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

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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-owned life insurance (COLI) policies. (COLI is also known as company-owned life insurance.) 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 tax advantages of COLI, including limiting instances in which loan interest is allowed to be tax deductible. The 108th and 109th Congresses saw several bills introduced as well as floor and committee amendments on COLI. Language limiting COLI's tax advantages to policies taken out on the highest-paid 35% of employees and linking tax advantages to employee notice and consent was agreed to in the Senate Finance Committee in 2004 and ultimately incorporated into P.L. 109-280, which was passed by the 109th Congress in 2006.

In the 111th Congress, the Life Insurance Employee Notification Act (H.R. 251), introduced by Representative Gene Green, would require employee notice of COLI, similar to those enacted in 2006, but would enforce these requirements through the Federal Trade Commission Act, rather than the Internal Revenue Code. Representative Luis Gutierrez's Employer-Owned Life Insurance Limitation Act (H.R. 3669) would require disclosure of COLI policies to employers and limit COLI policies to employees with a salary of more than $1 million per year. H.R. 3669 includes a civil private right of action and criminal penalties.

This report begins with a general background on COLI, followed by current proposals on COLI. 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. An appendix provides a detailed discussion of legislation addressing COLI from the 108th through 110th Congresses. This report 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-owned life insurance (COLI) policies. (COLI is also known as company-owned life insurance.) Such policies enjoy the same two basic preferences under the tax laws as other life insurance. 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. 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.

Although the federal tax preferences for life insurance have been passed 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.[1] 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 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

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

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,[2] some companies have used broad-based COLI programs that covered not only key officials, but all or most of a corporation's employees. This 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."[3] 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.

Although COLI is not particularly well known, it has drawn attention both in the print media and even in film. In April 2002, the *Wall Street Journal* initiated a three-part series subtitled "Janitor's Insurance—Profiting When Employees Die"[4] on COLI plans. The articles were critical of COLI

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[2] 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.

[3] 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).

[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, (continued...)

and named major corporations that reportedly have put millions of dollars into COLI policies insuring thousands of employees. Following the *Wall Street Journal* series, other major newspapers, including the *Washington Post*,[5] carried articles critical of COLI/BOLI. The *Wall Street Journal* focused more recently on COLI, reporting in May 2009 on the most recent filings by banks on their usage of COLI. In 2008, COLI reported by banks totaled $122.8 billion.[6] COLI also drew popular notice as it was criticized in a Michael Moore film, *Capitalism: A Love Story*.

Proposals in the 111th Congress

The President's 2011 Budget Proposal

The President's 2011 Budget Proposal would reduce the ability of companies to claim an interest expense deduction from COLI. Specifically, the proposal would repeal the exception from the pro rata interest expense disallowance rule for contracts covering employees, officers, or directors, other than 20-percent owners of a business that is the owner or beneficiary of the contracts.

The Administration has argued that this provision will restrict a tax arbitrage opportunity that inappropriately reduces the taxable income of corporations. Businesses that own life insurance on employees and borrow from a third-party lender or from the public can achieve tax arbitrage by deducting interest that funds the tax-free inside buildup on the life. This opportunity for tax arbitrage results from the exception under the pro rata interest deduction limitation for insurance covering employees and others, it is argued.

The tax policy issue of COLI is the tax arbitrage opportunity it creates to deduct expenses such as interest with respect to tax-free inside buildup of life insurance contracts. The allowance of deductible expenses with respect to untaxed income is inconsistent with the concept of an income tax. While there may be social policy benefits to limiting employer opportunities to collect death benefits on insured individuals whom the employer has no economic incentive to protect, that is not the tax policy issue created by COLI; tax arbitrage is.

This tax arbitrage opportunity is being utilized particularly by financial intermediation businesses that often have a relatively large amount of debt in the ordinary course of business. According to one study, COLI held by banks grew to $126.1 billion in 2008, a 5% increase from $120.1 billion in 2007.[7]

The Life Insurance Employee Notification Act (H.R. 251)

H.R. 251 was introduced by Representative Gene Green on January 7, 2009. This bill would require employee notice of COLI, including the benefit amount and the beneficiary of the policy. Violation of these requirements would constitute an unfair trade practice and be enforced by the

(...continued)

C11.

