M Benefit Solutions®

A Primer on Corporate-Owned Life Insurance (COLI)

The single source for your total executive benefit needs

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Variable life insurance products are long-term investments and may not be suitable for all investors. An investment in variable life insurance is subject to fluctuating values of the underlying investment options and it entails risk, including the possible loss of principal.

Variable Universal Life insurance combines the protection and tax advantages of life insurance with the investment potential of a comprehensive selection of variable investment options. The insurance component provides death benefit coverage and the variable component gives you the flexibility to potentially increase the policy's cash value. Death benefit guarantees of variable life insurance products are subject to the claims paying ability of the insurance company.

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Overview

Since the passage of ERISA in 1974, nonqualified retirement plans have become useful tools to help employers attract, motivate, and retain key contributors to their success. These types of plans include:

- Elective deferred compensation plans
- Supplemental executive retirement plans
- Phantom Stock Plans
- Other employer-sponsored defined contribution plans

Nonqualified plans have been commonplace with *Fortune 1000* size companies for decades and have become much more prevalent with smaller employers over the last several years.

One key characteristic of these types of programs is that, unlike qualified retirement plans such as 401(k) plans, they cannot be formally funded with segregated assets guaranteed to be secured from creditors of the employer in the event of bankruptcy. Nonqualified plans are often "informally" funded, however, for a number of reasons.

Benefit Funding

Why Do Companies Informally Fund Nonqualified Benefits?

- To create an asset to offset emerging liabilities
- To minimize P&L volatility
- To shift the responsibility of funding to current management
- To neutralize shareholders to the financial impact of emerging liabilities
- To provide a level of security that is as close as possible to the security level available to qualified plan participants

In choosing an appropriate funding device, there are many important factors to consider, including the investment's after-tax yields and how well it tracks plan liabilities. Largely because of these factors, two primary vehicles used for funding nonqualified benefit plans are mutual funds and Corporate-Owned Life Insurance (COLI). Under both tax and insurance law, an employer has an insurable interest in its executives. Therefore, COLI is a unique, but limited tax advantaged asset for corporate financing of executive benefit plans.

Life Insurance (COLI)

COLI Product Types

General vs. Variable, Separate Account Products

There are significant differences between the two primary COLI structures, general account and variable (also known as "separate account") life insurance products. Information is presented on page 7 which compares the features of these products. General account products are held in the "general account" of the carrier. While with separate account products, since the policyholder is determining the investment strategy, the assets are held in a "separate account."

Mutual Funds Compared to Variable COLI

While both mutual funds and COLI can be beneficial as funding devices, the tax advantaged status of COLI may offer a more favorable return to the corporation. A comparison of financial characteristics of mutual funds and variable COLI is provided below. Note that while the comparison is specific to variable COLI, the tax treatment of general account COLI is the same as variable, separate account COLI.

	MUTUAL FUNDS	VARIABLE COLI
Asset Management Fees	Yes	Yes
Insurance Charges	No	Yes
Death Benefits	No	Yes
Tax Considerations	■ Capital gains* generated by: – Trading within the fund by the fund manager – Liquidation of the funds to pay benefits – Liquidation of the funds to exchange to other funds ■ Dividend pass-throughs from mutual funds** ■ Interest income pass-throughs from mutual funds* ■ With dividend, interest and capital gains pass-throughs the owner (the corporation) has no control over the timing of taxation	■ Cash values grow income tax-deferred (tax-free if held until death) ■ Insurance death benefit proceeds are income tax-free to the corporation ■ Fund transfers between variable subaccounts are not taxable ■ With most contracts, cash values which must be accessed from the insurance prior to death are withdrawn basis first
P&L Impact	■ Realized and unrealized gains flow through to Income Statement (assets are marked to market); deferred tax liability booked on unrealized gains***	■ All earnings flow through to income statement (offsetting annual benefit costs); although no tax-deferred liability is booked ■ Death proceeds in excess of already recognized cash surrender value are recognized in earnings

