TESTIMONY OF

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PRESIDENT

ASSOCIATION FOR ADVANCED LIFE UNDERWRITING

BEFORE

THE SENATE FINANCE COMMITTEE

OCTOBER 23, 2003

HEARING ON

COMPANY-OWNED LIFE INSURANCE

I. INTRODUCTION

The Association for Advanced Life Underwriting ("AALU") appreciates the opportunity to submit this testimony to the Finance Committee in connection with its review of business-owned life insurance, sometimes referred to as company-owned life insurance or "COLI." This testimony is submitted jointly on behalf of AALU and the National Association of Insurance and Financial Advisors ("NAIFA").

AALU is a nationwide organization of life insurance agents, many of whom are engaged in complex areas of life insurance such as business continuation planning, estate planning, retirement planning, and deferred compensation and employee benefit planning. AALU represents approximately 2,000 life and health insurance agents and financial advisors nationwide. NAIFA is a federation of nearly 800 state and local associations representing 250,000 insurance and financial advisors and their employees.

AALU and NAIFA strongly oppose the COLI proposal that was offered as an amendment by Sen. Jeff Bingaman (D-NM) and adopted by the Finance Committee on September 17. If enacted, the Bingaman amendment would eliminate a means by which many businesses maintain and expand important employee benefit programs. AALU and NAIFA believe that abuses involving COLI have been addressed by legislation enacted by Congress in 1996 and 1997, and that current concerns over COLI reflect a fundamental misunderstanding of its present-day uses. If Congress believes that additional legislation is necessary to address perceived concerns in the COLI area, AALU and NAIFA would recommend that Congress act carefully and protect the important, legitimate uses of COLI today. In this regard, AALU and NAIFA endorse the COLI proposal that has been advanced by Sen. Kent Conrad (D-ND) as an alternative to the Bingaman amendment.

In this testimony, AALU and NAIFA provide an overview of the present-day uses of COLI, dispel myths that have been created and perpetuated in recent media stories, highlight the important employee benefits that are funded by COLI, outline the adverse consequences that would result from enactment of the Bingaman amendment, and recommend a course of action that would preserve the important uses of COLI today.

II. WHY BUSINESSES BUY LIFE INSURANCE TODAY

Businesses today purchase insurance on the lives of employees to meet critical needs, such as funding the cost of employee benefits or protecting against the loss of business owners or key employees.

Most often, employers use proceeds from COLI to fund the cost of new or expanded employee benefits, including broad-based health and supplemental retirement benefits. Because of accounting changes adopted by the Financial Accounting Standards Board in 1992,[1] retiree health and other benefit liabilities are required to be accrued as they are earned over the working lifetime of the covered employee rather than as they are paid after retirement. Companies use life insurance to build an asset to offset this balance sheet liability, thus providing reassurance to employees and investors that the company is not making promises it cannot afford to keep.

Life insurance provides a stable financing tool, ideally suited to long-term benefit plan funding. Arrangements are structured, based on actuarial projections, so that the pattern of death benefits received closely mirrors the company's benefit payments. In the meantime, earnings – i.e., the "inside build-up" – are allowed to grow and offset the accrued cost of the future employee benefit liabilities on a company's balance sheet.

In the case of banks, the Office of the Comptroller of the Currency ("OCC") has specifically identified life insurance as an appropriate means of financing employee benefit plans. OCC guidelines note, "National banks may, as other corporations frequently do, use corporate-owned life insurance (COLI) as a financing or cost recovery vehicle for pre- and post-retirement employee benefits."[2] The guidelines add, "In these arrangements, banks and other corporations insure the lives of certain employees to reimburse the corporation for the cost of employee benefits."[3]

[1] Financial Accounting Statement No. 106 ("FAS 106"), "Employers' Accounting for Postretirement Benefits Other Than Pensions."
[2] OCC Bulletin 2000-23, Appendix at 2.
[3] Id.

Smaller businesses often purchase life insurance to protect against financial loss from the deaths of key employees and to facilitate business continuation after the death of a business owner. Without COLI, many of these businesses would not have the resources necessary to keep operations running and provide jobs after the loss of an owner or key employee.

