S. HRG. 108–342

COMPANY-OWNED LIFE INSURANCE

HEARING

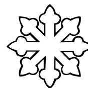
BEFORE THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

ONE HUNDRED EIGHTH CONGRESS

FIRST SESSION

OCTOBER 23, 2003



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COMPANY-OWNED LIFE INSURANCE

THURSDAY, OCTOBER 23, 2003

U.S. SENATE,
COMMITTEE ON FINANCE,
Washington, DC.

The hearing was convened, pursuant to notice, at 2:05 p.m., in room SD–215, Dirksen Senate Office Building, Hon. Charles E. Grassley (chairman of the committee) presiding.

Also present: Senators Lott, Snowe, Santorum, Smith, Bunning, Baucus, Conrad, and Bingaman.

OPENING STATEMENT OF HON. CHARLES E. GRASSLEY, A U.S. SENATOR FROM IOWA, CHAIRMAN, COMMITTEE ON FINANCE

The CHAIRMAN. Good afternoon, everybody. Senator Baucus and I can only be here for a short period of time, and Senator Lott is going to come and conduct the hearing because of our involvement in the Medicare and energy conferences. The Medicare conference started at noon today, but did not really get started until 1:00 because of votes.

But I want to thank everybody for being here on a very important issue, joining us today on the issue of company-owned life insurance. The Internal Revenue Code provides strict rules on tax treatment of all life insurance contracts.

In response to concerns about the misuse of company-owned life insurance, Congress has legislated three times in the past 17 years to limit some uses of corporate-owned life insurance.

These rules affect the treatment of death benefits, limits on amount of premiums that can be paid and prohibitions on the deductibility of premium payments and rules addressing the treatment of interest on policy loans.

But some concerns on the use of corporate-owned life insurance remain, or of course we would not be here for this hearing today. Senator Bingaman has had a longstanding interest in ending what he believes are abuses of corporate-owned life insurance. That is his right. Whether or not any other member agrees or disagrees with Senator Bingaman is their right as well.

For over a year now, Senator Bingaman has made it clear that he intends to raise the COLI issue as soon as an appropriate vehicle appears. On September 16, 2003, he filed an amendment for the mark-up of the pension bill. That same day, the insurance industry met with my staff. My staff asked that they work out a compromise with Senator Bingaman, but they refused.

After the market-up, some people in Washington feigned surprise that the Bingaman amendment had the support that it had. They

have demanded that I stop you, Senator Bingaman, from doing what you are doing, and I think that is absurd in the U.S. Senate, and maybe in an parliamentary body, because you do not get very far in this body if you trample on other people's rights.

My own feeling is that we dealt with a majority of the perceived abuses with COLI in 1996 and 1997. But that is not how Senator Bingaman feels, and I respect that. Even if we did not deal with Senator Bingaman's issues in this committee, and the committee is the ideal place to deal with things, we would be then dealing with it on the floor. That is the reality of the Senate. Any such refusal, I promise you, would only make it worse for the issue.

I want to say that I hope this hearing will help clear the air on this issue. I am troubled about the testimony from the General Accounting Office. That office will testify that they tried to complete a survey on corporate-owned life insurance so we could learn more about its scope and uses.

It is difficult for Congress to legislate or to decide not to legislate without information. Transparency is very important. It is a part of our oversight responsibility to understand these issues.

Unfortunately, the General Accounting Office was not able to complete its survey because some in the industry "did not have the information" or "did not have it in a usable form."

At the same time, I understand that there is a corporate-owned life insurance survey that was published by a consultant somewhere in California. It is available for $7,000. But it will only be sold to approved parties within the industry.

If insurance companies could give this consultant access to information on corporate-owned life insurance, why could not the General Accounting Office get it to help Congress with our constitutional jobs of oversight?

Now, lobbyists tell my staff that company-owned life insurance is 25 percent of their business. How is it that companies do not have information about a quarter of their business?

If the industry is telling us that we are legislating in an area where legislation is not needed, then we need to know why. If we have got questions, you need to give us answers, and that would surely include data to back it up.*

Now I will turn to Senator Baucus.

OPENING STATEMENT OF HON. MAX BAUCUS, A U.S. SENATOR FROM MONTANA

Senator BAUCUS. Thank you very much, Mr. Chairman. I commend you for holding today's hearing on company-owned life insurance. As has been noted, the Finance Committee ordered the Pension bill reported on September 17. On that day, and again at the mark-up of the JOBS bill on October 1, the committee has confronted the issue of company-owned life insurance.

It has been many years since Congress chose to exclude life insurance proceeds from taxable income. The uses of company-owned life insurance have certainly evolved since then.

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*For more information on this subject, *see also*, "Present-Law Federal Tax Treatment, Proposals, and Issues Relating to Company-Owned Life Insurance ('COLI')," Joint Committee on Taxation Staff Report, October 14, 2003 (JCX–91–03).

Congress has acted to address perceived abuses in this area, particularly to restrict the deduction for interest on repayment of policy loans. Some among us feel strongly that abuses remain. Others feel just as strongly that current COLI practices are valuable to companies, employees, and indeed to the Nation.

Mr. Chairman, it is plain that we will need to work out a resolution on this issue. I hope that today's hearing—in fact, I am quite confident—can and will contribute to that end. I look forward to working together with all those involved to see that the committee can reach an agreeable solution to this challenge. Thank you.

The CHAIRMAN. Thank you very much.

I usually do not call on members to speak, but we have got two members on the Democratic side that are on both sides of this. If you would like to make a short statement, I would call on you. I would call on you, too, Senator Bunning, if you want to get in. But I think we should make it quick, if you could.

Senator Conrad?

OPENING STATEMENT OF HON. KENT CONRAD, A U.S. SENATOR FROM NORTH DAKOTA

Senator CONRAD. All right. First of all, I want to thank the Chairman and Ranking Member for holding this hearing. I think it is important for our overall understanding of the issue before us to have this hearing before taking action and I thank very much the Chairman and Ranking Member for accommodating that need.

I know that they are very busy with the conference and will have to leave us soon, but I know their staffs will be here.

I think the fundamental question before us is, are there ongoing problems with corporate-owned life insurance after the changes Congress has already made, and if there are, how to address them.

The amendment that I have put before my colleagues reaches the conclusion that corporate-owned life insurance is an appropriate way to provide an incentive for retiree benefits, retirement benefits, health benefits, but that there are things that could be done to improve COLI, to reform COLI, and to ensure that anybody who has a policy written on their life is given informed consent, that the benefits are proportional, that they key man definition is clear. That is what the amendment that I have offered my colleagues seeks to do.

It also seeks to make certain that the money is used for the purpose intended. But we all know that there are many views on this subject. And we have got good witnesses here today. Hopefully, at the end of this process we can be more informed in reaching a conclusion on how to best proceed. I again thank my colleagues.

The CHAIRMAN. Thank you.

Senator Bingaman, did you want to say something?

OPENING STATEMENT OF HON. JEFF BINGAMAN, A U.S. SENATOR FROM NEW MEXICO

Senator BINGAMAN. Yes. Thank you very much, Mr. Chairman. Thank you for holding the hearing. I know you and Senator Baucus have a lot to deal with these days, and I appreciate your good work in the various conferences that both of you are involved in. I hope you can stick to your guns in those forums as well.

I appreciate your opening comments here. I do think this is a very important issue and I thank you for holding the hearing.

Let me give just a little overview. I know you do not want to take a lot of time at this, but I would like to sort of describe how I see the problem, if the Chairman would permit me to do that.

And we have several witnesses here who will testify about this. Spencer Tillman is going to testify about this, and we also have the testimony of Vicki Rice, who was not able to be here, and I will describe that later.

But at one level the question is, why should corporations, companies be allowed to buy an insurance policy on an employee and then, years or decades after that employee leaves that company, get a tax-free pay-out on that insurance policy when it is clear that the insurance policy was not to guard against any risk. I mean, I have no problem with them buying policies. But I do think there is a question as to why taxpayers should grant tax preferential treatment to those pay-outs to companies at that stage.

At another level, let me just put up a chart here, and maybe this would be something I can ask Mr. Jenner about. We have a system for trying to get benefits from employers to employees through qualified plans at the current time.

We provide a tax incentive for that, because clearly there is a strong public policy reason to want employers to provide post-retirement or retirement benefits to employees. So, that is the yellow part that you see up there.

Also, if you want to give deferred compensation to your employees you can do that, but you do not get a tax benefit for doing it. We do not prohibit it, but we do not provide a tax incentive for you to do it.

Now, let me put up this second chart which describes how COLI operates, as I understand it, and Mr. Jenner can respond. Here at the top you have got the same thing you had in the previous chart.

That is, an employer providing a benefit to an employee through a qualified plan, or the alternative, which of course we are talking about in this hearing, is where the employer decides to buy a COLI policy and get tax benefits through that avenue, and then is able to use that money either for corporate needs of any kind, or for deferred compensation, or for anything else. That, to me, is the problem area.

It seems to me that for us to provide a tax incentive for companies to pursue that second route undermines the system we have been working to get in place for several decades now, and it creates a disincentive for employers to continue operating through qualified plans. I will pursue that series of questions with the witnesses as we go through it.

But I do thank you for the chance to go through these charts, Mr. Chairman. Again, I thank you for having the hearing.

The CHAIRMAN. Anybody on this side want to speak?

Senator BUNNING. I just would like to put an opening statement in the record and say how much I disagree with my good friend from New Mexico.

The CHAIRMAN. All right.

[The prepared statement of Senator Bunning appears in the appendix.]

The CHAIRMAN. Senator Smith?

Senator SMITH. Mr. Chairman, I appreciate the hearing. I think it is an important topic. I think Senator Conrad has come up with a very good amendment that I think we ought to be adopting, because I think it is responsible, without undoing a lot of the good that is done by the life insurance industry on these issues.

The CHAIRMAN. I announced before you came in, Senator Smith, that Senator Lott was going to be here momentarily to chair the hearing.

I thought you were leaving.

Senator BUNNING. No. I was coming up because I knew you were leaving. [Laughter.]

The CHAIRMAN. Thank you. Thank you very much. I appreciate it. I will let you continue.

Senator BUNNING. The first panel is Hon. Greg Jenner, Deputy Assistant Secretary, U.S. Department of Treasury.

Mr. Jenner, go right ahead.

STATEMENT OF HON. GREG JENNER, DEPUTY ASSISTANT SECRETARY, U.S. DEPARTMENT OF THE TREASURY, WASHINGTON, DC

Mr. JENNER. Thank you very much, Mr. Chairman. Thank you for the opportunity to testify regarding the taxation of corporate-owned life insurance.

To say the least, COLI has been a considerable source of debate and controversy over the years. And, while we should not be so naive as to think that today's hearing will resolve that controversy, I hope we can assist in separating wheat from chaff.

For the most part, regulation of insurance companies has been left to the States under the McCaran-Ferguson Act. The most important aspect of that regulation today is determining when the purchaser has an insurable interest in the insured.

Traditionally, States have allowed employers to ensure the life of a key person, or when the employer has a liability for future benefits for the employee. As you know, life insurance does receive preferential tax treatment on the Internal Revenue Code. Death benefits are excluded from income, and inside build-up is not taxed unless the policy is surrendered.

The tax laws do distinguish between corporate and individual owners in certain circumstances, and Congress has enacted limits on corporate owners to prevent tax arbitrage, the most recent example being the so-called leverage COLI.

Leveraged transactions are still in place because they have been continually grandfathered since 1986. I want to assure you that the IRS has, and will continue, to challenge grandfathered arrangements that do lack economic substance.

We understand that most broad-based COLI arrangements today are used for specific purposes. Non-leveraged COLI serves as a relatively low-cost way to ensure against financial hardships from the death of a key person. Corporations also use death benefits to provide funds for the payment of company expenses such as retiree health benefits.

This use of COLI can be traced to the enactment of Sections 419 and 419(a) in 1984. Those sections limit the tax benefits available

to corporations to pre-fund liabilities under welfare benefit arrangements. That makes it more difficult to match the funding assets with the liabilities.

COLI often fits this need because COLI proceeds often are received close to the same time the obligation to pay benefits arises, particularly in cases of retiree medical expenses, which often increase significantly in the retiree's final years. For financial reporting purposes, COLI enables a corporation to disclose assets of sufficient value to offset the value of disclosed liabilities.

Recent press reports about COLI appear to be focused less on tax issues than with issues concerning the breadth and nature of State insurable interest laws. This differs from previous efforts to eliminate perceived abuses, which have focused on opportunities for tax arbitrage.

Congress is, of course, free to establish circumstances under which favorable tax treatment will be afforded. In doing so, however, we believe there are several issues the committee should consider.

First, there may be significant administrative difficulties associated with trying to separate good COLI from bad COLI. Second, the committee should be aware that such changes may have the effect of creating a Federal scheme for regulating insurance.

Third, the committee should consider collateral policy issues associated with permitting COLI for only limited purposes, a point I will deal with more directly in a moment.

Fourth, any limitations on key person insurance must be carefully drawn. We would be pleased to work with the committee to ensure that any limitations are structured appropriately.

Fifth, limiting COLI to situations where the insured remains an employee could severely limit the use of COLI to fund retiree benefit plans. Although retirees are no longer employees, an employer's obligation to fund those benefits often continues.

Finally, let me touch on one proposal that would link tax benefits of COLI on former employees to benefits they are scheduled to receive. The total death benefits under COLI and other policies could not exceed projected future benefit costs and would require that these policies be held in an irrevocable trust, subject only to the claims of creditors and bankruptcies and used solely to fund such benefits. We have serious reservations about this approach.

Welfare benefit plans and non-qualified pension plans are not subject to the same rules under ERISA that apply to traditional qualified plans. An employer can change or eliminate these benefits at any time, but if the premise of the proposal is that the tax benefits from COLI should be conditioned on actual receipt of the benefits by the employee, it could be argued that ERISA-like protections may be necessary, such as vesting, non-discrimination, and funding rules.

This would be problematic at best, would run counter to over 25 years of ERISA law, and may cause employers to reduce or eliminate welfare benefit plans. We should not forget the ill-fated Section 89, enacted as part of the 1986 Act to provide such rules for welfare benefit plans. That section was repealed less than 3 years later. This proposal on COLI could force Congress to consider similar rules to ensure that benefits are received.

Mr. Chairman, this concludes my statement. I would be happy to answer any questions you might have.

[The prepared statement of Mr. Jenner appears in the appendix.]

Senator BUNNING. Mr. Conrad, you are first up.

Senator CONRAD. Thank you very much, Mr. Chairman. Mr. Jenner, thank you very much for your testimony. First of all, just on a fact basis, maybe we can go through a series of statements I would make about the state of play, and I would like your reaction to it, just in terms of fact.

Mr. JENNER. Certainly.

Senator CONRAD. The amendment that I have offered the committee would tighten COLI in certain respects. That is, informed consent, worker status, trying to match benefits with policy amounts. But it is a tightener. That is why it raises $165 million, according to the Joint Committee on Taxation.

Do you agree with the Joint Committee on Taxation's assessment that my amendment would raise approximately $165 million?

Senator CONRAD. Senator, we have not seen the Joint Committee's estimate, but I would certainly agree that your proposal does tighten the rules.

Senator CONRAD. Thank you.

The second question, or just a statement of fact as I understand it, and correct me if I am wrong. COLI premiums today are not deductible under current law and would not be deductible under my amendment. Is that correct?

Mr. JENNER. That is correct.

Senator CONRAD. Next, COLI death benefits are tax-free under current law. Under my amendment, they would be tax-free only if they meet the conditions specified in my amendment.

That is, that notice be required of those whose lives are insured, the workers' status provisions, and that there be some proportionality to the aggregate benefit obligation. Do you agree with those statements of fact?

Mr. JENNER. In part, Senator. I believe that under your proposal, notice would not be required for any employee or consultant that currently works for the company or had been employed within 1 year. It would only be the other workers who would have to give consent.

Senator CONRAD. That is correct.

And an additional statement of what I see as an accurate assessment of the current circumstance. Deferred compensation, under current law, is deductible for the employer and taxable to the employee when paid.

Mr. JENNER. When it is paid to the employee. Correct.

Senator CONRAD. Right. So, in fact, deferred compensation today is deductible to the employer?

Mr. JENNER. When it is paid. But, of course, the notion behind "deferred" is that it is deferred for significant periods of time.

Senator CONRAD. Exactly. But that is a statement of fact as to how it works.

Mr. JENNER. Correct.

Senator CONRAD. And my amendment would not change that situation.

Mr. JENNER. That is correct.

Senator CONRAD. There is no deduction for the employer for funds placed in the trust specified in the Conrad amendment.

Mr. JENNER. Correct.

Senator CONRAD. Let me ask you, in the judgment of the administration, should COLI be eliminated?

Mr. JENNER. No, Senator.

Senator CONRAD. And in the administration's judgment, should COLI be reformed? Is it wise to have provisions to tighten COLI?

Mr. JENNER. Senator, I think our view is that if Congress chose to limit COLI in certain ways, that could be done. We would be very concerned about how it was done, as I indicated before. There are certain unintended consequences that might flow from how it was limited, and we would be very concerned about those unintended consequences.

Senator CONRAD. A final question. Do you believe my amendment would be strengthened if the trust fund feature were removed?

Mr. JENNER. If the trust fund feature were removed? The trust fund feature of your amendment, Senator, is what I was tangentially referring to.

Senator CONRAD. That is what I understood. That is the thrust of my questions. It struck me that you were suggesting, and we have heard that—let me just say, this trust fund idea was originally Senator Breaux's idea. We incorporated it to try to give some assurance to people that the money was used for the purpose intended. That is the reason we have got the trust fund.

