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White paper

# COLI: it's not contagious!

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## Key highlights

- History of COLI
- Uses of COLI
- Insurable interest
- Code sec. 101(j)
- COLI products

A quick search on the internet for the acronym "COLI" returns about 62 million hits — the majority of which are about E. coli, a bacterium found in the gut of warm-blooded organisms. The COLI discussed in this paper is "company-owned life insurance" and has nothing to do with bacteria!

Although "COLI" (pronounced *co lee*) is the commonly-used acronym, it refers to any company-owned life insurance contract on the life of a company employee. When a bank owns COLI, it is referred to as BOLI (bank-owned life insurance), and when an insurance company owns COLI, it is often referred to as ICOLI (insurance company-owned life insurance). No matter what terminology is used, COLI, BOLI, or ICOLI, it is simply life insurance owned by and payable to an employer on the life (or lives) of one or more of its employee(s). Throughout this paper, I will use "COLI" to mean any type of employer-owned life insurance on one or more of its employees.

## History of COLI

COLI has existed in one form or another for over 100 years.[1] In the United States prior to 1986, COLI was used as a form of tax arbitrage where the owner of a life insurance contract could take out large loans from the policy and pay interest that was tax-deductible while continuing to enjoy income tax-free cash value growth. In response to large corporations insured thousands of employees simply as a tax-avoidance scheme, Congress limited the ability of a company to deduct loan interest on life insurance policies issued after June 20, 1986. In 1997, Congress went even further and disallowed a deduction for any loan interest paid or accrued on policies issued after June 8, 1997, except that a corporation may be able to deduct interest on loans of up to $50,000 for certain key employees.[2]

In 2002, the *Wall Street Journal* published a series of articles describing COLI as "dead peasant insurance" and "janitor insurance" disclosing that Nestle USA had life insurance policies covering 18,000 workers, Pitney Bowes Inc. had policies on 23,000 employees, Proctor & Gamble had policies covering 15,000 workers and Winn-Dixie had policies on 36,000 employees.[3] At about the same time that these articles were published, the IRS had disallowed deductions for loan interest taken by companies that held large blocks of COLI. Those companies sued the IRS for refunds and lost.[4]

In 2006, Internal Revenue Code ("Code") sec. 101(j) was enacted into law. It provides that a portion of death benefits paid on COLI policies will be taxed if the employee does not receive notice from the employer and then consent to being insured for the benefit of the employer. In addition, it limits the employees who can be insured for the employer to receive income tax-free death benefits.[5]

**COLI has long been a financial asset used by companies of all sizes and industries to informally fund a nonqualified deferred compensation plan.**

The uses of COLI have evolved over the past 30 years, and today lawmakers, the IRS and businesses seem to have come to an understanding that COLI is a valuable financial asset when used appropriately.

# Uses of COLI

Businesses purchase COLI for a variety of reasons. These are the most common.

### Buy/sell agreements

It is common practice among closely-held businesses to have the company purchase life insurance on each owner to fund a buy-sell agreement. When an owner dies, the company receives a tax-free life insurance death benefit that is used to purchase the decedent's share of the business from his or her heirs. Using cash value life insurance may also provide the company with a source of tax-free income to buy-out an owner when he or she is ready to retire.

### Key person protection

The death of a key employee can be disruptive to the business and it may take a long time to be able to find a replacement. Life insurance can provide cash to the business to ease the financial stress while recruiting and training a new employee to replace the decedent.

### Economic benefit (endorsement) split dollar life insurance

To help executives obtain personal life insurance coverage, as well as provide the employer with key person coverage, companies often purchase COLI on their key employees and then "endorse" a portion of the death benefit to the employee, usually for only as long as the employee is employed. Each year, the employee must pay tax on the value of the death benefit that would be paid to his/her personal beneficiary. That value is measured either by the IRS Table 2001 rates or by the carrier's annual renewal term rates.

### Nonqualified deferred compensation plans

COLI has long been a financial asset used by companies of all sizes and industries to informally fund a nonqualified deferred compensation plan (NQDCP). The employer owns and is the beneficiary of life insurance contracts on the lives of the executives who are eligible to participate in the NQDCP. Most plans permit participants to allocate their NQDCP balances among a variety of notional investment options. The employer chooses those options from among sub-accounts in variable universal life COLI and allocates the COLI cash values to match the participants' balances, so that the NQDCP liability and the COLI cash values move in tandem on the company's balance sheet. In addition, the COLI cash values can be withdrawn or loaned to the employer on a tax-free basis and used to pay benefits to employees in future years. Finally, tax-free death benefits can be used to recoup some or all of the costs of the NQDCP.

### Funding other employee benefit plans

COLI is also purchased, primarily by banks and insurance companies, to fund the costs of other employee benefits such as a 401(k) matching contribution, and employer-provided medical and disability insurance, among others. When COLI is purchased for these purposes, the employer asks employees who fit within the categories outlined in Code sec. 101(j) (discussed later) to consent to being insured.

