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Mr. Chairman and Members of the Committee:

I appreciate the opportunity to appear before you to discuss the tax issues that arise in connection with Corporate Owned Life Insurance arrangements ("COLI"). These arrangements have attracted a great deal of attention over the last several years – in the popular press, in litigated cases and in Congress. The issues raised in connection with COLI have led this Committee to consider several possible amendments to the Internal Revenue Code that might reduce the tax benefits that these arrangements generate under current law.

I do not represent any private interest in connection with the subject matter of today's hearing. I have analyzed tax issues as they apply to life insurance products since the early 1980s when I served in the U.S. Department of the Treasury's Office of the Tax Legislative Counsel, and subsequently as a consultant to the Joint Committee on Taxation, the Internal Revenue Service and the Congressional Research Service.

Summary and Conclusions

For the reasons set out below, I believe that COLI arrangements produce inappropriate tax benefits. Specifically:

- life insurance proceeds are excluded from a corporation's income even where the corporation retains the proceeds, rather than distribute them to the insured's family or estate; and

- corporations participating in COLI arrangements obtain inappropriate "tax arbitrage" profits. The existing limitations contained in IRC section 264 are inadequate to eliminate these inappropriate tax savings.

The life insurance industry asserts that the tax benefits claimed with respect to COLI arrangements are justified because the corporate beneficiaries will use the insurance proceeds to pay employee benefits to current and retired employees. Congress has not enacted any explicit tax incentive for corporations that invest financial resources to meet these general business needs, and it would be unwise to do so.

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* Portions of this testimony are drawn from "TAXATION OF LIFE INSURANCE PRODUCTS: BACKGROUND AND ISSUES," a report that I prepared for the Congressional Research Service.

If the Congress determines, however, that the tax law should provide an incentive to help corporations pay for these employee benefits, it makes no sense to limit this incentive to COLI arrangements. Rather, businesses should be allowed to use any financial instrument to prefund these benefits.

1. Traditional Corporate Owned Life Insurance – Or "Key Person" Insurance

In all COLI arrangements, a corporation purchases (and owns) life insurance contracts that insure one or more of the business' employees. In the most traditional arrangement, the business purchases insurance on the lives of a small number of individuals – typically the business' top executives and owners. These arrangements, also known as "key person" life insurance, are designed to provide a source of funds that the business will need following the death of the insured executives or owners.

For example, businesses may purchase life insurance to provide a source of funds that will be used to purchase (or buy-out) the ownership interest of a deceased owner. This type of life insurance is purchased when the owners of a business reach an agreement that the surviving owners of the business will purchase the interest of any deceased owner at a specified price. Similarly, a member of a family may provide important (and perhaps unpaid) services for the family business. The proceeds of the "key person" life insurance enable the family to continue their family business. In both of these situations:

- insurance proceeds are either paid to, or directly benefit, the family of the insured individual employee; and
- the need for funds arises at the time of, and as a result of, the insured's death.

This notion – that the surviving family members of the insured need the life insurance proceeds to meet their economic needs – provides the primary justification for the favorable tax treatment that life insurance receives under the income tax. Specifically, the beneficiaries of a life insurance contract are not taxed when they receive the life insurance proceeds that are payable by reason of the death of the insured. Moreover, an owner of cash value life insurance generally avoids taxation on the entire amount of interest (or other return on their investment) that is credited to their contract's cash value. Absent concern for the survivors of the insured individual, it would be impossible to justify the favorable tax treatment of investments made in the form of cash value life insurance.

2. Large Scale COLI – Or "Janitor's Insurance"

In recent years, large corporations have purchased life insurance contracts that insure the lives of large numbers of their employees. Reports in the Wall Street Journal and other newspapers have referred to these arrangements as "janitor's insurance." According to these reports, the employees were not notified that their employer had purchased life insurance on their lives.

Under the typical large scale COLI arrangement, the life insurance contract designates the employer as the beneficiary of the contract. When an insured employee dies, the employer uses the proceeds for any corporate purpose rather than pay the insurance proceeds to the employees' surviving family members or other designated beneficiaries. It is important to note that corporations generally do not utilize these large-scale COLI arrangements to meet expenses that are attributable to the insured's death. Rather, the corporation uses the proceeds for any corporate purposes.

