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April 15, 2015

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United States Senate
219 Dirksen Senate Office Building
Washington, DC 20510

The Honorable Ron Wyden
Ranking Member
Committee on Finance
United States Senate
219 Dirksen Senate Office Building
Washington, DC 20510

Dear Chairman Hatch and Ranking Member Wyden:

The Association for Advanced Life Underwriting ("AALU") appreciates the opportunity to share our views with the Senate Finance Committee's Tax Reform Working Groups. The AALU is a nationwide organization of more than 2,000 life insurance agents and professionals who are primarily engaged in the sale of life insurance for estate, charitable, retirement, and deferred compensation and employment benefit planning.

The life insurance industry offers essential benefits to the 75 million American families, thousands of businesses, and millions of employees that rely on life insurance products for their financial well-being. Savings in permanent life insurance and annuities alone represent approximately 17 percent of Americans' long-term savings in this country. The life insurance industry pays out $1.5 billion every day, and is a cornerstone of the U.S. economy—generating 2.5 million jobs and investing $5.6 trillion to support economic growth in our country. In fact, life insurers are the largest institutional source of bond financing for American businesses, holding 20% of all U.S. corporate bonds.

Furthermore, life insurance products are currently taxed appropriately. In particular, life insurance inside buildup is not the recipient of any special treatment under federal tax law that would justify characterization as a "tax expenditure."[1] In fact, there is no provision in the Tax Code that excludes, exempts, or deducts inside buildup from gross income. Life insurance is purchased with after-tax dollars, and the gains on inside buildup are not taxed when held within the contract—consistent with treatment of unrealized appreciation on other assets. Furthermore, unlike other assets, should policyholders actually receive gains (for example, upon surrender of a contract), they pay taxes at ordinary income rates, not the preferential capital gains tax rate.

Regrettably, previously introduced Congressional proposals, including H.R. 1, the Tax Reform Act of 2014, introduced in the 113th Congress, would have imposed more than $60 billion in new taxes on life insurance companies, life insurance products, and, most importantly, the American families and businesses whom our members serve.[2] These proposed taxes would represent a 26% net tax increase on the life insurance industry—raising the cost of life insurance products while reducing availability and choice, and diminishing the ability of families and businesses to protect against risk and provide long-term financial and retirement security.[3]

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[1] For further information, see Statement of Americans to Protect Family Security to the House Ways and Means Committee Pensions/Retirement and Financial Services Working Groups, April 15, 2013, which can be accessed using the following link: http://waysandmeans.house.gov/uploadedfiles/americans_to_protect_family_security_wg_comment.pdf
[2] Joint Committee on Taxation revenue estimates of life insurance-specific provisions of Tax Reform Act of 2014.
[3] Ernst and Young analysis of tax liability impact of the Camp tax plan on the US business sector and life insurance industry based on Joint Committee on Taxation revenue estimates, September 2014.

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In particular, proposed taxes on business uses of life insurance—explained further in the attached appendix—represent an indirect approach to taxing the inside build-up of life insurance contracts. Such proposals would impair the broad use of life insurance by businesses of all sizes—making it much more difficult to continue operating after the death of a key owner or employee, as well as to finance important employee benefits, including broad-based health, disability, survivor, and retirement benefits.

Proposals such as H.R. 1 would also largely eliminate the viability of company-sponsored nonqualified deferred compensation plans, whose liabilities are often informally financed by life insurance. Nonqualified deferred compensation plans are integral to the ability of businesses, both large and small, to recruit and retain high-quality employees by helping them save for retirement. There are 4 million employees that participate in nonqualified deferred compensation plans, with 60% of all participants contributing less than $25,000 annually.[4]

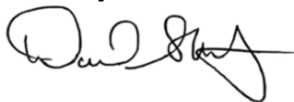
In fact, given the large financial security, savings, and retirement challenges facing our country, Americans need more of what life insurance offers, not less. While experts suggest a family's life insurance coverage should equal seven to ten times its annual income, about 60 percent of families have enough coverage to provide financial support for five years or fewer. In addition, Americans who reach retirement age are living longer than ever, yet many have limited savings. Further, sources of guaranteed income in retirement are critical, as Americans are increasingly shouldering more of the risk involved in providing for their retirement security. According to a Gallup Economy and Personal Finance poll taken in April 2014, 68 percent of Baby Boomers aged 50-64 and 50 percent of Millennials aged 18-29 are worried about having enough money for retirement.

Fortunately, life insurance products are well suited—and in some cases uniquely suited—to meet the financial security and retirement challenges Americans are facing. Public policy must promote personal financial independence and provide greater solutions to help families build their own safety nets by encouraging the purchase of life insurance products.

