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Corporate Owned Life Insurance (COLI): Insurance and Tax Issues

Baird Webel, Government and Finance Division

May 29, 2007

Abstract. This report begins with a general background on COLI, followed by an overview of the congressional activity of the past few years. It then addresses federal limitations on COLI from previous years, discusses state approaches to the issue, and concludes with an analysis of the issue from a public-finance perspective. It will be updated in the event that legislation dealing with COLI progresses.

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Baird Webel
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Summary

Life insurance policies taken out by and payable to companies on their employees, directors, officers, owners, and debtors are commonly known as corporate (or company) owned life insurance (COLI) policies. Such policies are separate and distinct from typical group life insurance policies offered to many employees as an employment benefit. In general, only the company, not the employee's family or other beneficiary, receives any benefit from a COLI policy. In some cases, employees or their families have no knowledge of any policy being taken out. Concerns about people "gambling" on the deaths of strangers has led to "insurable interest" laws in most states that require some possibility of financial loss as the result of an insured's death as a prerequisite for the purchase of life insurance. Although employment has generally been accepted to fulfill the need for an insurable interest, many have expressed concern about employers holding policies on lower-paid employees and continuing to hold policies after a worker has left employment.

Although the chief historical justification for the favorable tax treatment of life insurance focuses on individuals, not companies, COLI policies enjoy the same basic preferences as other life insurance. As a result, a corporation enjoys either tax-deferred or tax-free growth of funds invested in COLI plans. These tax preferences are a large reason for companies to choose COLI policies rather than simply investing the money in a more straightforward way. Moreover, under certain circumstances, companies have taken loans using the cash value of the life insurance policy as collateral, used the loan proceeds to pay for the premiums of the life insurance policies, and then deducted the interest expense from their taxable income, further enhancing the advantages of COLI-related transactions. In the past, Congress has restricted the instances in which this interest is allowed to be tax deductible.

Legislation on COLI was first introduced by Representative Gene Green in the 107th Congress. In the 110th Congress, Representative Green's bill, the Life Insurance Employee Notification Act (H.R. 150), was introduced January 4, 2007. The 108th Congress saw several bills introduced and both floor and committee amendments on the issue. While language somewhat limiting COLI and requiring employee notice and consent was agreed to in the Senate Finance Committee in 2004 and attached to S. 2424, the 108th Congress did not enact any COLI legislation into law. Legislation in the 109th Congress with the Senate Finance Committee language regarding COLI included S. 219, S. 1783, S. 1953, H.R. 4, H.R. 2251, and H.R. 2830. Ultimately the 109th Congress passed H.R. 4 and it was signed by the President on August 17, 2006.

This report begins with a general background on COLI, followed by an overview of the congressional activity of the past few years. It then addresses federal limitations on COLI from previous years, discusses state approaches to the issue, and concludes with an analysis of the issue from a public-finance perspective. It will be updated in the event that legislation dealing with COLI progresses.

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Introduction

Life insurance policies taken out by and payable to companies on their employees, directors, officers, owners, and debtors are commonly known as corporate (or company) owned life insurance (COLI) policies. Such policies enjoy the same two basic preferences under the tax laws as other life insurance.[1] First, death benefits paid under life insurance policies are not taxable income to the beneficiaries of the policies. Second, increases in the value of the policies over and above the premiums paid that result from investment earnings on such premiums are not taxable unless the policy is surrendered prior to the death of the insured. This second preference is generally referred to as the "tax-free inside buildup" of life insurance.[2] Therefore, the corporation enjoys either tax-deferred growth or tax-free growth of funds invested in COLI plans. This tax treatment of COLI policies explains a large portion of their usage, because it is certainly possible for a corporation to make a similar investment without the complication of a life insurance policy. Without the life insurance policy, however, such investments would be subject to regular taxation.

In addition, under certain circumstances, companies have deducted the interest expense for loans from COLI policies from their taxes. Some companies have then used the loan proceeds to pay for the premiums of the life insurance policies, further enhancing the advantages of COLI-related transactions. Congress has increasingly restricted the instances in which this interest is allowed to be tax deductible. The payment of premiums by the company, on the other hand, is not tax deductible.

