PRESENT-LAW FEDERAL TAX TREATMENT, PROPOSALS, AND ISSUES RELATING TO COMPANY-OWNED LIFE INSURANCE ("COLI")

Scheduled for a Public Hearing
Before the
SENATE COMMITTEE ON FINANCE
on October 15, 2003

Prepared by the Staff
of the
JOINT COMMITTEE ON TAXATION

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INTRODUCTION

The Senate Committee on Finance has scheduled a public hearing for October 15, 2003, on Federal tax issues relating to company-owned life insurance. This document,[1] prepared by the staff of the Joint Committee on Taxation, provides a discussion of the present-law tax treatment, proposals, and issues relating to company-owned life insurance.

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[1] This document may be cited as follows: *Joint Committee on Taxation, Present-Law Federal Tax Treatment, Proposals, and Issues Relating to Company-Owned Life Insurance ("COLI")* (JCX-91-03), October 14, 2003.

I. EXECUTIVE SUMMARY

The term company-owned life insurance, or "COLI," refers to the ownership of life insurance contracts by a business. The life insurance contracts in COLI arrangements typically have covered the lives of employees, customers, or other individuals in whom the business has an insurable interest under applicable State law. COLI policies have served as an indirect funding vehicle for cash needs of the business, including cash to pay for employee benefits.

COLI contracts are subject to the favorable tax rules generally applicable to life insurance contracts. Amounts received under a life insurance contract paid by reason of the death of the insured are not includible in gross income for Federal tax purposes. No Federal income tax generally is imposed on a policyholder with respect to the earnings under a life insurance contract (inside buildup).

In addition, present law imposes limits on the deductibility of premiums and interest associated with life insurance, including COLI contracts. Borrowing with respect to a life insurance contract is attractive because the earnings under the policy (i.e., inside buildup) increase tax-free. Loans permit the borrower to have the current use of income that has not been taxed. Interest paid by the borrower is credited to the policy, which the borrower owns, so the effect is equivalent to the borrower paying interest to itself. Provisions of tax legislation designed to limit the tax arbitrage of deducting interest on borrowings with respect to a life insurance contract date to the 1940's, and limitations were enacted more recently in 1986, 1996, and 1997, although exceptions for key persons, employees, officers, directors and 20-percent owners apply under these limitations. Interest deductions under COLI arrangements have also been limited by recent case law applying general principles of tax law, including the sham transaction doctrine.

Recent proposals have addressed notice requirements and the excludability of death benefits under COLI contracts. H.R. 414, introduced January 28, 2003, by Mr. Green of Texas, provides that written notice generally must be provided to an employee within 30 days after an employer purchases a life insurance policy on the life of the employee or his or her spouse or dependent. H.R. 2127, introduced May 15, 2003, by Mr. Emanuel and others, provides that the income on certain COLI contracts is includable in income, as are death benefits (to the extent they exceed the sum of previously included income on the contract and premiums paid). An amendment relating to COLI was adopted in the markup in the Senate Committee on Finance of the "National Employee Savings and Trust Equity Guarantee Act" on September 17, 2003. Two amendments relating to COLI were filed in connection with the markup in the Senate Committee on Finance of the "Jumpstart Our Business Strength (JOBS) Act," with modifications, on October 1, 2003.

Several issues have been raised with respect to COLI. From a tax policy standpoint, business investment in COLI is criticized because it presents an opportunity for tax arbitrage. Tax arbitrage occurs because the tax-free income of a COLI investment is offset by deductible expenses. Congress has demonstrated a concern with the problem of tax arbitrage in enacting generally applicable rules limiting the deductibility of expenses and interest allocable to tax-exempt income, as well as rules limiting the deductibility of premiums and interest expense associated with COLI contracts.

Some argue that COLI is a valuable means of prefunding certain types of necessary business expenditures such as payments under nonqualified deferred compensation arrangements and retiree health plans. Others argue that permitting a business to fund deductible compensation-related expenditures with tax-free inside buildup and tax-free death benefits under COLI contracts raises a tax arbitrage concern. They assert that Congress has already provided tax-favored funding mechanisms for employee benefits, and that a policy determination as to the scope of tax-favored funding mechanisms for employee benefits should be affirmatively decided by Congress, not justified based on practices that have evolved with respect to a particular investment product. They also argue that COLI has no relation to the benefits that would be funded, pointing to the fact that the death benefits payable when the insured workers or former workers die are necessarily used to fund benefits for others who are still alive.

It is also argued by some that COLI serves an important investment purpose for businesses with volatile earnings that fluctuate with market factors such as interest rates. Opponents of this view agree that hedging volatility of earnings is a reasonable goal, but argue that the tax law should not create relative advantages and disadvantages among different types of investments used as hedges.

Some argue that the original policy rationale for the present-law rule excluding amounts received under an insurance contract by reason of the death of the insured has little relation to the current uses of COLI. They argue that a company has no real connection to a former employee who remains insured. They argue that the business no longer has a risk of lost productivity if the former employee dies. They also argue that the tax benefits of funding others' employee benefits upon the former worker's death should be terminated within a reasonable period after the employment relationship has ended. Others argue that companies should be able to continue to insure key persons after they have ceased to perform services for the business so long as they were key persons at the time they were insured. Otherwise, it is argued, no tax incentive is provided for businesses to insure key persons if the death benefits under the key person insurance contract become taxable after the key person no longer performs services in the business. Some nevertheless argue that term life insurance can serve the purpose of providing insurance against the loss of a key person for the period that the person is providing services to the business without adverse tax consequences.

II. BACKGROUND AND TAX TREATMENT

A. Background

In general

The term company-owned life insurance, or "COLI," refers to the ownership of life insurance contracts by a business. The life insurance contracts in COLI arrangements typically have covered the lives of employees, customers, or other individuals in whom the business has an insurable interest under applicable State law. The type of life insurance contract used for COLI is often referred to generically as whole life insurance.

The term "whole life insurance" does not refer to the period for which the insurance contract is in effect, but rather to the fact that the contract has a “cash value,” as well as providing a death benefit upon the death of the insured person. The cash value arises because the premiums paid to the insurer for the contract are invested, and some of this investment income is credited to the contract. The amount of the future death benefit payable under the contract is funded both by premium payments, and by investment earnings on the premium payments. The earnings credited to the contract are referred to as "inside buildup." The amount of the cash value at any point in time generally is the sum of the premiums paid plus the earnings on premiums that are credited to the policy, reduced by the cost of death benefit coverage for the current period, fees, and other charges imposed by the insurer. The amount of the cash value generally is zero or small at first, and increases over the duration of the contract. The cash value of a whole life insurance contract usually may be borrowed or withdrawn by the contract holder; the amount borrowed reduces the amount that will be paid as a death benefit under the contract.