Since that time, as all of us have dug more deeply into it, we have learned that there are certain technical questions that arise from the creation of such a trust fund, and you referred to those in your testimony, did you not?

Mr. JENNER. I did. To elaborate, again, it depends on what the premise of your proposal is. If you are seeking to tie the use of COLI directly to the provision of benefits, then your trust fund probably does not accomplish that very well because there is not a direct link between what the employee is insured for and the benefits that they get, which of course does raise the collateral consequences of whether, and how you would go about doing that.

Senator CONRAD. Can I ask a final question, Mr. Chairman?

Senator BUNNING. Certainly.

Senator CONRAD. A final question would be, in your judgment, would my amendment preclude the so-called "janitor's insurance" that has been the subject of much criticism?

Mr. JENNER. It certainly would not preclude it. It depends on how we define janitor's insurance. If it is the insurance that is on the employees' lives without their consent, et cetera——

Senator CONRAD. I think that is generally what is referred to here.

Mr. JENNER. Yes. Your amendment would preclude that from hourly workers.

Senator CONRAD. I thank the witness, and I thank the Chair.

Senator BUNNING. Senator Bingaman, you are up.

Senator BINGAMAN. Thank you, Mr. Chairman.

Are you sure you did not want to go over to the Republican side? I do not mind going back and forth, whatever you prefer.

Senator BUNNING. You showed up first.

Senator BINGAMAN. All right. I appreciate that.

Let me ask you, Mr. Jenner. You say in there that "we understand that most broad-based COLI arrangements entered into today are used for somewhat specific purposes, most notably for funding certain employee and retirement benefits."

How do you understand that? GAO has been trying to get information about precisely what these funds are used for. The industry has advised GAO that they do not know, or that the information is not in a form readily accessible, or something to that effect. How do you know that?

Mr. JENNER. We do not, Senator. That is why this testimony states "we understand." We could not——

Senator BINGAMAN. You understand things you do not know?

Mr. JENNER. We hear anecdotes. The anecdotal evidence that we have received indicates that. But if you were to put me on the stand and swear under penalties of perjury, I would say we do not know for sure.

Senator BINGAMAN. You do not know.

Let me just put one of these charts up, the second of those two charts that I had there, and ask you about it. One of the concerns that I have had with COLI, is that once a company buys one of these policies, the proceeds from that policy can be used for anything the company wants, as a legal matter.

Mr. JENNER. Correct.

Senator BINGAMAN. That would not change under the Conrad amendment. They would still be usable, assuming that he dropped the trust provision. There would be no legal requirement as to how the company used those proceeds.

Mr. JENNER. That is correct. The only requirement would be that the amount of the coverage would have to be tied to the expected level of benefit.

Senator BINGAMAN. But there is nothing to say that the proceeds are used for the payment of benefits.

Mr. JENNER. Money is fungible. That is correct.

Senator BINGAMAN. Now, would there be anything in the law if a company loaded up on COLI policies and did so even with the good intention of funding a retiree health program or something, and then decided to cancel the retiree health program? There would be no reason they would not still get all the proceeds from those policies.

Mr. JENNER. That is correct, Senator.

Senator BINGAMAN. So the fact is that there is no obligation to use the proceeds of these policies for any purpose.

Mr. JENNER. That is correct.

Senator BINGAMAN. Does that not cause the Treasury Department, the IRS, anyone in the administration any pause? Do you not think it is a bit of a problem when we are providing a tax incentive for people, or preferential tax treatment for something that may be used to buy a corporate jet or may be used to do anything.

Mr. JENNER. The concern that we have, Senator, is that if you try and draw lines around the good and the bad, it becomes very difficult to do. It then becomes necessary to assure that if something is purchased for good, that it is indeed used for good.

That is the concern that we had about what Senator Conrad was proposing with his trust, that you would begin to implicate all of these ERISA-type rules.

Senator BINGAMAN. Well, referring to that, in the case of qualified plans, we have real limits as to how much corporations can contribute to these qualified plans, how much employees can contribute.

Mr. JENNER. Correct.

Senator BINGAMAN. And we have done that because we are worried about the loss of revenue to the taxpayer, to the Federal treasury. Why are you not worried about the loss of revenue here? Why does it not concern you to know how much revenue is being lost through the use of COLI policies that may or may not be benefitting any employee?

Mr. JENNER. I think one of the things that overrides the concern, to the extent that we believe that revenue would be lost, is that there are probably administrative difficulties with limiting it. There are also ways in which the corporation could get around those rules.

For example, simply investing in tax-exempt bonds gets you close to the same place. The income on that would be tax-free. So, there are ways in which you can begin to mimic certain aspects of life insurance.

Senator BUNNING. Well, a tax-exempt bond, you get the face value of the bond at the end.

Mr. JENNER. Correct.

Senator BINGAMAN. It is not like buying an insurance policy.

Mr. JENNER. Well, it depends on the extent to which the mortality assumptions that go into the insurance policy are met or not met. Actually, insurance policies can turn out to be losers in certain cases, so there is a gamble, a risk that is not inherent in tax-exempt bonds.

Senator BINGAMAN. My time is up, Mr. Chairman.

Senator BUNNING. Mr. Smith?

Senator SMITH. Thank you, Mr. Chairman.

To Senator Bingaman's point, it does occur to me that life insurance is a risk. You do not know how it is going to work out. But I believe there is a public policy to be served by helping, especially small businesses, to pass on from one generation to another a business that, frankly, can be the backbone of a community.

I understand the Senator's concern, where it could be abused. But I have got to tell you, I think there is so much more good that comes out of key man policies that are fairly central to estate planning for small business than it negates any bad that might flow from it.

So, I think it is really critical that we not jeopardize this tool for businesses to be able to continue their businesses when they lose key personnel. I think the question that I had, and I want some clarification on, is what Senator Conrad asked about the janitor, policy where someone does not know. Are you familiar with the testimony that has been submitted by a Vicki Rice?

Mr. JENNER. Senator, I have not seen any of the testimony, but I will be happy to try and respond to it.

Senator SMITH. She has a very lamentable and tragic story to tell. What I want to make sure of, is that the amendment that I support of Senator Conrad's would require that employees are informed if the company is taking a policy on their life, because this should not be allowed.

It is my understanding that situations like this would be taken care of by the Conrad amendment. So, I would appreciate it if you would read this at some point and get me an answer if this amendment will cover this situation.

Mr. JENNER. That, I can address, Senator. Senator Conrad's proposal would not require consent unless the individual were no longer employed after a year's time. So, in other words, the proposal, as I understand it, would allow companies to insure the lives of current employees without their consent and without notification.

Senator SMITH. I think that is an issue we want to address. But for the record, I just think that key man policies relates to business in America, passing wealth on from one generation to another, from one management team to another.

I would hate to see us get into micro-managing too closely what they do, because I think an awful lot of good public policy is served and a lot of damage could be done if we narrow this field of life insurance too much.

Mr. JENNER. Well, as my testimony indicate, Senator Smith, we share the concerns about key man, and we would want to work with the committee to make sure, if they went down that road, it was not too restrictive.

Senator SMITH. Thank you, Mr. Chairman.

Senator BUNNING. Mr. Lott?

Senator LOTT. Thank you, Mr. Chairman.

Thank you for being here with us today.

Mr. JENNER. My pleasure.

Senator LOTT. Do a lot of States not already have legislation on their books in this regard?

Mr. JENNER. Most States have insurable interest rules. They vary widely. Some States are restrictive, some States are more permissive. That is typically what Congress has relied on in the past.

There was a movement, I should add, in the 1980's and 1990's to broaden insurable interest rules to allow more employees to be covered.

Senator LOTT. I have wondered, for the last 10 years, why this issue—which I refer to as E. COLI—keeps popping up. I always assumed that it was because the Finance Committee staff said to the Treasurer, we need some revenue raisers, and send us over some suggestions, and that this is always on the list. It seems to be regurgitated up from the Treasury Department, regardless of administration, regularly.

Did this suggestion come from the Treasury Department this year, or do you know?

Mr. JENNER. No, Senator.

Senator LOTT. All right. Good.

Mr. JENNER. Actually, as a former Finance Committee staffer, I can assure you that neither end of the avenue asks the other about COLI. It is just kind of there.

Senator LOTT. It just kind of comes out of thin air every couple of years. I do not understand it.

Mr. JENNER. Exactly.

Senator LOTT. What have been, if any, the effects of the action that was taken by this committee a month ago? Did it affect the industry? Was there an immediate, precipitous decline in the coverage or the policies that were being sold?

I assume there would be, because unfortunately the committee said it would take effect immediately when the committee acted, contrary to what I thought usually was the policy, date of enactment. Do you have any statistics or information on that?

Mr. JENNER. No, Senator. We can only speculate as to what the effect was.

Senator LOTT. I do not think there is any doubt that there is justification for these key man policies. How that money is used also should be open to a lot of latitude, as Senator Smith was just saying, particularly in small businesses. I have had some recent experience with it.

You can have a small-town restaurant that is named after the chef, who is a very famous, Louisiana-type chef. If he dies, you have got a big problem. You have got to change the marquee out front. You have got to take down your billboards.

You have got to convince people you can get another chef that can provide this great food. So, I mean, he is a key man. For the government to be trying to come in and say in any way that you cannot use it for this, that, or the other, I think, is a real problem.

Do you have any response to that?

Mr. JENNER. Yes, Senator. We would agree. The concerns we have about key man are expressed in our testimony. Again, we want to work with the committee to make sure that, if anything is changed, it is not too restrictive.

Senator LOTT. The last time I remember really getting deeply into this, Bob Dole was the Majority Leader and on the Finance Committee. I can remember going to his office and asking why it was being done the way it was.

But what came out of that was some reasonable, and I thought responsible, limits on how the COLI could be used. So the Congress has already acted in this area in the 1990's, has it not? Why do we feel like there is a necessity to do even more?

Mr. JENNER. Senator, you are probably referring actually back to 1984.

Senator LOTT. That far back?

Mr. JENNER. Yes.

Senator LOTT. I have been here a long time.

Mr. JENNER. That was when there was the first real restriction limiting deductibility to policies of $50,000 or less. In 1996, and then again in 1997, the committee acted to basically completely undercut what is called leveraged COLI, which is what we would indicate would be an aggressive tax arbitrage system.

The issues today, as my testimony indicated, really are not true tax policy issues. Again, of course, the committee and the Congress are free to impose whatever restrictions they want, but they do not implicate tax, per se.

Senator LOTT. Thank you very much, sir.

Senator BUNNING. I have got a couple of questions, since I am not supposed to be sitting in the chair, usually.

In reading your testimony, it seems to me you feel many of the concerns are really State regulatory issues rather than tax treatment issues. Is that a fair reading of your testimony?

Mr. JENNER. Yes, Senator.

Senator BUNNING. You have also said that the committee will have to determine whether fusing COLI to fund employee and retirement benefits is appropriate. Does Treasury have an opinion on whether or not it is appropriate?

Mr. JENNER. It is certainly a permissible use. If the committee concludes that the tax policies, such as inside build-up and excludable death benefits are appropriate, then using these policies to fund retiree benefits is certainly a permissible use.

Senator BUNNING. Mr. Conrad, do you have any more questions?

Senator CONRAD. I am wondering if I could borrow Senator Bingaman's chart.

Senator BINGAMAN. Please.

Senator CONRAD. Because I think this in some ways goes to the heart. Before I go to it, I want to go back to something Mr. Jenner said with respect to notice, because I think you have misread my amendment.

Mr. JENNER. All right.

Senator CONRAD. I believe my amendment requires written notice for anybody making less than $90,000 a year. The first part of my amendment deals with so-called "key men" policies. Those would be people earning over $90,000 a year. That is in line with what the controller of the currency provided.

Then there is a second part of my amendment, and I would read it to you: "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, (1) the employee must not be an hourly employee; (2) the insured employee must be eligible, either currently or upon the future satisfaction of aid, service, or similar eligibility criteria to participate in an employee pension plan or other benefit plan under which benefits are payable to the participant; (3) 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."

Is that not correct?

Mr. JENNER. You have read the section correctly, but I do not want to get into parsing statutes too closely. That applies to the definition of what is an employer-owned life insurance contract. Your proposals says that, in the case of employer-owned life insurance contracts that do not meet the requirements of this section, the death benefit will be included.

The sentence following that says, "the preceding sentence," which is the one that I just read, "shall not apply in the case of amounts received by reason of death of an individual who was an employee or consultant of the policyholder at any time during the 12-month period prior to his or her death." Therefore, those restrictions, pur-

suant to the statutory language, do not apply if the individual is an employee or was an employee within 12 months.

Senator CONRAD. Well, I will tell you, that is not the intent. I am not sure what language you are reading. I do not have that same language in front of me. But that is something we can work out.

Mr. JENNER. Absolutely, sir.

Senator CONRAD. The intent is that there be notice for everybody other than those key man policies. That has been the intent.

Let me go to this chart, if I could, because I just want to say I think Senator Bingaman has done us all a service to put before us in chart form what the key issue is. As I take our conversation, Senator Bingaman is troubled that we have an alternative to the qualified benefit plans. I can understand his concern.

The problem that I see, is very few firms have qualified benefit plans. I just have had, as I discussed with him earlier today, a series of meetings with small business people in my State. They have told me there is no way they can take on those plans because of the administrative complexity.

Is that your experience, Mr. Jenner? We are not having a high take-up rate on those plans, are we?

Mr. JENNER. We certainly have a lower take-up rate than we would like. Actually, you have provided me the opportunity to mention a proposal that the administration has in its budget which we think would enhance that take-up rate.

Senator CONRAD. And is the reason that we do not have a high take-up rate administrative complexity and cost?

Mr. JENNER. In part.

Senator CONRAD. That is what business tells me. I have just had discussions with small business people from around my State. What they say to me is, there is just too much complexity. We cannot afford the manpower, the costs associated with this requirement.

So the fundamental question here is, if you do not have as much of a take-up rate as you would like there, does it make sense to provide the given incentive to employers to provide employee benefits, retirement benefits, health benefits? I believe, yes. I think Senator Bingaman has come to a different conclusion, but I think that is central to the dispute here.

Mr. JENNER. One of the concerns that we would have, Senator, of course, is that the tax incentives to fund qualified benefit plans are conditioned upon full funding, non-discrimination, et cetera.

When you move into the non-qualified area, none of those restrictions apply, none of those limitations apply. So, that becomes problematic if you are going to provide incentives to fund in that way.

Senator BUNNING. Senator Conrad, did you finish?

Senator CONRAD. My time has expired.

Senator BUNNING. Senator Bingaman?

Senator BINGAMAN. Thank you very much.

Let me just clarify something. I know Senator Smith raised this issue. I just want to be sure that I am correct in my understanding, so I will ask you this, Mr. Jenner.

The amendment I offered earlier, that the committee adopted by voice vote, was not intended and did not, by its language, interfere in any way with this key man capability to go out and buy a OSHA

policy in order to ensure that a key person working in your company, or a partner, or somebody that is providing service to the company, if they die, the company ought to have insurance against that eventuality. So, I was not trying to interfere with that, and my amendment did not interfere with that.

Is that your understanding of it, too?

Mr. JENNER. Senator, your proposal has a specific exemption for key person insurance. We would probably want to chat with you about the definition you use, but it clearly attempts to deal with the issue of key person insurance.

Senator BINGAMAN. Well, let me just make clear to everybody here that I have no problem with that. That, to me, is clearly an insurable interest. If a company wants to take out a policy on someone who is of value to that company, they ought to be able to do so. They ought to be able to get the benefits tax-free. That is an entirely appropriate use of COLI, and I have no problem with that.

What I have been trying to get away from is a situation. My amendment said, if the employee on whom the policy is written has left the company's employment and has not worked there for over a year, then there is real doubt as to whether or not the company can claim that they are losing a whole lot when the person dies.

So my concern was that you have got a lot of individuals like the woman you referred to, the husband of the woman you referred to earlier, and the company has no insurable interest there. Now, I know that is a State policy determination.

Let me just ask about that for a minute. You say this is not a tax policy issue. That strikes me as odd. Do you really believe that, but for these Federal tax breaks that we are talking about here, they would be selling COLI policies of the type that concern me?

Mr. JENNER. I am not certain, Senator, exactly what you mean by the types that concern you. Are you talking about broad-based?

Senator BINGAMAN. Yes

Mr. JENNER. It is conceivable that there would be fewer sales.

Senator BINGAMAN. I would tell you, I think there would be many fewer sales.

Mr. JENNER. You may be right.

Senator BINGAMAN. I mean, I read in testimony here that there are hundreds of thousands of these policies out there. Most of them have nothing to do with key men or key women, or anybody who is working for a company at the time of their death. It just strikes me, these are tax policy issues.

Let me just also ask another question. Senator Conrad raised the question about the administrative complexity of going through this qualified benefits or qualified plans route.

The real complexity is if it is in defined benefit.

Mr. JENNER. Well, a qualified plan is a defined benefit or defined contribution.

Senator BINGAMAN. Yes. But I am saying, a defined contribution plan, to set up a 401(k) for your employees, is not the heavy lift that setting up a defined benefit plan is.

Mr. JENNER. I think that is correct, Senator

Senator BINGAMAN. And I think, clearly, I would agree with Senator Conrad that it is difficult and complex to set up a defined ben-

efit plan, particularly if you are a small employer. But if you want to set up a 401(k), it is not that big a problem.

It is a question of whether you want to put in place a plan that benefits all your workers, as required, if it is going to be a qualified plan, or whether you want to just benefit key executives. In that case, you can go with the COLI.

