ACLI's Request for Guidance under New Sections 101(j) and 6039I

by John T. Adney and Bryan W. Keene

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On Aug. 17, 2006, Congress passed the Pension Protection Act of 2006 (the "PPA") which, among other things, enacted new federal income tax rules for insurance that an employer purchases (for its own benefit) on the lives of its employees. Under section 101(j), as added by the PPA, death benefits in excess of premiums paid under "employer-owned life insurance contracts" are taxable unless the individuals who are insured fall within certain limited classes (*e.g.,* highly compensated employees) or if the death benefits are used for specified purposes (*e.g.,* for the benefit of the insured's heirs) and unless the employer meets certain notice and consent requirements.[1] The PPA also added section 6039I to the Code, which imposes reporting requirements on holders of employer-owned life insurance contracts. Generally, the insurance industry has been supportive of the new rules, which are widely viewed as codifying "best practices" with respect to corporate-owned life insurance (COLI). The new rules generally apply to contracts issued after Aug. 17, 2006, subject to certain transition rules. (For a more detailed discussion of the new COLI best practices rules, see John T. Adney and Bryan W. Keene, *New "Best Practices" Rules for Corporate-Owned Life Insurance,* in the February 2007 edition of *Taxing Times*.)

On April 11, 2007, the American Council of Life Insurers (ACLI) filed a letter with representatives of the Treasury Department (followed by a meeting with the Treasury Department on May 14, 2007, and subsequent letter dated May 21, 2007) to request guidance on several interpretive matters involving the new COLI best practices rules. The ACLI highlighted a number of issues under section 101(j) that it believes need clarification to assist COLI issuers and owners in implementing the new rules. Several of those issues relate to the notice and consent requirements imposed by section 101(j)(4). Generally, to satisfy those requirements, an employer must (1) obtain each insured's written consent to the coverage and that the coverage may continue after employment, (2) notify each insured in writing of the "maximum face amount for which the employee could be insured at the time of coverage," and (3) inform each insured in writing that the employer will be a beneficiary of the death proceeds. These requirements must be met "before the issuance of the contract."

In its letter, the ACLI stated that many employers and issuers have experienced administrative difficulties in meeting the notice and consent requirements in connection with contracts issued shortly after the PPA's effective date. As a result, the ACLI asked the Treasury Department to provide an additional transition rule under which the notice and consent requirements would be deemed satisfied for contracts issued within the first few months *after* Aug. 17, 2006, if the requirements otherwise are met within one year of that date. In other words, in these limited cases the notice and consent requirements could be met after a contract was issued. Similarly, the ACLI requested a rule allowing a one-year "correction period" following the issuance of an employer-owned life insurance contract to correct inadvertent failures to comply with the notice and consent requirements, thereby providing a mechanism to address so-called "foot faults" made in implementing the rules. Finally, with respect to the notice and consent requirements, the ACLI requested guidance on the manner in which an employer may satisfy the requirement to notify the insured of the "maximum face amount for which the employee could be insured at the time of coverage," particularly in situations in which coverage is increased. The ACLI suggested that a new notice and consent should not be required merely because of such an increase, as long as the increased coverage does not exceed the amount described in the original notice, whether expressed as a dollar amount or a formula (such as a percentage of salary).

In addition to issues relating to the notice and consent requirements, the ACLI requested guidance on several other aspects of the new rules. Specifically, the ACLI requested guidance on the classes of "highly compensated" persons who can be insured under section 101(j). In that regard, section 101(j)(2)(A)(ii) provides that tax-

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[1] Unless otherwise indicated, references to "sections" are to sections of the Internal Revenue Code of 1986, as amended (the "Code").

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free treatment of death benefits under employer-owned life insurance contracts will be retained for any contract that insures the life of a "highly compensated employee" or a "highly compensated individual." The provision cross-references sections 414(q) and 105(h), respectively, for the meaning of these terms, with several differences noted in the statute. The guidance requested by the ACLI seeks clarification on how the rules under sections 414(q) and 105(h) should be interpreted in applying section 101(j).

The ACLI also requested guidance on whether the new COLI best practices rules apply in certain specified instances. In particular, guidance was sought on whether the new rules apply to endorsement split-dollar arrangements, to life insurance owned by a VEBA (i.e., a voluntary employees' beneficiary association), or to life insurance owned by a trust established by business owners under a cross-purchase or stock redemption agreement.

Further, the ACLI requested guidance on several issues relating to the effective date and transition rules under the PPA. As indicated above, section 101(j) generally applies to contracts issued after Aug. 17, 2006 (the "general effective date"), subject to two significant exceptions. Specifically, section 863(d) of the PPA states that the new rules apply to contracts issued after the general effective date "except for a contract issued after such date pursuant to an exchange described in section 1035 of the [Code] for a contract issued on or prior to that date. For purposes of the preceding sentence, any material increase in the death benefit or other material change shall cause the contract to be treated as a new contract …" The legislative history for the PPA (provided by the Joint Committee on Taxation) also states that certain types of changes (e.g., certain increases in coverage that do not require the insurer's consent) to a contract issued prior to the general effective date will not cause the contract to lose its "grandfathered" status and become subject to the requirements of section 101(j). The ACLI requested guidance on (1) whether these "grandfathering" rules also apply to contracts issued after the general effective date, such that new notice need not be provided and new consents need not be obtained upon the occurrence of such events, and (2) the application of the grandfathering rules in the context of a tax-free exchange under section 1035 and in the context of "deemed exchanges" that result from material changes that are made to an existing contract.

Finally, the ACLI requested guidance on the reporting and recordkeeping requirements imposed by section 6039I. Those requirements state that certain information must be provided on behalf of each "applicable policyholder," which section 101(j)(3)(B) defines to include not only the entity that actually owns the relevant life insurance contract, but also certain related parties. The ACLI expressed a concern that these requirements might be read to impose reporting requirements on multiple entities with respect to the same employer-owned life insurance contract, and that there is uncertainty regarding the specific information that employers will need to assemble to meet the requirements. As a result, the ACLI asked the Treasury Department to provide guidance on these issues. (The IRS has indicated that there will be no reporting form for 2006 but that it is working to provide such a form beginning with the 2007 tax year.)

At the May 31, 2007, Insurance Tax Seminar held by the Federal Bar Association in Washington, D.C., a representative of the Treasury Department indicated that the Department is considering the issues raised by the ACLI. Stay tuned for further developments on these issues in upcoming editions of *Taxing Times*.

Sections 101(j) and 1035—The IRS Issues Rulings Addressing Employer Owned Life Insurance

by John T. Adney and Michelle A. Garcia

In private letter rulings 200711014 (March 16, 2007) and 200715006 (Jan. 9, 2007), the Internal Revenue Service (IRS) addressed the treatment of employer owned life insurance in the context of section 1035 as well as new section 101(j).[1] In both of these rulings, the IRS dealt with the treatment of "partial block" exchanges of life insurance policies covering the lives of the policyholders' employees under the tax-free exchange rules of section 1035, and in the second ruling—the very first ruling issued by the IRS relating to section 101(j), enacted by the Pension Protection Act of 2006—the IRS also addressed the effect of such an exchange for purposes of the effective date of that provision.

Section 1035 and Partial Block Exchanges

In PLR 200711014, a corporate policyholder owned a block of individual, general account life insurance policies that, at the time the policies were first issued, covered the lives of active employees of the company. The policies involved in the ruling were modified endowment contracts under section 7702A (MECs).

[1] All references to "sections" are to sections of the Internal Revenue Code of 1986, as amended.