III. DISTORTIONS IN RECENT MEDIA STORIES

The Finance Committee's approval of the Bingaman amendment followed on the heels of sensationalist stories in the *Wall Street Journal* that presented a grossly distorted picture of the uses of COLI.[4] The following are among the "myths" surrounding COLI that have been perpetuated by the media:

- ***Myth #1: COLI as "Janitor's Insurance":*** "Janitor's insurance" and "dead peasants' insurance" are sensationalist terms used by some reporters to describe COLI programs that prior to 1996 covered rank-and-file workers, apparently without obtaining the employees' consent, and under which employers claimed significant tax benefits from borrowing against the life insurance.

  These past programs bear no resemblance to current business uses of life insurance. The tax benefits associated with these past programs were eliminated by Congress in 1996. Further, business-owned life insurance generally covers only the lives of managerial-level employees. And pursuant to the laws of most States and good business practice, employers almost universally obtain the consent of insured employees.

- ***Myth #2: COLI as a Corporate "Windfall":*** Recent press reports have described COLI as a "windfall" for corporations, with companies boosting earnings when a worker dies. As discussed below, businesses today use life insurance not as a profit generator, but rather as a means of offsetting liabilities arising from programs that benefit the very workers whose lives are covered under the COLI arrangement. In the case of banks, the OCC has issued guidelines explicitly providing that life insurance may not be used as a means of generating a profit.

- ***Myth #3: Employees are Disadvantaged by COLI:*** To the contrary, business-owned life insurance programs are good for employees. Without the financing made possible by these programs, employers would be less likely to provide or expand employee benefit programs. The business pays all of the cost of the premiums. The employee pays nothing.

  A COLI program in no way limits the ability of an employee to buy life insurance protection, either as an individual purchaser or under an employer program. According to the Bureau of Labor Statistics, 84 percent of large employers – the most likely group to own broad COLI policies – provide group life insurance benefits to their employees. Thus, most individuals whose lives are covered

[4] See, e.g., "'Janitor's Insurance' Issue Leaves Workers in Dark on Coverage," *Wall Street Journal*, April 24, 2002; "Valued Employees: Worker Dies, Firm Profits," *Wall Street Journal*, April 19, 2002.

under a COLI program likely receive separate life insurance protection through their employers.

The State of New York in 1996 recognized the importance of COLI to workers and modified its insurable interest law to specifically authorize businesses to purchase insurance on the lives of employees to fund employee benefit plans. In taking this action, the New York legislature stated:

> The legislature hereby finds and declares that assisting employers in developing innovative means of financing employee health and other benefits is in the best interests of the working people of this state. This legislation is intended to achieve that goal by authorizing businesses to purchase insurance on the lives of their employees in order to fund employee benefit plans which provide retirement, health and life insurance and deferred compensation benefits, a product known as corporate or trust-owned life insurance (COLI/TOLI).[5] [emphasis added]

- ***Myth #4: Lawmakers, Regulators Have Failed to Scrutinize COLI:*** Few practices have been scrutinized by the government as thoroughly as the use of business-owned life insurance. Congress has enacted legislation in 1986, 1996, and 1997 that addressed specific concerns that were enumerated regarding COLI practices at those times:

  - **1986 legislation**: The Tax Reform Act of 1986[6] placed limits on the deductibility of interest on loans secured by COLI in response to concerns regarding tax sheltering resulting from excessive borrowing. The 1986 Act specifically prohibited companies from deducting interest on more than $50,000 of loans per covered person. The provision was applicable to life insurance contracts purchased after June 20, 1986.

  - **1996 legislation**: In response to concerns about the continuing breadth of favorable tax treatment available for leveraged COLI after 1986, Congress in the "Health Insurance Portability and Accountability Act of 1996"[7] eliminated deductions altogether for interest on COLI loans. Specifically, the 1996 Act denied a deduction for interest paid or accrued on any indebtedness with respect to any life insurance policies covering an officer, employee, or financially interested individual of the policy owner.

  - **1997 legislation**: Congress in the "Taxpayer Relief Act of 1997"[8] took action in response to concerns about COLI programs being established with respect to borrowers whose loans were held by the Federal National Mortgage Association ("FNMA"). In these cases, the 1997 Act disallowed a deduction for the portion of a taxpayer's total interest

[5] NY Laws 1996, ch. 491, Sec. 1.
[6] P.L. 99-514.
[7] P.L. 104-191.
[8] P.L. 105-34.

