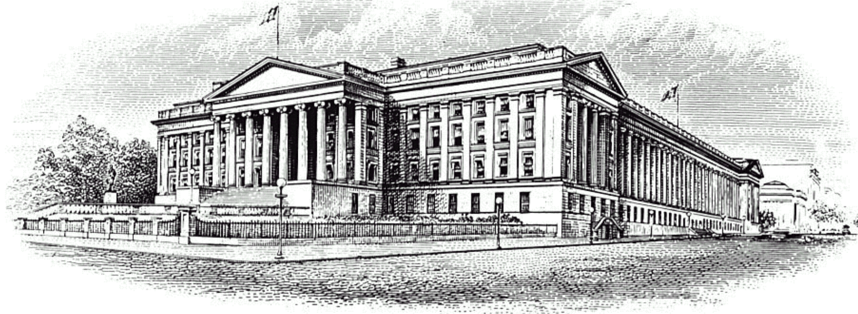

# DEPARTMENT OF THE TREASURY
## OFFICE OF PUBLIC AFFAIRS

Embargoed Until Delivery — Contact: Tara Bradshaw
October 23, 2003 — (202) 622-2014

**TESTIMONY OF GREGORY F. JENNER**
**DEPUTY ASSISTANT SECRETARY (TAX POLICY)**
**UNITED STATES DEPARTMENT OF THE TREASURY**

**BEFORE THE COMMITTEE ON FINANCE**
**UNITED STATES SENATE**

Mr. Chairman, Senator Baucus, and distinguished Members of the Finance Committee:

Thank you for the opportunity to testify regarding the taxation of corporate-owned life insurance – more commonly known as COLI. COLI has been a considerable source of debate and controversy over the years, particularly as the extent of its use and the purposes for which it is acquired have changed. While we should not be so naïve as to think that today's hearing will put that debate and controversy to rest forever, I do hope that our testimony can assist in separating wheat from chaff. Our testimony will discuss the legitimate uses of COLI, identify where any problems might exist, and suggest how those problems should be addressed.

To understand where we are today with respect to COLI, it is important to understand where we have been; i.e., how the taxation and regulation of COLI policies has evolved over the years. As preliminary matter, Congress, in the McCarran-Ferguson Act, 15 U.S.C. § 1011, *et* seq., provided that regulation by the states of most aspects of insurance is in the public interest. Congress reaffirmed that decision to allow the states to regulate insurance in the 1999 Financial Modernization Act, P.L. 106-102, more commonly known as the Gramm-Leach-Bliley Act. Thus, while Congress establishes rules regarding the Federal tax treatment of COLI policies, the states have principal responsibility for regulating all other aspects of life insurance. For our purposes today, the most important aspect of that regulation is the establishment and enforcement of rules for determining when the purchaser of insurance has an insurable interest in the person whose life is insured.

## **Insurable Interest and Other State Responsibilities**

In order for anyone to purchase insurance on the life of any individual, the purchaser of the insurance must have an insurable interest in that individual. Judicial case law and state statutes have, historically, determined under what circumstances a purchaser of insurance has such an insurable interest and, if such an interest exists, to what extent insurance may be purchased on the life of the insured.

Traditionally, states have recognized that employers can suffer significant losses on the death of a key employee or principal owner. States have responded by allowing employers to be the beneficiary under a life insurance policy covering the life of such a "key person." In addition, some courts have recognized an insurable interest of an employer in the life of an employee when the employer is exposed to liability for future medical, death, disability, or pension benefits for the employee, whether that responsibility is based on custom (*Neely v. Pigford, 181 Miss. 306 (1938)*) or law (*Bauer v. Bates Lumber Co., Inc., 503 P.2d 1169 (N.M.App. 1972), cert. den. 83 N.M. 390*). This principle has been codified in many states, and while differences exist between the approaches taken, most states allow insurance on employees and, in some cases, retirees for the purpose of funding employee benefits (Wamberg, Warren T., *The Theory and Practice of Bank Owned Life Insurance*, Chicago, Illinois: T.W.O. Publishing, 1995). Bank regulatory practice has also followed this approach. The Office of the Comptroller of the Currency has issued guidelines for national banks (*Bulletins 2002-19 and 2000-*23) that allow COLI to be used as a funding vehicle for meeting a bank's employee benefit liabilities.