Our nation's public policies have historically recognized the significance of encouraging families and businesses to save more, plan responsibly, and protect their financial security. As you continue your consideration of tax reform, we urge you to maintain that perspective as it relates to the essential role that the life insurance industry and life insurance products play in providing financial and retirement security for more Americans. To that end, we would also like to commend to your attention the submission of Americans to Protect Family Security, of which AALU is a member, further detailing the industry's role, and our support for a variety of policies that advance Americans' financial well-being.

We look forward to the opportunity to provide additional information on the critical role that our industry and products play in our nation's economy, family security, and business stability as you continue your work.

Sincerely,



David J. Stertzer,
Chief Executive Officer

cc: Members, Committee on Finance

[4] "2012 Nonqualified Deferred Compensation Survey Results: Plan Sponsors & Plan Participants, Select Findings", conducted by Boston Research Group for Principal Financial Group, December 2012 AND "2014 NQDC Buyers Guide", *PLANSPONSOR,* July 2014.

APPENDIX

Corporate-Owned Life Insurance (COLI) provides essential benefits for businesses and their employees.

Life insurance is widely used by businesses with respect to employees in which they have an insurable interest—to keep businesses running after the death of a key owner or employee and to finance important employee benefits including broad-based health, disability, survivor, and retirement benefits. Under Financial Accounting Standards Board accounting rules, retiree benefit liabilities must be accrued as they are earned over the working lifetime of the employee rather than when paid after retirement. Life insurance builds an asset to offset this balance sheet liability and reassures employees and investors that the company is not making promises it cannot keep. Employers receive no tax deduction for paying COLI premiums, while employees bear no cost for COLI, yet receive substantial benefits. In addition, COLI is widely utilized by financial institutions under the direct authority of bank regulators, which authorize its use within the strict guidelines they have set, precisely because of the widely accepted benefits and security COLI provides to these institutions and their employees.

Congress carefully considered the business uses of life insurance from 2003 to 2006, and enacted bipartisan legislation in 2006 (the COLI Best Practices Act of the Pension Protection Act) that recognized COLI's key role in protecting jobs and providing employee benefits, and upheld COLI's appropriate tax treatment in compliance with codified best practices (under IRC § 101(j)) that ensure its responsible use.

Unfortunately, Congressional proposals such as the Tax Reform Act of 2014 would make the use of COLI impractical, reversing established tax policy based on years of careful study and harming the businesses and employees who benefit from these products. That legislation would expand IRC § 264(f) by disallowing business interest deductions for unrelated borrowing to the extent that businesses own life insurance covering those other than 20 percent owners. This would apply a tax penalty in a way that Congress never intended when the pro-rata interest disallowance was enacted in 1997—by applying it to policies covering employees.

The reason Congress originally enacted a pro-rata interest deduction disallowance (IRC § 264(f)) did not relate to compliance problems (under IRC § 264(a)(4)). It was enacted to preemptively deter financial intermediaries Fannie Mae and Freddie Mac from initiating a broad program to insure mortgage borrowers, which Congress understood was under consideration at the time, by imposing a tax penalty for policies covering non-employees. Accordingly, under IRC § 264(f), interest is disallowed under policies covering those other than someone who, when first insured, was an officer, director, employee or 20 percent owner of the business, by the ratio that the average unborrowed cash values held in COLI policies bears to the sum of: (1) those average unborrowed cash values, plus (2) the average tax basis of other assets held by the business.

Expanding IRC § 264(f) to disallow business interest deductions for unrelated borrowing would have significant and harmful consequences. As an example of the inappropriate impact of such a COLI proposal, suppose a business (Acme) purchased COLI to secure employee benefits promised to its employees. Fifteen years after the purchase of the policy, that business borrows money (unrelated to its COLI policy) to help fund an expansion of its business and the hiring of additional employees. Despite the fact that this loan is wholly unrelated to the purchase of COLI, under the proposal, the business's deduction for interest paid on this business expansion loan would be disallowed by the ratio of the unborrowed cash value of the business's COLI policies to all of its assets.

To illustrate the dramatic impact that enacting this proposal could have, assume, in the example above, that Acme: (1) has $1 million of interest expense attributable to indebtedness unrelated to COLI; (2) holds life insurance policies on officers and key employees with average unborrowed cash values of $2 million; and (3) owns other assets with average adjusted tax bases of $6 million. Under current law, Acme's general interest deduction of $1 million appropriately would not be limited, but under the proposed change, Acme's deduction for borrowing unrelated to COLI would be reduced by 25 percent or $250,000 because the ratio of the COLI policies' average unborrowed cash value to Acme's total average assets is $2,000,000 / $8,000,000.