> expense that is allocated pro rata to the excess of the cash surrender value of the taxpayer's life insurance policies over the amounts of any loans with respect to the policies, effective for policies issued after June 8, 1997. Section 264(f)(4) provided that there was to be no change in prior law for policies covering 20-percent owners, officers, directors, or employees of the owner of the policy. Thus, Congress in the 1997 Act took special care to continue to allow COLI to be used where policies are purchased on the lives of employees.

The States have frequently revisited laws that govern business-owned life insurance. For example, California in September of this year amended its laws to prohibit policies on rank-and-file workers but to specifically permit them on managerial employees (those "exempt" from California wage and hour laws).

- ***Myth #5: COLI as an Abusive Tax Shelter:*** Recent media stories have sought to portray COLI as an abusive tax shelter. As discussed above, legislation enacted in 1996 eliminated a company's ability to generate COLI interest deductions to shelter income. Moreover, unlike abusive tax transactions, business investments in COLI have a clearly demonstrated business purpose, namely, to offset the cost of benefit programs. The courts have recognized and upheld the business purpose of COLI investments.[9]

  It also should be noted that the tax treatment of COLI is <u>disadvantageous</u> in several important respects. Most significantly, COLI premiums are not deductible. Further, cash-value buildup is taxable at ordinary income tax rates if the policy is not held until maturity.

IV. <u>BROAD BENEFITS OF COLI TO EMPLOYEES</u>

As discussed above, COLI is used today by employers to maintain and expand important employee benefits covering a broad range of employees. Examples of programs funded by COLI include nonqualified deferred compensation and retiree health benefits.

By way of background, a typical nonqualified deferred compensation plan is a contractual arrangement between an employer and employee under which the employee elects to defer a part of salary until a future date. Individuals typically enter into these arrangements as a means of saving for retirement, in many cases augmenting amounts saved through 401(k) and other qualified plans. According to a recent survey by Clark Consulting, 86 percent of Fortune 1000 companies offer nonqualified deferred compensation plans, and 65 percent of these plans are funded by COLI.[10] Small

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[9] See, e.g., *American Electric Power, Inc. v. United States*, 136 F. Supp. 2d 762 (S.D. Ohio 2001), in which the court stated:

> AEP has established by substantial, credible evidence that its purpose for entering into the MBL COLI VIII plan was to provide earnings and cash flow that would partially offset its increased employee benefits expense attributable to the implementation of FAS 106. AEP intended to use the COLI earnings and cash flows to offset reductions in earnings caused by FAS 106 and to fund the VEBA. <u>This was a proper business purpose</u>. [<u>emphasis</u> added]

[10] *Executive Benefits: A Survey of Current Trends, 2002 Results*, Clark/Bardes [Clark] Consulting, at 9, 19.

businesses also commonly offer nonqualified deferred compensation plans; while there is little empirical data on the number of small business plans, the importance of these arrangements to small firms is evidenced by the strong opposition of the National Federation of Independent Business and the U.S. Chamber of Commerce to punitive nonqualified deferred compensation legislative proposals advanced in 2002.

Contrary to conventional wisdom, top executives are not the only employees able to participate in nonqualified deferred compensation plans. According to the Clark Consulting survey, 44% of companies with these plans extend them to individuals with salaries below $100,000.[11] The following are actual examples of plans now in operation benefiting middle-level managers:

- A nationwide retailer, based in the Midwest, offers its nonqualified deferred compensation plan to 1,868 employees, 55% of whom have salaries less than $100,000. 662 workers participate, of whom 39% (or 258) have salaries below $100,000.

- A grocery manufacturer offers its plan to 434 employees, of whom 255 participate. Among participants, 47% have salaries between $62,000 and $100,000.

- A hospitality industry employer offers its plan to 399 employees, 82% of whom participate. Among participants, 21% have salaries between $58,000 and $100,000.

- A nationwide food retailer offers its plan to 650 employees, of whom 353 participate. Among participants, 58% have salaries between $62,000 and $100,000.

- An environmental services provider, based in the Southeast, offers its plan to 161 employees, of whom 129 participate. Among participants, 52% have salaries between $61,000 and $100,000.