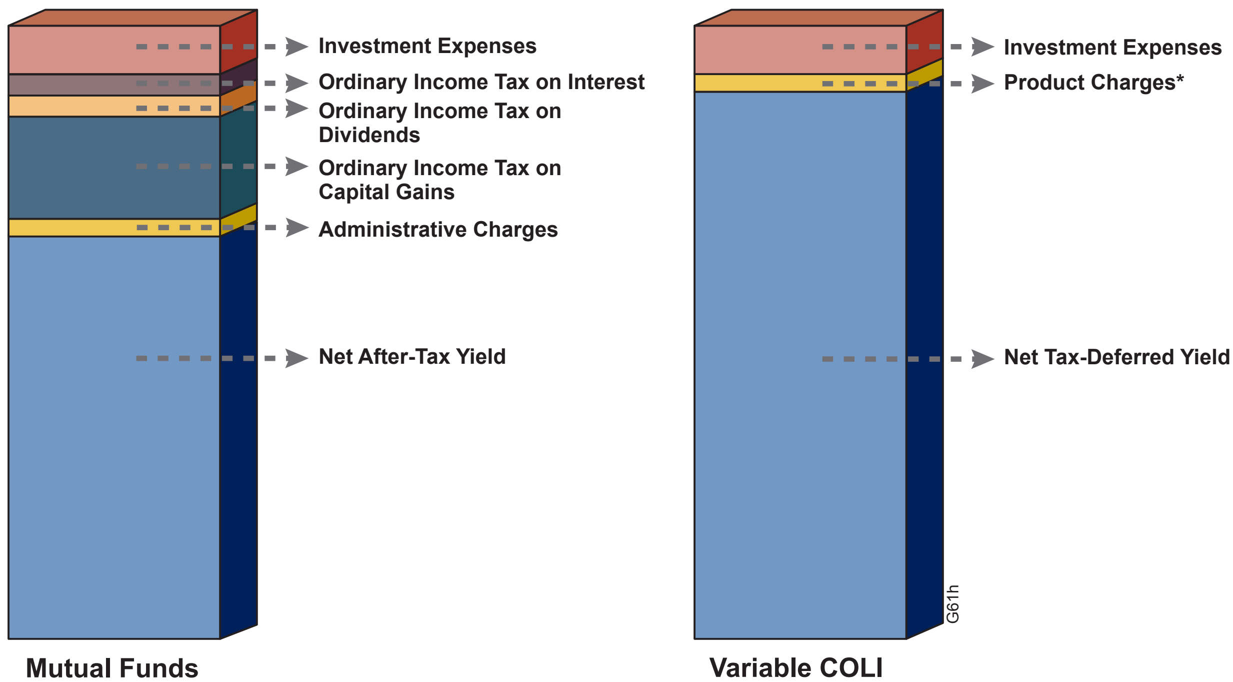
NOTE

**Taxed at ordinary income rates for C-corporation owners.*

***70% of dividends are excluded from taxable income for C-corporation owners.*

****When assets are categorized as "Trading." However, in an effort to be more conservative, accounting firms are increasingly requiring that the investments be classified as "Available for Sale," resulting in only realized gains flowing through P&L.*

Mutual Funds Compared to Variable COLI



NOTE

**Product charges include sales expense charges, federal and state premium taxes, cost of insurance, annual administrative charges, and mortality and expense risk charges.*

Underwriting Alternatives

Full Underwriting

Before life insurance coverage is issued, an insurance company will generally require the potential insured to provide medical history/records and, depending on the level of coverage, the individual may be required to undergo:

- A medical exam including blood tests;
- A resting EKG; and/or
- A treadmill test.

In certain circumstances, individual financial information and criminal histories may also be required. The results of the tests and information obtained will determine the risk rating, and therefore the ultimate pricing/performance of the policy.

Guaranteed Issue

In the institutional marketplace, including Corporate-Owned Life Insurance (COLI), a more streamlined process is available called "Guaranteed Issue" underwriting. Guaranteed Issue is a form of underwriting that does not require any medical exams—each insured simply signs a form answering a few basic questions, usually some form of the following:

- Are you actively at work full time at least 30 hours or more per week, at your usual place of employment and physically performing all your customary duties of your regular occupation?
- During the past three months, have you been absent from work for a total of four or more days or been hospitalized for any illness or injury?
- Are you a U.S. citizen or have a permanent U.S. resident status and currently residing in the U.S.?
- Have you used tobacco or nicotine in any form within the past 12 months?

Guaranteed Issue relies on the concept of risk sharing and is thus only available if the purchasing corporation has a potential insured group of at least 10–15 individuals (minimum varies by insurance company). Because the aggregate risk is less when considering the group as a whole, the insurance company is willing to forego the medical underwriting process.

The decision to utilize Guaranteed Issue underwriting is based on the individual circumstances of the corporation contemplating the transaction. Legislation effectively limits insureds to the top 35% of wage earners in an organization. As a result, the size of the corporation in terms of total number of employees is a factor in whether guaranteed issue is available.

Simplified Issue

For the reasons outlined above, Guaranteed Issue may be unavailable, but an institution might wish to avoid having its employees go through the full underwriting process. In these cases, Simplified Issue may be appropriate. Like Guaranteed Issue, Simplified Issue can avoid a medical exam. Unlike Guaranteed Issue, the insurer will ask medical questions to assess the potential insured. The questions will vary from carrier to carrier, but Simplified Issue has the potential to help employees avoid a full medical exam.