Whole life insurance can be contrasted with "term" life insurance, which pays a death benefit upon the death of the insured person, but has no cash value. Under a term life insurance contract, the death benefit coverage applies only for a set term (e.g., one year or five years), and the premium payments are set at a level to fund the death benefit only during that period. The contract holder does not have the right to borrow or withdraw cash under a term life insurance contract, because it has no cash value.

"General account" and "separate account" COLI

A life insurance company generally maintains several pools of assets that back its obligations to pay benefits under different types of insurance contracts. "General account" COLI contracts generally bear a rate of return determined by the insurer, usually with a guaranteed minimum rate, and are backed by all the general account assets and the financial stability of the insurer. "Separate account" COLI contracts generally provide a variety of investment options, including variable rates and equity-based yields, and are backed by the assets in the separate account, which are held separate from the insurer's general account assets. The buyer of separate account contracts takes on market risks associated with the market yields, but may purchase supplemental insurance protection against market fluctuations.

State law notice, consent and insurable interest requirements

Some States require notice to, or written consent from, the insured individual in some cases. The State-law notice or consent may be required if, for example, an employer insures its employees and the employer is entitled to receive death benefits as the insured individuals die.

Under State law, generally the purchaser of a life insurance contract covering an individual must have an "insurable interest" in the individual. State laws defining the scope of an insurable interest have been expanded to include employees and former employees, and in some cases, persons with other relationships to a business, such as mortgagees.

Financial accounting treatment of COLI

A company that owns COLI contracts includes the increase in cash value (net of premiums paid) in earnings each year for financial accounting purposes. Even though cash is not received until the insured person dies and the death benefit is paid out, the company generally includes the inside buildup in earnings on a current basis, as it is earned. If the inside buildup is received as a death benefit, it is generally not subject to Federal income tax. As a result, a company generally need not report a deferred tax liability associated with the inside buildup that it is including in earnings.[2]

Banking regulations applicable to COLI purchases

The Office of the Comptroller of the Currency (OCC) issues guidelines for national banks relating to safe and sound banking practices. Due to the purchase of COLI by banks (known as "BOLI" or bank-owned life insurance), the OCC has issued guidelines specifically relating to BOLI. Recent OCC guidelines provide that because of heightened liquidity, credit and tax risk, purchasing or holding excessive BOLI represents an unsafe and unsound banking practice, and national banks should review their BOLI holdings to verify that the contracts are associated with a legitimate insurance need and divest those that are not.[3]

Use as funding vehicle

COLI policies have been used as an indirect funding vehicle for employee benefits and for other cash needs of the business. If COLI policies held by the company are not specifically allocated to fund a particular expenditure, they can be used as a means of providing liquidity when direct funding of a future obligation is unnecessary or undesirable. For example, the death benefits paid to a business under COLI policies have been used to pay the business' obligations

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[2] FASB Technical Bulletin No. 85-4, *Accounting for Purchases of Life Insurance*, para. 2 (1985); FASB Statement of Financial Accounting Standards No. 109, *Accounting for Income Taxes*, para. 14; *see also* FASB Statement 133, Implementation Issue No. B31, *Embedded Derivatives: Accounting for Purchases of Life Insurance,* rev. May 1, 2003.

[3] Comptroller of the Currency, OCC Bulletin 2002-19, *Unsafe and Unsound Investment Portfolio Practices, Supplemental Guidance*, May 22, 2002, and OCC Bulletin 2000-23, *Bank Purchases of Life Insurance*, July 20, 2000.

under deferred compensation arrangements, or to cover the business' obligations to retired employees under retiree health arrangements. As the insured individuals die, the life insurance proceeds received by the business are used to fund benefits for other employees of the company.

In contrast to the use of COLI as an indirect funding vehicle, present law provides specific funding rules which allow (and in some cases, require) tax-favored prefunding of certain employee benefits, including pension and retiree health benefits. For example, assets used to fund benefits under qualified employer-sponsored retirement plans are required to be held in a tax-exempt trust that meets certain requirements. Employers are entitled to deductions, within limits, for contributions to the trust. Earnings on trust assets accumulate on a tax-free basis (i.e., inside buildup is not taxed). Distributions of benefits are includible in the income of the plan participants, except to the extent the distribution is a return of the participant's own contributions. Similarly, present law provides two main means of prefunding retiree health benefits, through the use of a separate account within a qualified pension plan (called a "401(h) account") and through the use of a tax-exempt trust or voluntary employee beneficiaries' association. Contributions to such arrangements are generally deductible to the employer, subject to certain limitations depending on the type of arrangement. Earnings on assets in a 401(h) account accumulate on tax-free basis; earnings on assets held to prefund retiree health benefits may be subject to unrelated business income tax. Retiree health benefits are not includible in the gross income of the individual receiving the benefit.

Borrowing in connection with COLI

Patterns of business borrowings with respect to COLI contracts the business owns have changed over the past several decades. These changes have resulted from growth in the marketing to businesses of life insurance on employees, customers or other individuals, and from changes in the tax law, among other factors.

Borrowing with respect to a life insurance contract is attractive because the earnings under the policy (i.e., inside buildup) increase tax-free. These loans permit the borrower to have the current use of income that has not been taxed. Interest paid by the borrower is credited to the policy, which the borrower owns, so the effect is equivalent to paying interest to itself. If the business borrows directly from the policy under a loan administered by the insurance company, the amount of the loan reduces the death benefit when the insured person dies. Alternatively, the business may borrow from a third party lender, perhaps using the life insurance contract as security for the loan, either formally or informally.

A further advantage of borrowing with respect to a life insurance policy arises if the interest on the policy loan is deductible. However, because of the opportunity for tax arbitrage that arises when a taxpayer deducts interest expense against tax-free income, recent legislation has restricted the deductibility of interest associated with COLI. These restrictions have not had the effect of denying all interest deductions associated with COLI contracts. Rather, the restrictions limit the deductibility of interest (1) paid or accrued on debt with respect to a COLI contract, or (2) allocable to unborrowed COLI contract cash surrender values. In the first situation, however, an exception is provided if the insured individual is a key person, to the extent of interest on debt up to $50,000 per insured person. In the second situation, an exception is provided if the insured individual is an employee, officer or director, or 20-percent owner. If an employee ceases to be an employee, for example, this exception continues to apply. Judicial decisions applying general principles of tax law may in certain cases imposed additional restrictions on the deductibility of such interest.

