WRNewswire

An AALU Washington Report

Monday, 3 February 2014 **WRN# 14.2.03**

The *WRNewswire* is created exclusively for AALU Members by insurance experts led by Steve Leimberg, Lawrence Brody, Linas Sudzius and AALU Staff. The *WRNewswire* provides timely reports and commentary on tax and legal developments important to AALU members, clients and advisors, delivered to your inbox as they happen.

TOPIC: Proposal to Modify the Tax Treatment of Corporate-Owned Life Insurance Continues to Receive Attention

CITE: DEPT. OF THE TREASURY, GENERAL EXPLANATIONS OF THE ADMINISTRATION'S FISCAL YEAR 2014 REVENUE PROPOSALS, 77 –78 (2013); *Ken Kies, History of Corporate-Owned Life Insurance (COLI) Reforms (Dec. 2013); AALU Policy White Paper, Reject the COLI Pro-Rata Interest Disallowance Proposal (Dec. 2013).*

SUMMARY: The tax treatment of corporate-owned life insurance ("**COLI**") continues to receive scrutiny from congressional tax writers and the Obama Administration. While progress toward reform of the Internal Revenue Code ("**IRC**") may slow in light of the upcoming congressional midterm elections, a proposal that would indirectly impose a tax penalty on owners of COLI continues to be considered for inclusion in draft tax reform language. This proposal, which is described in detail below, has been included as a revenue provision in each of President Obama's budgets dating back to Fiscal Year 2010. The President's Fiscal Year 2015 budget is slated for release on March 4th, and is expected to once again include this provision. The AALU has worked to expand upon our messaging in opposition to this proposal as consideration of tax reform has progressed. This *WRNewswire* bulletin provides context regarding the current status of tax reform as it pertains to the tax treatment of COLI, as well as an explanation of our associated messaging—which explores the relevant text of the IRC, the legislative history behind these provisions and other regulatory initiatives involving COLI, and why—based on history, public policy, and practice—attempts to change the tax treatment of COLI are misguided.

ANALYSIS: The Obama Administration has, on several occasions, proposed as a revenue measure an "expansion of the pro rata interest expense disallowance for COLI" ("**The proposal**"). The Administration explains the proposal, and its perceived justifications, as follows:

> The interest deductions of a business other than an insurance company are reduced to the extent the interest is allocable to unborrowed policy cash values on life insurance and annuity contracts. The purpose of this pro rata interest disallowance is to prevent the deduction of interest expense that is allocable to inside buildup that is either tax-deferred or not taxed at all . . . . A current-law exception to this rule applies to contracts covering the lives of officers, directors, employees, and 20-percent owners. The [proposal would] repeal the exception for officers, directors, and employees unless those individuals are also 20-percent owners of the business that is the owner or beneficiary of the contracts. Thus, purchases of life insurance by small businesses and other taxpayers that depend heavily on the services of a 20-percent owner would be unaffected, but the funding of deductible interest expenses with tax-exempt or tax-deferred inside buildup would be curtailed.

OFFICE OF MGMT. & BUDGET, EXEC. OFFICE OF THE PRESIDENT, ANALYTICAL PERSPECTIVES, BUDGET OF THE UNITED STATES GOVERNMENT, FISCAL YEAR 2014, 188–189 (2013), *available at* http://www.whitehouse.gov/sites/default/files/omb/budget/fy2014/assets/spec.pdf.

Put simply, the proposal would apply the interest deductibility disallowance provisions of IRC § 264(f) to the interest deductions of *all* corporate taxpayers, allocable to unborrowed life insurance policy cash values—regardless of any connection between the policy and a corporation's debt. To illustrate, suppose a corporation purchased COLI to secure employee benefits promised to its employees. Subsequently, fifteen years after the purchase of the policy, that corporation borrows money (unrelated to its COLI policy) to help fund an expansion of its business and the hiring of additional employees. Under the proposal, the corporation's deduction for interest paid on this business expansion loan would be disallowed by a ratio that reflects the extent of the unborrowed cash value of the corporation's COLI policy to all assets of the corporation.

The problems with this proposal are numerous. For example, as a policy matter, the proposal would create a detriment to life insurance ownership and the use of COLI. Further, the proposal reflects a misunderstanding and lack of recognition of the history of legislative and regulatory initiatives pertaining to COLI. Lastly, the mechanics of the proposal involve an improper expansion of IRC § 264(f)—the statute imposing the existing pro-rata interest expense disallowance for *select* and disfavored COLI policies.