Mr. JENNER. Senator, there are complexities associated with defined contribution plans and which could cause the hurdle to be high for particular employees. But there is no question that a part of the calculus is whether or not you want to cover everybody or whether you want to target the benefits.

Senator BINGAMAN. That is all I have, Mr. Chairman.

Senator BUNNING. Senator Santorum?

Senator SANTORUM. Since I came in the middle of this, I apologize because I do not know what has been asked or what has not been asked. But, in talking about this whole provision of limiting to key man, the Senator from New Mexico talks about the problem he has with people who used to work for a company who are no longer employed, but then continue to be insured.

My understanding is that these programs are put in place at the time to take out insurance for the purposes of funding some stream of benefits. Is that correct?

Mr. JENNER. Often the case, although not in every case.

Senator SANTORUM. Not always, but that, ostensibly, at least the people who have come to my office say that is what they use it for, and that is the reason they are doing this.

Would it not create a great deal of complexity in trying to provide insurance if we kept dropping people who left the company? Is there not an understanding that if you insure someone who may have left the company, the issue is really not the person you are insuring, it is really the concept of creating sort of a risk pool, if you will? Is that not really what is going on here?

Mr. JENNER. To be honest with you, Senator, I think that would be better addressed to the experts in the life insurance industry who are more familiar with how the contracts themselves operate. I do not know, to be honest, how complex it is to substitute people in and out of policies.

Senator SANTORUM. I mean, that is sort of my understanding of this. Again, maybe you are the wrong person to ask, but that was the question that came to my mind. I think we might be trying to tinker with making things a lot harder to do if we play around with trying to undermine the insurability of this whole product.

But if you are not the person to ask that question, then I will not ask if of you. Thank you.

Senator BUNNING. Senator Smith, do you have anything else?

Senator SMITH. No.

Senator BUNNING. No.

Senator Lott?

Senator LOTT. No.

Senator BUNNING. Thank you, Mr. Jenner.

Mr. JENNER. Thank you very much, Mr. Chairman.

Senator BUNNING. The next panel will please come. Ms. Davi M. D'Agostino, General Accounting Office, Financial Markets and Community Investment, accompanied by Daniel Meyer, Senior An-

alyst, U.S. Accounting Office, Washington, DC; Mr. Spencer Tillman, Sports Analyst, Sugar Land, Texas; Hon. Frank Keating, president, American Council of Life Insurers, accompanied by Stanley B. Tulin, vice chairman and chief financial officer of The Equitable Life Assurance Society of the United States; Mr. Andrew Pike, Professor of Law and Academic Dean, American University—Washington College of Law, Washington, DC; and Mr. Robert Plybon, president, Association for Advanced Life Underwriting, Falls Church, Virginia.

Senator CONRAD. Mr. Chairman, might I take a moment on a matter related to this question of drafting and the intention of the amendment?

Senator BUNNING. Certainly.

Senator CONRAD. I appreciate the indulgence of the Chairman.

I might just say, members of this committee know that we typically offer amendments in this committee based on the concepts involved and what the intent of the member is, and then our lawyers draft the amendment.

I just want to make clear to my colleagues and to those who are listening that what I provided the committee in terms of the intent of the amendment is to require full notice and consent of all those who would have policies written on their lives, with the exception of the key man policies. That is the concept paper that we gave the lawyers.

So, I just want my colleagues to know, and those who are listening to know, the absolute clear intent of the Conrad amendment is to require written consent, informed consent. That will be before we vote. We do not vote, typically, on the legal language. We give that to our lawyers to translate what we provide in terms of intent.

Senator SMITH. Will the Senator yield?

Senator CONRAD. I just want them to know that is the case. I do not want to have misled anyone with respect to that.

Senator SMITH. If the Senator would yield. Is it your expectation then, your intention then, that your amendment would cover situations like Vicki Rice's?

Senator CONRAD. Absolutely.

Senator SMITH. All right.

Senator CONRAD. When we had this discussion previously and we had the amendment that I presented the committee, I think it made very clear that written consent is required.

Senator BUNNING. Ms. D'Agostino?

STATEMENT OF DAVI M. D'AGOSTINO, GENERAL ACCOUNTING OFFICE, FINANCIAL MARKETS AND COMMUNITY INVESTMENT, WASHINGTON, DC, ACCOMPANIED BY DANIEL S. MEYER, SENIOR ANALYST, U.S. GENERAL ACCOUNTING OFFICE, WASHINGTON, DC

Ms. D'AGOSTINO. Thank you. Mr. Chairman, members of the committee, I am pleased to be here before you this afternoon to discuss the preliminary results of GAO's ongoing work on business-owned life insurance done at the request of Senators Akaka and Bingaman.

We use the term "business-owned life insurance" to include permanent, corporate-owned, bank-owned, and trust-owned life insur-

ance that is held by employers on the lives of their employees. Under these policies, the employers receive the death benefits.

Our preliminary information focuses on the uses and prevalence of business-owned life insurance and, second, on Federal and State regulatory requirements for, and oversight of, this insurance.

First, our work to date shows that no comprehensive data are available on the uses and prevalence of these policies. We do know, however, that some of the insurance is used to protect against the loss of key executives, while some covers larger groups of employees and is used to fund current and future benefits.

All permanent business-owned life insurance receives tax advantages, such as tax-free policy earnings and death benefit payments. Neither Federal nor State regulators collected comprehensive data on the uses and prevalence of business-owned life.

However, banks and thrifts reported some information to their regulators if the cash surrender value exceeded certain thresholds, and other institutions sometimes voluntarily provided information on their policies.

Thirty-two hundred and nine banks and thrifts, about one-third of the total, did report the cash surrender value of their policies at $56.3 billion. Twenty-three of the top 50 reported holding $36.9 billion, or 66 percent of the total reported.

In addition, the SEC, Securities and Exchange Commission, did not have a specific requirement that publicly traded companies disclose the value or uses of business-owned life insurance in their filings. Rather, SEC expected the companies to disclose any information material to investors.

In this regard, some public companies, including insurers, did report information on their holdings. Our preliminary review of the annual 10(k) filings of 100 randomly selected Fortune 1,000 public companies showed that 15 discussed owning these policies.

Eleven of the 15 cited their intended use, and most commonly they cited the use of the insurance to fund deferred executive compensation.

In addition, our review of financial statements from 32 of the 50 largest life insurance companies that filed 10(k)s showed that 9 reported a total of over $3 billion in business-owned life insurance premiums from their 2002 sales.

Also, three insurance companies reported the cash surrender value of the business-owned life insurance policies they sold as totaling about $28 billion as of the end of 2002.

Neither IRS, nor State insurance regulators collected comprehensive information on the value of, or the income from, business-owned life insurance. As part of our work, we initially planned to compile more comprehensive data on the prevalence and uses of these policies.

We worked with representatives from six insurance companies and the ACLI, who is here to talk with you today, to develop a survey. The industry cooperated in a survey pre-test and the association offered to encourage members to participate in the survey. But our pre-test results led us to conclude that we could not obtain sufficiently reliable data to go forward with the survey.

On my second point, the Federal and State regulators had guidelines or requirements applicable to business-owned life insurance, but did not identify significant regulatory concerns.

As part of their safety and soundness oversight, Federal bank regulators issued guidelines for banks and thrifts that buy this insurance. They also said that they have reviewed the holdings of many financial institutions with significant amounts of this insurance. They did not, however, identify major regulatory concerns.

As I mentioned earlier, SEC officials had told us that they rely on public companies to disclose information material to investors in their financial statements.

The IRS had some requirements related to the tax treatment of business-owned life and is studying issues related to banks and others who are indirectly borrowing to purchase these policies.

They are also studying whether selected banks with separate account policies, which are policies that allow them some investment choices, are exercising excessive control over their investments.

State laws define insurable interest and consent requirements and can differ by State, as previously testified. Our preliminary analysis indicates that, at the end of July, 2003, more than 30 States required written consent, but most of these States exempted group life insurance policies from those consent requirements.

Also, regulators in the four States that we contacted described limited oversight of the policies. Their oversight involved reviewing blank policy forms to ensure that they complied with the States' notification, consent, and other requirements.

However, where applicable, the States did not determine whether the amounts of coverage obtained were appropriate, nor did they confirm that employers actually obtained employees' consent when taking out insurance on their lives.

State regulators said that they would investigate sales of policies if they received customer complaints, but they told us that they had received no such complaints.

Mr. Chairman, that completes my oral summary. I would be happy to answer questions at any time.

Senator BUNNING. Thank you very much.

[The prepared statement of Ms. D'Agostino appears in the appendix.]

Senator BUNNING. Mr. Tillman?

STATEMENT OF SPENCER TILLMAN, JOURNALIST, SUGAR LAND, TEXAS

Mr. TILLMAN. Thank you, sir.

Mr. Chairman, members of the committee, my name is Spencer Tillman. I am a businessman and analyst for CBS Sports out of New York. I am here to offer my thoughts on the matter of corporate-owned life insurance.

When my brother, Felipe died in 1992, his former employer, Camelot Music, and its parent company CM Holdings, Incorporated, cashed in an insurance policy on his life, enriching themselves to the tune of $340,000.

In a similar case in which the courts found in favor of the deceased's family, IRS records presented as evidence detailed spe-

cifically where those monies went. Here are the facts as it relates specifically to my brother's case.

That money was used to pay executives even more money. Felipe had long since left that company, which raises a red flag concerning CM's ongoing insurable interest. I found, along with my family, that it was particularly noteworthy the company's own admission on the amount spent training employees in this low-level position that my brother occupied was less than $500.

What is more, Felipe was not operating in a key executive position. The policy on his life was unknown to him and/or our family. This company, as many others today, used Felipe's life as a means to help the company boost its bottom line, a fact that myself and my family finds callous and unethical.

The act of profiting from death and dying is unavoidable, but this comprehensive employee life insurance tactic gambles with employees' live to profit, hedging their bets rather than concentrating on good management and sound business principles to turn a profit.

My take on this, ladies and gentlemen, is this practice is nothing more than a sophisticated form of bounty hunting. Men and women go to work, in effect, with a bounty on their heads. If they die from whatever cause, the bounty flows to the coffers of corporations to used as executives see fit. The difference is, workers are not guilty of any crime here, and function in this context as a commodity to be gambled and bartered.

Does it not seem possible that a business practice which propagates the concept of employees as profitable, whether they are employed in working, or dead, would not result eventually in management principles bordering on the unethical is a question I would pose to everyone here today.

At the very least, an employee that has a price on their head should at least know what that price is and, having agreed to have that price placed there, be allowed to have a portion go to their family should they die. And, last, they should be able to have the insurance policy discontinued if their employment is discontinued.

I did not come here to rail against corporations or profits. As a former NFL player, I know full well the meaning of fierce and violent competition. But there is more to sports and more to business competition than the bottom line, ladies and gentlemen.

This issue is whether using humans' death is a responsible means to gain its moral position. I think it is unethical and immoral.

As we experience the fall-out of shareholder robbery by some of the most once-respected corporations in this country, including the financial community, executives are now headed to jail where they belong. Many corporations are changing their operating procedures, adopting—and I stress enforcing—a code of ethics while adhering to a value system that sets an example of honesty and integrity.

What Felipe's company did to him and our family, and what some of America's blue ribbon corporations institute every day in the name of sound business practices, is nothing less than operating in the gutter.

What needs to be done is two-fold. The media should give these neo-bounty hunters the scrutiny they deserve and bring these prac-

tices to the attention of the public more extensively than they already have.

Second, Congress needs to pass legislation to put a stop to this robbing of a disproportionately poor Peter to pay an already prosperous Paul. The same kind of oversight that was demonstrated during the age of Enron needs to be implemented here. Not to do so would be ethically questionable and morally untenable.

Thank you very much. If you have any questions, I would be more than happy to answer them.

[The prepared statement of Mr. Tillman appears in the appendix.]

Senator BUNNING. Mr. Keating?

STATEMENT OF HON. FRANK KEATING, PRESIDENT, AMERICAN COUNCIL OF LIFE INSURERS, WASHINGTON, DC, ACCOMPANIED BY STANLEY B. TULIN, VICE CHAIRMAN AND CHIEF FINANCIAL OFFICER, THE EQUITABLE LIFE ASSURANCE SOCIETY OF THE UNITED STATES

Mr. KEATING. Mr. Chairman and members of the Committee, thank you for having me here.

And let me say, as an Oklahoman, I am a big fan of Spencer Tillman and loved when he played for the University of Oklahoma. What happened to his brother was unacceptable and wrong. It is the past. It is not prologue. It could not happen today, and certainly would not happen if the Conrad amendment were adopted.

Mr. Chairman, as the president and CEO of the American Council of Life Insurers, this association represents nearly 400 life insurance companies, which account for the majority of premiums written in the United States.

The products provided by the life insurance industry help both families and businesses manage risk, as well as ensure a secure means of providing funds for employers to use for the benefit of their employees and their families.

On behalf of our member companies, I appreciate the opportunity to discuss corporate-owned life insurance with you this morning.

As the committee realized, had the effective date of September 17 that was initially adopted, gone into effect, 20 percent of the premiums written in the United States, $8 billion worth of company-owned life insurance, would have stopped. The sale of those products would have stopped.

We are particularly appreciative of the efforts of the committee in moving the effective date and in scheduling these hearings for the purpose of further deliberation and education.

I am pleased to be joined here today by Stanley B. Tulin, to my left, the vice chairman of The Equitable Life Assurance Society of the United States. Stan is an actuary by training and has been leading Equitable for 7 years, and has 30 years in the life insurance industry.

With his broad-ranging experience, Stan will be able to assist this committee in its inquiry by answering questions or concerns relating to the issuance of corporate-owned life insurance policies by his company.

Corporate-owned life insurance, or COLI, has been, in one form or another, a fixture of American business since the early 1900's.

Although COLI has been a part of American business for decades and is thoroughly regulated by the States, we understand the interest of the committee in looking at how COLI is currently being used, and might best be used for all the people in the future.

Businesses currently use COLI for a variety of reasons: to ensure against the loss of key employees; as a prudent and responsible way to plan for the payment of future employee benefits for a broad group of employees; to provide retirement plans as a way to attract and retain valuable employees at all levels of a company; and to provide employers a way to fund transition planning under buy/sell agreements.

Now more than ever, we know that American businesses need the stability and certainty of life insurance to provide for their employees and the future of their businesses.

As was recently noted in an article on pensions in The Washington Post, investors keep companies focused on keeping earnings up and costs predictable. With the fluctuation of the stock market and interest rates, costs are not predictable, and many companies have found themselves making large cash contributions to the pension funds when they can least afford it.

Companies relying on COLI to pay employee benefits do not have that fluctuation in the marketplace to worry about. They know that they will have the funds to pay benefits, regardless of what the stock market is doing. Businesses face economic pressures that are driving them to look for affordable and reliable sources of revenue to finance employee benefits rather than cutting them out altogether.

We meet at an important time for our economy, because the need for COLI to help employers continue to fund retirement and health benefits for the employees of our national workforce and for their families is greater now than ever. In the past year, costs for employer-sponsored health insurance rose substantially faster than the overall inflation rate.

In addition, as the 76 million baby boomers look toward retirement, the need for retirement savings is increasing. A bill is coming due for our Nation's employers, and I urge the Committee to keep COLI in place as one of the most effective financial products employers have to pay this bill.

COLI is an important asset of business to guard against the uncertainties of life as it affects employees, whether on the job or in retirement. It is appropriate that policymakers both facilitate and oversee how we approach these responsibilities.

We welcome the effort to work with the Committee in making sure that the COLI product remains available to businesses and their employees, and that any limitations placed on the use of COLI fit within current best business practices.

To that end, we strongly support the proposed effort by Senator Conrad for the future of COLI. His amendment proposes appropriate and reasonable guidelines and limitations.

Finally, I would urge the Committee to review the recommendations of a study being conducted currently by the GAO. We have met with the GAO representatives on a number of occasions and have had frank and open discussions with them concerning COLI.

While our member companies' data systems do not have all of the quantitative data that the GAO was seeking, we did share with them a wide range of qualitative information, including how and why employers use COLI to meet their business needs and how insurers make sure that State insurable interests and notice and consent requirements are met.

Again, Mr. Chairman and members of the committee, thank you for the opportunity to testify today. Both Stan Tulin and I look forward to any questions that you might have.

[The prepared statement of Mr. Keating appears in the appendix.]

Senator BUNNING. Do you have a statement or are you just there to answer questions?

Mr. TULIN. I will just answer questions, Senator.

Senator BUNNING. All right.

Mr. Pike?

STATEMENT OF ANDREW PIKE, PROFESSOR OF LAW AND ACADEMIC DEAN, AMERICAN UNIVERSITY—WASHINGTON COLLEGE OF LAW, WASHINGTON, DC

Mr. PIKE. Thank you, Mr. Chairman, members of the committee. I appreciate the opportunity to appear before you today.

As a professor, I spend most of my time presenting hypothetical questions to my students. Today I would like to do that with you, but I will answer the questions that I raise.

I would like to ask the following. If the favorable tax treatment of life insurance extended only to policies that benefitted individuals or key persons in a business arrangement, would you support an amendment that extends that treatment to the broad-based corporate-owned life insurance that we are discussing today. I believe the answer to that question would be no.

Why not? First, I believe that the life insurance industry has it right in its marketing agenda. A lot of its advertisements state that life insurance is for the living. I have never seen an industry advertisement that says that life insurance is really a tax-free savings vehicle that corporations can use to meet their business expenses. It is not, and should not be.

I believe that when the favorable tax treatment accorded life insurance was enacted and endorsed over the years, people were thinking about families and small business people. They were not thinking about generalized funding vehicles.