Premium Allocation Across Policies

Individual Funding

COLI can be purchased on an individual basis in amounts projected to recover/offset the costs of providing benefits for that specific individual. While this methodology has some intuitive appeal and allows face amounts to be set to ensure any necessary preretirement death benefit coverage, it has the following drawbacks:

- Medical underwriting, which can be politically and emotionally sensitive, is often required because of high required face amounts in some cases and to ensure there is no adverse selection.
- Increases in one individual's projected benefits often necessitate the need for additional insurance purchases even if total plan liabilities have not changed significantly.
- "Fine-tuning" is administratively complex.

Aggregate Funding

A common alternative to individual COLI funding, particularly for companies with numerous plan participants, is aggregate COLI funding. With aggregate funding, policies are placed on a pool of eligible plan participants, typically with either level face amounts or premium amounts. Funding is designed to offset liabilities on a total, not individual, basis. Aggregate funding provides the following advantages to funding liabilities on an individual basis:

- Policies are kept on insureds after they leave the company; exchanges, therefore, are unnecessary.
- Policies can often be issued on a "guaranteed issue" basis, thus eliminating intrusive underwriting requirements.
- The need for frequently fine-tuning each participant's funding to recover projected liabilities is eliminated—the company only needs to review total funding levels on a periodic basis.
- Insurance purchases are made at the most efficient levels possible, as funding is reviewed in the aggregate, not individually.

COLI Best Practices

Overview

Signed into law in 2006, Section 863 of the Pension Protection act added the so-called COLI Best Practices provision to the Internal Revenue Code as subsection (j) to Code Section 101. Recognizing the continued viability of funding nonqualified benefit plans with COLI, under the provision death benefits paid from a COLI policy are tax-free only if:

- The deceased individual was an employee within 12 months of his or her death;
- The benefits were payable to the employee's family, beneficiary (not the employer), trust or estate, or were used to purchase an equity interest in the employer, as in a buy-sell agreement; or
- The employee was a director, a "highly compensated employee" under Section 414(q) of the Internal Revenue Code, or a "highly compensated individual" under Section 105(h)(5) (i.e., among the highest paid 35% of all employees of the employer at the time the contract was issued).

Notification, Consent, and Reporting

There are also additional requirements that individuals be notified of, and consent to, such coverage. Specifically, before a policy is issued, the employee:

- Must be notified in writing that the employer intends to insure the employee's life and the maximum face amount for which the employee could be insured at the time the policy is issued;
- Must provide written consent to being insured under the policy and that such coverage may continue after the insured terminates employment; and
- Must be informed in writing that the employer will be a beneficiary of any proceeds payable upon the death of the employee.

In addition, employers will need to report annually to the IRS (Form 8925) the total number of its employees, the number of employees covered under a COLI program, and the total amount of insurance in force at the end of the year under the life insurance contracts.

APPENDIX

GENERAL ACCOUNT	VARIABLE, SEPARATE ACCOUNT
PORTFOLIO COMPOSITION	
Typically, high-quality corporate bonds and collateralized mortgages.	A variety of investment options are available which allow for selection of a preferred asset class.
RETURNS	
Depends on underlying general account yield. Rate is periodically declared by the carrier.	Based on returns of underlying investment funds.
GUARANTEED RATES	
Typically range from 1.00%–4.00%.	No guaranteed minimum crediting rates.
INVESTMENTS AND INVESTMENT RISK	
Investments contained in carrier's general account. Carrier makes all investment decisions. Typically, less earnings volatility.	Policyholder chooses asset managers and investment strategy. Allows greater investment strategy flexibility. Typically, experience more earnings volatility depending upon asset class.
COST	
Costs are imbedded in difference between overall portfolio yield and net rate actually credited to policies.	Costs (e.g., mortality, costs of insurance, and subaccount expenses) are broken out, thus creating transparency.
ACCOUNTING	
Cash surrender values pursuant to ASC 325 (FAS 85-4).	Mark-to-market cash surrender values pursuant to ASC 325 (FAS 85-4).
CREDIT RISK	
Cash Value and Death Benefits. Full exposure to general account. Credit risk of underlying asset default borne by carrier.	**Cash Value.** Market value of assets protected from general creditors of insurance company.* Credit risk of underlying asset borne by policyholder. **Death Benefits.** Credit risk of underlying asset default borne by carrier.
SIMPLICITY	
Easy to understand.	Numerous parties and complex pricing components. Product structure provides greater transparency.

NOTE

**Variable products typically provide a general account alternative with characteristics of general account products.*

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