Policy Implications. As a general matter, the proposal would unnecessarily penalize life insurance ownership and undermine the public policy objectives that are fulfilled by COLI. The AALU has voiced these threshold concerns in our opposition to this proposal, conveying the following policy arguments regarding the tax treatment of life insurance and the implications of the proposal:[i]

> The proposal would cost jobs and hurt employees**.** Seventy-five million American families, thousands of businesses and millions of employees rely on life insurance for financial security. COLI keeps businesses running after the death of a key owner or employee, and helps finance and secure broad-based health, disability, survivor, and supplemental retirement benefits.
>
> The proposal moves in the wrong direction by discouraging sorely-needed savings and protection**.** American families and businesses are not putting aside enough for protection, long-term savings, and retirement security. The last thing Congress should be considering are taxes on life insurance products or the life insurance industry that make it harder and more costly to take responsible steps.
>
> The current tax treatment of life insurance, whether owned by families or businesses, is appropriate**.** Life insurance is purchased with after-tax dollars and taxed when gain is realized during the life of the insured at ordinary income rates.
>
> The proposal is an attack on inside buildup through the imposition of a tax penalty on life insurance ownership**.** Current law already prohibits businesses from deducting interest for loans connected with life insurance.

Legislative & Regulatory Initiatives Pertaining to COLI. The proposal ignores the long history of congressional and administrative initiatives regarding COLI. Cumulatively, these initiatives have created a legal and regulatory framework which assures that COLI is used responsibly and for its intended purposes.[ii]

For example, in 1954 Congress enacted IRC § 264(a)(1) and (2), which collectively established the general rule that no deduction shall be allowed for the premiums paid on life insurance, endowment or annuity contracts if the taxpayer is the direct or indirect beneficiary, nor shall a deduction be allowed for "any amount paid or accrued on indebtedness incurred or continued to purchase or carry a single premium life insurance, endowment, or annuity contract."[iii] In 1964, Congress enacted IRC § 264(a)(3), which established the rule that no deduction shall be allowed for "[a]ny amount paid or accrued on indebtedness incurred or continued to purchase or carry a life insurance, endowment or annuity contract . . . pursuant to a plan of purchase which contemplates the systemic direct or indirect borrowing of part or all of the increases in the cash value of such contract."

In 1996, Congress enacted IRC § 264(a)(4). Under this provision, corporations are prohibited from deducting interest on loans to purchase or carry one or more life insurance policies covering the life of any individual—subject to a *de minimus* key person exception set out in Section 264(e). These amendments to IRC § 264 were aimed at curtailing the incidence of a practice in which corporations would purchase life insurance policies on very large numbers of employees, at times without proper notice and consent.

In 1997, Congress enacted a Code provision relating to COLI policies for the very specific purpose of deterring financial intermediaries Fannie Mae and Freddie Mac from using COLI policies to insure the lives of mortgagees, which Congress understood those entities to be contemplating at that time. Under IRC § 264(f), a portion of an entity's interest expense is deemed allocable to unborrowed policy cash surrender values of certain disfavored COLI policies, including those insuring mortgagees, and no deduction is allowed for that deemed interest expense. This provision was intentionally structured to apply only to the planned transactions of Fannie Mae and Freddie Mac.

In the early 2000s, the IRS undertook an extensive, multi-year effort to audit holders of COLI policies, scrutinizing how COLI was structured and used in order to determine whether applicable legal tests were satisfied. In addition to confirming the business purposes of the COLI policies that were reviewed, the IRS examined whether the businesses that owned the policies had insurable interests under applicable state law, whether there was inappropriate investor control of the COLI policies, and whether direct borrowing occurred to purchase COLI. After the lengthy audits, the IRS did not propose a single adjustment to the tax liabilities of the businesses examined.

Finally, in 2006, after a multi-year examination of COLI, Congress enacted the "COLI Best Practices Act" as part of the Pension Protection Act of 2006. The Act affirmed the importance of COLI and codified best practices for its continued responsible use. The Act also included new Code Section § 101(j), which provides that businesses can only take out policies on an employee that is a director, a five percent owner, or a highly compensated employee (*e.g.*, top 35% of pay). IRC § 101(j) also requires an employer to obtain informed consent before taking out life insurance on an employee. Specifically, when seeking consent, the employer must notify the employee in writing of the employer's intent to insure the employee's life and the maximum amount of insurance that may be taken out and that the employer will be the beneficiary of the policy, both during and after employment. The employee must then provide written consent to the terms of the policy.