Use of cash value life insurance constitutes another defining characteristic of large scale COLI arrangements. Many individuals concerned about the financial consequences of the untimely death of an individual obtain term life insurance protection. These individuals either purchase this insurance directly or obtain it as part of an employment-based group life insurance contract. As with all forms of life insurance, the insurance company pays the specified death benefit if the insured dies during the period of coverage. Unlike cash value policies, however, term life insurance does not incorporate an investment return that accrues to the benefit of the policy owner.

In contrast, large scale COLI arrangements are designed primarily to take advantage of the investment returns paid in connection with cash value life insurance.[**] Absent the favorable tax treatment of these investment returns, it is highly unlikely that any corporation would enter into a large scale COLI arrangement. In light of the tax-based motivation for the large-scale COLI arrangements, two distinct tax policy issues arise. Both of these issues are discussed below.

Issue 1: Should the preferential tax treatment of life insurance apply to large scale COLI arrangements? Under current law, the investment income that a corporation earns in connection with a COLI arrangement is not taxed if it is paid to the employer on account of the death of the insured. The first tax policy question is whether the corporation should be able to avoid taxation on its income from these arrangements.

Rationale for Preferential Tax Treatment. It is generally thought that the exclusion of investment income from taxation can be justified, if at all, because the insured's family will use the life insurance proceeds to replace the income that the insured would have earned if she had

[**] COLI arrangements may be profitable even where the corporate owner will not utilize the life insurance proceeds to meet its business needs. Earlier this year, the Wall Street Journal reported that large corporations are purchasing cash value life insurance contracts with the intent of donating the proceeds of the contracts to charity. It is claimed that the tax benefits are sufficient to generate the contributions to charity at no net cost to the corporations. T. Francis and E. Schultz, "Dying to Donate: Charities Invest in Death Benefits" The Wall Street Journal (February 6, 2003).

survived. If this rationale is respected, then life insurance proceeds that a corporation receives should be free of tax only if the employer distributes the proceeds to the employee's family or other designated beneficiary.

In many circumstances, however, corporations purchase life insurance to obtain a tax-free investment return. Rather than making the proceeds available to the employee's family to replace the employee's income, the corporations use the proceeds to meet their general business needs (including the payment of benefits to other employees). In these circumstances, the policy justification for exempting the life insurance proceeds from taxation does not exist. Consequently, it would be appropriate to reconsider the tax exemption of the interest income credited to the cash value of large-scale corporate owned life insurance.

Indeed, this approach is fully consistent with the life insurance industry's own view of life insurance. In one of its marketing campaigns, the life insurance industry proclaims that "life insurance is for the living." This campaign relies upon the fact that many responsible individuals are concerned with the financial well-being of those who will survive after their death. I have been unable to find an advertisement with an alternative, albeit less appealing, sales pitch: "Life insurance is for the Fortune 500 corporation that seeks a tax-preferred source of investment income."

<u>Does this rationale extend to COLI?</u> The life insurance industry frequently claims that corporations use the COLI-generated life insurance proceeds to pay for employee benefits (including nonqualified deferred compensation and health insurance for current and retired employees). The industry argues that the use of the life insurance proceeds for these purposes provides sufficient justification for the current preferential tax treatment of the COLI arrangements.

This argument does not withstand serious scrutiny for several reasons. First, financial and tax analysts recognize that money is fungible, and that the formal designation of a use for funds is immaterial. The tax savings that result from COLI arrangements simply increases the financial resources available to the corporation. There is no vested legal obligation, under law or in any contract, to use the proceeds to pay benefits. In fact, the corporation may use these funds to pay benefits, increase the compensation paid to its executives, distribute additional dividends to its shareholders or for any other purpose. In other words, a tax preference attributable to the use of funds for designated reasons operates in the same manner as a non-targeted tax reduction.

Second, Congress has never recognized the principle that investment income should be free of tax if the proceeds are used to pay employee benefits (apart from benefits established in connection with a qualified pension plan). Indeed, COLI arrangements are designed to avoid the explicit limits on comparable tax benefits that Congress enacted in 1984 in connection with welfare benefit plans.