In order for there to be a valid insurable interest, the amount of death benefits purchased must have a reasonable relationship to the prospective pecuniary expense of the employer. Thus, in the case of broad-based employee coverage, the anticipated death benefit proceeds cannot be grossly disproportionate to the expected benefit obligations of the employer. Indeed, a number of states have limited the amounts of insurance on non-key employees to amounts equal, in the aggregate, to the present value cost of the employer's ERISA welfare benefit plans.

The demonstration of an insurable interest on the part of a policy holder generally has been required only at the time that insurance is purchased. Thus, the Supreme Court has upheld that an originally valid life insurance contract does not cease to be so when the beneficiary's interest in the life of the insured changes (*Grigsby v. Russell, 222 U.S. 149 (1911)*).

State law typically allows for the enforcement of the insurable interest requirements. COLI contracts may be deemed invalid if it can be shown that an insurable interest did not exist or that the insurable interest was insufficient relative to the size of the death benefit. In some cases, as was recently demonstrated in Texas (*Mayo v. Hartford Life Insurance Co.,* 220 F. Supp. 2d 714 (S.D. Tex., Aug 2, 2002), a court may award death benefits to an employee's estate, rather than to the policy's beneficiary, in the case where a contract is deemed invalid. State insurance commissioners may also punish insurance companies through fines, licensing revocations, or other means, for issuing policies where no insurable interest exists.

States may regulate whether employees must receive a portion of any death benefit on policies written on their lives. The states may also specify whether an employee must approve of a policy being written on his or her life, or whether an employee must be notified that such a policy exists.

## Income Taxation of COLI

Life insurance policies receive preferential tax treatment under the Internal Revenue Code whether owned by an individual or a corporation. Death benefits paid under a life insurance policy are generally excluded from the income of the beneficiary. Earnings from a life insurance policy are not subject to tax, unless those amounts are distributed to the holder of the policy in the form of a partial or full surrender of the contract. Even then, favorable "basis-first" distribution rules apply to policies that are not modified endowment contracts. Proceeds of policy loans are also not subject to tax, unless those amounts are not repaid, or the policy is a modified endowment contract.

Corporations are not the same as individuals, however, and the tax laws have recognized that distinction where appropriate. Some tax deductions available to corporations (but not to individual taxpayers) may allow opportunities for tax arbitrage by coupling tax deductibility with tax-free inside buildup and excludable death benefits. The combination could encourage the purchase of COLI not for the life insurance protection provided but rather as a tax-favored investment. To limit these benefits, while at the same time permitting the purchase of COLI for valid business purposes, Congress has enacted several special tax rules designed to limit the use of COLI merely as a tax-favored investment.

First, no deduction is allowed for premiums paid on a COLI policy if the business is directly or indirectly a beneficiary under the policy. Otherwise, the situation would be akin to a business taking a deduction for an investment of principal, while not being taxed on the earnings or the return of that principal amount.

Second, in order to discourage the purchase of contracts with front-loaded premium structures, Congress denied any deduction for amounts paid or accrued on indebtedness incurred to purchase or carry a single premium life insurance, endowment, or annuity contract.

Third, in order to further limit interest rate arbitrage on front-loaded policies, Congress denied a deduction for any amount paid or accrued on indebtedness incurred to purchase or carry a life insurance endowment or annuity contract (other than a single premium contract) if the plan of purchase contemplates the systematic direct or indirect borrowing of part or all of the increase in the contract's cash value. Exceptions to this third restriction are allowed, however, the most important being the "four-out-of-seven rule." Under this rule, interest may be deducted as long as at least four of the initial seven annual premiums are not paid by means of indebtedness.