Improper Expansion of IRC § 264(f). In support for the proposal, the Administration suggests that "leveraged businesses can fund deductible interest expenses with tax-exempt or tax-deferred income credited under [life insurance contracts] insuring certain types of individuals . . . ." Furthermore, as noted by the Joint Committee on Taxation ("**JCT**") upon review of a prior identical Administration proposal, this purported tax arbitrage opportunity has been pursued principally by highly-leveraged financial intermediaries. *See* JOINT COMM. ON TAXATION, DESCRIPTION OF REVENUE PROVISIONS CONTAINED IN THE PRESIDENT'S FISCAL YEAR 2010 BUDGET PROPOSAL PART TWO: BUSINESS TAX PROVISIONS (2009), *available at* https://www.jct.gov/publications.html?func=startdown&id=3576.

However, as discussed above, IRC § 264(f) was enacted to address only the narrow concern associated with the anticipated transactions of Fannie Mae and Freddie Mac. It is therefore important to note that the anticipated problem addressed by Section 264(f) did not pertain to *compliance* with the laws and regulations that govern the use of COLI. Rather, the provision was specifically designed to preempt these large, highly-leveraged financial intermediaries from engaging in the practice of insuring mortgagees who were not employed by the company. The statute did so by imposing a tax penalty in connection with policies designed to do precisely that—insure *non-employees*. Because Section 264(f) narrowly targeted such policies, the statute expressly excludes any COLI policy that is owned by an entity engaged in a trade or business that covers an individual who is a 20-percent owner of the entity, or an officer, director, or employee under IRC § 264(f)(4).

Notwithstanding the above statutory framework and underlying practical considerations, the Administration suggests—without empirical support—that ". . . tax arbitrage benefits [*also*] result when insurance [*sic*] companies invest in certain insurance contracts that cover the lives of their employees, officers, directors, or 20-percent shareholders and fund deductible reserves with tax-exempt or tax-deferred income" (emphasis added). Thus, the Administration appears to be inferring that a compliance problem now exists with respect to interest deductibility associated with traditional COLI policies—*i.e.,* those insuring key employees—and seeks to employ an expansion of Section 264(f) as a vehicle for addressing this purported problem. However, even if this assertion were to be substantiated, the fact remains that these policies were never intended to be covered by IRC § 264(f) and were expressly excluded to cement this intention. Thus, the proposed expansion of Section 264(f) as a means of covering policies owned by corporate taxpayers to insure key employees is inapposite.

TAKEAWAYS: While the proposal has not been included in any congressional funding measure or legislative revenue proposal, the staff of the Senate Finance Committee indicated in its May 2013 "tax reform options paper" entitled "Economic Security: Health, Retirement, Life Insurance, Fringe Benefits and Executive Compensation" that the Committee could consider expanding the pro rata interest expense disallowance for COLI as part of a larger reform initiative. Moreover, House Ways & Means Committee Republicans continue to leave open the possibility of including the proposal in a tax reform draft.

It is important for AALU members to internalize these arguments and present them to lawmakers when given the opportunity. Although, on its face, the proposal would affect only the COLI marketplace, because the proposal largely ignores the legislative and regulatory history of COLI and the public policy benefits of life insurance, the justifications for it could certainly be applied to future proposals affecting individual policies. Accordingly, it is appropriate to view this proposal as an indirect attack on the ownership of life insurance—one that should be taken seriously in any context.

WRNewswire* # – 14.2.03 *was written by the AALU Staff.

In the event that this Washington Report is also considered to be a "marketed opinion" within the meaning of the IRS guidance, then, as required by the IRS, please be further advised of the following:

THE ABOVE ADVICE WAS NOT WRITTEN TO SUPPORT THE PROMOTIONS OR MARKETING OF THE TRANSACTIONS OR MATTERS ADDRESSED BY THE WRITTEN ADVICE, AND, BASED ON THE PARTICULAR CIRCUMSTANCES, YOU SHOULD SEEK ADVICE FROM AN INDEPENDENT TAX ADVISOR.

The AALU *WRNewswire* and *WRMarketplace* are published by the Association for Advanced Life Underwriting® as part of the Essential Wisdom Series, the trusted source of actionable technical and marketplace knowledge for AALU members—the nation's most advanced life insurance professionals.

NOTES:

[i] For further reading on the AALU's policy arguments regarding the proposal, *see* the appended AALU policy white paper entitled "*Reject the COLI Pro-Rata Interest Disallowance Proposal."*

[ii] We note that several of legislative and administrative developments pertaining to COLI described in this bulletin are summarized in the appended document entitled "*History of Corporate-Owned Life Insurance (COLI) Reforms*," authored by AALU counsel Ken Kies.

[iii] A "single premium life insurance contract" is considered as such if "substantially all the premiums on the contract are paid within four years from the date on which the contract was purchased." 26 C.F.R. **§ 1.264-2 (2012).**