Since the proposal would impose a tax penalty based on the cash value of life insurance policies owned by a business, it would effectively tax both inside build-up and premiums paid, both of which are included in a policy's cash value. Also, as the cash value increases—as additional premiums are paid and the inside build-up accumulated—the tax penalty would also increase. Small service businesses would be punished in a particularly severe manner because they tend to have relatively modest assets, and many own significant amounts of life insurance to fund employee benefits and help the business survive in the event of the death of a key person.

Put simply, the proposal would markedly discourage the use of life insurance by businesses. In effect, it would limit firms' ability to insure key persons, finance and secure health, disability, survivor, and retirement benefits, and engage in prudent business succession planning.

To assist in illustrating the practical benefits of COLI, what follows is a set of several *real-world* examples provided by active life insurance professionals that explain how COLI helps businesses of all types and sizes, and their employees, nationwide:

- At a medium-sized diversified manufacturer, the life insurance proceeds paid after the sudden death of a sole owner created the liquidity necessary for the management team to reassemble, buy out the interests of the founding family, and enable the company to continue. As a result, no jobs were lost, and the company is expanding today into new products.

- A medium-sized community bank purchased life insurance to informally finance and secure broad employee benefits. Despite increased pressure on costs and employee benefits, the bank was able to avoid reducing health insurance coverage or passing on increased costs to employees. The bank was also able to provide a broad group-term life insurance benefit it had not previously provided.

- A small construction company, during a recessionary period in the 1990s, borrowed $1 million from the cash value of its COLI policies to finance a successful expansion project. In 2001, that same company again borrowed from its COLI policies to weather another economic downturn and avoid layoffs.

- A small school bus company used COLI to finance benefits for key employees. In addition, during the financial crisis, the COLI cash values were used to buy out the stock of the company's founder and transfer the business to the next generation when no bank was willing to extend a loan for the buy-out.

- A medium-sized bank utilized life insurance to support its ability to provide deferred compensation benefits for its key employees who had helped keep the bank healthy during the financial crisis. This enabled the bank to retain these employees. It also provided for a lump sum benefit for the employees' families in the event of death before retirement. One key employee died prior to turning 50 and his wife and children received what he would have made through retirement.

- A large company purchased life insurance to informally finance an important salary continuation benefit plan for approximately 20 percent of employees who were performing at particularly high levels. The employees, many of whom were not highly compensated, received the assurance that if they died prematurely, their families would continue to receive the value of their salaries for a period of ten years after their death.
- At a small investment firm, the proceeds from life insurance—after the sudden death of a sole owner who had driven nearly all of the company's revenue—provided financial means to buy the time necessary for the company to be sold to a "friendly" competitor who retained all employees. This avoided a possible dissolution or consolidation that would have cost jobs.
- At a medium-sized insurance and risk management firm, the life insurance proceeds from the death of two of the founders, who died within a year of each other, provided the liquidity necessary to buy out ownership interests and streamline a dysfunctional management structure to create a more sustainable enterprise going forward. This not only made sure that existing employees kept their jobs; it created a more robust organization for decades to come.
- One of the nation's leading homebuilders offered a COLI-financed deferred compensation plan to almost 500 employees. Sixty percent of those employees had annual salaries below $140,000, and 40 percent had annual salaries below $120,000.
- A large bank used life insurance to finance broad-based retiree health benefits at a time in which many employers were cutting back on such benefits and increasing the costs to be borne by the Medicare Trust Fund.

Nonqualified deferred compensation (NQDC) is widely used by businesses of all sizes to attract and retain quality employees.

NQDC provides broad benefits. With longer life expectancies, rising health care costs, the need for substantial retirement savings, and limits on qualified retirement plans, NQDC plans have become important to a wide-range of employees and businesses. Both large and small employers view these plans as valuable tools for retaining and attracting talent.

A typical NQDC plan is an arrangement under which a portion of an employee's salary is deferred 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. Limits on such qualified plans make NQDC plans particularly important savings tools for employees.

Life insurance is commonly used to informally finance and secure NQDC benefits—with data indicating that COLI is used by 54 percent of companies that informally fund their NQDC obligations.[5] Life insurance provides a stable tool which is well suited to the informal financing of NQDC obligations. 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—grow and offset the accrued cost of the future employee benefit liabilities on a company's balance sheet.

