



COLI best practices talking points

The following is a brief summary of the rules that apply to employer-owned life insurance policies. It is not meant to be comprehensive or to cover every situation, and should not be construed as tax or legal advice. Policyholders should consult with and rely on the advice of their own tax counsel.

1. Where are the rules found?

The rules are found in section 101(j) of the Internal Revenue Code. Additional guidance can be found in IRS Notice 2009-48.

2. When do the rules apply?

- The rules apply to employer-owned life insurance policies issued after August 17, 2006. They also apply to employer-owned policies issued before August 18, 2006 where there is a material increase in the death benefit or other material change.
- The rules apply to all COLI and BOLI policies, including those purchased in key person, entity buy-sell, deferred compensation and endorsement split dollar arrangements.

3. What are the rules?

In general, a portion of the death benefit in excess of premiums paid will be taxable unless the employer satisfies a notice and consent requirement before the policy is issued, and, in addition, meet one of the exceptions based on status (see 7 below) or use for certain specified purposes (see 8 below).

4. What are the employee notice and consent requirements?

Before an employer-owned policy is issued:

- **The employee must be notified in writing:**
 - That the employer intends to insure the employee's life,
 - That the employer will be the beneficiary of death benefits, and
 - What the maximum face amount covering the employee could be.
- **The employee must give written consent:**
 - To be insured, and
 - That the coverage may continue after the employee terminates employment.

5. How soon after an employee provides written consent must a contract be issued in order for the consent to be valid?

The contract must be issued before the earlier of:

- The expiration of the one-year period beginning on the date the consent was executed, or
- Termination of the employee's employment. Therefore, "warehousing" of consents for more than a year is not permitted.

6. How can an inadvertent failure to satisfy the notice and consent requirements be corrected?

The IRS will not challenge the applicability of an exception based on an inadvertent failure to satisfy the notice and consent requirements if the following conditions are met:

- The taxpayer made a good faith effort to satisfy those requirements, such as by maintaining a formal system for providing notice and securing consents from new employees,
- The failure to satisfy the requirements was inadvertent; and
- The failure to obtain the requisite notice and consent was discovered and corrected no later than the due date of the tax return for the taxable year of the policyholder, in which the employer-owned life insurance contract was issued.

However, failure to obtain consent cannot be corrected after the insured employee has died.

7. What are the insured employee exceptions that allow death benefits to be eligible for income-tax-free treatment?

Provided the notice and consent requirements are satisfied, the death benefit is generally income-tax-free, if the insured was either an employee at any time during the 12-month period before death, or was, at the time of the issuance of the policy:

- A director,
- A greater than 5% owner of the business at any time during the current or the preceding year,
- An employee receiving compensation in excess of \$125,000 in 2019 for policies issued in 2020 and \$130,000 in 2020 for policies issued in 2021, as adjusted for increases in the cost-of-living in future years. Please consult your tax advisor.
- Among the highest-paid 35% of all employees.

8. What uses will allow the insurance proceeds to be eligible for income-tax-free treatment?

Provided the notice and consent requirements are satisfied, COLI death benefits received by the employer will generally be income-tax-free:

- **To the extent paid to:**
 - A family member of the insured,

- A designated beneficiary of the insured under the contract (other than the employer),
- A trust established for a family member or other named beneficiary, or
- The insured's estate.

OR

- **To the extent used by the due date,** including extensions, of the tax return for the year when death benefits under the policy are received, to purchase an equity interest in the employer/policyholder from:
 - A family member of the insured,
 - A designated beneficiary of the insured under the contract (other than the employer),
 - A trust established for a family member or other named beneficiary, or
 - The insured's estate.

9. What constitutes a “material change” to a policy?

Unfortunately, there is no clear answer. The IRS has indicated that a new notice and consent is not required in the following circumstances:

- Contracts issued as a result of a Section 1035 exchange, as long as there is no material increase in the death benefit or material change (other than a change in issuer).
- Increases in the death benefit where the insurance company's consent is not required and that occurs as a result of:
 - IRC Section 7702, or
 - The normal operation of the existing contract, for example:
 - Dividends used to purchase paid-up additions.
 - Variation in the death benefit of a variable universal life contract resulting from changes in the cash value of the contract.
- Certain changes to a contract including:
 - Administrative changes,
 - Changes from general to separate account, or separate account to general account
 - Changes resulting from the exercise of an option or right granted under the original contract.