## The Tax Reform Act of 1986 – Limits on the Deductibility of Policy Loan Interest

In 1986, Congress became concerned that the death benefit promised to an insured employee under a COLI arrangement would be illusory if an employer borrowed against the policy (and thereby reduced the death benefit by the amount of the borrowing). The ability of a corporation to deduct interest on such policy loans could encourage that type of borrowing. Consequently, in order to discourage such loans, the Tax Reform Act of 1986 added an additional restriction on interest deductibility. This provision generally disallowed the deduction for policy loan interest with respect to life insurance policies covering the life of an officer, employee, or individual financially interested in any trade or business carried on by the taxpayer. The provision applied even if the proceeds of the loan were used in the taxpayer's trade or business. This limitation did not apply, however, to the extent that the aggregate amount of policy debt incurred by the taxpayer covering a single individual did not exceed $50,000. It also did not apply to contracts purchased on June 20, 1986 or before ("pre-1986 contracts").

**<u>The Rise of Broad-Based COLI</u>**

While the 1986 tax changes eliminated some tax planning opportunities, the expansion of insurable interest laws by several states in the 1980s and 1990s to allow insurance of non-key employees created the opportunity for corporations to buy broad-based COLI plans. Corporations entered into COLI contracts covering, in some cases, hundreds of thousands of employees. Many of the plans initiated after 1986 were leveraged-COLI plans, under which much of the accumulated cash value was ultimately accessed by the employer through policy loans and used to pay future premiums. While this meant that less cash value would be available for the payment of employee benefits, the leveraged plans nevertheless were extremely profitable. Policy loan interest was deductible as long as the company satisfied the four-out-of-seven rule and the amount borrowed against the policies per individual did not exceed $50,000.

Often, under a leveraged COLI arrangement, the policy crediting rates were set at levels just below the policy loan rates, so that an insurer would be indifferent as to the level of policy loan interest rates. These rates were often substantially higher than policy loan interest rates customarily charged at the time of the loan. This was done because the higher the interest rate, the greater the interest deduction and, consequently, the tax savings. Thus, deductibility of policy loan interest was key to the profitability of the leveraged COLI arrangement.

Treasury and the Internal Revenue Service (IRS) became concerned that these broad-based leveraged COLI arrangements were designed as tax-saving vehicles and served no legitimate, non-tax business purpose. The IRS undertook extensive audits of numerous leveraged COLI transactions and successfully challenged the deductions taken by taxpayers on the grounds that the transactions were sham transactions. (*American Elec. Power v. United States*, 326 F.3$^{rd}$ 737 (6$^{th}$ Cir. 2003), *Internal Revenue Service v. CM Holdings,* 301 F.3d 96 (3$^{rd}$ Cir. 2002), *Winn-Dixie Stores v. Commissioner,* 254 F.3$^{rd}$ 1313 (11$^{th}$ Cir. 2001), *cert. den.* 535 US 986 (2002)). These efforts continue today.

**<u>The HIPAA of 1996 – General Restrictions on the Deduction of Policy Loan Interest</u>**

Congress responded to the use of broad-based leveraged COLI in the Health Insurance Portability and Accountability Act (HIPAA) of 1996. In general, the enacted provision modified

and strengthened the 1986 limitation by disallowing a deduction for any interest on borrowing by businesses with respect to life insurance, endowment, and annuity contracts covering any individual who is or was an officer, employee, or person financially interested in any trade or business carried on (currently or formerly) by the taxpayer.

The provision provided only two exceptions. Congress retained the $50,000 loan exception in the case of policies covering the life of key persons, but limited the number of key persons that could be insured under the COLI policy. In addition, pre-1986 contracts continued to be excluded from the provision. Both of these exceptions tied the allowable interest deduction to market interest rates in order to prevent excessive interest deductions.

The new legislation also provided transition rules for existing policies. These transition rules allowed some deductibility of policy loan interest through 1998 on amounts borrowed prior to January 1, 1996 on non-grandfathered contracts and on amounts borrowed prior to January 1, 1997 with respect to non-grandfathered contracts entered into in 1994 or 1995.