Unfortunately, the Tax Reform Act of 2014 would also radically alter the long-standing, appropriate tax treatment of NQDC. For example, one proposal would have imposed a tax on a current basis unless the employee risks losing amounts deferred if the employee takes another job or is laid off prior to when the employee is due to receive the NQDC. Specifically, the proposal would tax amounts attributable to

[5] "2014 Executive Benefits Survey Summary of Results", *MullinTBG/PLANSPONSOR*, March 2015.

services performed as soon as there is "no substantial risk of forfeiture" with regard to the employee's rights to that compensation.

However, the proposal's definition of "substantial risk of forfeiture" excluded many circumstances where there is a substantial risk of forfeiture, and limits it to a single circumstance—i.e., "the employee's rights to the deferred compensation are subject to the performance of substantial services" in the future.

With NQDC, an employee does not have access to deferred compensation until the termination date, which is set when the plan is created and cannot be subsequently changed. It would be extremely rare for an individual who is currently entitled to compensation to elect to defer that compensation subject to the risk of loss if his or her employment is terminated before the date to which he or she deferred receipt.

In short, the proposal would make such a radical departure from long-standing tax rules applicable to NQDC, with such draconian consequences, that employees would almost never make NQDC deferrals and employers would no longer offer NQDC—hurting thousands of businesses and millions of employees because NQDC is integral to the ability of employers to recruit and retain quality employees by helping them adequately save for retirement. Further, NQDC plans encourage employees to focus on the long-term health of their employer, and penalizing these plans removes this beneficial incentive.

More generally, current law contains appropriate differences in the tax and other treatment of qualified and nonqualified plans. A nonqualified plan is not eligible for the tax treatment granted to qualified plans. Under a qualified plan, the employer may deduct the deferred compensation currently, as amounts are contributed to the plan, while the employee is able to defer paying taxes until receiving distributions from the plan. By contrast, in a nonqualified plan, the employer's deduction is postponed until the employee recognizes the compensation for income tax purposes. Thus, an employer entering into the deferred compensation arrangement is foregoing an immediate deduction for the payment, thereby increasing its current tax liability. The employer is willing to do this in order to attract and retain quality employees.

Another key difference between nonqualified and qualified plans is that amounts deferred in a nonqualified plan are not protected in the event of the employer's bankruptcy. Assets intended to support the employer's ability to fund its NQDC obligations must remain subject to the claims of the employer's general creditors. Thus, if the employer becomes insolvent, there are no assurances that the deferred amounts will ever be paid to the employee. In this case, the employee becomes another unsecured creditor of a bankrupt company. Accordingly, employees with NQDC balances have a greater interest in contributing to a financially strong enterprise for the very reason that their retirement income is dependent on the long-term financial stability of the company.

Additionally, since employees must specify the date in the future when they will receive their compensation when setting up the plan, they give up control over the timing of a NQDC distribution. Unlike participants in a qualified plan, NQDC plan participants cannot choose to take distributions in a strong market, nor can they avoid taking distributions in a weak market.

The tax treatment of NQDC under current law is appropriate, and exhaustive rules ensure its responsible use. In 2004, Congress enacted sweeping additional requirements (IRC § 409A) on NQDC. The legislation imposed strict rules affecting deferral elections, funding, and distributions, and imposed tax and other penalties for violations of these rules. These rules were designed to ensure that employees do not have control over the receipt of income that is deferred.

Further, the doctrine of "constructive receipt" is one of the key principles that guide the present-law treatment. Deferred compensation will be taxed currently if the individual who has not *actually* received compensation is determined to have *constructively* received these amounts. An amount is constructively

received if the individual is able to draw on it, without restriction, at any time, even if the individual has not actually received the income. As previously noted, employees set the date when they will receive their deferred compensation up front, and they cannot subsequently change that date or access their deferred compensation beforehand.

NQDC is available to a wide range of employees, with recent data indicating that that there are 4 million nonqualified plan participants nationwide.[6] NQDC plans were offered by 84 percent of businesses, large and small.[7] In fact, data indicates that as many as 33 percent of current participants are enrolled in plans with ten or fewer participants, with 60 percent of all participants expected to make annual contributions of less than $25,000.[8]

Clearly, NQDC represents a major source of personal savings for many employees. Policymakers should consider ways to make it easier, not more difficult, for all employees to save more for retirement.

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[6] "2014 NQDC Buyers Guide", *PLANSPONSOR,* July 2014.
[7] "2014 Executive Benefits Survey Summary of Results", *MullinTBG/PLANSPONSOR*, March 2015.
[8] "2012 Nonqualified Deferred Compensation Survey Results: Plan Sponsors & Plan Participants, Select Findings", conducted by Boston Research Group for Principal Financial Group, December 2012.