

HISTORY OF CORPORATE-OWNED LIFE INSURANCE (COLI) REFORMS

COLI is widely used by businesses with respect to employees in which they have an insurable interest to keep businesses running after the death of a key owner or employee. COLI also is used to finance employee benefits, including broad-based health, disability, survivor, and supplemental retirement benefits—companies use life insurance to build an asset to offset those balance sheet liabilities. Employers receive no tax deduction for paying COLI premiums and employees bear no cost for COLI, yet reap substantial benefits.

Over the course of several decades, through both legislation and IRS initiatives, a framework has evolved that ensures that COLI is used responsibly. Congress has, in recent years, thoroughly reviewed those safeguards. Congress concluded that the safeguards are working and that, as a consequence, the current use of COLI does not present tax policy concerns that need to be addressed by further legislation. Key steps taken by Congress and the IRS to ensure the proper use of COLI include the following:

- **Internal Revenue Code section 264(a)(3).** Enacted in 1964, this provision established the general rule that no deduction shall be allowed for “Any 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”.
- **Internal Revenue Code section 264(a)(4).** In 1996, Congress enacted amendments to section 264 which eliminated the deduction for post-1995 interest in connection with debt related to life insurance placed by an employer on the lives of large numbers of employees. This provision effectively curtailed so-called “janitors’ insurance”, a practice in which corporations would purchase life insurance policies on very large numbers of employees.
- **Internal Revenue Code section 264(f).** In 1997, Congress enacted a measure relating to COLI policies for the very specific purpose of deterring Fannie Mae and Freddie Mac from using COLI policies to insure the lives of mortgagees, which Congress understood those entities were contemplating at that time. Under that provision, Internal Revenue Code section 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. Because section 264(f) was targeted at policies insuring mortgagees, it expressly did not apply to any COLI policy 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.
- **IRS Audit Initiative.** 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.
- **Internal Revenue Code section 101(j).** Enacted in 2006, section 101(j) 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). Section 101(j) also requires an employer to obtain informed consent before taking out life insurance on an employee. When seeking consent, the employer must notify the employee of 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.