10. What are the employer reporting requirements?

Employers who own life insurance policies issued after August 17, 2006, are required to report the following information to the IRS annually:

- Total number of employees at the end of the year.
- Number of employees insured under employer-owned life insurance contracts at the end of the year.
- Total amount of insurance in force under such contracts at the end of the year.
- Employer's name, address and taxpayer ID.
- Employer's type of business.
- Statement verifying the employer has valid consent forms for each insured employee.
- Total number of insured employees from whom the employer has not obtained consent forms. IRS Form 8925 (Report of Employer-Owned Life Insurance Contracts) is used for this purpose.

11. How does the Code define an employer-owned life insurance policy?

The term "employer-owned life insurance contract" means a life insurance contract that:

- Is owned by a person engaged in a trade or business, and under which such person (or a related person) is directly or indirectly a beneficiary under the contract, and
- Covers the life of an insured who is an employee of the policyholder on the date the contract is issued. In general, a contract is an employer-owned life insurance contract only if it is owned by a person engaged in a trade or business. Thus, a contract that is owned by the owner of an entity engaged in a trade or business (e.g., shareholder) for purposes of financing a buy-sell between owners is not treated as employer-owned life insurance. Similarly, a policy owned by a qualified plan or VEBA that is sponsored by an entity engaged in a trade or business is not an employer-owned life insurance contract. A contract, however, that is owned by a grantor trust (such as a rabbi trust), assets of which are treated as assets of a grantor that is engaged in a trade or business, is an employer-owned life insurance contract. Ownership of a contract by a partnership or sole proprietorship does not prevent the contract from

being treated as an employer-owned life insurance contract. A life insurance contract that is owned by a sole proprietor on his or her own life is not, however, an employer-owned life insurance contract.

12. How do these rules affect my policyholders?

- The rules apply to employer-owned policies issued or materially changed after August 17, 2006.
- It does not apply to policies issued under an executive bonus arrangement, since those policies are owned by the executive.
- It does apply to employer-owned policies issued for entity buy-sell agreements, key person insurance and endorsement split dollar.

13. Do the rules apply to term insurance?

Yes, if policies are employer-owned. The rules do not differentiate among types of life insurance policies.

14. What do I need to do if a policyholder wants to change in force policies or insure additional employees?

MetLife requests that you:

- Inform the policyholder of the rules and request that the policyholder sign and return MetLife's Employer Acknowledgement Form.
- Advise policyholders to use compliant Notice and Consent Forms and provide MetLife sample forms.

15. What information will MetLife require for new business?

For applications submitted after August 17, 2006, MetLife requests that you:

- Inform the policyholder of the new rules under the Act and request that the policyholder sign and return MetLife's Employer Acknowledgement Form.
- Advise policyholders to use compliant Notice and Consent Forms and provide MetLife sample forms.

16. What if the policy holder has a 1035 exchange?

If a contract is issued after August 17, 2006 pursuant to a section 1035 exchange involving a contract issued on or before August 17, 2006, these rules don't apply as long as there is no material increase in the death benefit or other material change (other than a change in issuer). The policyholder should consult with and rely on the advice of its own tax counsel.

17. Will MetLife require that copies of a policyholder's Employee Notice and Consent Forms be submitted with insurance applications or in the event of a material change?

Yes.

18. Will MetLife provide Notice and Consent Forms for policyholders to use?

For the policyholder's convenience, MetLife will provide sample Employee Notice and Consent Forms. Alternative forms will generally be accepted for our policies, subject to MetLife's discretion. The policyholder's company should consult with, and rely on, the advice of its own tax counsel.

19. Will MetLife require an employer to sign and submit the Employer Acknowledgement Form?

Yes. Please note that even if MetLife accepts an employer's alternative Employee Notice and Consent Form, MetLife procedures will still require that the employer submit a signed Employer Acknowledgement Form.

20. How do the rules affect our grandfathered COLI policies (i.e., those issued before August 18, 2006)?

The Act should not affect your in force COLI or BOLI policies issued before August 18, 2006 unless you choose to:

- Materially change the in force policies, or
- Purchase new COLI or BOLI policies.

21. Our company wants to change our in force grandfathered policies/insure additional employees. What do we need to do?

MetLife requests that you:

- Review, sign and return MetLife's Employer Acknowledgement Form. It outlines the new rules and asks for your company's acknowledgement that you are aware of them.
- Use and submit compliant Notice and Consent Forms. For your convenience, MetLife will provide sample Employee Notice and Consent Forms. Alternative forms will generally be accepted for our policies, subject to MetLife's discretion. Your company should consult with, and rely on, the advice of your own tax counsel.

Any discussion of taxes is for general informational purposes only and does not purport to be complete or cover every situation. MetLife, its agents and representatives may not give legal, tax or accounting advice and this document should not be construed as such. You should confer with your qualified legal, tax and accounting advisors as appropriate.

