exchange to be "issued" after that date solely due to the exchange. However, a §1035 exchange that results in a material change in the policy (other than issuer), such as an increase in death benefit, is subject to the provisions of §101(j), and a new notice and consent will be required to qualify for an exception.

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

By its own terms, 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. As above, the interpretation of "good faith" and "reasonable interpretation" can provide risk for cases with unusual facts, but the assurance should afford some protection.

A Sample Employee Consent Form and Master Notice and Consent Form for an Employer are included along with this Special Edition of *Central Intelligence*. For more information, stay tuned for our upcoming John Hancock Advanced Markets (JHAM) Radio broadcast on this topic with Stephan Leimberg.

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