**Taxpayer Relief Act of 1997 – Limits on Debtor-BOLI**

In 1997, Congress again turned its attention to COLI. The concern this time was that broad-based COLI might be extended to insurance contracts covering the lives of debtors, as well as the lives of individuals with other relationships to the taxpayer, such as shareholders. Specifically, Congress was concerned that financial institutions, notably banks, could use their access to depositors and other lenders to fund an expansion of bank-owned life insurance (BOLI). Such an expansion potentially could achieve the same sort of tax arbitrage that prompted the 1996 COLI legislation.

In response to these concerns, Congress strengthened the current prohibitions on certain deductions. Under the new rules, no deduction is permitted for the payment of premiums on any life insurance, endowment or annuity contract if the taxpayer is directly or indirectly a beneficiary under the contract, regardless of the identity of the insured. In addition, except for key-person and pre-1986 grandfathered contracts, no deduction is now permitted for any interest paid or accrued on any indebtedness with respect to any life insurance, endowment or annuity contract owned by the taxpayer covering any individual.

Congress also enacted a special rule applicable only to taxpayers other than natural persons. It denies a deduction for the portion of a corporation's interest expense which is allocable to unborrowed policy cash values on policies other than those covering employees, officers, directors, or 20-percent owners. This treatment is akin to the rules governing tax-exempt bond interest earned by banks. Insurance companies must also treat any increase in non-employee-based COLI cash values in the same manner as tax-exempt interest, so that the portion of such earnings that is allocated via proration rules to the satisfaction of policyholder liabilities (equivalent to a bank's interest expense) results in a reduction of certain insurance company deductions.

**COLI Today**

While press reports have focused a great deal of recent attention on COLI, the changes to the treatment of COLI-related interest and other deductions appear to have all but eliminated the use of leveraged COLI plans. We understand that most broad-based COLI arrangements entered into today are used for somewhat specific purposes, most notably the funding of certain employee and retiree benefits. The leveraged transactions still in place are generally those that were entered into prior to 1986, which have been continually grandfathered, and those associated with key-person insurance. It should be noted that, although the pre-1986 transactions have been grandfathered by Congress, the IRS will still challenge those specific arrangements it believes are sham transactions or lacking economic substance.

Non-leveraged COLI serves as a relatively low cost way for corporations to insure against the financial hardships that might occur upon the unexpected death of a key employee or owner of the corporation. Corporations may also use tax-free death benefits to pay future premiums or to provide tax-advantaged funds for the payment of company expenses including, but not limited to, retiree health benefits. COLI policies earn tax-exempt income, recoverable at the death of the employees, or through partial withdrawals of cash value, at very low cost. The amount of the tax-exempt income is dependent upon the number of employees covered by the COLI policy – the more employees are covered, the more premiums are paid, and the more earnings on those premiums can accrue. In order to take full advantage of this tax benefit, employers insure as many employees as possible under their broad-based COLI policies, and continue to insure a former employee long after the employment relationship has ended.

In 1984, Congress enacted sections 419 and 419A of the Code. These sections limited the tax benefits available when a corporation "pre-funds" its liabilities under employee welfare benefit arrangements. These provisions made it more difficult for businesses to match the assets intended to fund such liabilities with the liabilities themselves. COLI often fits this need, because the proceeds from COLI often are received at about the same time the obligation to pay such benefits arises (or shortly thereafter). This is particularly true in the case of retiree medical expenses, which often increase significantly in the retiree's final years.

COLI generally is a conservative investment for businesses. Risks are relatively low, and, for financial reporting purposes, COLI enables a corporation to disclose assets of sufficient value to offset the value of disclosed liabilities. While other investments, such as equities and bonds, are available, evidence indicates that COLI may be uniquely suited for that purpose.

## Current Concerns Regarding COLI

### Generally

The outrage expressed in recent press reports about COLI appears to be focused less on tax issues than with issues concerning the breadth and nature of state insurable interest laws. In some states, an employer is under no obligation to notify employees that it holds insurance on their lives, and generally there is no obligation to pay any portion of the death benefits received to a beneficiary of the deceased employee or former employee. A number of states do not require consent of the employee before the insurance can be procured. Moreover, the employer

can continue to hold the insurance long after the employment relationship has ended. Some commentators have viewed these allowable arrangements as being somehow unfair or immoral.