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

[6] Ellen E. Schultz, "Banks Use Life Insurance to Fund Bonuses," *Wall Street Journal*, May 20, 2009, p. C1.

[7] Darla Mercado, "Survey: Bank-owned life insurance assets hit $126B in '08," *Investment News.com*, June 23, 2009.

Federal Trade Commission. This proposal is similar to the limitations included in the Pension Protection Act of 2006 (discussed below), but with a different enforcement mechanism.

Employer-Owned Life Insurance Limitation Act (H.R. 3669)

Representative Luis Gutierrez introduced H.R. 3669 on September 29, 2009. This bill would prohibit COLI policies on employees with a salary of less than $1 million per year. Employers would be required to disclose COLI policies to those insured. Enforcement would be through a civil private right of action and criminal penalties.

Past Limitations on COLI

Capping legislative activity from the 109th Congress, the Pension Protection Act of 2006[8] included language adding 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. The term "highly compensated" employee includes any employee receiving a salary in the top 35% of the company. Companies were also required to file a yearly return with the Secretary of the Treasury detailing their usage of COLI policies. Note, however, that the information from these returns are confidential as is most tax information.

The interest in COLI over the past few years is only the most recent congressional focus on the issue. Since 1986, the tax benefits of COLI relating to the tax deductibility of interest on COLI-related loans have been limited by legislation. In 1986, Congress capped deductible interest for indebtedness exceeding $50,000 per individual contract.[9] 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.[10] 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.[11] 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.[12]

[8] Section 863 of P.L. 109-290, 120 Stat. 780.

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

[10] 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.

[11] 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.

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

Congress addressed this behavioral response in 1997 by further restricting interest expense deductions for life insurance loans.[13] The 1997 change required that interest deductions be 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.[14] 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, FY2000, and FY2001 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).[15]

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.[16] 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,

[13] Taxpayer Relief Act of 1997, P.L. 105-34, Sec. 1084. Insurance policies issued after June 8, 1997, are subject to the pro rata allocation.

[14] 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.

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

[16] For additional information on state insurance regulation, see CRS Report R40771, *Insurance Regulation: Issues, Background, and Legislation in the 111th Congress*, by Baird Webel.

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 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.[17]

Because the NAIC has no ability to compel the states to act on this or any other issue, these revisions become effective only on a state-by-state basis, as state legislatures enact laws following the guidelines. As of October 2009, the NAIC reports 43 states have adopted these 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.

[17] NAIC, *Model Laws, Regulations and Guidelines*, vol. IV (Kansas City, MO: 2009), p. 602-2.

Tax Issue Analysis

Life insurance policies often combine features of insurance and tax-favored savings accounts. The investment income from the money paid into life insurance policies (commonly called inside buildup) is not included in taxable income until it is paid out to the policyholder. If the accumulated income is paid out as a death benefit, it can escape inclusion and taxation entirely. In addition, the tax-favored nature of life insurance also brings to the forefront questions concerning economic efficiency and opportunities for tax arbitrage.

Inside Buildup

A general benefit granted to life insurance policies is the tax treatment of inside buildup. Inside buildup refers to the increase in the cash value of a life insurance policy. Under current law, inside buildup is not taxed. This tax treatment in conjunction with the tax-free status applied to most death benefits, makes investments in life insurance policies virtually tax-free.

The current treatment of inside buildup is commonly justified using market failure arguments. Proponents of the current treatment argue that individuals systematically underestimate the hardship that their death will impose on their families and that in the absence of the current tax treatment, society would purchase a sub-optimal amount of insurance. In the case of corporations, COLI can be seen as a hedge against the future lost productivity of the covered employee.