There are many reasons why lower-level managers need to utilize nonqualified savings plans. A common scenario is a "two-earner" couple whose combined income affords significant additional savings capacity. There also are situations where a worker making less than $100,000 is prevented – by operation of the tax law's nondiscrimination rules – from making his or her full contribution to a qualified plan.

Retiree health plans funded by COLI provide substantial benefits to a broad range of employees. A private analysis undertaken on behalf of AALU and NAIFA of COLI programs implemented by 40 large corporations shows COLI being used to fund benefit liabilities including more than $2 billion of FAS 106 liabilities, which are comprised primarily of retiree health plans benefiting many thousands of workers. While industry-wide data on the amount of COLI used to fund retiree health obligations is not available, we are aware of one carrier that has in excess of $3 billion in current COLI policy cash

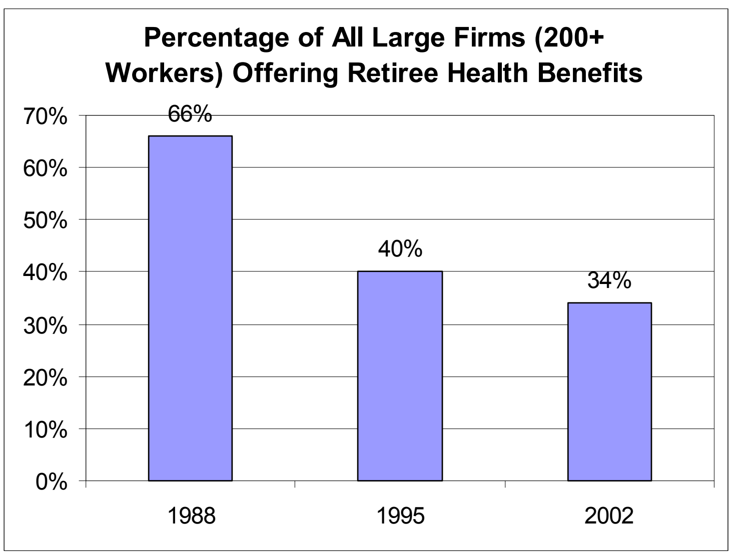
[11] Id. at 10.

values used to fund retiree health obligations. A Hewitt Associates/Henry J. Kaiser Family Foundation survey of large companies offering retiree health benefits found that 83 percent provide such benefits to hourly workers.[12]

V. ADVERSE CONSEQUENCES OF BINGAMAN AMENDMENT

The COLI amendment advanced by Sen. Bingaman would make it impossible to fund important retiree benefits with COLI. As discussed above, COLI purchases are structured, based on actuarial projections, so that policy benefits will closely mirror the company's benefit payments. Effectively, the insured employees who participate in these benefit plans form a "pool," whereby policy proceeds from the death of one retiree will cover benefit payments to other retirees. Because the Bingaman amendment would tax employers on insurance policy proceeds if the insured plan participant dies more than one year after retiring, it would destroy the pooled funding approach relied upon by COLI programs today.

By removing COLI as a funding mechanism, the Bingaman amendment clearly would discourage employers from offering retiree health programs. Recent studies have shown a marked decline over the past several years in the number of employers offering retiree health insurance. For firms with 200 or more workers, 66 percent provided retiree health coverage in 1988, but only 34 percent did so in 2002.



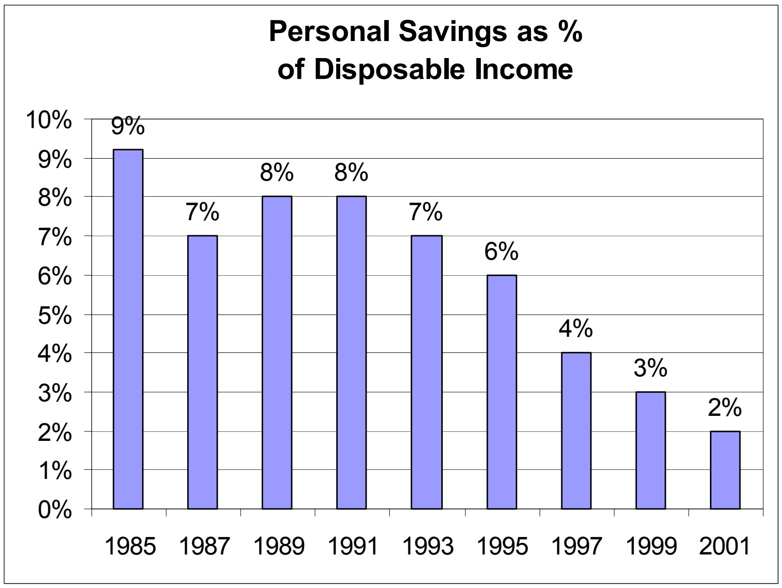
Source: *Employer Health Benefits – 2002 Annual Survey – Retiree Health Benefits*; The Kaiser Family Foundation and Health Research and Educational Trust