B. Tax Treatment

<u>Pattern of COLI legislation</u>

Present law provides generally applicable rules limiting the deductibility of expenses and interest allocable to tax-exempt income.[4] Provisions of tax legislation designed specifically to limit the tax arbitrage of deducting interest on borrowings with respect to a life insurance contract date to the 1940's.[5] The deductibility of interest on borrowings that relate to life insurance contracts has been limited most recently by Federal tax legislation in 1986, 1996, and 1997.

In 1986, deductible interest on borrowings under life insurance contracts was capped at debt of $50,000 per contract, to combat the use of life insurance loans as an "unlimited tax shelter."[6] This provision was effective for contracts purchased on or after June 20, 1986. Life insurance contracts purchased before that date were grandfathered; the $50,000 cap did not apply to interest on debt borrowed under such contracts.

A pattern then developed of businesses insuring the lives of thousands of their employees to increase the amount of interest to deduct on borrowings under the contracts.[7] In 1996, a broader limitation on deductibility of interest on debt under a life insurance contract was enacted, generally replacing the $50,000 cap. That rule provided that no deduction is allowed for interest paid or accrued on any indebtedness with respect to one or more life insurance, annuity or endowment contracts owned by the taxpayer, and covering the life of any individual who is or has been (1) an officer or employee of, or (2) financially interested in, any trade or business currently or formerly carried on by the taxpayer.[8] A key person insurance exception was provided. The 1996 legislation applied generally to interest paid or accrued after October 13,

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[4] Section 265.

[5] Section 129 of the Revenue Act of 1942 (Pub. L. No. 753, 77th Cong., 56 Stat. 798) added Internal Revenue Code section 24(a)(6), which provided that no deduction was allowed for "any amount paid or accrued on indebtedness incurred or continued to purchase a single premium life insurance or endowment contract. For the purposes of this paragraph, if substantially all the premiums on a life insurance or endowment contract are paid within a period of four years from the date on which such contract is purchased, such contract shall be considered a single premium life insurance or endowment contract."

[6] Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1986* (JCS-10-87), May 4, 1987, at 579. *See* Tax Reform Act of 1986, Pub. L. No. 99-514, sec. 1003, 100 Stat. 2388 (1986).

[7] *See* Lee Sheppard, "'Janitor' Insurance as a Tax Shelter," *Tax Notes,* Sept. 25, 1995, p. 1526.

[8] Joint Committee on Taxation, *General Explanation of Tax Legislation Enacted in the 104th Congress* (JCS-12-96), Dec. 18, 1996, p. 365. See Health Insurance Portability and Accountability Act of 1996, Pub. L. No. 104-191, sec. 510, 110 Stat. 2090 (1996).

1995, with a phase-in rule. However, the grandfather rule for pre-June 20, 1986, contracts was preserved, with a new interest rate cap based on a Moody's rate.[9]

The interest deduction limitation was further expanded in 1997 when Congress became aware of the practice of businesses insuring the lives of customers or debtors (for example, financial institutions insuring the lives of mortgage borrowers while borrowing under the life insurance policies, or maintaining other debt, and deducting the interest thereon).[10] The 1997 legislation provided that no deduction is allowed for interest paid or accrued on any debt with respect to a life insurance, annuity or endowment contract covering the life of any individual. It also provided that, for taxpayers other than natural persons, no deduction is allowed for the portion of the taxpayer's interest expense that is allocable to unborrowed policy cash values of a life insurance, annuity or endowment contract. An exception is provided under this proration rule for contracts that cover an individual who is a 20-percent owner, officer, director or employee of the taxpayer's trade or business.[11] The pro rata interest deduction limitation applied generally to contracts issued after June 8, 1997. Thus, the phase-in rule under the effective date of the 1996 legislation, and the grandfather rule under the 1986 and 1996 legislation for contracts purchased on or before June 20, 1986, were not affected.

Judicial decisions relating to COLI

Interest deductions under COLI arrangements have also been limited by recent case law applying general principles of tax law, including the sham transaction doctrine. These cases generally relate to taxable years of the taxpayers before the recent 1996 and 1997 legislation took effect. These principles of tax law continue to apply after enactment of the specific interest deduction limitation rules.

The case of *Winn-Dixie Stores, Inc. v. Commissioner*[12] involved the application of the sham transaction doctrine. In 1993, Winn-Dixie entered into a COLI program on the lives of its 36,000 employees. Under the program, Winn-Dixie purchased whole-life insurance policies and was the sole beneficiary. Winn-Dixie borrowed periodically against the policies' account value at interest rates that averaged 11 percent. Interest expense under the 11-percent average interest rate, when coupled with the administrative fees, exceeded the net cash surrender value and benefits paid on the policy. Although Winn-Dixie lost money on the program each year, the tax deductibility of the interest and fees were projected to yield a benefit of several billion dollars

[9] Sec. 264(e)(2).

[10] *See* "Fannie Mae Designing a Program to Link Life Insurance, Loans," *Washington Post*, Feb. 8, 1997, p. E3; "Fannie Mae Considers Whether to Bestow Mortgage Insurance," *Wall St. Journal*, April 22, 1997, at C1.

[11] See Taxpayer Relief Act of 1997, Pub. L. No. 105-34, sec. 1084, 111 Stat. 951 (1997), and see Joint Committee on Taxation, *General Explanation of Tax Legislation Enacted in 1997* (JCS-23-97), Dec. 17, 1997, p. 272.

[12] *Winn-Dixie*, 113 T.C. 254 (1999), *aff'd* 254 F.3d 1313 (11th Cir. 2001), *cert. denied*, April 15, 2002.

over 60 years. In 1997, Winn-Dixie terminated its participation in the COLI program following the enactment of tax law changes in 1996 that limited the deductibility of interest on COLI policy loans. On audit, the IRS disallowed the deductions for interest and administrative fees that Winn-Dixie claimed on its 1993 tax return with respect to its COLI program and COLI policy loans.

On petition to the Tax Court, Winn-Dixie argued that the deductions relating to its COLI program were proper because: (1) the COLI program satisfied the business purpose and economic substance prongs of the sham transaction doctrine, and (2) in any case, the sham transaction doctrine was inapplicable because Congress explicitly authorized the deductions in connection with the COLI program. However, the Tax Court sustained the IRS disallowance of the COLI-related deductions claimed by Winn-Dixie, concluding that the COLI program (including the associated policy loans) was a sham.