Third, if Congress determines that corporations should be able to earn tax-free earnings on funds set aside to pay employee benefits, it should do so in a manner that encourages sound financial practices. Businesses should be allowed to make investments that will generate needed funds at the time that the funds will be needed to pay the costs of the benefit programs. The financial services industry has created financial instruments that will meet these needs. In contrast, COLI arrangements meet these goals in a less satisfactory fashion. They generate funds upon the happening of an employee's death rather than when the business needs the funds. COLI arrangements are complicated in design, and expensive to operate. Included in the expenses that the investing corporation must bear are the mortality charges that the corporate investor must incur if these arrangements are to be characterized as life insurance. If the advance funding of employee benefits represents a sound policy goal, there is no reason to give the life insurance companies a monopoly on the financial instruments that can meet these needs.

Does Senator Conrad's modified amendment create adequate safeguards? The amendment to the JOBS Act proposed by Senator Conrad would not provide sufficient safeguards. Under this proposal, it appears that the existing tax treatment of COLI arrangements would be retained for a life insurance contract if any of the following tests are satisfied:

- test 1: the death benefits are either (1) payable to a member of the insured's family (or a trust for such a family member) or the insured's estate or (2) are used to purchase an equity interest in the employer from a family member, trust for a family member or the insured's estate.

- test 2: the life insurance contract covers highly compensated employees, as defined in section 414(q).

- test 3: each insured employee consents to the issuance of the life insurance contract and:

  – the insured is an employee who is eligible to participate in any employee pension plan (other than a qualified plan described in section 401(a) or other benefit plan under which benefits are payable to a participant (or a beneficiary designated by the participated);

  – the aggregate amount of death benefits under the COLI arrangements must be "reasonably related" to the current and projected future costs of the benefits established by the employer; and

  – the contract is placed in trust for the exclusive purpose of funding the employee benefit plans.

The first test covers the traditional uses of "key person" life insurance. The second and third tests, however, will retain the existing tax treatment for most COLI arrangements.

Specifically, under test 2 large corporations will be able to purchase life insurance insuring all the employees who are "highly qualified employees" of the employer (or any affiliate) on the date that the contract is issued. For purposes of IRC section 414(q), an employee is generally treated as highly compensated if the employee's compensation exceeds $80,000 (adjusted for inflation). Alternatively, a corporation is permitted to designate twenty percent of its workforce as highly compensated if this would produce a larger class of highly compensated employees. As I understand this proposed amendment, under test 2 large corporations would be able to create COLI arrangements that cover up to 20 percent of its non-unionized workforce. These arrangements would generate substantial tax-free savings which may be used for any corporate purpose.

Similarly, test 3 would permit the purchase of sufficient life insurance to fund the cost of all current and future benefits under employee benefit plans.. Given the cost of health insurance, and the possible increases in future medical costs, this limitation is more apparent than real.

Issue 2: Are the existing limits in section 264 sufficient to prevent inappropriate "tax arbitrage" profits? The second tax policy issue arises in connection with what has been termed "leveraged" COLI. In fact, the same policy concern arises in most large scale COLI arrangements.

In a leveraged COLI arrangement, the corporate owner of the life insurance contract borrows to pay a substantial portion of the insurance premiums. This is a form of "tax arbitrage" in which a taxpayer incurs tax deductible interest while earning tax-free investment returns. The combined effect of this arrangement is similar to many other corporate tax shelters: the tax savings may exceed the costs incurred in paying for the life insurance.

Illustration of COLI Tax Arbitrage. The economics of a "leveraged" COLI arrangement can be illustrated by examining the facts of *Winn-Dixie Stores, Inc. v. Commissioner*, 113 T.C. 254 (1999), *aff'd,* 254 F.3d 1313 (11th Cir. 2001). In the first year of this arrangement, it was projected that the taxpayer would pay aggregate premiums of $114 million on the lives of 38,000 of its employees. After taking into account all outlays and receipts, the plan anticipated that the taxpayer would incur a pretax loss of more than $4 million.

If the purported COLI tax savings are considered, the pre-tax loss is transformed into a slight after-tax profit. The difference between the pretax loss and the after tax profit was attributable to the following two factors: (1) the deduction of the interest and fees generates substantial tax savings; and (2) the nontaxable nature of the loans and death benefits from the life insurance contract. For the period 1993-2052, it was projected that the taxpayer would realize after-tax earnings in excess of $2.2 billion, while incurring pretax losses aggregating more than $750 million. The after-tax profit in this case arose solely by the tax benefits generated by the tax arbitrage.