While the federal tax preferences for life insurance have been enacted by Congress, the ability of firms, as well as individuals, to purchase such insurance in the first place is regulated by the states. Because of this, the state and federal governments effectively have a joint role in the regulation of life insurance policies for tax purposes. The most basic requirement that states have instituted for purchasers of life insurance is that a policyholder must be able to demonstrate "an insurable interest" in the insured.[3] Companies have typically justified an insurable interest in employees, officers, directors, and owners based on the potential financial costs associated with the death of those individuals. Some states require the insurable interest to be established only at the time the insurance is purchased; therefore, companies may continue to hold life insurance policies and enjoy the tax advantages of COLI policies covering insureds no longer employed by the company.

Background on COLI

COLI can be acquired on an individual or group basis, and the employer generally becomes the applicant, owner, premium payer, and beneficiary of the policy. Because the corporation pays all of the premiums and receives all of the benefits, neither the individuals actually insured nor their heirs receive any of the death benefits. Thus, COLI is not an employee benefit and should not be confused with group life insurance benefits that employers provide to their employees. COLI can

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[1] For further discussion on the taxation of life insurance in general, see CRS Report RL32000, *Taxation of Life Insurance Products: Background and Issues*, by Andrew D. Pike.

[2] For a discussion of the tax-free growth within life insurance policies, see CRS Report RS20923, *Taxes and the "Inside Build-Up" of Life Insurance: Recent Issues*, by David L. Brumbaugh.

[3] An *insurable interest* is an interest that might be damaged by the death of the insured individual.

take many forms. Traditionally, narrow-based programs known as "key man insurance" have been used by corporations to insure the lives of their top executives and to protect themselves against the death of those key employees who are especially difficult or costly to replace. Other related uses of narrow-based COLI programs have included the financing of individual stock redemption agreements or deferred compensation plans for key employees.

According to news reports,[4] some companies have used broad-based COLI programs that cover not only key officials, but all or most of a corporation's employees. This relatively new application of the principles of COLI apparently developed to generate a funding source for other corporate purposes (e.g., executive benefits, supplemental pensions, and broader employment-related benefits, such as retiree medical plans). The use of COLI to fund retiree medical benefits is largely attributable to the promulgation of Statement 106 by the Financial Accounting Standards Board (FASB 106). Under FASB 106, post-retirement benefits, including retiree health benefits, are required to be recognized as a cost as they are earned over the working lifetime of the employee, rather than as they are paid after retirement. If these accrued benefits are not funded in some manner, they create a growing balance sheet liability.

The COLI benefits accruing to a corporation from the death payouts on employees and the tax-free inside buildup in the value of the policies can be used to create a balance sheet asset that the corporation can use to offset the liability and finance the cost of retiree benefits. Advocates of using COLI to finance such post-retirement benefits assert that without such funding, many companies would discontinue their voluntary retirement health benefits. On the other hand, critics claim that companies should not profit from the deaths of rank-and-file employees, sometimes referring to COLI as "janitor's insurance" or "dead peasant insurance," and note that although companies claim to be using COLI to finance employee benefits, there is no regulation of this use as there is for benefit plans under the Employee Retirement Income Security Act (ERISA), which also provides for tax-preferred investments to fund employee benefits.

When banks purchase COLI policies, they are sometimes referred to as *bank-owned life insurance* (BOLI) policies. In 1996, the Office of the Comptroller of the Currency (OCC) issued general guidelines for national banks to ensure that bank purchases of BOLI are "consistent with safe and sound banking practices."[5] The OCC determined that a purchase of life insurance is incidental to banking and therefore legally permissible, if it is convenient or useful in connection with the conduct of the bank's business. The OCC guidelines specifically state that national banks may use COLI as a financing or cost recovery vehicle for pre- and post-retirement employee benefits, that the value of COLI is a corporate asset even after the employer/employee relationship is terminated, and that employees have no interest in the insurance other than their general claim against corporate assets arising from the corporation's obligation to provide the stated benefits.

In April 2002, the *Wall Street Journal* initiated a three-part series subtitled "Janitor's Insurance—Profiting When Employees Die"[6] on COLI plans. The articles were critical of COLI and named

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[4] See, for example, Ellen E. Schultz and Theo Francis, "Worker Dies, Firm Profits—Why?," *Wall Street Journal*, April 19, 2002, pp. A1, A8; "Many Banks Boost Earnings With 'Janitors' Life Insurance," *Wall Street Journal*, April 26, 2002, pp. A1, A2; and "Big Banks Quietly Pile Up 'Janitors' Insurance," *Wall Street Journal*, May 2, 2002, pp. C1, C11.