Other recent cases have also upheld the disallowance by the IRS of deductions for interest relating to COLI programs. In *Internal Revenue Service v. CM Holdings, Inc.*,[13] Camelot Music had purchased COLI policies in 1990 covering the lives of 1,430 employees. Camelot borrowed under the policies to pay the first three annual premiums and sought to deduct the interest on the borrowings. Camelot subsequently filed a petition under chapter 11 of the Bankruptcy Code, and the IRS filed proofs of claim based on disallowance of the interest deductions. The District Court held that the interest deductions should be disallowed, and also concluded that the application of accuracy-related penalties was appropriate. The court stated that there were two rationales for the interest deduction disallowance. First, the interest deductions were part of a transaction that was in part a factual sham and therefore did not meet the "4-out-of-7" exception to the interest deduction disallowance rule of Code section 264(a)(3). In addition, the COLI plan lacked economic substance and business purpose, and was a sham in substance.[14] On appeal, the Third Circuit affirmed, "based on the . . . reasoning, that the COLI policies lacked economic substance and therefore were economic shams."[15] The Appellate Court also affirmed the assessment of penalties.

In *American Electric Power, Inc. v. U.S.*,[16] the District Court concluded that interest deductions on policy loans under a COLI program covering the lives of over 20,000 employees should be disallowed. The court concluded that the "plan as a whole was a sham in substance,"[17] as well as concluding that first-year policy loans, and the first-year and fourth-through seventh-year loading dividends and corresponding portions of the premiums, were factual shams. The

[13] *Internal Revenue Service v. CM Holdings, Inc.*, 254 B.R. 578 (D. Del. 2000).

[14] *Id.* at 583, 654.

[15] *IRS v. CM Holdings, Inc. (In Re: CM Holdings, Inc.)*, 301 F.3d 96 (3d Cir. 2002), at 96.

[16] *American Electric Power, Inc. v. U.S.*, 136 F.Supp. 2d 762 (S. D. Ohio 2001), *aff'd*, 326 F.3d 737 (6th Cir. 2003), *reh. denied*, 338 F.3d 534 (6th Cir. 2003).

[17] *Id*., 136 F.Supp. 2d 762, 795.

court stated that it had "independently reached many of the same conclusions as the [District] court in *C.M. Holdings*," and that the policies in that case were in all relevant respects identical to those involved in this case.[18] The Sixth Circuit Court of Appeals affirmed, concluding that the company's "COLI plan as a whole lacked economic substance."[19]

In another recent case, *Dow Chemical Company*, however, the District Court held that the IRS improperly disallowed the taxpayer's deductions for interest and expenses in connection with its COLI plans.[20] The District Court concluded that the "policies in this case were not 'empty transaction[s]' entered into 'for the sole purpose of generating a deduction,' 301 F.3d at 105 [citing the Third Circuit's opinion in *CM Holdings*], and the COLI policies were therefore not an economic sham."[21]

<u>Present-law tax rules relating to life insurance contracts</u>

COLI contracts are subject to the following Federal tax rules generally applicable to life insurance contracts.

<u>Amounts received under a life insurance contract</u>

Amounts received under a life insurance contract paid by reason of the death of the insured are not includible in gross income for Federal tax purposes.[22] No Federal income tax generally is imposed on a policyholder with respect to the earnings under a life insurance contract (inside buildup).[23]

Distributions from a life insurance contract (other than a modified endowment contract) that are made prior to the death of the insured generally are includible in income to the extent

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[18] *Id*. at 769.

[19] 326 F.3d 737, 745.

[20] *Dow Chemical Company v. U.S.*, 250 F. Supp.2d 748 (E.D. Mich. 2003), *modified*, Case No. 00-10331-BC, E. D. Mich., Aug. 12, 2003.

[21] *Dow Chemical Company, modified opinion*, Case No. 00-10331-BC, E.D. Mich., Aug. 12, 2003, at 25.

[22] Sec. 101(a).

[23] This favorable tax treatment is available only if a life insurance contract meets certain requirements designed to limit the investment character of the contract (sec. 7702). By contrast to the treatment of life insurance contracts, if an annuity contract is held by a corporation or by any other person that is not a natural person, the income on the contract is treated as ordinary income accrued by the contract owner and is subject to current taxation (i.e., the contract is not treated as an annuity contract) (sec. 72(u)).

that the amounts distributed exceed the taxpayer's investment in the contract (i.e., basis). Such distributions generally are treated first as a tax-free recovery of basis, and then as income.[24]

Premium and interest deduction limitations[25]

Premiums.--Under present law, no deduction is permitted for premiums paid on any life insurance, annuity or endowment contract, if the taxpayer is directly or indirectly a beneficiary under the contract.[26]

Interest paid or accrued with respect to the contract.--No deduction generally is allowed for interest paid or accrued on any debt with respect to a life insurance, annuity or endowment contract covering the life of any individual.[27] An exception is provided under this provision for insurance of key persons.

Interest that is otherwise deductible (e.g., is not disallowed under other applicable rules or general principles of tax law) may be deductible under the key person exception, so long as it is interest paid or accrued on debt with respect to a life insurance contract covering an individual who is a key person, to the extent that the aggregate amount of the debt does not exceed $50,000 per insured person. The deductible interest may not exceed the amount determined by applying a rate based on a Moody's Corporate Bond Yield Average-Monthly Average Corporates. A key person is an individual who is either an officer or a 20-percent owner of the taxpayer. The number of individuals that can be treated as key persons may not exceed the greater of (1) five individuals, or (2) the lesser of five percent of the total number of officers and employees of the taxpayer, or 20 individuals.[28]

Pro rata interest limitation.--A pro rata interest deduction disallowance rule also applies. Under this rule, in the case of a taxpayer other than a natural person, no deduction is allowed for the portion of the taxpayer's interest expense that is allocable to unborrowed policy cash

[24] Sec. 72(e). In the case of a modified endowment contract, however, in general, distributions are treated as income first, loans are treated as distributions (i.e., income rather than basis recovery first), and an additional 10 percent tax is imposed on the income portion of distributions made before age 59-1/2 and in certain other circumstances (secs. 72(e) and (v)). A modified endowment contract is a life insurance contract that does not meet a statutory "7-pay" test, i.e., generally is funded more rapidly than seven annual level premiums (sec. 7702A).

[25] In addition to the statutory limitations described below, interest deductions under company-owned life insurance arrangements have also been limited by recent cases applying general principles of tax law, including the sham transaction doctrine, discussed above.

[26] Sec. 264(a)(1).

[27] Sec. 264(a)(4).

[28] Sec. 264(e)(3).

surrender values.[29] Interest expense is allocable to unborrowed policy cash values based on the ratio of (1) the taxpayer's average unborrowed policy cash values of life insurance, annuity and endowment contracts, to (2) the sum of the average unborrowed cash values (or average adjusted bases, for other assets) of all the taxpayer's assets.