The Tax Court concluded that this arrangement was a sham transaction. Under the sham transaction doctrine, tax benefits are disallowed if the transaction lacks economic effects or substance other than the generation of tax benefits. As a consequence, the court determined that the taxpayer was not entitled to the claimed tax benefits.

Existing Anti-Arbitrage Provisions. The Internal Revenue Code contains a number of provisions designed to prevent taxpayers from obtaining the benefits of tax arbitrage. In 1986, 1996 and 1997 Congress enactment a series of provisions that limit the amount of interest that may be deducted in connection with COLI arrangements. As the Joint Committee on Taxation has reported, however, in its report on Enron Corporation, many large COLI arrangements were "grandfathered" under the transition rules enacted when these provisions were enacted. Consequently, the tax benefits from most of these older COLI arrangements are limited only by the results of litigation initiated by the IRS.

The life insurance industry asserts that any unjustified tax benefits arising under "non-grandfathered" COLI arrangements were fully addressed in legislative changes enacted in 1996 and 1997. These changes limited the interest deduction allowed in connection with certain COLI arrangements.

First, in 1996 Congress enacted IRC section 264(e) to limit the deductions for interest paid "with respect to" life insurance contracts insuring the lives of corporate employees. Under this provision, deductions are allowed only on interest paid on a limited amount of indebtedness incurred "with respect to" life insurance contracts. Specifically:

(1) the maximum amount of indebtedness that may give rise to deductible interest is limited to $50,000 per insured "key person" and

(2) at most, 20 insured individuals are characterized as key persons.

Consequently, no more than $1,000,000 of indebtedness could give rise to deductible interest payments. This limitation would eliminate most of the tax benefits claimed in connection with transactions structured in the same manner as the transaction in the *Winn-Dixie Stores* case discussed above. Specifically, this provision limits tax benefits arising under those COLI arrangements in which the corporate owner of the life insurance contracts uses the contracts as security for the loans.

This limitation, however, seems to apply only to interest arising under life insurance policy loans. If a taxpayer borrows from other unrelated sources in a manner that the borrowing appears to be unrelated to the life insurance, it is possible that this limitation would not apply. In 1997, Congress recognized that IRC section 264(e) was unduly narrow. The popular press reported that the Federal National Mortgage Association ("Fannie Mae") planned to enter into a COLI arrangement covering the lives of the individuals who had borrowed money to purchase homes. To address this situation, Congress enacted IRC section 264(f). This provision disallows a portion of a corporation's interest deduction. The magnitude of the disallowance depends upon the aggregate cash value of the corporation's life insurance contracts and the aggregate adjusted basis of its other assets. For example, consider a bank that owns life insurance contracts with an aggregate cash value of $1 billion and assets with an aggregate basis of $10 billion. The unborrowed cash value represents ten percent of the bank's assets. In this example, IRC section 264(f) would disallow ten percent of the bank's interest expense.

This provision will achieve its narrow goal – to eliminate the tax benefits of BOLI (i.e., Bank Owned Life Insurance) arrangements in which financial institutions purchase life insurance contracts on the lives of individuals who borrow from the bank. By its terms, however, this interest disallowance provision does not apply to COLI arrangements that involve life insurance contracts on the lives of a corporation's officers, directors, employees and certain shareholders. Consequently, unless the interest is treated as incurred "with respect to" life insurance contracts, a corporation would not lose its interest deduction when it continues to borrow funds (other than policy loans) at the same time that it pays the life insurance premiums on the lives of its employees.

Conclusions Concerning COLI Tax Arbitrage. In conclusion, the existing statutory limitations are inadequate to prevent corporate taxpayers from enjoying tax arbitrage profits from their COLI arrangements. Consequently, additional legislation is needed to limit these abuses. First, the broader interest disallowance approach contained in section 264(f) should be extended to all COLI arrangements. Second, as the Joint Committee staff recommended in its report on the Enron corporation, Congress should terminate the grandfather rule for pre-June 20, 1986 COLI contracts. As it noted, even though Enron did not purchase any additional life insurance contracts after 1994, Enron's debt and deductible interest under life insurance contracts continued to increase throughout the 1980s and 1990s. The grandfather rule can no longer serve any reasonable need for transition relief. Unless these changes are enacted, corporate taxpayers will continue to use COLI as a source of tax arbitrage profits.