[5] Office of the Comptroller of the Currency, "Bank Purchases of Life Insurance: Guidelines for National Banks," OCC Bulletin 96-51, September 20, 1996 (1996 WL 560115).

[6] See, for example, Ellen E. Schultz and Theo Francis, "Worker Dies, Firm Profits—Why?," *Wall Street Journal*, April (continued...)

major corporations that reportedly have put millions of dollars into COLI policies insuring thousands of employees. The articles pointed out that the death benefits paid to the corporations on their COLI policies were tax free, and that the value of the COLI policies in force also yielded tax free income on their inside buildup. Although most corporations surveyed by the *Wall Street Journal* indicated that they use the money from COLI insurance benefits to help pay for various employee and retiree benefits, some used the benefits for other purposes, such as executive compensation. The May 2 article stated that some of the largest U.S. banks hold billions of dollars in COLI insurance on their present and former employees, and the April 26 article alleged that some banks receive as much as 10% to 15% of their net income from the tax-free earnings they get on premiums they pay on COLI policies. Following the *Wall Street Journal* series, other major newspapers, including the *Washington Post*,[7] carried articles critical of COLI/BOLI.

Recent Congressional Activity

Although it would be within congressional authority to simply preempt the current state regulatory system, the congressional approaches to addressing questionable COLI practices would address such practices without directly preempting states. These approaches include using the Federal Trade Commission's power over "unfair trade practices" and placing requirements on the tax-free usage of COLI. Ultimately Congress passed H.R. 4 in the 109th Congress enacting an approach based around the tax code.

Legislation in the 110th Congress

H.R. 150, the Life Insurance Employee Notification Act, was introduced by Representative Gene Green on January 4, 2007. It would deem the nondisclosure of employer-owned life insurance coverage of employees an unfair trade practice under Section 5(a)(1) of the Federal Trade Commission Act.[8] It also would require a detailed written notice to each employee and former employee for whom the employer carries a COLI policy. Representative Green introduced the same language in the 108th Congress as H.R. 414 and the 109th Congress as H.R. 107.

Legislation in the 109th Congress

H.R. 4, the Pension Protection Act of 2006, was introduced by Representative John Boehner on July 28, 2006, after conference negotiations to resolve the differences between H.R. 2830 and S. 1783. It passed the House on July 28, the Senate on August 3, and became P.L. 109-280 when it was signed by the President on August 17. It included, in Section 863, language to add requirements to the tax code in order for a COLI policy to enjoy the typical tax advantages of life insurance. These requirements were that these policies must be on directors or highly compensated individuals and that insured employees must be notified and provide written consent at the time the life insurance contract is issued. Companies were also required to file a yearly

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19, 2002, pp. A1, A8; "Many Banks Boost Earnings With 'Janitors' Life Insurance," *Wall Street Journal*, April 26, 2002, pp. A1, A2; and "Big Banks Quietly Pile Up 'Janitors' Insurance," *Wall Street Journal*, May 2, 2002, pp. C1, C11.

[7] Albert B. Crenshaw and Bill Brubaker, "Companies Gain a Death Benefit," *Washington Post*, May 30, 2002, p. E1.

[8] 12 U.S.C. 45(a)(1).

return with the Secretary of the Treasury detailing their usage of COLI policies. This language grew out of Finance Committee activity during the 108th Congress (detailed below). Although this language would have been more restrictive than then-current COLI requirements, the Joint Tax Committee's revenue estimates from the 108th Congress found that it would not raise appreciable revenue. This would suggest that the language would not substantially change the total amount of COLI policies purchased, though it might change the types of employees who are covered by those policies.

H.R. 2830 was originally introduced by Representative John Boehner as the Pension Protection Act of 2005; after being amended by the Senate, its title became the Pension Security and Transparency Act of 2005. As introduced and passed by the House, it did not include provisions addressing the COLI issue. After its passage by the House in December 2005, the Senate took up the bill on March 3, 2006, and amended it with the text of S. 1783, including the COLI language, as detailed below. After conference negotiations on this bill, the House and Senate ultimately took up and passed H.R. 4, the Pension Protection Act of 2006.

S. 1783, the Pension Security and Transparency Act of 2005, was introduced by Senator Chuck Grassley on September 28, 2005. Its COLI language was identical to that in S. 219 from the 109th Congress and S. 2424 from the 108th. The Senate passed S. 1783 on November 16, 2005.