Under the pro rata interest disallowance rule, an exception is provided for any contract owned by an entity engaged in a trade or business, if the contract covers only one individual who is a 20-percent owner of the entity, or an officer, director, or employee of the trade or business. The exception also applies to a joint-life contract covering a 20-percent owner and his or her spouse.

"Single premium" and "4-out-of-7" limitations.--Other interest deduction limitation rules also apply with respect to life insurance, annuity and endowment contracts. Present law provides that no deduction is allowed for any amount paid or accrued on debt incurred or continued to purchase or carry a single premium life insurance, annuity or endowment contract.[30] In addition, present law provides that no deduction is allowed for any amount paid or accrued on debt incurred or continued to purchase or carry a life insurance, annuity or endowment contract pursuant to a plan of purchase that contemplates the systematic direct or indirect borrowing of part or all of the increases in the cash value of the contract (either from the insurer or otherwise).[31] Under this rule, several exceptions are provided, including an exception if no part of four of the annual premiums due during the initial seven-year period is paid by means of such debt (known as the "4-out-of-7 rule").

Tax treatment of employee benefits

Under present law, compensation provided by an employer to an employee, including noncash employee benefits, is generally deductible as an ordinary and necessary business expense. Compensation, including noncash employee benefits, is includible in the gross income of the employee and subject to employment taxes unless an exclusion applies. Present law provides favorable tax treatment for certain types of employee benefits.

Under present law, certain employee benefits are excludable from the income and wages of the employee. For example, health benefits provided by an employer to current and former employees (and their spouses and dependents) are excludable from gross income and wages.[32] Certain other employee benefits are also excludable from gross income and wages, subject to certain restrictions and, in some cases, dollar limitations, including educational assistance,[33]

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[29] Sec. 264(f). This applies to any life insurance, annuity or endowment contract issued after June 8, 1997.

[30] Sec. 254(a)(2).

[31] Sec. 264(a)(3).

[32] Secs. 104, 105, and 106.

[33] Sec. 127.

dependent care assistance,[34] adoption assistance,[35] qualified transportation benefits,[36] and certain other miscellaneous fringe benefits.[37] In addition, through the use of a cafeteria plan,[38] an employer may allow employees to choose between receiving cash and receiving certain nontaxable benefits.

Present law also provides favorable tax treatment for employer-sponsored retirement plans that meet the qualification requirements set forth in the Code ("qualified retirement plans").[39] These qualification requirements include limitations on the maximum benefits that can be required and nondiscrimination rules that are designed to ensure that a qualified retirement plan benefits a broad group of employees, not only an employer's highly compensated employees. Under a qualified plan, the employer is entitled to current deductions for contributions to the plan (within limits). The contributions are made to a tax-exempt trust, which allows for earnings on the contributions to accumulate on a tax-free basis. Employees do not include qualified retirement plan benefits in income until received. The tax rules relating to qualified plans allow employers to prefund benefits that will not be provided to employees until some time in the future.

Employers may also provide retirement benefits or other deferred compensation to employees outside of a qualified retirement plan. Such "nonqualified deferred compensation arrangements" are not subject to the qualification rules and are typically limited to a relatively small group of higher-paid employees and officers. An employer is not entitled to a deduction for such compensation until it is includible in the gross income of the employee. The time for inclusion of such compensation depends on whether the arrangement is considered funded for tax purposes or unfunded. If the arrangement is funded, the deferred compensation is includible in gross income when it is vested.[40] If it is considered unfunded, it is generally includible in gross income when paid or otherwise made available to the employee. Most nonqualified deferred compensation is provided through arrangements that are not considered funded for tax purposes, because that results in current taxation to the employee. However, over time, practices have developed that seek to provide security for employees while not triggering current taxation. Such arrangements include, for example, so-called "rabbi trusts," through which amounts can be set aside solely for the purpose of paying nonqualified deferred compensation, subject to the claims of the employer's general creditors.

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[34] Sec. 129.

[35] Sec. 137.

[36] Sec. 132(f).

[37] Sec. 132.

[38] Sec. 125.

[39] Present law also provides tax treatment for similar types of employer-sponsored retirement plans, such as tax-sheltered annuities.

[40] Sec. 83.

Present law also allows prefunding of retiree health benefits, subject to certain restrictions. There are two main ways that retiree health benefits can be funded: (1) through a section 401(h) account that is part of a qualified defined benefit plan or qualified money purchase pension plan; or (2) through a voluntary employees' beneficiary association ("VEBA") or other trust. Employers can make deductible contributions to a 401(h) account; the earnings on contributions accumulate on a tax-free basis. Contributions to the account can be no more than 25 percent of the actual contributions made to the qualified plan of which the account is apart since the account was established. Deductions for prefunding retire health benefits through a VEBA or other trust are governed by sections 419 and 419A, which generally allow retiree health benefits to be funded over the working life of the employee (assuming current medical costs). However, earnings on assets set aside to fund retiree health benefits may be subject to unrelated business income tax.[41] Retiree health benefits may also be funded indirectly by transferring excess pension plan assets to a section 401(h) account to pay for current retiree health expenses.[42]

[41] Sec. 512(a)(3).

[42] Sec. 420.

III. PROPOSALS RELATING TO COLI

A. Introduced Bills

H.R. 414

H.R. 414, introduced January 28, 2003, by Mr. Green of Texas, provides that written notice generally must be provided to an employee within 30 days after an employer purchases a life insurance policy on the life of the employee or his or her spouse or dependent. The notice must contain (1) a statement that the employer is carrying the policy, (2) the identity of the insurer, (3) the amount of the benefit under the policy, and (4) the name of the beneficiary under the policy. The bill provides that a violation of the notice requirement constitutes an unfair method of competition and an unfair or deceptive act or practice under the Federal Trade Commission Act. The period within which the notice must be provided is one year following enactment in the case of former employees covered by life insurance after 1984, and 90 days following enactment in the case of current employees covered by life insurance.

H.R. 2127

H.R. 2127, introduced May 15, 2003, by Mr. Emanuel and others, provides that the income on certain COLI contracts is includable in the gross income of the policyholder for the year. A death benefit paid under such a COLI contract is includable in income to the extent it exceeds the sum of previously included income on the contract and premiums paid. These rules generally apply to any life insurance policy or endowment contract held by an entity engaged in a trade or business. Exceptions are provided for a policy or contract that (1) covers only key persons, (2) is acquired by an estate of a decedent by reason of the decedent's death, (3) is held by a qualified retirement plan or under a 403(b) program or individual retirement account, (4) is a qualified funding asset in connection with a structured settlement arrangement, or (5) is purchased in connection with certain terminations of qualified retirement plans. Information reporting is required with respect to COLI contracts to which the bill applies.