Second, I believe that using tax benefits for these purposes, when only life insurance arrangements and life insurance contracts can generate the tax benefits, is irrational.

There are lots of different financial vehicles that can be used to help pay for employee benefits. The financial services sector is very creative. But only one financial vehicle, life insurance, gets tax-preferred treatment when it is used to pay for post-retirement medical benefits, future medical costs and non-qualified deferred compensation costs.

If these needs of the businesses are so important, and that is a determination for you to make, why not make these tax benefits available to all financial services industry members? The life insurance contract is not well-suited to meet these needs. The life insur-

ance contract is very well-suited to meet the financial needs of the survivor of a family earner.

The life insurance contract is also well-suited to meet the needs of key person insurance arrangements.

The death benefits paid under a life insurance contract, however, are paid out at the wrong time to meet that employee's lifetime benefits. Industry needs to pay for post-retirement medical benefits when the employees are living, but the proceeds of the contracts come in after the employee's death. If you wanted a business to set up a funding arrangement that was timed to meet the needs of the benefit plans, this is the wrong financial contract to use.

If I were drafting the legislation and I were told that we needed to create a vehicle to help industry pay for benefits, I would make it available across the board in the financial services sector.

Finally, I believe, notwithstanding the legislation enacted in 1996 and 1997, that the broad-based COLI arrangements produce tax arbitrage profits. Your hearings on tax shelters demonstrate beyond question that large taxpayers, sophisticated taxpayers know how to get high-quality advice to structure their arrangements to produce substantial and unintended tax benefits.

The 1997 legislation had the correct design. The so-called BOLI arrangements are discouraged because interest that is payable on debt that is economically allocable to the life insurance contracts is no longer deductible. I believe that extension of the BOLI rules would take the tax arbitrage profits out of all COLI arrangements. Then, if businesses wanted to use life insurance arrangements to meet their future benefit needs, they could do so purely on the investment return, not the tax arbitrage profits.

Thank you.

[The prepared statement of Mr. Pike appears in the appendix.]

Senator BUNNING. Mr. Plybon?

STATEMENT OF ROBERT PLYBON, PRESIDENT, ASSOCIATION FOR ADVANCED LIFE UNDERWRITING, FALLS CHURCH, VIRGINIA

Mr. PLYBON. Thank you, Senator. Good afternoon. I am Bob Plybon. I am president of the Association for Advanced Life Underwriting. AALU represents some 2,000 agents around the country who do this type of business.

We are also today testifying on behalf of the National Association of Insurance and Financial Advisors, NAIFA, and their approximately 250,000 advisors and their employees.

We see business-owned life insurance, what most folks are referring to as COLI, as a positive tool for both businesses large and small to allow them to maintain and expand their employee benefit programs.

Let me start out today by stating that business-owned insurance appears to be fundamentally misunderstood. Stories in the media have painted a picture that grossly misrepresents business-owned insurance practices today.

I do not have the time in a very few minutes to clear away all the smoke, but let me address a few of these misconceptions.

First of all, you have all heard the references to "janitor's insurance." It is true that there were cases of hourly workers being in-

sured in so-called leverage arrangements that were entered into years ago. But in 1996 and 1997, as has previously been stated, Congress took action and removed those arrangements. Typically, business practice today is to only cover managerial and above employees.

You have heard of workers covered without their knowledge. Pursuant to the laws in most States, the practice today is that business-owned insurance programs cover only workers who consent to be insured. AALU and NAIFA supports the effort being taken by the National Association of Insurance Commissioners to make consent requirements uniform nationwide.

You have also heard that business-owned life insurance is used by companies simply as a means of generating profit. This is not the case. Today, business-owned life insurance primarily is used either as a means of ensuring business continuation after the death of the business owner, or increasingly as a means of funding important employee benefit programs.

I believe the debate in this committee over the past few weeks has been helpful. It highlights the importance of business-owned life insurance and its effect with employers to maintain and expand employee benefits.

These include retiree health plans and deferred compensation programs. All of these programs benefit a broad range of employees.

The State of New York, in approving legislation authorizing the use of business-owned life insurance, expressly endorsed the use of these types of funding arrangements. The legislature concluded, "it was in the best interests of the working people of this State."

AALU, NAIFA, and other industry organizations have done our best to clear up the confusion that has grown around the business uses of life insurance. We have met with Senators and staff, we explained current industry practices.

We are now meeting with the General Accounting Office to provide information to be used in GAO's forthcoming study on business insurance. We are proud of what we do. We are proud of the benefits that we are providing.

Let me turn, now, to the legislative proposals that have been advanced. Make no mistake. The amendment that was advanced by Senator Bingaman would lead to an erosion of employer-based benefit programs. Business-owned life insurance gives employers a uniquely-suited tool by which to maintain and expand programs.

At a time when Congress is looking for ways to encourage retiree health plans to promote retirement saving, we believe it would be a grave mistake to take away a perfectly legitimate tool that companies can use to provide these benefit programs.

AALU and NAIFA wish to eliminate even the perception of abuse in this market. In that regard, we strongly support the amendment that has been advanced by Senator Conrad.

It would allow life insurance to be used by businesses to fund benefit programs where the individual covered by the policies were salaried employees, where the covered individuals are provided with advanced written notice and consent, and where the employee participates in the benefit plan. Senator Conrad's amendment codi-

fies what are now the best practices we see today and would definitely rule out any perceived concerns.

I also want to express my deep thanks of AALU and NAIFA to the Finance Committee for deciding to apply a date of enactment as the effective date of this legislation. The September 17 effective date that was initially adopted froze businesses' efforts in this market.

Now employers will be able to pursue implementation of benefit plans without fear of being subject to adverse changes in the law. Adoption of the Conrad amendment will reinforce these positive efforts.

In closing, I would just say that I have seen first-hand how business-owned life insurance is vital to employees and the companies they work for. I strongly urge the committee to allow this crucial benefit funding tool to continue. I will be glad to answer any questions.

[The prepared statement of Mr. Plybon appears in the appendix.]

Senator BUNNING. Thank you all for your testimony.

Senator Conrad?

Senator CONRAD. Thank you, Mr. Chairman. Thank you. All of the witnesses, I think, were exceptionally good.

To Mr. Tillman, I would say, the amendment that I am advancing would address what happened to your brother. That should not have happened. The amendment that I am advancing would preclude that from happening to anybody else.

Mr. Tulin, perhaps you are the right one to answer this question. As I see it, the fundamental difference between Senator Bingaman and myself is a question of whether or not it makes sense to have corporate-owned life insurance as one way of providing an incentive to employers to provide benefits to their employees.

I think Senator Bingaman's position, and he can certainly speak for himself, is that it is an inefficient way, and I might even agree with that.

The problem is, we do not have any mandate. Employers are not required to provide benefits, health benefits, retiree benefits. We do not have any requirement. We do not have any such requirement. So, if we want to have employers provide benefits, we have got to provide encouragement.

I think that is especially important in light of what is happening elsewhere in Congress. The reason our Chairman and Ranking Member are not here, is they are over working on a Medicare reform prescription drug plan which the Congressional Budget Office has told us is going to lead to 37 percent of employers that currently have plans that provide prescription drug benefits, they are going to drop them.

If we simultaneously eliminate corporate-owned life insurance as an incentive to employers to provide employee benefits, we are going to see a trend that is already under way that is very clear across the country: employers are dropping plans left, right, and sideways.

Senator Bingaman and I share a concern about what is happening to defined benefit plans. They are being dropped like hot rocks, we know that, all across the country.

We know that if the prescription drug plan passes, that prescription drug plans are going to be dropped. The Congressional Budget Office says that 37 percent of employers that have them now are going to drop them.

What can you tell us as to the ability of corporate-owned life insurance to provide an encouragement to employers to provide benefits?

Mr. TULIN. I am going to try to answer the question, Senator, from the perspective of why corporate-owned life insurance is a very efficient and useful funding vehicle for these kinds of benefits as opposed to trying to answer the question of the differences between you and Senator Bingaman on this topic.

I actually believe—and my training, 30 years or so of it have proven to me—that corporate-owned life insurance is actually uniquely useful in doing this. Senator Santorum made mention of this earlier when he talked about how we fund based on expected liabilities, which are, by definition, whether they are for retirement, or death benefits, or retiree health care, or key man insurance, they are unknown in nature and they are extremely long-term. They go out over very long periods of time.

What do they have in common with life insurance? They have in common with life insurance that the pay-out of those is very much dependent upon the underlying mortality of the people.

That gives rise to two reasons why life insurance is a unique funding vehicle. First, it allows you, when you have a large number of people—more than one, certainly, and the more the better—to do expected funding in exactly the same way, by the way, as a pension plan would do expected funding, creating exactly the same kinds of conflict, by the way. People who die young in pension plans get less of the benefits than the people who live for long periods of time.

This same thing is true, by the way, with Social Security. Without getting into all of that on my first trip in this forum to Washington, the original construct of Social Security was exactly in the form of an actuarially funded vehicle, where over time there would be enough paid to ensure that the money was there to pay the retirees.

That is exactly the way this works, so anybody who uses it has to do an expected calculation of the liability and then figure out, based on the people involved, how much life insurance they need to fund that based on the underlying mortality of those people involved. That is unique to life insurance.

As to the point that Mr. Pike made about the notion that it gets the money there in the wrong time, in fact, I would tend to agree much more with what Mr. Jenner from Treasury said. It actually gets the money there at the right time.

If you look at, for instance, retiree health, we know that most of the health insurance costs occur within the last year, and in fact probably more likely the last six months, before death. Life insurance proceeds obviously show up at death.

So, there is not perfect funding, but there is better funding with life insurance than there is with any other kind of vehicle that we can think of, and that is why it is used so often.

So, to answer your question, finally, I think it is unique. I think it encourages the efficient funding of these benefits that I believe—

but it is not important whether or not I believe it or not—that they are important for public policy with an aging population and the baby boom about to retire under-saved.

Senator BUNNING. Senator Bingaman?

Senator BINGAMAN. Thank you very much, Mr. Chairman.

Let me start by asking Ms. D'Agostino. I am concerned about the existence of the consultants' reports that GAO has been unable to obtain. Senator Grassley said that he understands that there is a COLI survey that was published by a consultant. It is available for $7,000, but will only be sold to approved parties within the industry.

Could you elaborate? Did you attention to obtain this? Do you know about this?

Ms. D'AGOSTINO. Yes, Senator Bingaman, we did attempt to obtain it. It is a CAST management consultant study. They have declined to even allow us to buy it. It is only available to qualified market participants. So, we have not had a chance to look at it to determine what information was available to them versus us.

Senator BINGAMAN. Mr. Chairman, I will obviously raise this with Chairman Grassley and Senator Baucus, but I think the committee should use its subpoena power if necessary. I do not see how we can be expected to pass judgment on public policy issue when the industry is denying us access to the information that is essential. So, I will raise that with the Chairman.

Senator BUNNING. That is a very good idea. Raise it with the Chairman. [Laughter.]

Senator BINGAMAN. Let me ask Professor Pike a couple of questions here. I guess I am concerned that the underlying assumption of a lot of the testimony, particularly from the industry representatives here, is that these policies are being used by companies to provide retiree health benefits.

Now, do we have any basis that you are aware of for concluding that that is the case, or the extent to which that is the case? I assume that there are some instances where some of the companies that buy COLI policies are also providing retiree health benefits, but I am skeptical about the extent of it.

Mr. PIKE. Well, what I have always heard is that these arrangements are used to fund employee benefits much more broadly than just retiree health. Specifically, I have heard they are used to fund non-qualified deferred compensation arrangements which are not health insurance arrangements at all, and benefits under these plans are typically provided to senior management and executives as opposed to a broad-based employee group.

I believe they can be used to pay for future health insurance costs, retiree or non-retiree, or they can be used, to the extent they save money in one place, to make funds available for any corporate purpose. As was stated earlier today, money is fungible. Any tax savings generates more funds for the taxpayer who saves the taxes.

Senator BINGAMAN. Let me ask. We have made a conscious policy decision, as I understand it, in Congress not to provide a tax incentive for companies to fund these deferred compensation plans for top executives. I mean, if they want to do it, it is all right, but we are not going to give you a tax break to do it. That has been the policy, as I understand our general policy.

Mr. PIKE. That is correct. In a qualified plan, funds that are set aside to pay for future pension benefits accumulate tax-free and are deductible when the amounts are contributed to the plan.

For a non-qualified plan, if a business sets money aside to pay for those benefits, the income that is generated by those funds are fully taxable. It is that accumulation phase where the different tax treatment really is quite pronounced.

Senator BINGAMAN. And as I understand, the use of the COLI to fund these deferred compensation plans is an exception to that.

Mr. PIKE. It operates as a exception. I am not sure that Congress ever specifically focused on that.

Senator BINGAMAN. And there is nothing specific in the law that sanctions it. There would be if we adopted the Conrad amendment. For the first time, we would be sanctioning that.

Mr. PIKE. I believe that would be correct.

Senator BINGAMAN. But at the current time we do not sanction it, because we do not think there is a public policy justification for providing that tax-preferred treatment.

Mr. PIKE. That is correct. However, as was stated earlier, I believe that the tax benefits claimed under the COLI arrangements are legal.

Senator BINGAMAN. Oh, I understand they are legal. But I am just saying, we have never written into the tax law a tax preference for funds under these circumstances.

Mr. PIKE. Indeed, when Congress enacted Section 419 and Section 419A, there was an express intent to limit tax benefits for those funding arrangements.

Senator BINGAMAN. Let me ask Mr. Tillman a question. Senator Conrad is correct in saying that his amendment would correct the problem that was referred to by you in the sense that there would have to be a consent given by your brother. There would have had to have been, had his amendment been law, a consent given at the time he took the job.

I guess my question is, how realistic is that? In the real world, is that any kind of leverage on the part of the employee? I can remember the many jobs that I applied for. When I would go in for a job and they said, all right, you got the job, now sign here, I would sign anything they laid in front of me at that point.

I am just wondering, had your brother been advised that the very same thing that did happen was going to happen, would that have totally satisfied your concerns or do you think there is basic unfairness in the company getting this pay-out from the insurance policy when the family of your brother got nothing?

Mr. TILLMAN. Senator, I guess the best way to succinctly answer that is, I am offended on a couple of points. First of all, prior consent is certainly something that would appease me and my family, and I know it would have appeased my brother, Felipe. Where the money went, necessarily, is of concern.

But I think the chief issue is the fact that he was no longer in the employ of the company. That is the biggest concern that I have regarding this. I am not sure if that is answering your question specifically. But, again, prior knowledge would have certainly satisfied that.

Senator BINGAMAN. So your view is, once he left the company's employment, they should no longer be able to benefit from his death.

Mr. TILLMAN. That is correct, Senator. And I might add that I am in complete compliance with what has been mentioned here today. In the spirit of political correctness, key person insurance as opposed to key man insurance, I think, is something that is fair.

But, again, my brother Felipe was occupying a very low-level position in which, at the own admission of the company, they paid less than $500 to train him for that position. I am not sure how $340,000 is warranted. I think it is a very untenable position.

Senator BINGAMAN. Thank you, Mr. Chairman.

Senator BUNNING. Yes. Mr. Lott?

Senator LOTT. Thank you, Mr. Chairman.

Governor Keating, thank you very much for being here with us today. I take it that, on behalf of the industry, you do support the Conrad language. Is that correct?

Mr. KEATING. Senator Lott, we do. Let me, if I may, answer that question in two pieces, really, as a response to Senator Bingaman about this mysterious report. I do not know anything about this report. This is a think tank report. It is not an industry report.

We will make every effort to get it, assuming we can, and provide it to the Committee. There is nothing to hide. We want all the facts to be out because we think this is a very defensible product.

Second, in response to Spencer Tillman's comment about the use of these proceeds, what the Conrad amendment does is precisely the right thing to do. Hourly workers cannot be covered, but hourly workers can be benefitted. There has to be notice. There has to be consent. It has to go for benefits. The life insurance sold has to have a reasonable relationship to the package which is provided.

Lastly, if it can be done consistent with the tax laws, not to raise ERISA problems, we have an insistence that there be a lock box or some kind of secure mechanism where the company cannot use the money for things other than employee benefits. We think that is very fair.

Senator LOTT. All right. And you have no objection to the notice to employees before they would be covered by the COLI policy? I believe that Senator Conrad is suggesting that that be the case.

Mr. KEATING. Absolutely. As a matter of fact, I think what the Senator said earlier about insisting on notice, advance notice and opportunity to say no, is absolutely the way this product should be sold.

Senator LOTT. How do you respond to GAO's inability, they say, to obtain data on COLI?

Mr. KEATING. Well, I am happy that the report did say that the industry has been very cooperative. I know ACLI has been very cooperative. I think the problem is that the data just simply has not been assembled in the scientific fashion that they wish.

For example, the industry is like a manufacturing company. Say that it is like a Ford or General Motors. They manufacture the product. The sale of that product is done by the agents. The company does not know, nor would General Motors or Ford know, whether a car was sold to be a limousine, whether a car was sold

for a soccer mom, whether a car was sold for somebody to drive to and from work.

What the industry does is manufacture the product, life insurance, and the agents sell it. So, the information we have is largely anecdotal. It is not scientific.

The anecdotal information is that these products are sold for deferred compensation, they are sold for medical insurance, they are sold for group life, they are sold for a whole variety of employee benefits. But we do not have the specific hard evidence that an entity like GAO would want, because they want specific hard, not anecdotal, evidence. But we are certainly cooperating every bit we can.

Mr. PLYBON. Senator, I might be able to shed a little bit of light on this as well. AALU's members probably sell 90 to 95 percent of this product that is sold in the United States. We annually have a meeting, and at that meeting is the sharing of ideas, and there are seminars on exactly what is going on in our marketplace.