S. 219, the National Employee Savings and Trust Equity Guarantee Act of 2005, was introduced by Senator Grassley on January 31, 2005. Its COLI language was identical to that in S. 2424 from the 108th Congress.

S. 1953, also entitled the National Employee Savings and Trust Equity Guarantee Act of 2005, was introduced by Senator Grassley on November 2, 2005. Its COLI language was identical to that in S. 219 and S. 1783 from the 109th Congress and S. 2424 from the 108th Congress.

H.R. 107, the Life Insurance Employee Notification Act, was introduced by Representative Gene Green on January 4, 2005. It would have deemed the nondisclosure of employer-owned life insurance coverage of employees an unfair trade practice under Section 5(a)(1) of the Federal Trade Commission Act.[9] It would have required a detailed written notice to each employee and former employee for whom the employer carries a COLI policy. Representative Green introduced the same language in the 108th Congress as H.R. 414.

H.R. 2251, the COLI Best Practices Act of 2005, was introduced by Representative Tom Reynolds on May 11, 2005. It contained in a stand-alone vehicle the requirements found in S. 219 and S. 1783, namely that tax-advantaged COLI policies cover only directors and highly compensated employees, that such employees be notified and provide written consent, and that companies file yearly returns detailing their COLI use.

Legislation in the 108th Congress

H.R. 414, the Life Insurance Employee Notification Act, was introduced by Representative Gene Green on January 28, 2003. It would have deemed the nondisclosure of employer-owned life insurance coverage of employees an unfair trade practice under Section 5(a)(1) of the Federal

[9] 12 U.S.C. 45(a)(1).

Trade Commission Act.[10] It would also have required a detailed written notice to each employee and former employee for whom the employer carries a COLI policy.

H.R. 2127, the Taxpayer Savings and Employee Notification Act of 2003, was introduced by Representative Rahm Emanuel on May 15, 2003. It contained notification provisions as in H.R. 414, but went beyond notification and would have repealed the tax benefits relating to COLI. H.R. 2127 would have included in a companies's taxable gross income both the inside buildup and the proceeds of a company-owned life insurance policy above the premiums paid except in a limited number of circumstances, such as policies on "key persons." Representative Emanuel also introduced a similar amendment on the tax benefits of COLI in the March 12, 2003, Budget Committee Markup of the FY2004 Budget, H.Con.Res. 95. This amendment was defeated by a vote of 17-24.

S.Amdt. 662, by Senator John Edwards, along with Senators John McCain and Lindsey Graham, was offered on May 15, 2003, during the debate on S. 1054, the Jobs and Growth Tax Relief Reconciliation Act of 2003. This amendment was similar to H.R. 2127 in that it would have eliminated the tax benefits of COLI, but it did not include the notification provisions common to both House bills. The amendment fell on a point of order made by Senator John Kyl under the Congressional Budget Act of 1974 because it was ruled not germane to the underlying reconciliation measure. Prior to this, a motion to waive the point of order was defeated by a vote of 37-63.

S. 2424, the National Employee Savings and Trust Equity Guarantee Act was introduced by Senator Chuck Grassley on May 24, 2004, and included language (Section 812) adding requirements to the tax code in order for a COLI policy to enjoy the typical tax advantages of life insurance. These requirements are that these policies must be on directors or highly compensated individuals and that insured employees must be notified and provide written consent at the time the life insurance contract is issued. Companies are also required to file a return with the Secretary of the Treasury detailing their usage of COLI policies. S. 2424 was reported by the Finance Committee but not acted upon by the full Senate before the end of the 108th Congress.

Consideration began on the bill that would become S. 2424 while it was still in draft form several months earlier. In a September 17, 2003, markup of the draft S. 2424, Senator Jeff Bingaman offered an amendment that would remove the tax-preferred nature of the majority of COLI policies. This amendment was adopted by the Finance Committee, but the draft bill was not introduced or brought to the floor at the time. Prior to the next Finance Committee markup, on S. 1637, the Jumpstart Our Business Strength Act, Senator Bingaman re-filed his amendment. In addition, Senator Kent Conrad filed an amendment, later modified, that would have required notification and would have restricted the tax advantages of COLI to a much lesser extent than Senator Bingaman's amendment.[11] In response to these filings, Chairman Grassley scheduled a hearing to directly consider the issue, and neither amendment was offered at the markup of S. 1637.

[10] 12 U.S.C. 45(a)(1).