At least 60 days before purchase of a COLI contract to which the bill applies covering the life of an employee, the business entity making the purchase must provide written disclosure to the employee of (1) a statement of the plan to purchase the contract on the life of the employee, (2) the identity of the insurer, (3) the amount of the benefit under the policy, and (4) the name of the beneficiary under the policy. The bill provides that any increase in Federal receipts by reason of the provisions of the bill is to be used to reduce the public debt.

The bill is effective for contracts entered into after the date of enactment. The bill provides that none of its provisions is to be construed to affect any case in controversy or investigation by the Secretary of the Treasury relating to any leveraged COLI contract entered into before the date of enactment.

B. Amendments in Committee

Markup of the "National Employee Savings and Trust Equity Guarantee Act"

On September 17, 2003, the Senate Committee on Finance marked up the "National Employee Savings and Trust Equity Guarantee Act." An amendment relating to COLI was adopted at the markup, described below.

Amendment of Senator Bingaman

The amendment would require businesses to treat payments received from COLI policies as gross income if the insured has not been an employee in the year preceding the death of the insured. Proceeds of the life insurance policies going to the families or beneficiaries of the insured will continue to receive tax-free treatment. Additionally, any proceeds of the policy received by the business owning the policy that are used to buy back any equity interest owned at death by the insured are excluded from income. This amendment is effective for all policies and new employees added to a policy after September 17, 2003. The amendment would grandfather all policies existing as of September 17, 2003, and includes an exception for "key persons" as defined under section 264(e)(3).

Markup of the "Jumpstart Our Business Strength (JOBS) Act"

In connection with the markup in the Senate Committee on Finance of the "Jumpstart Our Business Strength (JOBS) Act," with modifications, on October 1, 2003, two amendments, described below, relating to COLI were filed with the Committee. At the markup, Chairman Grassley announced that the Committee would hold a hearing during the week of October 13th, and that the effective date of the COLI-related amendment previously adopted by the Committee in its markup of the "National Employee Savings and Trust Equity Guarantee Act" on September 17, 2003, would be modified so as to be effective for contracts issued after the date of enactment.

Amendment of Senator Bingaman

The amendment would require businesses to treat payments received from COLI policies as gross income if the insured has not been an employee in the year preceding the death of the insured. Proceeds of the life insurance policies going to the families or beneficiaries of the insured will continue to receive tax-free treatment. Additionally, any proceeds of the policy received by the business owning the policy that are used to buy back any equity interest owned at death by the insured are excluded from income. This amendment is effective for all policies and new employees added to a policy after September 17, 2003. The amendment would grandfather all policies existing as of September 17, 2003, and includes an exception for "key persons" as defined under section 264(e)(3).

Amendment of Senator Conrad

Conrad amendment.--The amendment provides that, unless an employer-owned life insurance contract meets specified requirements under this provision, death benefits received under the contract would be fully taxable (except to the extent of premiums previously paid). For this purpose, an employer-owned life insurance contract would be defined as a life insurance contract in which the insured is an employee of the policyholder on the date the contract is issued. However, a life insurance contract would not be an employer-owned life insurance contract to the extent death benefits are payable to a member of the family of the insured, a trust for such a family member, the insured's estate, or are to be used to purchase an equity interest in the employer from a family member, trust for a family member, or the insured's estate.

A life insurance contract would satisfy the requirements of this provision if prior to the issuance of the contract, the employee consents in writing to be insured and one of two alternative tests are met. Under the first alternative test, the insured employee would have to be a "key employee." That is, the individual would have to be a bona fide executive, administrative or professional employee, an outside salesman, or a computer professional under the Fair Labor Standards Act (29 U.S.C. secs. 213(a)(1), (17)). Under the second alternative, other employees could be insured. However, in this case, (i) the insured employee must be eligible (either currently or upon the future satisfaction of age, service, or similar eligibility criteria) to participate in an employee pension or other benefit plan under which benefits are payable to the insured (or a beneficiary designated by the insured) and (ii) the death benefit coverage under the life insurance contract, when added to that under other such contracts held by the taxpayer, must be reasonably related to the costs of the employee or retiree benefits already incurred in connection with the employee benefit plans plus the projected future costs of the benefits as established by the employer.

The provision would apply to life insurance contracts issued after the date of enactment.

<u>Modified Conrad amendment</u>.--Under a modified version of the amendment, unless an employer-owned life insurance contract meets specified employee benefit funding requirements under this provision, death benefits received under the contract would be fully taxable (except to the extent of premiums previously paid). This rule would not apply to death benefits received with respect to individuals who were employees or consultants during the year prior to death. An employer-owned life insurance contract would be defined as a life insurance contract in which the insured is an employee (other than a highly compensated employee within the meaning of section 414(q)) of the policyholder (or an affiliate) on the date the contract is issued. However, a life insurance contract would not be an employer-owned life insurance contract to the extent death benefits are payable to a member of the family of the insured, a trust for such a family member, the insured’s estate, or are to be used to purchase an equity interest in the employer from a family member, trust for a family member, or the insured’s estate.

Under the modified version, a life insurance contract would satisfy the specified employee benefit funding requirements of this provision if prior to the issuance of the contract, the employee consents in writing to be insured and at the time the contract is issued: (i) the employee must not be an hourly employee; (ii) the insured employee must be eligible (either currently or upon the future satisfaction of age, service, or similar eligibility criteria) to participate in an employee pension plan (other than a qualified plan described in section 401(a)) or other benefit plan under which benefits are payable to the participant (or a beneficiary designated by the participant); (iii) the death benefit coverage under the life insurance contract, when added to that under other such contracts held by the taxpayer, must be reasonably related to the costs of the employee or retiree benefits already incurred in connection with the employee benefit plans plus the projected future costs of the benefits as established by the employer; and

(iv) the contract is placed in trust (subject to the claims in bankruptcy of the employer's general creditors) the exclusive purpose of which is to fund the employee benefit plans.

C. Senate Floor Amendment

On May 15, 2003, during debate in the United States Senate on S. 1054, the "Jobs and Growth Reconciliation Tax Act of 2003" (reported by the Senate Committee on Finance on May 8, 2003), Senator Edwards submitted an amendment relating to COLI.[43] The amendment was not adopted (a motion to waive a point of order against the amendment failed by a vote of 63-37). The amendment provided that income on COLI contracts for any taxable year is included in gross income for the year. The amendment further provided death benefits under COLI contracts are included in income, to the extent the death benefit exceeds the investment in the contract. These rules do not apply with respect to any contract that covers the life solely of individuals who are key persons (as defined in section 264(e)(3)). The amendment was effective for contracts entered into after the date of enactment.