GAO made a request to come to our meeting. We opened the doors for them to attend any session they wanted, and they attended a great number of those sessions. So, I think any implication that the industry has been trying to hide the ball, if you will, from GAO is just not true. We have tried to be helpful at every turn to the GAO.

Senator LOTT. Mr. Tulin, I want to recognize you next. I think I saw you wanting to respond to several things that Senator Bingaman was asking about, so here is your opportunity.

Mr. TULIN. Thank you, Senator. First, before I go there, on the issue of what the industry knows, I think the Governor's analogy is quite good. What we get on a COLI policy, generally—and we manufacture some, not a whole lot, by the way, that we are aware of at Equitable Life—is individual contract applications for life insurance, the same way that they come in in many other instances.

We can identify it as a COLI policy if it is big enough that it captures the attention of somebody and you can see that the premium is coming from an institution. That is the kind of information that we can provide in terms of getting estimates of this. We never get anything that would show us how it is used, whether it is used for retiree health, or deferred compensation, or executive benefits.

There, our experience, again, is that we do attend some of the industry meetings, we know how the sales forces are selling it, but we do not know exactly what portion of it is used for different things.

With respect to, I guess, the comments that I was thinking about as Senator Bingaman was questioning Mr. Pike, the only thing that I would say I would want to emphasize, is I guess I would go in two places. First, deferred compensation is really retirement savings. That is what it is about.

It is about employees who have an adequate amount of money that they are willing not to take it all into income and pay the taxes on it immediately, agree to defer it. They put it at risk and they leave it to accumulate inside of company plans.

Those plans are commitments between the company and the employee, and then there is a question of how those plans are funded.

The funding can be in any number of ways, but it is ideal to see it funded in some way.

That is very different from qualified plans where, on a qualified plan, the tax deduction and tax incentive occurs in the fact that what is actually contributed for the employee is tax deductible. In a deferred compensation plan, in fact, the employer gets no tax deduction at the point of deferral. In fact, it actually creates income for the employer and he has to pay more tax, if you will.

The employee pays no tax at that point, but rather is taxed at the point that the money comes out. And at that point, by the way, that is the point where the employer gets a tax benefit or tax deduction.

COLI, used to fund that, again, is an efficient vehicle because, along with funding the expected retirement benefits, it can also fund survivor benefits and other death benefits, as well as, potentially, retiree health.

The last point, if I could make one other point——

Senator BUNNING. You have made enough points. Thank you.

Mr. TULIN. Sorry. Sorry, Senator.

Senator BUNNING. Senator Santorum?

Senator SANTORUM. If you answer my question, then I will give you the rest of the time to make your last point. [Laughter.]

I think the only question I do not feel comfortable has been answered, is the one that I tried to pose earlier and the one that Mr. Tillman has expressed some concern about. I think it has been partially answered by the fact that no hourly workers will be covered by this. But it has not been completely answered. If you have a salaried employee who has left the business, why should they continue to be the subject of insurance?

And I asked that question to the improper person, so now I am going to ask it to the proper person, as to why, from an insurability point of view, do we need to continue to have policies written on people who no longer work for the companies which the policy was written for.

Mr. TULIN. Thank you, Senator. Clairvoyance, by the way, is nothing I would have expected a Senator to have with respect to an actuary, but that is where I was going.

Senator BUNNING. Particularly that one. [Laughter.]

Mr. TULIN. So that is where I was going with my last comment. If you go back to the point that I was trying to make about the way we would fund it actuarially, where we take the expected benefit costs and project them out over a long period of time and then we project, basically, the proceeds that would be coming out of the insurance, that is basically a contained equation or estimate that occurs at the point of issue and periodically gets adjustment, but it occurs at the point of the creation of the plan.

One thing we can predict with great certainty is death. We know if we take enough people, we can project pretty well when they are going to die. We do not know who, obviously, but we know when.

Senator SANTORUM. So the employer is basically not just willy-nilly insuring everybody who comes in the door with a policy. They are making sure they have the right mix of people who are being insured so they have a predictable pay-out.

Mr. TULIN. That is correct, Senator. And under the proposed Conrad amendment, it forces the employer to do that.

Senator SANTORUM. It makes it harder.

Mr. TULIN. Well, it actually will enforce the employer to do it right because it will force proportionality with respect to the benefits. But one thing that will be necessary, is that those policies will have to stay in force to the point of death because we cannot predict, at the point that the benefits are designed, when the employees are going to leave.

Senator SANTORUM. In fact, if, once someone left the employment they could no longer be insured, this will not work. Is that right?

Mr. TULIN. That is what I am trying to say.

Senator SANTORUM. Because most people do not die when they are employed. They die after they leave employment.

Mr. TULIN. And most of their health insurance is incurred at that point, and most of the retirement needs are obviously incurred after they leave employment.

Senator SANTORUM. So, it is vitally important that we continue to insure people past the point of when they work for the company. But the point that has been made here is that we need to get the consent, and it only is non-hourly employees, and that that is sort of the control to make sure that there are no abuses in place.

Mr. TULIN. Yes, Senator.

Senator SANTORUM. Thank you, Mr. Chairman.

Senator BUNNING. Senator Conrad?

Senator CONRAD. Mr. Chairman, I would like to make sure that no misimpression is left. Senator Bingaman is suggesting that somehow my amendment blesses something with respect to deferred compensation that is other than what happens under current law, and I do not think that is the case at all. Nothing in my amendment liberalizes current law.

My amendment tightens current law. Under current law, death benefits under COLI are tax-free. Under the Conrad amendment, they are tax-free only if they meet certain requirements. Those requirements are the ones that we have discussed, that there is proportionality here.

I think Mr. Tillman said it well. I think one of the things that offended him, and I would be interested to hear from him, is there was a $345,000 benefit that was paid to the company. That was very disproportional to the benefits that were offered his brother. That would be offensive to me. My amendment says it has got to be proportional.

Number two, there was no notice. Under my amendment, there would be notice. Number three, I assume he was an hourly worker, based on what Mr. Tillman described, so they could not have written a policy on him at all under my amendment.

On the question of deferred compensation, under current law, deferred compensation is deductible for the employer and taxable to the employee when paid, right? That is an expense. So, it is a deductible under current law. My amendment does not change that.

More important, I think, is just this fundamental question. This is where the Senator and I have a difference. Does it make sense to have an incentive to employers to provide employee benefits of this kind?

My conclusion is, because we do not have direct requirements, we do not require employers to provide health care coverage, we do not do that in this system. We do not have any requirement that employers provide retirement benefits. We have no such requirement.

We have other incentives, the qualified plans the Senator referenced. I can tell you, I had dozens of small business owners in North Dakota say to me, they cannot go down that road because it is so administratively complex.

One of the things I said to Senator Bingaman earlier today is, I would be happy to work with him on that part of the equation. I think we should make the qualified plans more accessible to employers.

But even with that, it seems to me it is a reasonable thing to have an incentive for employers to provide benefits. They are disappearing in the workplace of today. Retirement benefits are disappearing. Pension plans are disappearing. Health plans are disappearing.

At the very time we are here discussing this, in another part of Congress they are talking about a health care plan that the Congressional Budget Office has told us is going to, unfortunately, push over 30 percent of employers who currently provide benefits on health care to drop them. Boy, oh, boy. I mean, do we want to put another nail in the coffin of employer-provided benefits to employees? My answer is no.

Senator BUNNING. Senator Bingaman, would you like to respond? Then you will be the final responder.

Senator BINGAMAN. All right. Let me say a few things, and maybe ask a question or two.

First, let me just say in response, it seems to me the industry is trying to have it both ways here. On the one hand, they say, we sell these products. We do not know what companies use them for, and you cannot expect us to know that.

And then on the other hand they say, the justification for giving us preferential tax treatment on these products is that they are being used for all of these excellent purposes.

Nobody is willing to come forward and give us the information to substantiate that claim. Industry says they do not have the information. GAO says they cannot get the information.

So, the whole discussion is taking place sort of on the assumption that employers are taking this money, which can be used for any purpose under the law, and using it for very beneficial purposes that help their employees. We just do not have any basis for concluding that.

And when you push industry on that point, they say we do not have that information. You cannot expect us to have it. We do not keep track of what people do with the proceeds from these policies. So, it is a little hard for me to understand how we allow them to have it both ways.

I think, if they can demonstrate that these policies, in fact, are being used to provide employee health benefits, as Senator Conrad is making reference to, clearly we want to see employees have retiree health benefits. But I am not persuaded that a substantial amount of the funds being provided through these policies ever goes to that purpose.

Let me just ask Governor Keating. As I understand the Conrad amendment and the position of the industry, there should be no requirement on an employer that they provide any particular package of benefits, any health benefits as a condition of buying COLI, is there?

Mr. KEATING. No, Senator. But my understanding from the Conrad amendment is that these funds, that is, the COLI proceeds, cannot be used for general business purposes, which we fully embrace.

These funds have to be used for deferred compensation, for supplemental pensions, for health care, for buy-sells, for key man policies, those things that COLI are used for. We fully embrace that. We think that is the right reform.

I might also say, Senator, that the anecdotal information that we are assembling—as I said, it is not scientific, it is more anecdotal—I think is rather persuasive about how this has been used, and we will share it with the Committee from this day forward. As this information comes in, we want to share it with the Committee because, again, we think we have a positive story to tell.

Senator BINGAMAN. Well, Senator Conrad's amendment has this provision that you have got to take the proceeds of these policies and put them in trusts and use them for these purposes.

The spokesman for the Treasury Department, Mr. Jenner, says that they are opposed to that. They think that is bad public policy. They think that we should not try to nail that down. So, we are sort of in a catch-22 here. Senator Conrad says it is a good thing to do.

Senator CONRAD. Senator Conrad is in the catch-22.

Senator BINGAMAN. Yes. Senator Conrad says it is a good thing to do. We want to be sure this is used for good purposes but, in fact, it is too complicated to do, so therefore we are just going to let them go ahead and get the tax benefit at any rate.

Mr. KEATING. We embrace the opposite of the Treasury position. We think there ought to be a lock box mechanism that says this is the purpose of these COLI proceeds, and this is the way these COLI proceeds are to be used.

Now, if for some reason that would put in jeopardy other provisions of the Tax Code such that we cannot view it as a trust, any other vehicle would be fine with us as an industry, or just the flat fiat that it only can be used for these purposes. Then, of course, if they are not used for those purposes, arguably, they would be fully taxable to the taxpayer.

Mr. PLYBON. I am the only one, Senator, in this room that actually markets this stuff and I would like to address that, if I may.

Senator BINGAMAN. All right.

Mr. PLYBON. Number one, Senator Conrad's amendment, if you forget the trust, requires that you cannot fund any more than the present value of your liability.

Senator BINGAMAN. No. Present or future value.

Mr. PLYBON. Present value of future liabilities. But I think there is a perception that people are out here buying this stuff because it is highly profitable to the corporation. It is a very expensive product.

It is a product that, on a day-to-day basis, I am calling on corporations and explaining to them that they have an obligation. It is a liability that, under accounting rules, they have to post on their books, and it is sound business to create an asset to benchmark against that.

What we are doing here, is saying, no, no, you cannot use this asset, which means it is better off for the employee to have no asset to go against that liability. The reality is, the corporation is much more likely to have that benefit plan and to actually give the employee the benefit if he has the money to pay for it.

The assertion has been made that money is fungible, and it is, but it is true in every aspect of life. If you borrow money against your house, nothing says that you cannot go buy tax-exempt bonds with that money and that the U.S. Congress is going to let you deduct the interest.

But money is fungible. It does not require that you use the money to buy another house. At some point in time you have got to say, if he has got the liability and he has got the asset, that they are matched up. That is what is happening.

Senator BINGAMAN. Let me ask one other question, Governor Keating. You have indicated your industry is in favor of going ahead and providing, as Senator Conrad intends to, that consent be obtained from the employee when the policy is written. That would include, I assume, notification as to the amount of insurance being obtained?

Mr. KEATING. Yes, Senator. My understanding is that 42 States require the consent now.

Senator BINGAMAN. Do any of them require that the employee be advised of the amount of insurance being taken out on that employee's life?

Mr. KEATING. Yes. Some do, some do not. We provided the Committee with an analysis of all 50 States. But we certainly agree, the amount and the consent from the employee before the policy is issued is certainly sound public policy.

Senator BINGAMAN. I will stop with that, Mr. Chairman. Thank you.

Senator BUNNING. We are adjourned.

[Whereupon, at 4:03 p.m., the hearing was concluded.]

APPENDIX

TESTIMONY BY U.S. SENATOR DANIEL K. AKAKA
SENATE FINANCE COMMITTEE
"COMPANY OWNED LIFE INSURANCE"
October 23, 2003

Mr. Chairman and Senator Baucus, thank you for conducting this hearing. I also want to thank Senator Jeff Bingaman for his leadership on this issue and for working with me to request that the General Accounting Office (GAO) conduct a study on the issue of corporate-owned life insurance. I commend the efforts of the GAO for its thorough work on this request and I look forward to reviewing its final report.

I have several concerns about corporate-owned life insurance (COLI). Initially, I was drawn to examine this issue after learning about the broad-based life insurance policies on individuals who did not provide consent and who were not notified of the existence of these policies that solely benefit their employer. Though notification and consent requirements are currently determined by individual states, I think that it is fundamental of ethical behavior that businesses should not be able to obtain life insurance on the lives of their employees without the employees providing consent or being made aware of their employer's actions. I also question the retention of these policies by employers after employees have left the company and the company no longer has an insurable interest in their lives.

It is quite clear that consent and insurable interest are merely two of the many questionable aspects of corporate-owned life insurance. Despite the lack of comprehensive data available on the amount and use of corporate-owned life insurance, GAO's preliminary findings indicate the widespread use of corporate-owned life insurance. Although GAO has not been able to obtain comprehensive information on the holdings of banks and thrifts, they found that 3,209 banks reported cash surrender values of their policies at $56.3 billion. Also, nine insurers reported more than $3 billion in business-owned life insurance premiums from 2002 sales. These sums, which are only a portion of the total amount of corporate-owned life insurance policies that exist, are significant because the earnings on the policies' cash value build up tax-free and are not taxable unless the policy is surrendered prior to the death of the insured. Considering that our nation is confronted with a budget deficit of an estimated $374 billion according to the Congressional Budget Office, we must examine the benefits that result from the preferential tax treatment of corporate-owned life insurance. The Joint Committee on Taxation estimated that from FY 2003 through FY 2007 the foregone revenues of taxing business-owned life-insurance would be $7.2 billion. It is important to note that this estimate does not take into account the implications of taxing the proceeds that an employer receives upon the death of the insured employee.

Unfortunately, we know very little about the use of business-owned life insurance. There are no restrictions placed on the uses of the proceeds of these tax-advantaged investment vehicles. There have been examples of corporate-owned life insurance being used for lavish executive retirement benefits and child support payments for relatives of executives. While it is true that the policies could be used to fund retiree healthcare benefits, there is little evidence that the benefits of these policies are being used for healthcare for retirees.

I am deeply troubled by the significant reductions in employer-provided health care coverage for retirees. According to the Kaiser Family Foundation and Health Research and Education Trust, 38 percent of all large firms offer retirement benefits in 2003. This is a significant reduction from the 66 percent that offered retiree coverage in 1988. I am concerned that, while employers have been cutting back on providing retirees health care coverage, they are investing in corporate-owned life insurance, which some claim to be used to fund future benefits.

It is clear that more needs to be done to understand the justification for retaining the tax advantages of corporate-owned life insurance. It is curious that insurance industry representatives have indicated to the GAO that they do not routinely summarize information on the numbers of policies and insured individuals, cash surrender value of policies, and uses of business-owned life insurance. This information would aid us during a comprehensive examination of the justification for the tax advantages that these policies currently enjoy. If such information is not available, we should create additional regulatory requirements so that we may have a better understanding of the situation. I appreciate the willingness of the Finance Committee to examine corporate-owned life insurance and I look forward to working with you on this issue. Thank you Mr. Chairman and Senator Baucus.

United States General Accounting Office

GAO

Testimony
Before the Committee on Finance, United States Senate

For Release on Delivery
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BUSINESS-OWNED LIFE INSURANCE

Preliminary Observations on Uses, Prevalence, and Regulatory Oversight

Statement of Davi M. D'Agostino, Director,
Financial Markets and Community Investment

GAO-04-191T

Highlights

Highlights of GAO-04-191T, a testimony before the Committee on Finance, U.S. Senate

October 23, 2003

BUSINESS-OWNED LIFE INSURANCE

Preliminary Observations on Uses, Prevalence, and Regulatory Oversight

Why GAO Did This Study

Business-owned life insurance is held by employers on the lives of their employees, and the employer is the beneficiary of these policies. Unless prohibited by state law, businesses can retain ownership of these policies regardless of whether the employment relationship has ended. Generally, business-owned life insurance is permanent, lasting for the life of the employee and accumulating cash value as it provides coverage. Attractive features of business-owned life insurance, which are common to all permanent life insurance, generally include both tax-free accumulation of earnings on the policies' cash value and tax-free receipt of the death benefit.

To address concerns that businesses were abusing their ability to deduct interest expenses on loans taken against the value of their policies, Congress passed legislation to limit this practice, and the Internal Revenue Service (IRS) and Department of Justice pursued litigation against some businesses. But concerns have remained regarding employers' ability to benefit from insuring their employees' lives.

This testimony provides some preliminary information from ongoing GAO work on (1) the uses and prevalence of business-owned life insurance and (2) federal and state regulatory requirements for and oversight of business-owned life insurance.

www.gao.gov/cgi-bin/getrpt?GAO-04-191T.