[11] For details, see U.S. Congress, Joint Committee on Taxation, *Present-law Federal Tax Treatment, Proposals, and Issues Relating to Company-owned Life Insurance ("COLI")*, JCX-91-03, pp 17-19, found at http://www.house.gov/jct/x-91-03.pdf.

The Senate Finance Committee hearing on COLI was held October 23, 2003; it was followed by an additional markup of the draft S. 2424 on February 2, 2004. At this markup, Senator Bingaman's amendment was replaced with a modification presented by the Chairman. This modification, ultimately included in S. 2424 and subsequent legislation, was strongly supported by the life insurance industry. It retained the tax-preferred nature of COLI for policies that met notification and consent requirements and that were restricted to "highly compensated" employees, including key persons.[12] The Joint Committee on Taxation's revenue estimate indicated that this amendment would have a negligible revenue impact, suggesting that the total volume of COLI usage by corporations will not be significantly affected.

In addition to this legislative activity, the Joint Committee on Taxation issued a report recommending repealing the grandfather rules associated with pre-1986 COLI contracts (see below) as a result of the committee investigation of the federal tax issues surrounding the Enron corporation.[13]

Past Limitations on COLI

The interest in COLI over the past few years is only the most recent congressional focus on the issue. Three times in the past two decades, the tax benefits of COLI have been limited by legislation, each time relating to the tax deductibility of interest on COLI-related loans. In 1986, Congress capped deductible interest for indebtedness exceeding $50,000 per individual contract.[14] Only interest on loans related to policies purchased after June 20, 1986, was specifically covered. It has been suggested that companies responded to this limitation by expanding the coverage of life insurance from upper management to rank and file employees, thus generating more COLI-related loans, albeit at the capped amount.[15] In 1996, Congress approved legislation that entirely eliminated (with a phase-out rule) the interest deduction for loans on policies covering employees or officers, except for key persons.[16] Further, Congress capped deductible interest rates on key persons and pre-1986 contracts based on an average corporate bond rate. At least one business reacted by proposing to expand life insurance contract coverage and related tax-advantaged loans to policies covering customers, specifically mortgagors.[17]

Congress addressed this behavioral response in 1997 by further restricting interest expense deductions for life insurance loans.[18] The 1997 change required that interest deductions be

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[12] A description of the Chairman's Modification can be found on the Senate Finance Committee website at http://finance.senate.gov/sitepages/leg/012904modnes.pdf.

[13] U.S. Congress, Joint Committee on Taxation, *Report Of Investigation Of Enron Corporation And Related Entities Regarding Federal Tax And Compensation Issues, And Policy Recommendations*, JCS-3-03, 108th Cong., 1st sess. (Washington: GPO, 2003), vol. I, p. 34.

[14] Tax Reform Act of 1986, P.L. 99-514, Sec. 1003. As a note, the $50,000 limit was not indexed to inflation.

[15] Ellen E. Schultz and Theo Francis, "Death Benefit: How Corporations Built Finance Tool Out of Life Insurance—Firms Homed In on Tax Breaks With Coverage on the Lives Of Millions of Employees—The Payout Following September 11," *Wall Street Journal*, December 30, 2002, Sec. A, p.1.

[16] Health Insurance Portability and Accountability Act of 1996, P.L. 104-191, Sec. 501. Key persons were defined as an officer or 20% owner. The number of key persons cannot exceed 20 and may be further limited depending on the size of the company.

[17] Kenneth R. Harney, "Fannie Mae Designing a Program To Link Insurance, Loans," *The Washington Post*, February 8, 1997, Sec. E, p.1.

[18] Taxpayer Relief Act of 1997, P.L. 105-34, Sec. 1084. Insurance policies issued after June 8, 1997, are subject to the (continued...)

reduced through a pro rata calculation based on the ratio of the cash value of a corporation's life insurance policies to a corporation's total assets. However, policies for employees, directors, officers, and specified owners were explicitly excluded from this calculation, suggesting the change was intended to address specific policies, such as those covering borrowers. This mechanical approach has the effect of disallowing the interest deduction for cases such as lender policies covering mortgagors.

In addition to the increased restrictions Congress imposed on COLI interest deductions, the Internal Revenue Service (IRS) successfully litigated several cases of what it considered to be abuse.[19] Also, the IRS offered a settlement initiative to encourage the disclosure of questionable transactions and induce payment of a portion of the presumed tax liability.