It is odd that Sen. Bingaman would seek to discourage funding employer-based retiree health programs at a time when Congress, in connection with Medicare prescription drug legislation, is considering how to mitigate disincentives for employers to continue offering retiree drug benefits. AALU and NAIFA also would note that the long-term

[12] "The Current State of Retiree Health Benefits: Findings from the Kaiser/Hewitt 2002 Retiree Health Survey," Hewitt Associates and the Henry J. Kaiser Family Foundation, December 2002.

solvency of the Medicare program will be bolstered if companies are encouraged to finance retiree programs using COLI.

It also would seem unwise at this time to discourage nonqualified deferred compensation programs, which represent a major source of personal savings for many employees. In light of the sharp drop in U.S. individual savings since 1985, policymakers should consider ways to make it easier for employees to save for retirement.



Source: *Bureau of Economic Analysis*

AALU and NAIFA would note that reduced utilization of nonqualified deferred compensation plans would place even greater pressure on Social Security to provide for workers in their retirement.

VI. CONCLUSION

Legitimate issues recently have been raised about various aspects of COLI programs. These include legitimate questions regarding how employers should notify employees and obtain their consent before purchasing insurance policies on their lives and the types of employees covered under these programs. Most of these questions already are satisfactorily addressed under current business practices. Furthermore, these issues are presently being addressed at the State level, where the National Association of Insurance Commissioners ("NAIC") has begun a project, supported by the insurance industry, aimed at uniform State laws regarding COLI.[13]

[13] The NAIC project has recommended that States include the following elements in laws governing COLI practices: (1) The law should recognize that employers have a lawful and substantial economic interest in the lives of key employees and in other employees who have a reasonable expectation of benefiting from an employee welfare benefit plan. (2) Employers should be required to notify eligible employees of their proposed participation in the plan and the employees should be given an opportunity to refuse to participate. On a prospective basis, employers should obtain written consent of each individual being insured. Consent would include an acknowledgement that the employer may maintain the life insurance coverage even after the insured individual's employment has terminated. An employer shall not retaliate in

If Congress finds it is necessary to enact legislation clarifying the appropriate uses of COLI, AALU and NAIFA would recommend adoption of the proposal that has been developed by Sen. Conrad. The Conrad proposal would allow employers to use COLI to fund employee benefits where the individuals who are covered by the policies are salaried employees, provide advance written consent, and participate in employee benefit plans. The Conrad proposal also would require that COLI proceeds from the insurance policy be placed in a trust to fund the benefits. These changes would definitively eliminate any potential problems perceived with respect to existing COLI practices, and would protect the positive uses of COLI today. By contrast, the Bingaman amendment would destroy efforts by employers to maintain and expand employee benefit programs using life insurance.

AALU and NAIFA also wish to commend the action taken by the Finance Committee on October 1 to move the effective date of the COLI proposal that was adopted on September 17. As has been noted, the September 17 effective date that was initially adopted had the effect of freezing a significant segment of the insurance marketplace and frustrating in-process business benefit planning. The decision by Finance Committee members to make any COLI legislation effective no earlier than the "date of enactment" will allow taxpayers to proceed with ordinary business transactions while Committee Members and Congress consider what, if any, tax-law changes are appropriate.

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any manner against an employee or a retired employee for refusing consent to be insured. (3) For non-key or non-managerial employees, the amount of coverage should be reasonably related to the benefits provided to the employees. (4) With respect to employer provided pension and welfare benefit plans, the life insurance coverage purchased to finance the plans should only be allowed on the lives of those employees and retirees who, at the time their lives are first insured under the plan, would be eligible to participate in the plan.