### Funding an ESOP's repurchase obligation

Companies that are wholly or partially owned by an employee stock ownership plan (ESOP) have a responsibility to purchase stock that is distributed to ESOP participants upon the participant's termination of employment, death, disability, when the participant diversifies his/her account balance and when the participant is due an in-service distribution or required minimum distribution from the ESOP. There are a number of ways in which companies fund to meet this obligation including the purchase of COLI on the lives of key executives. Similar to when COLI is used to offset the costs of a NQDCP, the tax-free withdrawal and loans from cash value along with tax-free death benefits make COLI, either alone or in conjunction with another asset, an appropriate and cost-efficient method for funding the repurchase obligation.

## Insurable interest

The owner of a life insurance contract must have an insurable interest in the person who is insured when the policy is purchased. This means that the policy owner (or the owner's named beneficiary) would suffer a financial loss in the event of the insured's death. Any individual is permitted to purchase a life insurance contract on his/her own life and designate the beneficiary.

Each state has its own statutes regarding insurable interest in the life of an insured individual. There is no federal statute specifically addressing this issue, so it is important to know and understand the statute of the state in which a life insurance policy is issued. In some states a policy issued to someone who lacks insurable interest and where the insured did not consent, may be paid to a person who is equitably entitled to the proceeds and who is someone other than the named beneficiary, if a court so orders.

## Code sec. 101(j): make sure death benefits are income tax-free

Under Code section 101(j)(2)(A), death benefits paid to an employer will be free of income tax if notice and consent were obtained from the employee, and that employee falls into one of the following categories:

- The insured was an employee at any time during the 12-month period before death; or
- At the time the contract is issued, the insured is
  - A member of the board of directors;
  - A highly-compensated employee;[6]
  - One of the five highest paid officers;
  - A shareholder who owns more than 10% in value of the stock of the employer;[7] or
  - One of the highest paid 35% of all employees.[8]

When determining if an employee falls into one of the exempt classifications above, the date the contract is issued controls; not the date a consent to insure is signed. In this context, "issued" means the latest of: (1) the date of application for coverage; (2) the effective date of coverage; or (3) formal issuance of the contract.[9] If an employee signs a consent form but terminates employment prior to the issue date, that individual does not fall into one of the exceptions above.

The employer's notice to the employee must state the maximum face amount for which the employee can be insured, that the employer (or policy owner) will be the beneficiary and that the coverage may continue after the insured is no longer employed by the employer.

Every taxpayer that owns one or more COLI policies issued after August 17, 2006 must file a Form 8925 with its tax return showing the number of employees insured at the end of the year; the total amount of insurance in force at the end of the year; and stating that each insured consented to the insurance.[10]

## COLI products

COLI products are specifically designed and institutionally-priced for the corporate market. These products generally have lower upfront loads, high early cash values and lower insurance costs than products designed for the individual market.

## Summary

COLI is a valuable asset to companies that have a long-term need for protection against financial loss due to the death of a key employee or owner of a business; to informally fund nonqualified retirement plans; recover the cost of those plans through the receipt of tax-free death benefits; and to provide a source of tax-free income through cash value withdrawals and loans to the company. COLI products are specifically designed to provide the purchasing company with income on its financial statements in the early years to satisfy the needs of shareholders, partners and potential creditors. When designed properly, a COLI program may help mitigate losses due to the death of key person or because of costly employee benefit plans.

[1] Cussen, Mark P., *Everything You Should Know About Corporate-Owned Life Insurance*, www.investopia.com/articles/insurance/12/corporate-owned-life-insurance.asp.

[2] Code sec. 264(a)(4) and 264(e). A key employee means an officer or 20% owner. The number of key employees cannot exceed the greater of (a) five, or (b) the lesser of 5% of the business' total officers and employees or 20 people. The rate of deductible interest on policy loans is limited to the Moody's Average Monthly Corporate Bond Yield.

[3] Shultz, Ellen E. and Francis, Theo, *The Wall Street Journal Online*, April 19, 2002, www.online.wsj.com/public/resources/documents/april_19.htm.

[4] *See* Winn-Dixie Stores, Inc. v. Commissioner of Internal Revenue, 254 F.3d 1313 (11th Cir. 2001) and American Electric Power Company, Inc. v. United States of America, 326 F.3d 737 (6th Cir. 2003).

[5] Pension Protection Act of 2006, P.L. 109-280, sec. 863.

[6] A highly-compensated employee is an employee who is a 5% owner at any time during the year or the preceding year or who earns $120,000 or more (2018). This amount is indexed and may change from year to year.

[7] This includes stock owned due to the application of Code section 318 attribution rules.

[8] To determine the top 35%, "employer" means a controlled group under Code section 414(b), (c) and (m).

[9] Id.

[10] Code sec. 6039I.

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