Given the several restrictions imposed, it is useful to identify the type of interest expense associated with COLI loans that continues to be tax deductible. Interest deductions on debt related to COLI remain for at least two types of policies: contracts purchased on or before June 20, 1986, as a result of the Tax Reform Act's grandfather rule, and policies covering key persons. Furthermore, because debt is fungible, and because the interest expense a company pays to support investment in general is tax deductible, some companies may borrow for other purposes and simultaneously have the finances available to purchase tax-advantaged COLI policies. Under such circumstances, debt that is in fact used to finance COLI is difficult to distinguish from that which is not.

President Clinton included an expansion of the pro rata limitation for interest expense deductions as a component of his FY1999, 2000, and 2001 budget proposals. These proposals would have expanded the mechanical pro rata approach passed in 1997 by eliminating the exceptions from the calculation, other than for 20% owners. However, the proposals were not adopted. The Joint Committee on Taxation estimated that disallowing interest deductions in relation to the proportion of assets invested in COLI would have generated $200 million in additional revenue in FY2004 and $5.8 billion over the following 10 years (FY2004 through FY2013).[20]

State Issues and Activities

Unlike many other financial institutions that are regulated primarily at the federal level, insurance companies have been regulated by the states for the past 150 years.[21] State laws in the large majority of states require that to purchase COLI, the employer must have an insurable interest in the life of an insured employee. However, the exact wording of these statutes varies. In general, the state statutes provide that an insurable interest exists if the insured employees would benefit from an employee benefit plan provided by the employer, or that the insurable interest depends on

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pro rata allocation.

[19] See *Winn-Dixie Stores, Inc. v. Commissioner*, 113 T.C. 254 (1999); *Internal Revenue Service V. CM Holdings, Inc.* 254 B.R. 578 (D.Del. 2000); and *American Electric Power, Inc. v. United States*, 136 F. Supp. 2d 762 (S.D. Ohio 2001). However, on March 31, 2003, Dow Chemical prevailed in a suit regarding its COLI tax liability. See *Dow Chemical Co., et al. v. United States*, Case No. 00-10331-BC, E.D. Mich., March 31, 2003.

[20] U.S. Congressional Budget Office, *Budget Options* (Washington: GPO, March 2003) p. 205.

[21] For additional information on state insurance regulation, see CRS Report RL32789, *Insurance Regulation: Issues, Background, and Current Legislation*, by Baird Webel.

the loss to the corporation if the insured dies. Some states provide for an insurable interest in both situations.

If an insurable interest does exist, the next issue under state laws is whether companies must give notice to, or receive the consent of, employees covered under a COLI policy. At least 48 states now have laws requiring some form of notification or consent from an insured employee before a COLI policy can be issued. A number of states require actual consent (opt-in), some in writing, but others assume consent if the employee does not object (opt-out). In 1993, state insurance regulators, through their trade association, the National Association of Insurance Commissioners (NAIC), adopted model COLI guidelines explaining that COLI is generally used to provide employee benefits, such as a retiree health benefit plan. Following the controversy generated on the issue, the NAIC revised these guidelines at the end of 2002. The revised NAIC guidelines recommend that states considering a legislative response to insurable interest concerns should consider the following elements for inclusion in their law (2002 additions in italics):

> 1. The law should recognize that employers have a lawful and substantial economic interest in the lives of key employees and in other employees who have a reasonable expectation of benefitting from an employee welfare benefit plan.
>
> 2. Employers should be required to notify eligible employees of their proposed participation in the plan and the employees should be given an opportunity to refuse to participate. *On a prospective basis, employers should obtain written consent of each individual being insured. Consent would include an acknowledgment that the employer may maintain the life insurance coverage even after the insured individual's employment has terminated.*
>
> 3. *An employer shall not retaliate in any manner against an employee or a retired employee for refusing consent to be insured.*
>
> 4. For non-key or non-managerial employees, the amount of coverage should be reasonably related to the benefits provided to the employees.
>
> 5. With respect to employer-provided pension and welfare benefit plans, the life insurance coverage purchased to finance the plans should only be allowed on the lives of those employees and retirees who, at the time their lives are first insured under the plan, would be eligible to participate in the plan.[22]

Because the NAIC has no ability to compel the states to act on this or any other issue, these revisions would become effective only on a state-by-state basis, as state legislatures enact laws following the guidelines. Meanwhile, as to BOLI policies held by banks, OCC guidelines applicable to national banks encourage compliance with other applicable legal and regulatory considerations, such as state insurable interest laws, but do not specifically address the issue of employee notification or consent. This omission could lead to confusion and inconsistencies in BOLI, and possibly to state-federal regulatory conflict.