In contrast, the common thread running through all of the previous efforts to eliminate perceived abuses of COLI has been a desire to limit the deduction for premiums paid to purchase COLI and to limit the deductibility of interest paid on policy loans. As noted above, Congress, the Treasury Department, and the courts have been aggressive in limiting the inappropriate use of debt to finance the purchase of life insurance by corporations. In each legislative change to the treatment of COLI, Congress has weighed the need to close a "loophole" against the valuable uses of COLI. Each change was narrowly constructed to achieve the desired goal without impeding the valid uses of COLI, even in some cases leveraged COLI.

Congress is, of course, free to establish the circumstances under which favorable tax treatment is afforded. However, in determining what action, if any, to take, we believe that there are several issues that the Committee should consider:

First, we urge that the Committee consider the significant administrative difficulties associated with trying to separate "good" COLI -- COLI that funds employee and retiree benefits, provides protection against the death of a key employee, or serves other legitimate business needs -- and "bad" COLI -- COLI that is determined not to serve such purposes.

Second, if the Committee decides that it is necessary to limit the tax preferences available to life insurance policies that are purchased as part of a COLI policy, consideration should be given to the extent to which its actions will have the effect of over-riding state determinations regarding the definition of insurable interest and whether such a change in the tax treatment will have the effect of creating federal regulation of insurance.

Third, the Committee should consider the collateral administrative issues associated with permitting the use of COLI for only limited purposes, such as the funding of employee welfare benefits.

We urge that the Committee weigh the magnitude of the "abuse" being targeted against the proposed "solution." The tax abuses previously associated with COLI have long ago been remedied through litigation and legislation. The COLI plans of today are typically entered into for sound business reasons. We should be careful not to craft solutions that impose limits which would effectively prevent the legitimate use of COLI.

In addition, corporations today continue purchasing life insurance on the lives of key employees whose deaths could have a significant effect on the financial health of the corporation. Death benefits received under these arrangements may be used to meet the immediate needs of the corporation, including the economic loss that the corporation could suffer as a result of such an individual's death. We urge that particular care be exercised by the Committee in limiting the use of COLI for this purpose.

**Specific Concerns**

Specific questions have been raised about the propriety of an employer purchasing insurance on the life of an employee without notifying the insured employee. Others have suggested that an employer should be required to pay a portion of any death benefits to the estate or beneficiaries of the insured employee. Still others have asked whether tax-favorable treatment is appropriate for policies where the formal employment relationship with the employee has ended. To the extent that the Committee decides that a change in the Internal Revenue Code is needed to address any or all of these concerns, the Committee will need to determine the circumstances under which the tax benefits otherwise available should be denied. This will not be an easy task.

The Committee should consider whether lack of notification to, and consent of employees, lack of "sharing" of COLI proceeds with survivors, and continuation of coverage after the employment relationship ends, are issues with which the Federal tax law should be concerned. While the denial of a tax benefit for any of these reasons does not directly re-define "insurable interest," such a change in the Internal Revenue Code implicitly would override state law determinations of when it is appropriate for an employer to own life insurance on an employee. The Committee should ask whether such a change effectively creates a federal insurable interest standard and whether it is appropriate to resolve this important policy question through a change in the tax law. As discussed above, Congress previously has determined that the states, and not the federal government, should be the primary regulator of insurance. The Committee should also consider whether any change to the tax treatment of COLI would put pressure on state regulators to change their definition of insurable interest. If the Committee is concerned with imposing an implicit Federal insurable interest standard, it may wish to consider whether the issues are better dealt with directly through an amendment to the McCarran-Ferguson Act or through action by the National Association of Insurance Commissioners.

The Committee should also consider the extent to which the states are already addressing the identified abuses and whether their efforts are sufficient to eliminate the Committee's concerns. To the extent the States are re-visiting their insurable interest rules and tightening their definitions of insurable interest in an employment context, the need for federal intervention may dissipate. Upon examination, the Committee might determine that changes in state laws and enforcement of existing rules are already resolving the issues with which the Committee is concerned.