[43] 149 Cong. Rec. S6551 (May 15, 2003).

IV. ISSUES RELATING TO COLI

COLI has been the focus of legislative proposals, media attention and policy discussions. The tax benefits of COLI have been limited several times by Congressional action, starting in the 1940's. In the recent litigation described above, some COLI transactions have been attacked as an economic sham. Recent press reports have raised issues relating to consumer protection, tax sheltering, and financial reporting with respect to COLI.[44] At the same time, sales of COLI policies have continued, although there is little publicly available information about the number of COLI policies currently in force or the total dollar amount of the cash value or death benefits of COLI policies because reporting is not generally required.[45] Brokers, selling agents and issuers of COLI argue that it serves a useful purpose as a funding vehicle for business cash needs as well as being attractive from tax and accounting perspectives.

<u>The issue of tax arbitrage</u>

From a tax policy standpoint, business investment in COLI is criticized because it presents an opportunity for tax arbitrage. Tax arbitrage occurs because the tax-free income of a COLI investment is offset by deductible expenses. Inside buildup and death benefits under life insurance contracts generally are tax-free. Either deducting the costs of maintaining the tax-free

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[44] See, e.g., Wells, *U.S. Senate Panel to Revise Corp. Life Insurance Measure*, Dow Jones Newswires, Oct. 1, 2003; Wells, *Tax Facts: Hard Year for Insurers on Taxes*, Wall St. J., Sept. 24, 2003; Francis, *COLI Revenue Declines Sharply at Large Insurers*, Wall St. J., Sept. 3, 2003; Francis, *Janitors' Policies Advantages May be Eased by Lawmakers; Measures in House, Senate Would Impose on Companies a Levy on Death Benefits*, Wall St. J., May 15, 2003; Francis, *Court Rules Against AEP in 'Janitors Insurance' Case*, Wall St. J., April 29, 2003; Francis, *Bill Seeks Disclosure on Insuring Employees*, Wall St. J., Feb 5, 2003; Francis, *Insurance Disclosure of S&Ls May Change*, Wall St. J., Jan. 27, 2003; Schultz and Francis, *How Life Insurance Morphed into a Corporate Finance Tool*, Wall St. J., Dec. 30, 2002; Francis and Schultz, *Tax Benefits of Life Insurance Help to Boost the Bottom Line*, Wall St. J., Dec. 30, 2002; Gettlin, *Tax-Free Earnings: A Life-And-Death Issue*, National J., Oct. 26, 2002, at 3140; Clark, *Better Off Dead?*, U.S. News & World Report, May 6, 2002, at 32; Schultz and Francis, *The Economy: Senator to Target Tax Boon to Firms Insuring Workers*, Wall St. J., May 3, 2002; Francis and Schultz, *Big Banks Quietly Pile up 'Janitors' Insurance*,' Wall St. J., May 2, 2002; Francis and Schultz, *Many Banks Boost Earnings with 'Janitors' Life Insurance*,' Wall St. J., April 26, 2002; Francis and Schultz, *Why Secret Insurance on Employees Pays Off*, Wall St. J., April 25, 2002; Schultz and Francis, *Why Are Workers in the Dark? Most States Don't Force Firms to Disclose 'Janitors' Insurance,' But Congress May Change That*, Wall St. J., April 24, 2002; Schultz and Francis, *Valued Employees: Worker Dies, Firm Profits*, Wall St. J., April 19, 2002.

[45] A recent news article stated, "[p]rojections provided to [Senator] Conrad by the American Council of Life Insurers estimated that annual COLI and BOLI premiums were $8 billion." *Humbled Life Industry Faces Rocky Road In Justifying Tax-Sheltered Offerings*, Insurance Chronicle, Oct. 6, 2003.

investment, or funding deductible expenses with the proceeds of this tax-free investment, gives rise to tax arbitrage. This creates an incentive to invest in life insurance.

Tax arbitrage subverts the goal of an income tax system to impose tax on net income. In order to measure income accurately, the expenses associated with tax-free income should not be deductible. Alternatively stated, to the extent the expenses associated with income are deductible, the income should be taxable. Tax arbitrage possibilities can distort investment decisions, leading the taxpayer to choose a lower-yielding investment rather than a higher-yielding investment that is fully taxable. Such a decision reduces economic efficiency; that is, the total output of society is reduced.

Some might argue that legitimate business deductions should not be disallowed merely because a company has an unrelated investment that produces tax-free income. Others, however, argue that the financial resources of a business are fungible, and that income produced by assets of a business can be thought of as funding the obligations of the entire business. Because of this fungibility of money, a taxpayer's expenditures can be viewed as funded ratably from all its sources of income, whether taxed or untaxed. Thus, if a taxpayer has deductible expenses and tax-free income, tax arbitrage can be limited either by limiting the deductibility of the expenses, or by treating the income as taxable.

Congress has demonstrated a broad concern with the problem of tax arbitrage in enacting generally applicable rules limiting the deductibility of expenses and interest allocable to tax-exempt income.[46] This tax arbitrage concern is also reflected in the Congressional legislation to limit the deductibility of premiums and interest expense associated with earning tax-free inside buildup of COLI contracts.[47]

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[46] Section 265.

[47] Prior to the 1996 and 1997 enactment of interest deduction limitations with respect to COLI, some argued that businesses do not borrow to buy COLI contracts; rather, businesses incur debt to invest in their core businesses. Their deductible interest expenses consequently are associated with their business activities, not with holding COLI as a tax-free investment. However, many argued that the financial resources of a business are fungible. Debt with associated interest expense can be thought of as supporting the capital needs of the entire business, even though the debt may have been incurred at a time when a particular expenditure becomes due, or to fund a specific outlay. This fungiblity concept is reflected in the present-law rule imposing a pro rata interest deduction limitation on interest expense of taxpayers to the extent of the cash value of their COLI contracts (except for contracts covering officers, directors, employees, and certain owners). However, businesses that own COLI policies covering the lives of these excepted individuals and that borrow from a third-party lender or from the public are still able to achieve this type of tax arbitrage by deducting interest that funds the tax-free inside buildup of COLI. This tax arbitrage opportunity may be utilized by financial intermediation businesses, which may have a relatively large amount of debt in the ordinary course of business.