[22] NAIC, *Model Laws, Regulations and Guidelines*, vol. III (Kansas City, MO: 2003), p. 602-2.

Tax Issue Analysis[23]

A chief historical justification for the favorable tax treatment of life insurance in general has been to encourage behavior that improves the financial security of surviving family members (particularly widows and orphans). Supporters of the COLI tax advantages assert that companies purchase policies for two fundamental purposes: to meet and structure payments for employee benefits and to protect against potential financial losses in the event of the death of the insured. They add that such losses may be particularly significant for small businesses with a small contingent of integral employees. With regard to employee benefits, proponents indicate that COLI provides an important financing vehicle, with known premium expenses, that can ultimately provide a stream of earnings to match expected employee benefit liabilities.[24]

Critics question the motivation of COLI-related transactions and assert some companies primarily purchase policies to take advantage of the tax-free investment buildup within life insurance policies coupled with tax-deductible interest on related loans. Critics argue that some companies may simply be taking advantage of the asymmetrical tax treatment. Stories in the media about surviving family members who were not beneficiaries of a life insurance policy themselves while the one-time employer of the insured benefits from tax-free profits at the time of death may fuel the negative appearance of the transactions.

According to economic theory, the primary justification for preferences in the tax code is to address market failures. In particular, provisions in the tax code can be used to encourage (or restrain) certain behaviors. For example, a common market failure related to the provision of insurance is that of *adverse selection*. Adverse selection refers to a condition in which policies of high risk enter an insurance pool and, due to the increased risk, bid up the cost of the provision of insurance. As a result, low-risk policies often drop out of the pool and a spiraling of costs can ensue. If adverse selection presents itself in the market for life insurance under COLI, then offering tax preferences for COLI, particularly for policies covering key persons, may encourage additional life insurance in a market that would purchase less than the optimum amount, absent tax advantages, all else being equal. A comparable argument for market failure might be constructed to the extent that it can be shown an incentive is needed to encourage the secure financing of employee benefits.

But any attempt to offer a tax preference to life insurance explicitly puts this investment vehicle at a distinct advantage over other investment options that lack such preferences and, if the market failure does not exist, may encourage over-investment in life insurance. Economic theory indicates that absent market failures, market prices and returns that are undistorted by tax benefits or penalties are the most efficient way to allocate investment resources.

Another issue is whether existing restrictions on interest on COLI-related loans are appropriately designed. A recurring concern of policymakers over the past two decades has been borrowing from the life insurance policy with tax-deductible interest to pay for COLI premiums and offset taxable earnings from unrelated investments.[25] Strictly speaking, two groups—key persons and

[23] This analysis was originally authored by CRS Analyst in Public Finance Don Richards. Future questions regarding specific tax issues should be addressed to CRS Specialist in Public Finance David L. Brumbaugh.

[24] John T. Adney, Kirk Van Brunt, and Bryan W. Keene, "COLI Reconsidered," *Journal of Financial Service Professionals*, vol. 56, November 2002, pp. 41-58.

[25] 26 U.S.C. 264(d) includes interest deduction prohibitions when using debt to pay for more than three of the first (continued...)

pre-1986 contracts—appear to be excluded from the general prohibition against interest deductions. Further, the indebtedness is limited to $50,000 for key persons, and the applicable interest rate is capped on deductions for both groups. However, when debt is fungible, it is possible that a company's overall indebtedness could indirectly support tax-preferred investment in COLI. Currently, the IRS must attempt to link deductible interest and premiums paid in order to enforce the provisions of law. That said, there may exist an opportunity to claim an interest deduction on funds borrowed to reduce earned taxable income and fund the premiums of a tax-advantaged investment.

One approach advanced to resolve the issue of allowing indirect interest deductions has been to expand the allocation methodology used to disallow interest deductions on policies not covering employees, officers, directors, and specified owners. Such an approach presumes all assets throughout a company are equally financed through the same aggregate proportion of debt and equity. Opponents of this approach argue that it would amount to a tax penalty, as it would prohibit the deductibility of unrelated business interest solely because of the ownership of life insurance.

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seven annual premiums for a COLI policy.