



IRS Notice 2009-48 Highlights

1. Definition of Employer Owner Life Insurance:

Ever since the COLI Best Practices Act was enacted in 2006, there have been some open questions regarding the applicability of the Notice and Consent requirements to certain situations. Clearly, the Notice and Consent requirements apply to Employer Owned Life Insurance policies used in key person, entity buy-sell, deferred compensation and endorsement split-dollar arrangements. The confusion has surrounded the potential applicability of the requirements in situations where the policy, though not owned directly by the employer, might still be seen as indirectly owned by the employer. The most glaring of these situations was the use of life insurance to fund a cross-purchase buy-sell agreement. While the policies in such an arrangement are not owned directly by the employer, there was a concern that they might have been seen by the IRS as owned indirectly by the employer. If that was the case, then the notice and consent rules might have applied. However, Notice 2009-48 has provided more clarity as to exactly what situations are considered "employer owned" for purposes of the Notice and Consent requirements.

In the recent Notice, the IRS posed the following question: *Can a contract be an employer-owned life insurance contract if it is owned not by a person engaged in a trade or business, but by a related person who is not engaged in a trade or business?*

The IRS's answer to this question is NO. The answer specifically states "Thus a contract that is owned by the owner of an entity engaged in a trade or business (such as for purposes of financing the purchase of an equity interest of another owner), or by a qualified plan or VEBA...is not an employer owned-owned life insurance contract."

Practical Perspective:

Clearly, the IRS is using the example of a cross-purchase buy sell agreement. In those arrangements, the contract is owned by the owner of an entity for the purpose of purchasing an equity interest of another owner. **Therefore, going forward, MetLife will NOT require a Notice and Consent form in cross-purchase buy-sell settings.** Please keep in mind that if, prior to issue, the desired ownership of the policy applied for is changed so that it can be used in an "entity purchase" instead of a cross-purchase, the Notice and Consent form will still be required prior to issue.

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2. Material Changes

The COLI Best Practices Act applies to policies issued after August 17, 2006. However, a *material change* in a policy (whether or not subject to an IRC §1035 exchange) issued on or *before* this date may cause the contract to be considered a new contract and thus subject to the Notice and Consent requirements of 101(j). Precisely, what type of change is considered “material” was left *and still remains* an open question.

In the recent Notice, the IRS posed the following question: *If there is no actual exchange of an existing employer-owned life insurance contract for a new contract, what changes to the contract are nevertheless sufficiently material to cause the contract to be treated as a new contract and thus subject to 101(j)?*

In its answer, the IRS noted, a new Notice and Consent is required for contracts issued prior to August 17th, 2006 if a subsequent material change occurs. In typical fashion, the Service chose not to define the term “material”, but rather opted to describe “non-material” changes. These *non-material* changes include:

- A. Increases in death benefit that occur as a result of either the operation of IRC §7702, (i.e., cash value accumulation or guideline premium tests) or the terms of the existing contract (provided the insurer's consent to the increase is not required).
- B. Administrative changes.
- C. Changes from general account to separate account or from separate account to general account.
- D. Changes as a result of the exercise of an option or right granted under the contract as originally issued. (e.g., converting term to permanent insurance).

Practical Perspective

There are circumstances where a policy issued prior to 101(j) is later modified. Such changes, may result in an increased death benefit, lower premiums or other adjustments. As noted earlier, in this recent Notice, the IRS has chosen not to define *material*. Keep in mind that natural increases as a result of changes inherent within the life insurance contract are deemed to be immaterial and do not require new Notice and Consent. Consequently, it's recommended to obtain a new Notice and Consent when a contract is modified in a significant manner. For instance, an underwritten death benefit increase will require a new Notice and Consent.

3. Stale Consents are Invalid

An unanswered question after the publication of 101(j), was how soon after an employee provides written consent must a life insurance contract be issued to ensure such authorization is within full compliance with the law.

Specifically, the Notice asks, *How soon after an employee provides written consent must a contract be issued in order for the consent to be valid for purposes of 101(j)(4) with regard to the contract?*

It is important to note that Notice and Consent is generally a one time requirement. This has now been further clarified in the answer provided by the IRS. More precisely, the life insurance policy must be issued prior to the earlier of the close of one year beginning on the date the consent was initially given or the termination of that employee's employment. Further notice regarding the life insurance contract within these timeframes is unnecessary. Be aware, however, that if the total face amount of the employer owned life insurance contract exceeds the amount the employee initially notified and consented to, new Notice and Consent is required.

Practical Perspective

In order for the employee's consent to satisfy IRS requirements, the contract must be issued before the earlier of :

- (a) the expiration of the one-year period beginning on the date the consent was executed, or
- (b) termination of the employee's employment.

Every effort should be made to have the policy issued within the timeframe provided by IRS rules. Otherwise, new employee consents will be required to avoid adverse tax consequences.

4. Inadvertent Failure to Satisfy Notice and Consent Requirement Prior to Issue

One of the main concerns that has existed regarding the COLI Best Practices Act Notice and Consent rules was the fact that the law was silent regarding any means to correct a failure to comply prior to a policy being issued.

In the recent Notice, the IRS posed the question: "How can an inadvertent failure to satisfy the Notice and Consent requirements of Section 101(j)(4) be corrected?"

In answering this question, the IRS acknowledges that the law does not provide a means to correct an inadvertent failure to satisfy the requirements. However, the

Service states that it will not challenge “inadvertent” failures to meet the notice and consent requirements as long as:

- A. The applicable policyholder made a good faith effort to satisfy those requirements (such as maintaining a formal system for providing notice and consent and securing consent from new employees).
- B. The failure to satisfy the requirements was inadvertent, and
- C. 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 employer in which the policy was issued.

Practical Perspective:

A potential means of correcting an inadvertent failure to meet the Notice and Consent requirements is certainly welcome news. However, the relief certainly still contains some subjective issues. Therefore, Underwriting will require the previously mentioned MetLife Combined Employer and Employee Notice -Consent Acknowledgement Form EOLI 0809 form prior to issuing the policy.

Note: failure to obtain consent cannot be corrected after the insured employee has died.

5. Notice and Consent Must be Met Before Policy is Issued:

The COLI Best Practice provisions state that notice and consent must be obtained **prior** to a policy being “issued”. Exactly when that is has been the subject of much debate.

In the recent Notice, the IRS asks: *“Under Section 101(j)(2)(A) and (j)(4), when is a contract treated as “issued” for purposes of determining whether the notice and consent are timely, or whether the insured is a director, a highly compensated employee, or a highly compensated individual at the time the contract is issued?”*

The IRS’s answer is “Solely for purposes of § 101(j)(2)(A) and (j)(4), an employer-owned life insurance contract is treated as “issued” on the **later** of

- A. The date of application for coverage,
- B. The effective date of coverage, or
- C. The formal issuance of the contract.

Thus, if an employer-owned life insurance contract is effective for a limited period of time before formal issuance of the contract (such as to complete underwriting), the notice and consent requirements may be satisfied during the period between the effective date of coverage and formal issuance of the contract”.

Practical Perspective

This question makes it clear that Notice and Consent can be obtained prior to the formal issuance of the policy even in situations where a “binding check” is obtained and temporary coverage is in effect prior to issue.

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