In addition, proponents assert that information asymmetries do not allow for the accurate pricing of insurance contracts leading to what economists call the problem of adverse selection. Adverse selection, in the context of insurance, describes the situation where the demand for insurance (either the propensity to buy insurance, or the quantity purchased, or both) is positively correlated with the risk of loss (e.g., higher risks buy more insurance), and the insurer is unable to allow for this correlation in the price of insurance. This information asymmetry does not allow for the accurate pricing of insurance and leads to market failure. Finally, the current tax treatment of inside buildup could be justified based upon the principle of constructive receipt.[18]

The market failure arguments are not, however, compelling in the context of COLI. First, the corporate structure and reporting make it more likely that corporations understand the economic value of each employee, relative to an average family. As a result corporations are unlikely to systematically underestimate the value of a key employee and, as a result, underinsure. Secondly, the likelihood of COLI purchase is not related to the probability of death of the covered employee, but instead to the employee's value to the corporation. Accordingly, the favorable tax treatment of inside buildup cannot be used to offset adverse selection. Finally, even if the above points were justified, there is no compelling evidence that the current tax treatment of inside buildup (or COLI) is successful in reducing underinsurance.

[18] Using this argument, the interest income would not be viewed as belonging to the policyholders because they would have to give up the insurance protection or the annuity guarantees to obtain the interest. Congress has in the past examined this argument on a case-by-case basis. While not central to a discussion of COLI, this principle is important when thinking about taxing on an accrual basis.

Economic Efficiency

Some argue that COLI is a means of funding certain types of necessary business expenditures. In particular, it is argued that COLI provides a self-help mechanism for companies to prefund obligations under certain business expenditures that occur after a key employee is no longer employed by the company.[19] The current tax treatment of COLI makes it a cost-effective funding method for such obligations relative to other types of investments.

The current tax treatment of COLI, however, distorts investment decisions. By encouraging corporations to choose COLI over competing investment vehicles such as bonds or retained earnings, the result could be overinvestment in COLI relative to a scenario where investment decisions are motivated without regard to taxes. In addition, the current tax treatment of COLI may encourage a tax-induced increase in the value of those types of benefits. Finally, it can be argued that the COLI policies have no relation to the employee benefits being provided. That is, the tax favored benefits paid at the time of death, fund the benefits of individuals who are still alive.

Tax Arbitrage

In addition to the general tax benefit available to all life insurance policies, businesses may borrow against life insurance policies to achieve an additional tax benefit. This arbitrage opportunity occurs when tax free inside buildup is offset by deductible interest expenses and is commonly cited as chief motivation for COLI transactions.

To the extent that COLI transactions are motivated by arbitrage opportunities, COLI is undesirable on economic grounds. On economic grounds, the tax arbitrage encourages the misallocation of corporate resources from more productive uses to life insurance. This outcome may be defended based upon the potential to use COLI proceeds to fund business obligations, but this argument is not persuasive given the resources of a business are fungible. The current treatment of COLI also subverts the goal of horizontal equity in the tax code, by not taxing the input and output of such transactions. As a result, taxpayers with the same economic income have different taxable income, which leads to different tax liabilities.

In addition, Congress has previously demonstrated concern with the use of tax arbitrage. For example, the Pension Protection Act of 2006 restricted the tax arbitrage opportunities for COLI to a select few senior members of a corporation and current legislative proposals would further restrict arbitrage opportunities.

[19] Nonqualified deferred compensation plans and health benefits provided in retirement are two examples of these types of expenditures.

Appendix. Congressional Activity 108th-110th Congresses

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 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.[20] It also 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 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 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. 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 Congress. The Senate passed S. 1783 on November 16, 2005.

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[20] 12 U.S.C. 45(a)(1).

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.[21] 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 Trade Commission Act.[22] 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 company'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

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[21] 12 U.S.C. 45(a)(1).

[22] 12 U.S.C. 45(a)(1).

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.[23] 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.

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.[24] 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 as a result of the committee investigation of the federal tax issues surrounding the Enron corporation.[25]

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[23] 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.

[24] 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.

[25] 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.

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