To view the full product, click on the link above. For more information, contact Davi M. D'Agostino at (202) 512-8868 or d'agostinod@gao.gov.

What GAO Found

GAO's preliminary work indicated that no comprehensive data are available on the uses of business-owned life insurance policies; however, businesses can purchase these policies to fund current and future employee benefits and receive tax advantages in the process. Federal bank regulators have collected some financial information on banks' and thrifts' business-owned life insurance holdings, but the data are not comprehensive and do not address the uses of the policies. The Securities and Exchange Commission (SEC), the IRS, state insurance regulators, and insurance companies told GAO that they generally have not collected comprehensive data on the sales or purchases of these policies or on their intended uses, because they have not had a need for such data in fulfilling their regulatory missions. In an effort to collect comprehensive data, GAO considered surveying insurance companies about their sales of business-owned life insurance. However, based on a pretest with six insurance companies, GAO determined that it would not be able to obtain sufficiently reliable data to allow it to conduct a survey. GAO found, however, that some insurers have voluntarily disclosed information about sales of business-owned policies and that some noninsurance businesses have included examples of their uses in annual financial reports filed with SEC.

As part of their responsibility to oversee the safety and soundness of banks and thrifts, the federal bank regulators have issued guidelines for institutions that buy business-owned life insurance. Also, they told GAO that they have reviewed the holdings of many institutions with significant amounts of business-owned life insurance and concluded that major supervisory concerns do not exist. SEC officials said that the agency has not issued specific requirements for holders of business-owned life insurance, relying instead on its broadly applicable requirement that public companies disclose information material to investors in their financial statements; SEC did not have investor protection concerns about public firms holding business-owned life insurance. The IRS had some requirements related to the tax treatment of business-owned life insurance and expressed some concerns about compliance with these requirements. State laws governing business-owned life insurance differed; the four states' regulators that GAO interviewed described some limited oversight of the policies, and these regulators and NAIC reported no problems with them.

Mr. Chairman and Members of the Committee:

I am pleased to be here today to discuss the preliminary results of GAO's work on business-owned life insurance, done at the request of Senators Akaka and Bingaman. Business-owned life insurance—including corporate-owned, bank-owned, and trust-owned life insurance—is held by employers on the lives of their employees. The employer is the beneficiary of these policies. Some of this insurance protects against the loss of key executives—called key-person insurance—while some of it covers larger groups of employees and is called broad-based insurance. Unless prohibited by state law, businesses can retain ownership of these policies regardless of whether the employment relationship has ended. Generally, business-owned life insurance is permanent rather than term life insurance, lasting for the life of the employee and accumulating cash value as it provides coverage. Attractive features of business-owned life insurance, which are features common to all permanent life insurance, generally include both tax-free accumulation of earnings on the policies' cash value and tax-free receipt of the death benefit.

To address concerns that businesses were abusing their ability to deduct interest expenses on loans taken against the value of their policies, Congress passed legislation to limit this practice, and the Internal Revenue Service (IRS) and Department of Justice pursued litigation against some businesses. But concerns have remained regarding employers' ability to benefit from insuring their employees' lives—specifically, whether (1) employers should be considered to have an insurable interest in employees' lives that allows them to hold business-owned life insurance, (2) employers' insurable interest should continue after the employment relationship ends and, if so, under what circumstances, (3) employers should be required to obtain their employees' consent before purchasing business-owned life insurance, and (4) businesses should be allowed to receive tax advantages from owning these policies. Proponents of business-owned life insurance point out that, among its other purposes, businesses use these policies to fund broad-based benefits for their employees, including pre- and postretirement health care.

We currently have work underway, and today, I will provide some preliminary information on (1) the uses and prevalence of business-owned life insurance and (2) federal and state regulatory requirements for and oversight of business-owned life insurance.

To obtain this information, we analyzed the financial reports that banks filed with their regulators as well as the corporate annual financial

statements that publicly traded insurers and noninsurers filed with the Securities and Exchange Commission (SEC). In addition, we interviewed officials of the IRS, SEC, the federal bank regulators, four state insurance departments, the National Association of Insurance Commissioners (NAIC), two life insurance associations, and six life insurance companies. We began our work in February 2003, and it is still ongoing.

Summary

Based on our preliminary work to date, no comprehensive data are available on the uses of business-owned life insurance policies; however, businesses can purchase these policies to fund current and future employee benefits and receive tax advantages in the process. Federal bank regulators have collected some financial information on banks' and thrifts' business-owned life insurance holdings, but the data are not comprehensive and do not address the uses of the policies.[1] SEC, the IRS, state insurance regulators, and insurance companies told us that they generally have not collected comprehensive data on the sales or purchases of these policies or on their intended uses, because they have not had a need for such data in fulfilling their regulatory missions. In an effort to collect comprehensive data, we considered surveying insurance companies about their sales of business-owned life insurance. However, based on a pretest with six insurance companies, we determined that we would not be able to obtain sufficiently reliable data to allow us to conduct a survey. We found, however, that some insurers have voluntarily disclosed information about sales of business-owned policies and that some noninsurance businesses have included examples of their uses in annual financial reports filed with SEC. As part of their responsibility to oversee the safety and soundness of banks and thrifts, the federal bank regulators have issued guidelines for institutions that buy business-owned life insurance. Also, they told us that they have reviewed the holdings of many institutions with significant amounts of business-owned life insurance and concluded that major supervisory concerns do not exist. SEC officials said that the agency has not issued specific requirements for holders of business-owned life insurance, relying instead on its broadly applicable requirement that public companies disclose information material to investors in their financial statements; SEC did not have

[1] "Banks and thrifts," as referred to in this testimony, are the commercial bank and thrift institutions regulated by the Federal Deposit Insurance Corporation, the Federal Reserve Board, the Office of the Comptroller of the Currency, and/or the Office of Thrift Supervision. However, our testimony does not cover bank holding companies and foreign banks with domestic branches.

investor-protection concerns about public firms holding business-owned life insurance. The IRS had some requirements related to the tax treatment of business-owned life insurance and expressed some concerns about compliance with these requirements. State laws governing business-owned life insurance differed; the four states' regulators that we interviewed described some limited oversight of the policies, and these regulators and NAIC reported no problems with them.

No Comprehensive Data Were Available on the Uses and Prevalence of Business-Owned Life Insurance

Neither federal nor state regulators collected comprehensive data on the uses and prevalence of business-owned life insurance. Although no comprehensive data were available on the uses of such policies, businesses may purchase life insurance to ensure recovery of losses in the event of the untimely death of key employees and to fund pre- and postretirement employee benefits. Accounting standards require that the future costs of postretirement benefit plans be recorded as liabilities at their present value on current financial statements. The accounting standards do not require that such liabilities be directly offset with specified assets. However, businesses may choose to fund such future costs using life insurance, thereby becoming eligible for tax-free policy earnings and tax-free death benefit payments on the policies.[2] When businesses use nonqualified plans to provide postretirement benefits, they avoid the funding and other restrictions of tax-preferred qualified plans, while retaining control over the plan assets.[3]

Federal bank regulators did not collect comprehensive data on the uses and prevalence of business-owned life insurance by banks and thrifts, although they collected some financial information on such policies as part of monitoring the safety and soundness of individual institutions. Regulatory officials said that they collect this information to support their supervision of individual institutions. For supervisory purposes, banks and

[2]If a business owns life insurance policies, the earnings and death benefit proceeds are among the factors that could make the business subject to the alternative minimum tax. In general, the alternative minimum tax is based on a corporation's regular taxable income adjusted for certain tax preference income items, such as exclusions, deductions, and credits. The amount due is the amount by which the tax computed under this system exceeds a corporation's regular tax.

[3]Nonqualified employee pension benefit plans, unlike qualified plans, are not subject to the requirements of the Internal Revenue Code and the Employee Retirement Income Security Act of 1974 as to who can participate, the amount of benefits provided, and how the plan is funded. Further, in contrast to qualified employee benefit plans, the assets of nonqualified plans are not beyond the reach of a business's creditors in bankruptcy proceedings.

thrifts are only required to disclose the cash surrender value of business-owned life insurance and earnings from these policies in their quarterly financial reports to the regulators if the amounts exceed certain thresholds. For example, the Federal Deposit Insurance Corporation (FDIC), Federal Reserve Board, and Office of the Comptroller of the Currency (OCC) require the institutions they regulate to disclose the cash surrender value of policies worth more than $25,000 in aggregate and that exceed 25 percent of "other assets," which include such items as repossessed personal property.[4] The Office of Thrift Supervision (OTS) requires the thrifts it supervises to report the cash surrender value of policies if the value is one of the three largest components of "other assets." In addition to the banks and thrifts that meet a disclosure threshold, other institutions sometimes voluntarily provide data on their business-owned life insurance policies.

Our preliminary results indicated that about one-third of banks and thrifts, including many of the largest institutions, disclosed the value of their business-owned life insurance holdings as of December 31, 2002, either voluntarily or because they met the reporting threshold.[5] The remaining two-thirds either did not meet the reporting threshold or did not own business-owned life insurance. We found that 3,209 banks and thrifts (34 percent of all institutions) reported the cash surrender value of their policies at $56.3 billion. Twenty-three of the top 50 banks and thrifts—ranked by total assets—reported owning policies worth $36.9 billion, or 66 percent of the reported total of all banks and thrifts. Overall, 259 large banks and thrifts—those with assets of $1 billion or more, including those among the top 50—held 88 percent, or $49.4 billion, of the total reported cash surrender value of business-owned life insurance.

The quarterly reports that commercial banks and FDIC-supervised thrifts submitted did not require them to categorize business-owned life insurance policies according to their intended use. OTS-supervised thrifts, in contrast, were required to report the value of their key-person policies and the value of business-owned life insurance policies held for other

[4]FDIC, the Federal Reserve Board, and OCC regulate commercial banks, and FDIC regulates some thrifts.

[5]The data do not include bank holding companies or foreign banks with domestic branches. The Federal Reserve Board started collecting data on business-owned life insurance from bank holding companies in 2003, but the data were not available at the time of our analysis. The federal bank regulators did not collect business-owned life insurance data on foreign banks with domestic branches.

purposes as separate items, if they met the reporting threshold. However, since the disclosure threshold applied separately to the two categories, OTS-supervised thrifts could be required to report on only one type of policy, rather than the total value of their business-owned life insurance holdings, even if they held both key-person and other policies.[6]

According to SEC, agency regulations do not specifically require public companies to disclose the value or uses of business-owned life insurance in the financial statements submitted to the agency. The federal securities laws that SEC administers are designed to protect investors by requiring public companies to disclose information that is "material" to investors in their financial statements—that is, according to SEC, information that an investor would consider important in deciding whether to buy or sell a security or in making a voting decision related to a security that the investor owns. SEC officials said that for most companies, business-owned life insurance holdings are not likely to be material to the company's financial results, and therefore would not be subject to SEC reporting requirements.

IRS officials told us that the agency has not collected comprehensive information on the value of or income from business-owned life insurance policies, and agency officials said that they do not need this information. Specifically, businesses are generally not required to include the earnings or death benefits from business-owned life insurance in their taxable income. Businesses that are subject to the alternative minimum tax include income from death benefits and earnings from insurance when calculating the tax, but they are not required to list the insurance-related values or the uses of the policies on the alternative minimum tax form. Also, businesses that are required to complete Schedule M-1, Reconciliation of Income (Loss) per Books with Income per Return, as part of their Form 1120, U.S. Corporation Income Tax Return, would report earnings on business-owned life insurance as part of the income recorded on their books but not on the tax return. However, according to IRS officials, these earnings might not be separately identified as they are often "lumped" with other adjustments.

[6]OTS has proposed requiring all the thrifts that it supervises to report the value of both their key-person and other business-owned life insurance policies, beginning in 2004. "Proposed Agency Information Collection Activities; Comment Request—Thrift Financial Report," OTS, 68 Fed. Reg. 3318 (Jan. 23, 2003).

State insurance regulators, concerned with state requirements, rates, and solvency issues, have collected extensive financial information from insurers, but not at the level of detail that would describe the uses or prevalence of business-owned life insurance policies.[7] State insurance regulators use insurers' financial statements to monitor individual companies' solvency, and aggregate information on business-owned life insurance has not, in state regulators' views, been necessary for such monitoring. Insurers' financial statements list the number of all policies in force and premiums collected during the reporting period, but broken out only by individual and group policies, not by whether businesses or individuals owned the policies.

In an effort to compile more comprehensive data on business-owned life insurance, we worked with the representatives of six insurance companies and the American Council of Life Insurers (ACLI) to develop a survey of the uses and prevalence of business-owned life insurance sales. Although the insurance companies' representatives cooperated in a pretest of the survey, and ACLI representatives said that they would encourage their members to participate in the survey itself, the results of the pretest led us to conclude that we would not be able to obtain sufficiently reliable data to allow us to conduct the survey. These representatives told us that they do not have a business need to maintain the comprehensive data on business-owned life insurance that we needed for the survey. They said that insurers do not routinely summarize information on the numbers of policies and insured individuals, cash surrender value of policies, and uses of business-owned life insurance. They explained that various factors made it difficult to obtain summary information, including that individual businesses may own multiple policies; that the same individuals may be insured under multiple policies; and that when purchasing policies, businesses may state multiple policy uses or policy uses may change over time. They also explained that extensive efforts would be required for insurance companies to obtain information from their computer systems and, in some cases, paper files to identify business-owned policies on employees where the business is also the beneficiary.

[7]In commenting on this testimony, New York state insurance regulators said that while they did not collect detailed information on the prevalence or uses of business-owned life insurance, information about insurers that have a high volume of business-owned life insurance sales would be useful to them in conducting market conduct examinations. They also referred to survey data that they have collected since 2000 on business-owned life insurance, and we have requested this information from them.

Our preliminary review of the financial statements of 32 life insurance companies that filed 10-K annual reports with SEC and that were among the 50 largest such companies ranked by assets, disclosed some information on business-owned life insurance. Although SEC did not require insurance companies to identify business-owned life insurance sales in their annual statements to the agency, nine insurers reported over $3 billion in business-owned life insurance premiums from 2002 sales. Five of the insurance companies also reported that total premiums from 2002 business-owned life insurance premiums ranged from 10 to 53 percent of each company's 2002 total life insurance sales premiums. In addition, three insurance companies reported the value of their business-owned life insurance assets as totaling about $28 billion as of December 31, 2002.

Insurance companies have also reported business-owned life insurance sales in response to industry surveys. CAST Management Consultants, Inc., conducts research on business-owned life insurance and, in a summary report, estimated 2002 annual business-owned life insurance premiums of $2.1 billion, based on the survey responses of 20 insurance carriers increased by CAST adjustments.[8] CAST representatives declined to provide us any information about the complete survey, which is available only to "qualified market participants." We could not, therefore, determine whether CAST was able to collect the information we sought to obtain by conducting our own survey. In addition, a representative of the A.M. Best insurer rating company said that the company collects information on business-owned life insurance, but does not currently report the data. A.M. Best reported aggregate premiums from business-owned life insurance for 1998 (the last year for which it reported data) as more than $10 billion for 20 large insurers.[9]

Some businesses included anecdotal information about how they intended to use business-owned life insurance in the annual financial statements they filed with SEC. Our preliminary analysis of 100 randomly selected Fortune 1000 public companies' financial statements filed with SEC showed that 15 of the selected businesses referred to owning such policies, including 11 that provided information about their intended uses of the policies. The most commonly cited use of business-owned life

[8]"CAST 2002 Corporate-Owned Life Insurance Market Survey, Respondent Summary," CAST Management Consultants, Inc. (Apr. 2003).

[9]Cynthia Crosson, "Capturing COLI/BOLI," *Best's Review*, Vol. 100, No. 9 (2000).

insurance was to fund deferred executive compensation.[10] One business reported using policies to help fund postretirement health care benefits, and another reported using the policies to help fund an employee benefit plan for management employees as well as executives.

Some businesses have also provided survey responses on their uses of business-owned life insurance to fund executive benefit plans. Clark/Bardes Consulting conducts an annual executive benefits survey and reports on the uses of business-owned life insurance by companies to fund nonqualified deferred compensation plans and supplemental executive retirement plans. In the 2002 results from its survey of Fortune 1000 corporations, Clarke/Bardes reported that 65 percent of those companies that fund nonqualified deferred compensation plans and 68 percent of those that fund nonqualified supplemental executive retirement plans do so using business-owned life insurance.

Finally, the federal government estimated that the current tax exclusion of earnings on the cash value of business-owned life insurance results in over a billion dollars in foregone tax revenues annually—these estimates do not reflect the exclusion of additional income from death benefit payments. In its "Estimates of Federal Tax Expenditures for Fiscal Years 2003-2007," the Joint Committee on Taxation estimated that the foregone tax revenues resulting from the tax exclusion of investment income on life insurance for corporations would total $7.2 billion for 2003 through 2007. Similarly, the Office of Management and Budget, in its fiscal year 2004 budget "Analytical Perspectives," estimated foregone tax revenues of $9.3 billion for 2003 through 2007 resulting from the tax exclusion of life insurance.

[10]SEC requires companies to disclose information pertaining to the compensation of top officers. Therefore, the fact that companies most frequently disclosed the use of business-owned life insurance to fund executive compensation does not mean that this is necessarily the most common use of such policies.

