

## COLI: Pension Protection Act Adds Several Conditions

If the acronym “COLI” makes you think of bagged spinach or undercooked hamburgers, you may wish to read the background section that follows. If you already know that COLI is a popular benefits financing mechanism, you may wish to go directly to the sections explaining the changes to the taxation of COLI proceeds made by the *Pension Protection Act of 2006* (PPA).

### Background

COLI stands for corporate-owned life insurance. COLI is permanent life insurance (i.e., it builds cash value) that the employer takes out on the lives of its employees. The employer owns each policy and also is the beneficiary named to receive policy proceeds on the employee’s death.

In some cases, the employer needs to have life insurance on its employees. For example, if a company’s CEO or other senior officer died suddenly, it could cause the company financial hardships. The life insurance proceeds from COLI would ameliorate those hardships.

COLI also has tax advantages for an employer. First, the increase in the cash value of the policy accrues tax-free to the employer while the policy is in force. Second, the policy proceeds paid upon the death of the insured are tax-free. Finally, even before the policy matures, an employer can tap the cash value that has built up in a policy on a tax-free basis (e.g., by borrowing against the cash value).

These tax advantages — along with the fact that an employer can maintain a virtually unlimited amount of COLI — have made COLI an attractive savings vehicle for employers that have promised to provide benefits in the future (e.g., nonqualified deferred compensation and retiree medical coverage). Some employers found COLI to be such a good savings vehicle that they purchased coverage on many non-key employees (so-called “janitor insurance”) and left the policies in effect long after employees terminated employment. This broad use of COLI raised some questions.

- First, state insurance laws generally require that anyone purchasing life insurance have an “insurable interest” in the life of the insured. Under those laws, employers clearly have an insurable interest in the

lives of their key employees and those with special skills. An employer might not have an insurable interest in the lives of all of its employees, however.

- Second, some felt it was just unfair that a corporation could insure the lives of its employees, *not tell them that it had done so*, and then collect all of the proceeds from the policy at the employee’s death without anything going to the employee’s family or beneficiaries and without the employee ever receiving any benefit from the insurance.

Congress is now stepping in and resolving these issues by stripping COLI of some of its tax advantages unless several conditions are met.

### PPA Limits Tax Exemption for Proceeds of COLI

Under the PPA amendments, it is still possible for an employer to receive all policy proceeds of COLI on a tax-free basis, but several conditions must first be met.

First, the insured individual whose death has resulted in the pay-out must have been:

- employed by the employer within the 12 months before his or her death; or
- a director or highly compensated employee at the time the policy was issued.

Second, before the policy was issued, the employer must have provided the individual whose death has resulted in the pay-out with written notice of:

- the employer’s intent to insure the employee’s life;
- the maximum face amount of the policy at the time issued; and
- the fact that any proceeds paid on the employee’s death will be paid to the employer.

Third, the insured must have provided consent before the

policy was issued and, if applicable, that consent must specifically allow the employer to continue the coverage after termination of employment.

#### Reporting and Recordkeeping Requirements

In addition to meeting the new requirements to keep COLI proceeds tax-exempt, the employer must file a report each year that states:

- the number of employees of the employer at the end of the year;
- the number of employees insured by COLI at the end of the year;
- the total amount of COLI in effect at the end of the year;
- the name, address, taxpayer identification number, and type of business of the employer; and
- that the employer has written consents from all insured employees (or if any consents are missing, how many are missing).

The employer must also maintain records demonstrating that the information provided in the reports is complete and accurate.

#### Effective Date of Changes

These new provisions are effective for policies issued after August 17, 2006. If there is a material increase in the amount of coverage provided under a previously issued policy, or any other material change, an older policy may be deemed to be newly issued and subject to the new rules.

#### The Future of COLI

These changes will cause some administrative complexities for employers that purchase new COLI policies. Nevertheless, COLI remains an attractive financing vehicle. Many employers had already stopped using janitor insurance before the PPA was adopted. Most that use COLI currently have it only on the lives of executives and directors who are in the best position to understand the advantages that COLI has as a financing vehicle and are unlikely to object to the employer purchasing insurance on their lives. Finally, the disclosure and consent requirements seem likely to close off any challenges by the insured or a beneficiary.

If you have any questions about COLI or any other employee benefits matter, please contact your local Willis office.

## U.S. Benefit Office Locations

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