The Committee will have to determine whether the use of COLI to fund employee and retiree benefits is appropriate. To the extent that the Committee concludes that this is a valid use of COLI, the Committee will have to draw a line between appropriate coverage and inappropriate coverage. For example, is employee consent enough to preserve the tax preferences? Or, should there also be a limit on the type of employees covered by the COLI policy, i.e., permit coverage of key employees only or permit coverage on all employees? Another important question the Committee will have to address is the type of employee or retiree benefits that a COLI policy can fund.

Any limitations based on whether an individual is a "key person" must be carefully drawn. The definition of "key person" would be crucial. We would be pleased to work with the members of the Committee in structuring any limitations along this line to ensure that they are structured in an appropriate manner.

Similar line drawing may be necessary with regard to the coverage of former employees. For example, if the Committee determines that a limitation on coverage of former employees is appropriate, should that limitation extend to former key employees? If so, how will "key employee" be defined? If the COLI proceeds fund employee and retiree benefits, should coverage continue only as long as the former employee is eligible to receive those benefits? Finally, how much time should elapse between the end of the formal employment relationship and the termination of favorable tax benefits?

None of these issues will be easy to address. Their resolution, whether directly by Congress or through a legislative grant of authority to the Treasury Department to issue administrative guidance, will undoubtedly add significant complexities and administrative burdens to an already complex area of the Internal Revenue Code. We encourage the Committee to make sure, before moving forward, that these additional burdens are outweighed by the problems that they solve.

**Current Legislative Proposals**

Congress has under consideration a number of new legislative proposals that would further limit the tax benefits inherent in purchasing and holding life insurance policies by corporations. In the recently marked-up pension legislation, this Committee approved a provision that would tax death benefit proceeds in excess of premiums paid on any life insurance policy of any individual who had not been an employee of the taxpayer within twelve months from the date of that individual's death. This provision did not apply to proceeds received on the death of key employees.

Another proposal would tax all inside buildup on life insurance policies held by corporations on the lives of employees other than key employees. In addition, this proposal would tax the proceeds of any policy held on employees other than key employees. Finally, this proposal would require an employer to notify any employee that insurance was purchased on the employee's life, and would give the employee the opportunity to object to such coverage.

A third proposal would modify the proposal approved by the Committee by exempting from income tax insurance proceeds paid on non-key employees as long as that insurance policy is held in an irrevocable trust that would provide either non-qualified pension benefits or welfare benefits to these employees and former employees. This proposal would also disallow favorable tax benefits for death proceeds upon the death of employees that were paid on an hourly basis.

The theme running through these legislative proposals is that the purchase by a corporation of insurance on employees or former employees who are not or would not be key employees should not receive the same tax advantages obtained by insurance on key employees. The premise underlying these proposals is that corporations do not have a legitimate interest in insuring the lives of non-key employees.

These proposals would have the effect of creating a separate federal determination of insurable interest, running simultaneously with the regulations put forward by the various states. In most cases, however, these Federal rules would predominate, because the favorable tax benefits of life

insurance would be denied unless the insured individual met the Federal rules. Effectively, this would shut down the market for insurance on individuals that fails to meet the guidelines. While this type of legislation does not prohibit the purchase of insurance covering the lives of non-sanctioned individuals, legislators should understand that their determinations in this regard will nevertheless have the effect of overriding the insurability determinations of the states, a result contrary to the McCarran-Ferguson Act. More importantly, it will likely cause corporations to turn to other investments, such as tax-exempt bonds, that may not be as well-suited for the intended purpose.

Limiting the tax advantages of COLI to situations in which the insured individual remains an employee would severely limit the use of COLI to fund retiree benefit plans. Retirees are, by definition, no longer employees, yet the obligation of businesses to fund their benefits often continues. As described earlier, COLI is often well-suited for that purpose. Such a restriction would result in businesses using less-efficient means of funding these benefits, or dropping the benefits altogether.