COLI as a funding mechanism for business obligations

Some argue that COLI is a valuable means of funding certain types of necessary business expenditures. In particular, it is argued that COLI provides a self-help mechanism for companies to prefund obligations under certain employee benefit plans and arrangements, including nonqualified deferred compensation arrangements with current and former employees and retiree health plans. The tax benefits of COLI make it a cost-effective funding method for such obligations relative to other types of investments. As a result, it is argued, Congress should specifically provide that COLI used for these types of business obligations, and for any other employee benefit, should receive favorable tax treatment. It is further argued that the use of COLI can be targeted to employee benefits by requiring that the life insurance contracts be held in a trust for the exclusive purpose of funding employee benefits.

Others argue that permitting the virtually unlimited funding of deductible payments for nonqualified deferred compensation, retiree health, or generally for employee benefits raises a tax arbitrage concern. That is, explicitly providing that a business may fund deductible compensation-related expenditures with tax-free inside buildup and tax-free death benefits under COLI contracts would favor COLI as an investment product over other investment choices. Permitting tax-free income under COLI policies to fund companies' deductible expenditures for nonqualified deferred compensation, retiree health and similar deductible payments would give rise to tax-induced economic distortions and would result in the failure to measure income accurately.

It is also argued that Congress has already provided tax-favored funding mechanisms for employee benefits and has determined the appropriate scope of such funding. For example, pension benefits under qualified employer retirement plans can be prefunded on a tax-favored basis. Subject to certain limitations, employer contributions to such plans are deductible, and earnings accumulate on a tax-free basis. Similarly, present law provides rules for prefunding certain other employee benefits, including retiree health benefits, subject to certain limits and restrictions. Allowing prefunding on a tax-favored basis through the use of COLI undermines the rules already established by the Congress. If the present-law rules can be avoided only through the use of COLI, then COLI has a competitive advantage.

It is further argued that if the present-law rules relating to tax-favored funding of employee benefits are viewed as being too restrictive, the more appropriate approach would be to modify those rules, so that one particular mechanism or investment product is not favored. Proponents of this approach argue in essence for a "level playing field" that provides one set of rules that are determined to be appropriate based on the type of benefit being provided, rather than on the funding mechanism.

Opponents of permitting COLI to fund employee benefits point to the fact that the death benefits payable when the insured workers or former workers die are necessarily used to fund benefits for other individuals who are still alive. Thus, it is argued, the COLI policies have no relation to the employee benefits being provided.

Supporters of permitting COLI to fund employee benefits argue that the fact that the group of individuals who are insured is not the same group as those whose employee benefits are funded by the proceeds of the insurance does not matter, so long as the business has an insurable interest in the insured individuals under applicable State law. Whether a company has an insurable interest in a particular class of individuals is a determination properly made under applicable State insurable interest laws. It is not an appropriate question for Federal tax rules to address, it is argued.

COLI as a hedge

It is also argued by some that COLI serves an important investment purpose for businesses with volatile earnings that fluctuate with market factors such as interest rates. COLI policies invested in separate account assets that are targeted to a particular type of market risk can function as a hedge to counter the volatility of earnings in the core business, thus smoothing earnings for financial reporting purposes and ultimately benefitting shareholders and investors in the company. Alternatively, general account COLI might be used to provide a steady source of positive earnings, without functioning specifically as a hedge against earnings volatility. It is argued that either of these is a reasonable business goal which should not be made more difficult to attain by altering the tax rules applicable to COLI.

Opponents of this view agree that hedging volatility of earnings is a reasonable goal, but argue that the tax law should not create relative advantages and disadvantages among different types of investments used as hedges. The same argument applies to the use of general account COLI as an investment producing steady positive earnings. If the investment is either to hedge earnings volatility or to provide a steady income source, there is no reason to favor the purchase of assets indirectly through an insurance contract with tax-free inside buildup, as opposed to the purchase of the assets directly. It may be inefficient to incur the cost of insuring mortality risk on individuals in addition to the cost of the asset constituting the hedge.

As a corollary, it is argued that too much investor control over the choice of separate account assets backing the contract causes the contract to look less like insurance and more like a direct hedge that should be taxed as such. It is further argued that while hedging business risk may be a business purpose for a hedging transaction, it is not an appropriate business purpose for purchasing life insurance coverage, and that a significant attraction of life insurance as a hedge is its tax-favored treatment.

Policy rationale for exclusion of death benefits

Some argue that the original policy rationale for the present-law rule excluding amounts received under an insurance contract by reason of the death of the insured has little connection to the current uses of COLI today. They point to the notion that death benefits under life insurance contracts may have been made excludable to create an incentive for breadwinners to insure against loss of income resulting from their death, so that their families and dependents would not become wards of the state. This same rationale can be applied to workers in a business whose loss due to death would have a negative impact on the ability to conduct the business. These concepts, however, have little relation to the use of COLI as a tax-favored funding mechanism for business expenditures. Thus, it is argued, death benefits that are paid to employers rather than to the families, dependents or estates of the insured individuals (or to fund a buy-sell agreement with the insured) should not be excludable from the business' income after the insured individual has ceased working for the business. It is argued that a company has little connection to a former employee who remains insured. The business no longer need insure for the lost production of the employee, or for the expense of having to find and train a replacement. Thus, the tax benefits should be terminated within a reasonable period after the employment relationship has ended. After a reasonable time (such as a year) beyond the termination of the worker's employment in the business, there is no justification for the business to exclude from income the death benefits it receives upon that individual's death.

Some might argue that COLI is a product whose uses have changed, and that the original rationale is too limiting. They argue that a business insures workers not just against the risk of loss of the productivity of the insured individuals, but as a funding mechanism for legitimate business obligations. However, as discussed above, in response it can be argued that funding deductible expenses with the tax-free income from COLI raises a tax arbitrage concern, is economically inefficient in favoring COLI over other investment choices, and undermines the rules for prefunding employee benefits already established by the Congress.

Others argue that companies should be able to continue to insure key persons after they have ceased to perform services for the business so long as they were key persons at the time they became insured. Otherwise, it is argued, no tax incentive is provided for businesses to insure key persons if the death benefits under the key person insurance contract become taxable after the key person no longer performs services in the business. Thus, it is argued, an exception to any rule taxing death benefits with respect to former workers would be needed in the case of key persons. In response, it can be argued that term life insurance can serve the purpose of providing insurance against the loss of a key person for the period that the person is providing services to the business, and that present-law tax consequences of surrendering a whole life insurance policy can be avoided by the use of term insurance. Similarly, taxation of death benefits under the proposals would not apply in the case of term life insurance for key persons under which coverage ended within a year after the individual ceased providing services to the business.