Regulators Had Guidelines or Requirements Applicable to Business-Owned Life Insurance but Did Not Identify Significant Regulatory Concerns

The federal bank regulators, SEC, the IRS, and state insurance regulators had guidelines or requirements applicable to business-owned life insurance but did not identify significant regulatory concerns. The federal bank regulators had guidelines for purchases of business-owned life insurance by banks and thrifts. OCC and OTS guidelines describe the permissible uses of business-owned life insurance and require national banks and OTS-supervised thrifts to perform due diligence before purchasing policies and to maintain effective senior management and board oversight.[11] According to agency officials, FDIC and the Federal Reserve Board follow OCC's guidelines. The guidelines that are common among the regulators state that banks and thrifts can only purchase life insurance for reasons incidental to banking, including key-person insurance, insurance on borrowers, and insurance purchased in connection with employee compensation and benefit plans. Before purchasing policies, a bank's or thrift's management must conduct a prepurchase analysis that should, among other things, determine the need for insurance, ensure that the amount of insurance purchased is not excessive in relation to the estimated obligation or risk, and analyze the associated risks and the bank's or thrift's ability to monitor and respond to those risks. The guidelines also state that a bank or thrift should consider the size of its purchase of business-owned life insurance relative to the institution's capital and diversify risks associated with the policies. The guidelines require banks and thrifts to document their decisions and monitor their policies on an ongoing basis. In addition, banks and thrifts using business-owned life insurance for executive compensation should ensure that total compensation is not excessive under regulatory guidelines.

The federal bank regulators we spoke with said that their risk-based examination programs target any aspect of banks' and thrifts' purchases of business-owned life insurance that would raise supervisory concerns. The regulators monitor institutions' safety and soundness through their risk-based examinations, which they said assess banks' and thrifts' compliance with guidelines on business-owned life insurance on a case-by-case basis. For example, all of the regulators said that if the value of the policies exceeded 25 percent of the regulator's measure of the institution's capital, they would consider whether further supervisory review or examination of

[11]Department of Treasury, OCC, "Bulletin 2000-23" (July 20, 2000). Department of Treasury, OTS, "Regulatory Bulletin RB 32-26" (July 31, 2002). These bulletins rescinded previous guidelines.

these holdings was warranted. The regulators said that additional review or examination would be likely if the policies were held with one or very few insurers.

As of December 31, 2002, 467 banks and thrifts reported business-owned life insurance holdings in excess of 25 percent of their tier 1 capital.[12] We asked the bank regulators to explain their oversight of 58 institutions with the largest concentrations, all in excess of 40 percent of tier 1 capital. Bank regulatory officials said that their agencies were monitoring these institutions' levels of holdings, had conducted preliminary reviews or detailed examinations, and concluded that major supervisory concerns do not exist.

SEC officials said that the agency's regulations for public companies do not specifically address business-owned life insurance; rather, SEC has relied on its broadly applicable disclosure requirements to surface any investor protection concerns. SEC requires public companies to prepare their financial statements in accordance with generally accepted accounting principles (GAAP), which would require them to disclose information about business-owned life insurance policies when such information is material. According to SEC officials, however, following GAAP would rarely require purchases of and earnings from business-owned life insurance to be shown as separate line items because they typically are not financially material to the company. SEC officials also said that the agency would have an oversight concern if it became aware of a public company's failure to disclose material purchases of or earnings from business-owned life insurance, or if problems developed in accounting for these policies. However, they said that, to date, such problems have not arisen, and they have not had investor-protection concerns about public companies holding such insurance.

The IRS had some requirements related to the tax treatment of business-owned life insurance. The Internal Revenue Code defines life insurance for tax purposes and sets out the current limitations on permissible tax deductions that businesses can claim for the interest on policy loans against life insurance policies. Federal laws and IRS regulations have changed some aspects of the tax treatment of business-owned life

[12]The ratio of cash surrender value to tier 1 capital illustrates the institution's overall exposure to risk, including credit risk (the risk of counterparty default), since tier 1 capital is a measure of the equity cushion that banks have available to absorb loss, including credit losses from their holdings of business-owned life insurance.

insurance. While policy owners may access the cash value of their policies by borrowing against them, policy owners' ability to deduct the interest on such loans was limited by the Tax Reform Act of 1986 and further limited by the Health Insurance Portability and Accountability Act (HIPAA) of 1996, which amended Internal Revenue Code section 264.[13] Before these limitations, some businesses were leveraging their life insurance ownership by borrowing against the policies to pay a substantial portion of the insurance premiums. Known as leveraged business-owned life insurance, these arrangements created situations where businesses incurred a tax-deductible interest expense while realizing tax-free investment returns.[14] Various sources have reported that HIPAA curtailed new sales of leveraged policies, although such policies that were purchased in the past remain part of the life insurance policies currently in force. However, IRS officials expressed concern that HIPAA did not eliminate the tax arbitrage opportunities available through business-owned life insurance and that banks and other highly leveraged financial institutions may be indirectly borrowing to purchase policies on employees.[15] IRS officials said that the agency is also concerned that banks are using separate account policies to maintain control over investments in a way that is inconsistent with the Internal Revenue Code.[16] These

[13]The limit on interest deductibility does not apply to policies purchased before June 20, 1986.

[14]In addition to the legislation addressing leveraged business-owned life insurance plans, the IRS and Department of Justice prevailed in three cases involving the proper treatment of loan interest related to such plans. These plans covered over 55,000 employees. The courts found that the leveraged plans lacked economic substance, making the interest deduction unallowable. See *In re C.M. Holdings, Inc.*, 301 F.3d 96 (3rd Cir. 2002); *Am. Elec. Power v. United States*, 326 F.3d 737 (6th Cir. 2003); *Winn Dixie Stores v. United States*, 254 F.3d 1313 (11th Cir. 2001), cert. denied, 535 U.S. 986 (2002). The taxpayer prevailed in a fourth case. See *Dow Chemical Co. v. United States*, 250 F Supp. 2d 748 (E.D. Mich. 2003).

[15]The Congressional Research Service has reported that businesses could use overall indebtedness to indirectly support tax-preferred investment in business-owned life insurance. Since debt is fungible and businesses can deduct interest expenses to support investments, some businesses may borrow for purposes unrelated to life insurance and thereby have funds available to purchase these policies. Under such circumstances, it would be difficult to distinguish debt that is used to finance business-owned life insurance from that which is not. Congressional Research Service, The Library of Congress, *Corporate-Owned Life Insurance: Tax Issues* (Washington, D.C.: updated June 26, 2003). Congressional Research Service, The Library of Congress, *Taxation of life Insurance Products: Background and Issues* (Washington, D.C.: July 18, 2003).

[16]In separate account life insurance, an asset account is maintained independently from the insurer's general investment account. This arrangement permits wider latitude in the choice of investments, particularly equities.

officials said that the agency is continuing to study these business-owned life insurance issues at selected banks. Finally, in September 2003, the IRS issued final regulations on the tax treatment of split-dollar life insurance policies—policies in which the employer and employee generally share costs and benefits. Under the regulations, corporations cannot provide tax-free compensation to executives using split-dollar policies.

State law requires that one party have an insurable interest in another to be able to take out a life insurance policy on that person and defines the conditions for one party to have an insurable interest in the life of another person. Historically, insurable interest related to a family's dependency on an individual and a business's risk of financial loss in the event of the death of a key employee. The significance of employers having an insurable interest in their employees is illustrated by the 2002 decision of a federal district court in Texas. The court found that Wal-Mart did not have an insurable interest in employees' lives under Texas law, given the nature of the policies taken out on each of 350,000 Wal-Mart employees, and that under Texas law, Wal-Mart could not collect on the death benefits paid under policies covering deceased employees.[17]

NAIC, a membership organization of chief state insurance regulators that helps promote coordination among the states, initially developed model guidelines for business-owned life insurance in 1992 and revised them in 2002. The 1992 guidelines suggested that states consider including in their laws provisions that recognize employers' insurable interest in employees, including nonmanagement employees who could expect to receive benefits. The 2002 revision added a recommendation for states to consider requiring employee consent to be insured and prohibiting employers from retaliating against employees who refused to grant their consent.

Since NAIC adopted the revised guidelines, several states have passed legislation requiring employers to obtain employees' written consent before taking insurance on them. In some states consent provisions apply to life insurance policies in general, while in others these provisions specifically address business-owned life insurance. Our preliminary analysis indicated that, as of July 31, 2003, more than 30 states required written consent, including several states with provisions specific to

[17]*Mayo, et al., v. Hartford Life Insurance Company, et al.*, 220 F. Supp.2d 794 (2002). Texas law on insurable interest was changed after Wal-Mart purchased the policies in question to grant an insurable interest to third parties who take out life insurance on those giving informed consent.

business-owned life insurance. However, most of these states exempted group life insurance policies from consent requirements. Also, in some states consent requirements were satisfied if an employee did not object to a notice of the employer's intent to purchase a policy. Additionally, at least one state required employers to notify employees when purchasing business-owned life insurance, but did not require employee consent.

Officials of NAIC and four state insurance departments—California, Illinois, New York, and Texas—stated that, in recent years, some state legislatures adopted laws broadening the definition of employers' insurable interest to include broader groups of employees in order to permit using business-owned life insurance to finance employee benefit programs, such as current employee and retiree health care. The officials said that such laws responded in part to Financial Accounting Standard 106, which took effect in 1992 and requires businesses to report the present value of future postretirement employee benefits as employees earn them. Also, our preliminary analysis showed that several states limit the aggregate amount of insurance coverage on nonmanagement employees to an amount commensurate with the business's employee benefit liabilities. In addition, a few states recognize an employer's insurable interest in employees, provided that businesses use the proceeds solely to fund benefit programs.

Insurance department officials from the four states also told us that they primarily address compliance with their respective laws through a review of the proposed policy forms that insurers must submit for approval before marketing policies in their states. For example, in New York, the insurance department developed a checklist of items that must be included on forms that will be used for business-owned life insurance policies to ensure that the forms comply with the state's notification, consent, and other requirements. While NAIC officials said that state insurance regulators would generally have the authority to review policies currently in force for compliance with any state requirements, the officials from the four states said that they had not examined policies sold to confirm that employees consented to be insured or, where applicable, to test whether the amounts of coverage were appropriate. Officials in the four states said that their departments would investigate business-owned life insurance sales through their market conduct examinations of insurers

if they observed a pattern of consumer complaints about such sales.[18] However, the officials said that generally they had not received complaints about business-owned life insurance. Also, NAIC officials told us that the organization maintains a national database of consumer complaints made to state insurance regulators and that business-owned life insurance has not been a source of complaints.

Mr. Chairman, this completes my prepared statement. I would be happy to respond to any questions you or other Members of the Committee may have at this time.

[18]New York insurance department officials said that other factors might also cause the department to investigate an insurer. For example, they said that the department would investigate, as part of its market conduct examinations, insurers that sell a significant amount of business-owned life insurance.

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Written Testimony of Senator John Edwards

Before the
Committee on Finance
U.S. Senate

October ~~15~~ 23, 2003

Chairman Grassley, Senator Baucus, and Members of the Committee:

I applaud your dedicated bipartisan efforts to identify and close abusive tax loopholes. Widespread exploitation of the nooks and crannies of our tax code undermines faith in the fairness of our tax code and may lead to even greater tax avoidance. Moreover, as we face the largest budget deficit in our history and unknown costs for our global war on terror, every taxpayer should pay a fair share. I thank you for your continued hard work toward that goal.

In addition, I appreciate the opportunity to submit testimony on corporate owned life insurance. As debate in your Committee and on the Senate floor has demonstrated, the tax benefit provided to companies that purchase life insurance on their employees raises a wide range of concerns. Thank you for taking the time to closely examine this important issue.

Many corporations purchase life insurance policies to cover their employees and investors. The American Council on Life Insurers estimates that annual premiums on corporate owned life insurance, or COLI, policies exceed $8 billion.[1] Nearly one-third of all new life insurance policies are corporate owned.[2] In general, companies pay these life insurance premiums and benefit from the tax-free growth in the resulting investments. When insured workers die—even if they have retired, been laid off, or left for another job—the company receives tax-free death benefits.

In some cases, corporations have a legitimate interest in purchasing insurance, such as on a key executive. However, there are also many cases where insurance polices serve merely as a source of steady, tax-free investment earnings to boost a company's bottom line.

In my view, this practice is an abuse of the tax incentives society provides to encourage the purchase of insurance. The insured workers see no benefits and may not even be aware of the policies. These workers are sometimes even given the demeaning and insulting label of "dead peasants."[3] Allowing companies to construct these tax shelters is economically pointless and morally perverse.

A Tax Shelter for Corporate Investments

Since passing the first income tax laws in 1913, Congress has encouraged the purchase of life insurance. The tax benefits for insurance are twofold. First, the premiums paid into the insurance policy are invested and grow in value each year. These earnings, sometimes called "inside build-up," are credited to the insurance contract but are not included in gross income for Federal tax purposes. Second, the death benefits paid out upon the passing of an insured employee are not considered taxable income.[4]

Congress extended these tax benefits to corporations who purchase life insurance covering their officers, employees, directors, or shareholders. These COLI policies, known as "key person" insurance, protect the corporation against the loss of essential employees who are particularly expensive and difficult to replace.[5] The corporation owns the policy, pays the premiums, and receives all of the death benefits.

Over time, however, many corporations have expanded their COLI policies to include large numbers of rank-and-file employees. The premiums paid by large corporations for these policies more than doubled from 2000 to 2001 alone.[6] The *Wall Street Journal* reported that "corporations are now among the largest beneficiaries of life insurance."[7]

The *Wall Street Journal* has also reported that many workers too poor to afford their own life insurance are nonetheless covered by huge policies benefiting their employers.[8] They and their families rarely see any of the benefit. For example, when Felipe M. Tillman passed away at age 29, his former employer, CM Holdings, Inc., received $339,302 in life insurance benefits. The Tillman family got nothing.[9]

These COLI policies can no longer be called insurance in the conventional sense of protection against misfortune. Instead, COLI policies have become a convenient way to shelter investments from taxation.

Accounting rules allow companies to include these annual gains on their income statements, much as they include pension income, without incurring tax liability. Companies can and do use COLIs as a steady source of income that smoothes earnings over time.[10] As the Association for Advanced Life Underwriting (AALU) states, "Many businesses depend on company owned life insurance because it provides a steady, predictable source of funding they can use to provide quality health care and retirement benefits to their employees."[11]

In many cases these policies are valuable only for the tax savings they provide. *National Underwriter* put it bluntly, recommending COLI policies because the "cost of the insurance is less than the tax costs associated with mutual funds."[12]

Is COLI Needed to Fund Employee Benefits?

Some argue that COLI policies are necessary for corporations to pay for employee benefit programs. I disagree.

As members of this Committee are well aware, the Federal Government already provides corporations with tax deductions for the benefits it provides its employees, including health insurance and pensions. It is unclear why our tax code should provide additional incentives for one particular form of financing those promises.

Second, COLI tax breaks are poorly suited to the goal of encouraging companies to invest more in employee benefits. In fact, there is no requirement at all that corporations invest the proceeds of COLI policies into employee benefits.

Despite the claims of broad benefits for workers, many COLI policies fund benefits only for executives. By some estimates, the majority of large U.S. corporations use COLI policies to fund supplemental retirement benefits for executives.[13] For example, Portland General Electric, an Enron subsidiary, used the proceeds of $80 million in life insurance policies on the majority of its rank-and-file employees to expand executive pensions.[14] CM Holdings, mentioned above, used the proceeds of its insurance policy on Mr. Tillman in part for executive compensation.[15]

Third, if corporations truly entered into COLI arrangements to benefit their workers, they wouldn't hide those policies behind a veil of secrecy. In a number of states, workers and their families have been forced to sue companies that took out broad-based COLI policies without employee consent.[16]

For example, when Vicki Rice's husband died of a heart attack while on the job at Wal-Mart, the company requested that she provide a copy of his death certificate. Mrs. Rice was not told that her husband's employer would use this certificate to collect a $381,000 death benefit.[17]

Finally, the question of whether existing incentives should be expanded to encourage greater corporate investment in employee benefits need not be related to the current tax treatment given life insurance. If greater subsidies for employee benefits are needed, we should pass such a law directly, rather than let tax subsidies evolve in an ad hoc and undesirable way.

Looking Forward

Should the Committee decide to address abuses of COLI, there are a number of possible approaches. As you know, this spring Senator McCain, Senator Graham of South Carolina, and I

offered one proposal on the Senate floor. Our amendment would have eliminated tax exemptions on COLI policies for both inside build-up and death benefits. It would not have applied to "key person" insurance or to existing policies.

There are other possible approaches. For example, some have proposed disallowing a proportion of the interest deduction taken by a company holding COLI policies. Others have proposed requiring companies to disclose life insurance policies to the covered employees. I believe that these proposals also deserve your close and careful attention.

In sum, John H. Biggs, the chairman and chief executive of TIAA-CREF, was right to describe COLI practices as "revolting."[18] We should not ask American taxpayers to continue offer subsidies to corporations sheltering investments through COLI policies.

These perverse provisions complicate our already-complex tax code and distort the purpose of life insurance. It is time to rewrite them.

I look forward to continuing to work with you on this important issue.

ENDNOTES

[1] *Insurance Chronicle,* "Humbled Life Industry Faces Rocky Road," October 6, 2003

[2] *The Boston Globe*, "Office Indemnity," March 9, 2003.

[3] *Charlotte Observer*, "Profiting from Policies on Employees," May 12, 2002.

[4] Internal Revenue Code, Section 101(a)

[5] Congressional Research Service, *COLI: Corporate Owned Life Insurance*, August 29, 2003

[6] CAST Management Consultants, "The Growing COLI Market," April 26, 2002.

[7] *Wall Street Journal*, "Death Benefit: How Corporations Built Finance Tool Out of Life Insurance," December 30, 2002.

[8] *The Record (Bergen County, NJ)*, "Profiting from Death," May 29, 2002.