**Limiting COLI to Employee Benefits**

Finally, we would like to focus on a proposal currently under consideration which would link the continuation of the tax benefits of insurance coverage on individuals who are no longer employees to benefits that these former employees are scheduled to receive from the employer. These benefits are those provided under a non-qualified pension plan or an employee welfare plan. The proposal would mandate that the total death benefits under COLI and other insurance policies on the lives of these employees could not exceed the costs of the non-qualified pension benefits and projected future costs. In addition, the proposal would require that these insurance policies be held in an irrevocable trust, subject only to the claims of creditors of the employer in bankruptcy, and used solely to fund such employee benefits. We have serious reservations about this approach.

Under the Employee Retirement Income Security Act (ERISA), welfare benefit plans and non-qualified pension arrangements do not have the same vesting rules that apply to traditional qualified plans. (Section 201(1) and (2) of ERISA.) Under ERISA, an employer is permitted to change or eliminate the benefits under a non-qualified plan or a welfare benefit plan at any time. It is unclear whether the current proposal to limit the amount of corporate owned life insurance to the amount of welfare benefits is also intended to change the vesting rules. Examples will illustrate this point.

> Example 1. A company purchases life insurance on the lives of two non-key employees. The amount of life insurance purchased on the life of non-key employee A is equal to the projected medical benefits that will be payable to that employee under the company's retiree medical plan. An equal amount of life insurance on non-key employee B is purchased to fund B's non-qualified deferred compensation. Under the proposal, it appears that the employer could eliminate the retiree medical benefits for employee A and increase the non-qualified deferred compensation for employee B to $1 million.

Example 2. A company purchases life insurance on all of its employees in the amount of the projected costs of retiree medical benefits. The policy is placed in an irrevocable trust for the exclusive purpose of funding these medical benefits. Some of the employees are non-key employees and some of the employees are key employees. In future years the projected costs of retiree medical benefits increases to an amount in excess of the life insurance policy, which causes the company to eliminate the retiree medical benefit for its non-key employees and keep it for the key employees since the projected costs for key employees does not exceed the COLI death benefit. This appears to be permitted under the proposal.

The point to be made here is that restricting the use of COLI in this way raises a series of collateral, complicated issues. Some would contend that significant changes will be necessary (to ERISA and elsewhere) in order to add vesting rules, to provide for rules against discrimination in favor of highly compensated employees, and to deal with adequate funding. This would be problematic at best. Adding vesting rules to welfare benefit plans would run counter to over 25 years of ERISA law. It would effectively prevent employers from using COLI to fund welfare benefit plans if the price to do so would be the legal vesting of retiree medical benefit promises. Only those of us with short memories do not recall the ill-fated Section 89, which was enacted as part of the Tax Reform Act of 1986 in order to provide pension plan-like rules for employee welfare plans. After hundreds of pages of complicated IRS regulations trying to interpret the non-discrimination rules, businesses convinced Congress to repeal the section. This proposal on COLI could force Congress to consider new non-discrimination rules on the provision of retiree health benefits in order to prevent some of the perceived abuses detailed above.

## Conclusion

Over the years, Congress and Treasury have effectively shut down COLI transactions designed to achieve tax arbitrage through the deduction for interest paid on policy loans. As suggested above, we believe that the legislative proposals currently under consideration potentially open a Pandora's Box of thorny issues and problems that have yet to be explored fully. This is particularly true of proposals that require a link between a COLI policy and welfare benefits provided by an employer, which raise the specter of revisiting ERISA and the related welfare benefit tax provisions. Resolution of these issues may well extend beyond the jurisdiction of this Committee.

Concern over the broadened scope and nature of state insurable interest laws is appropriate, and the anger expressed by some families of deceased employees is understandable. However, Congress should not act too hastily. Instead, we urge that careful consideration of all of the issues raised by these efforts be given to ensure that the full consequences of any proposed changes be identified and considered, so that the intended results are those achieved.

By attempting to deal with these issues through the tax code, we run the risk of invoking the law of unintended consequences. We should be hesitant to cause that result.

Mr. Chairman, thank you again for the opportunity to appear before this Committee. I would be happy to answer any questions.

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