[9] *Wall Street Journal*, "Companies Profit on Workers' Deaths Through 'Dead Peasants' Insurance," April 19, 2002

[10] Joint Committee on Taxation, "Present-Law Federal Tax Treatment, Proposals, and Issues Relating to Company-Owned Life Insurance," October 14, 2003.

[11] Association for Advanced Life Underwriting, www.nolifeinsurancetax.com, visited October 14, 2003.

[12] *National Underwriter*, "Filling the Retirement Gap," June 24, 2002.

[13] Financial Services Distribution, *A Corporate Life*, September 1, 2002.

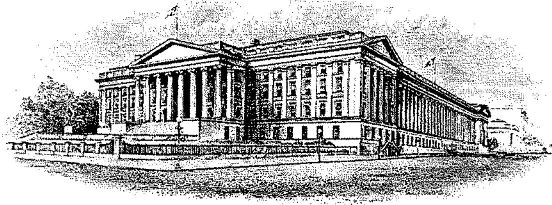
[14] *Houston Chronicle*, "'Dead Peasant' Policies Benefit Top Executives," April 24, 2002.

[15] *Wall Street Journal*, "Companies Profit on Workers' Deaths Through 'Dead Peasants' Insurance," April 19, 2002

[16] *Charlotte Observer*, "Profiting from Policies on Employees," May 12, 2002.

[17] *Spokesman Review (Spokane, WA)*, "Lawmakers May Tighten Up 'Dead Peasant' Laws," March 3, 2003.

[18] *Wall Street Journal*, "Death Benefit: How Corporations Built Finance Tool Out of Life Insurance," December 30, 2002.



DEPARTMENT OF THE TREASURY

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

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

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

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

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

Insurable Interest and Other State Responsibilities

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

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

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

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

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

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

Income Taxation of COLI

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

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

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

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

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

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

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

The Rise of Broad-Based COLI

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

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

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

The HIPAA of 1996 – General Restrictions on the Deduction of Policy Loan Interest

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

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

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

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

Taxpayer Relief Act of 1997 – Limits on Debtor-BOLI

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

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

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

COLI Today

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

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

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

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

Current Concerns Regarding COLI

Generally

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

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

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

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

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

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

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

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

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

Specific Concerns

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

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

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

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

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

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

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

Current Legislative Proposals

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

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

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

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

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

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

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

Limiting COLI to Employee Benefits

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

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

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

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

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

Conclusion

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

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

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

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

STATEMENT OF

FRANK KEATING,

PRESIDENT AND CEO

AMERICAN COUNCIL OF LIFE INSURERS

BEFORE THE

COMMITTEE ON FINANCE

UNITED STATES SENATE

WEDNESDAY, OCTOBER 15, 2003

Good morning, Mr. Chairman, thank you for the opportunity to participate in these important hearings. As President and CEO of the American Council of Life Insurers, I represent nearly 400 life insurance companies, which account for the majority of United States life insurance premiums. The products provided by the life insurance industry help both families and businesses manage risk as well as ensure a secure means of providing funds for employers to use for the benefit of their employees and their families.

On behalf of our member companies, I appreciate the opportunity to discuss company-owned or corporate-owned life insurance with you this morning. Corporate-owned life insurance, or COLI, has been in one form or another a fixture of American business operations since the early 1900s. American businesses insure their plants and office facilities; they insure patents, copyrights, and their sources of supply. It's not surprising then that businesses also insure their most valuable assets, their employees.

Although COLI has been a part of American business for decades and is thoroughly regulated by the states, we understand the interest of the Committee in looking at how COLI might be best used in the future.

Businesses currently use COLI for a variety of reasons: to insure against the loss of key employees, the exact number of which will vary from company to company; as a prudent and responsible way to plan for the payment of future employee benefits for a broad group of employees; to provide retirement plans as a way to attract and retain valuable employees at all levels of a company; and to provide employers a way to fund transition planning under buy-sell agreements. Now more than ever, we know that American businesses need the stability and certainty of life insurance to provide for their employees and the future of their businesses. Businesses face economic pressures that are

driving them to look for affordable and reliable sources of revenue to finance employee benefits rather than cutting them altogether.

COLI is an important asset of businesses to guard against the uncertainties of life as it affects employees, whether on the job or in retirement. It is appropriate that policyholders both facilitate and oversee how we approach these responsibilities, and we welcome the effort to work with the Committee in making sure that the COLI product remains available to businesses and their employees and that any limitations placed on the use of COLI fit within current "best businesses practices".

Like all life insurance, COLI is heavily regulated in every state. State laws govern insurable interests, who can be insured, as well as employee notice and consent. Most states limit those who can be insured to either employees who would be eligible for employee benefits or to employees who are key to the business. With respect to employee notice and consent, almost all states have specific laws requiring that employees receive notice of a pending COLI policy. Most states also require that the employee be given the opportunity to object to the coverage or explicitly require that the employee affirmatively consent. As part of this notice and consent requirement, employees are provided with documentation of the reasons for the coverage, how the employees as a group will benefit, and are given ample opportunity to have their questions answered. The ACLI supports these state law limitations. We have provided the members of this Committee with a comprehensive chart showing the laws governing COLI in each of the states.

Not only is COLI currently regulated under state laws, the Internal Revenue Code also places substantial restrictions on COLI. Unlike premiums on other types of insurance purchased by a business, premiums on COLI are not deductible. In most cases, no

deduction is permitted for interest on policy loans, although a business can deduct interest on loans for other assets.

We understand that the focus of this Committee is on the future of COLI. To that end, we fully support the Conrad amendment. It provides appropriate limits on COLI and will help ensure that all employers and employees, regardless of their home state, are subject to uniform rules. The Conrad amendment will ensure that the proceeds of COLI programs are directed toward activities that enhance, and do not diminish, employees and their families.

Finally, I would like to urge the Committee to review the recommendations of a study currently being conducted by the General Accounting Office. Members of this Committee have had the commendable foresight to request this study, and the request could not be more timely. We have met with the GAO representatives on a number of occasions and have been fortunate in being able to have frank and open discussions with them concerning the COLI product. While our member companies' data systems did not have all of the quantitative data that the GAO was seeking, we did share with them a wide range of qualitative information, including how and why employers use COLI to meet their business needs and how insurers ensure that state insurable interest and notice and consent requirements are meet. We would welcome an opportunity to meet with you to review the final GAO report in detail.

This is an important issue for the life insurance industry, the corporate clients that it serves, and the employees who rely upon life insurers for financial and retirement security.

Again, thank you for the opportunity to testify today. I look forward to answering any questions that you might have.

Frank Keating Biography

Frank Keating took over as president and CEO of the American Council of Life Insurers on January 14, 2003, the morning after leaving office as Oklahoma's 25th governor.

As president and CEO, Governor Keating is the chief representative and spokesman for the life insurance industry in Washington, D.C. He and his staff work as advocates for nearly 400 life insurance companies that account for 75 percent of the life insurance and annuity markets in the United States.

During the early months of his tenure at ACLI, Governor Keating was profiled in National Journal as a new leader "pumping life into the ACLI." He is traveling the country meeting with numerous executives from member companies. His Washington meetings have included key members of Congress and the Bush Administration. His plans also include being a visible public spokesman for the life insurance industry and the products it offers.

Born in St. Louis in 1944, Keating grew up in Tulsa, Oklahoma. He received his undergraduate degree from Georgetown University and a law degree from the University of Oklahoma. His 30-year career in law enforcement and public service included stints as an FBI agent, federal and state prosecutor, and state legislator. He served Presidents Reagan and Bush in the Treasury, Justice and Housing Departments.

In 1993 he returned to Oklahoma to run for Governor. He won a three-way race by a landslide and was easily reelected in 1998, becoming only the second governor in Oklahoma history to serve two consecutive terms.

Governor Keating won national acclaim in 1995 for his compassionate and professional handling of the Oklahoma City bombing. His accomplishments as Governor include winning a public vote on right-to-work, tort reform, tax cuts, major road building, and education reform.

Insurable Interest and Consent Required for Company or Corporate Owned Life Insurance

This compilation includes the state laws affecting insurable interest and notice and consent requirements for corporate owned life insurance (COLI). COLI is generally insurance owned by an employer, insuring the lives of employees.

The situations under which an employer has an insurable interest in its employees vary.

The NAIC has COLI Guidelines regarding insurable interest and notice and consent. A number of states have enacted legislation that mirrors these Guidelines. The Guidelines provide:

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.

3. An employer shall not retaliate in any manner against an employee or a retired employee for refusing consent to be insured.

4. For non-key or non-managerial employees, the amount of coverage should be reasonably related to the benefits provided to the employees.

5. 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.

The ACLI hopes this survey is helpful as a quick reference for your questions on insurable interest.

Laurie Lewis
October 2003

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American Council of Life Insurers

State	Citation	Date of Enactment	Employer Insurable Interest	Employee Consent
Alabama	§ 27-14-3(c) § 27-14-6(a)	§ 27-14-3(c) - 1971, 1994 § 27-14-6(a) - 1971, 1988	Yes. "A corporation, foreign or domestic has an insurable interest in the life or physical or mental ability of any of its directors, officers, or employees, or the directors, officers, or employees of any of its subsidiaries or any other person whose death or physical or mental disability might cause financial loss to the corporation..." [§ 27-14-3(c)]	Consent required, not specific to employer or trust owned insurance. Group consent exception exists, but it is not specific to employer or trust owned insurance. "No life or disability insurance contract upon an individual, except a contract of group life insurance or of group or blanket disability insurance, shall be made or effectuated unless at the time of the making of the contract the individual insured, being of competent legal capacity to contract, applies therefore or has consented thereto ..." [§ 27-14-6(a)]
Alaska	Alaska Stat. §§ 21.42.020, 21.42.090	§ 21.42.020 - 1966, 1992, 1996 § 21.42.090 - 1966, 1996	(d) *** (2) "[Insurable Interest includes] in the case of persons other than those described in (1) of this subsection [persons related closely by blood or by law], a lawful and substantial economic interest in having the life, health, or bodily safety of the person insured continue, as distinguished from an interest that would arise only by, or would be enhanced in value by, the death, disablement, or injury of the individual insured;" *** [§ 21.42.020]	Consent required, not specific to employer or trust owned insurance. Group consent exception exists, but it is not specific to employer or trust owned insurance. "A life or health insurance contract upon an individual, except a contract of group life insurance or of group or blanket health insurance, may not be made or effectuated unless at the time of the making of the contract the individual insured, being of competent legal capacity to contract, applies for the contract or has consented to it in writing..." [§ 21.42.090]
Arizona	Ariz. Rev. Stat. Ann. §§ 20-1104(C)(2), 20-1107	§ 20-1104(C)(2) - 1989 § 20-1107 - 1954	"(Insurable interest includes) In the case of other persons (other than those persons related closely by blood or by law), a lawful and substantial economic interest in having the life, health, or bodily safety of the individual insured continue, as distinguished from an interest which would arise only by, or would be enhanced in value by, the death, disablement, or injury of the individual insured." [§ 20-1104(C)(2)]	Written consent required, not specific to employer or trust owned insurance. Group consent exception exists, but it is not specific to employer or trust owned insurance. "No life or disability insurance contract upon an individual, except a contract of group life insurance or of group or blanket disability insurance, shall be made or effectuated unless at the time of making the contract the individual insured...applies therefore or consents thereto..." [§ 20-1107]

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State	Citation	Date of Enactment	Employer Insurable Interest	Employee Consent
Arkansas	Ark. Code Ann. §§ 23-79-103(a) through (c)(1)(D)	**March 18, 2003**	Any employer, corporation, other business entity, or the trustee of a trust providing life, health, disability, retirement, or similar benefits to employees, retired employees, or their dependents or beneficiaries, has an insurable interest in the lives of employees for whom the benefits are to be provided. 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 a pension and welfare benefit plan. For a non-key or non-managerial employee, the amount of coverage shall be reasonably related to the benefits provided to the employee. The life insurance coverage purchased to finance employer provided pension and welfare benefit plans shall only be allowed on the lives of those employees and retirees who have a reasonable expectation of benefiting from the plan at the time their lives are first insured under the plan.	Written affirmative consent required. The consent shall include an acknowledgement that the employer may maintain the life insurance coverage after the insured individual's employment has terminated. No employer may retaliate against any person for refusing to consent to the issuance of insurance on that person.
California	Cal. Ins. Code §10110.4(c)	§ 10110.1(c) – 1990, 2003	Yes An employer may only insure the life of a current or former exempt employee. An exempt employee is an administrative, executive, or professional employee who is exempt under section 515 of the California Labor Code and the regulations adopted pursuant thereto. [§10110.4(c)]	Written consent required. The employer shall provide the employee with (1) the identity of the insurer, (2) the benefit amount under the policy, (3) how the benefits will be used, and (4) the name of the beneficiary under the policy. [§10110.4(f)] No group exception.

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State	Citation	Date of Enactment	Employer Insurable Interest	Employee Consent
Colorado	Col. Stat. § 10-7-115	§ 10-7-115 – 1992	Common Law Insurable Interest "Notwithstanding any other provision of law, any organization that meets the requirements of section 170(c) of the federal "Internal Revenue Code of 1986", as amended, may own or purchase life insurance on an insured who gives written consent to the ownership or purchase of the insurance. The provisions of this section do not limit or abridge any insurable interest or right to insure now existing at common law or by statute, shall be construed liberally to sustain the existence of an insurable interest, and shall stand as a declaration of existing law applicable to all life insurance policies whenever issued, in existence on or after March 20, 1992. [§10-7-115]	
Connecticut	Conn. Gen. Stat. § 38a-291	§ 38a-291 – 1992	Common Law Insurable Interest	

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State	Citation	Date of Enactment	Employer Insurable Interest	Employee Consent
Delaware	Del Code Ann. tit. 18 §§ 2708(4), 2704; Regulation 64 § 4	§ 2708(4) – 1953 § 2704 – 1953; the section was updated in 2002, but the changes to the section do not affect the excerpt herein.	Yes. "An employer providing life, health, disability, retirement or similar benefits to some or all of its employees or the employees of its affiliates, or their dependents or beneficiaries, has an insurable interest in the lives of all of its employees or the employees of its affiliates..." [§ 2704(c)(3)] "An "employer owned life insurance policy" means an insurance contract for which an insurable interest exists under paragraph (c)(3) of this section, issued for delivery in this State and procured or effected by any employer, or a trust established by an employer, which employer as defined herein, is incorporated, registered or qualified to do business in this State and has at least 50 employees." [§ 2704(e)(3)]	Employee notification and/or consent not required. "No life or health insurance contract upon an individual, except a contract of group life insurance or of group or blanket health insurance, shall be made or effectuated unless at the time of the making of the contract the individual insured, being of competent legal capacity to contract, applies therefore or has consented thereto in writing, except in the following cases: ... (4) An employer, or the trustee of a trust described in § 2704(c)(3) of this title, may effectuate insurance under an employer owned life insurance policy, as defined in § 2704(e) of this title, upon any employee in whom it has an insurable interest, and the employer or trustee, as the case may be, shall not be required to notify employees of the effectuation of such insurance or obtain their consent. The insurer and any investment sub-advisors shall: a. Use best efforts to direct securities transactions relating to such employer owned variable life insurance policies utilizing separate accounts, through a securities agent licensed and located in this State, as opposed to a securities agent licensed and located in another state, unless a better price for the identical security (securities) is available through the securities agent located in that other state; and b. Direct all insurance and annuity transactions relating to such employer owned life insurance policies through an insurance agent or broker licensed and located in this State." [§ 2708]
District of Columbia				
Florida	Fla. Stat. Ann. § 627.404	§ 627.404 – 1992	No provisions. "An insurer shall be entitled to rely upon all statements, declarations, and representations made by an applicant for insurance relative to the insurable interest which such applicant has in the insured; and no insurer shall incur any legal liability except as set forth in the policy, by virtue of any untrue statements, declarations, or representations so relied upon in good faith by the insurer." [§ 627.404(1)]	Consent required, but not defined for COLI. Lopez v. Life Ins. Co. of America, 406 So.2d 1155 (1981) held: "An insurer has a duty to its insured not to issue a life insurance policy . . . without the knowledge or consent of the insured."

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State	Citation	Date of Enactment	Employer Insurable Interest	Employee Consent
Georgia	Ga. Code Ann. §33-24-3	§33-24-3 – 1995, 2003	Yes. "A corporation, foreign or domestic, has an insurable interest in the life or physical or mental ability of any of its directors, officers, or employees or the directors, officers, or employees of any of its subsidiaries or any other person whose death or physical or mental disability might cause financial loss to the corporation;" [§33-24-3(c)]	No consent required No provisions for group consent
Hawaii	Haw. Rev. Stat. §§ 431:10-202, 431:10-204, 431:10-206	§ 431:10-202 – 1987, 1988 § 431:10-204 – 1987 § 431:10-206 – 1987, 2002	Insurable Interest for someone not related by blood or law requires "a lawful and substantial economic interest in having the life, health or bodily safety of the individual insured continue, as distinguished from an interest which would arise only by, or would be enhanced in value by, the death, disablement, or injury of the individual insured." [§ 431:10-202]	Written consent required but not specific. No group consent exception. - "No life insurance or accident and health or sickness insurance contract upon an individual shall be made or effectuated unless at the time of the making of the contract the individual insured...applies for or consents to the insurance in writing..." [§ 431:10-206]
Idaho	Idaho Code §§ 41-1804, 41-1808	§ 41-1804 – 1961 §41-1808 – 1961	Insurable Interest for someone not related by blood or law requires "a lawful and substantial economic interest in having the life, health or bodily safety of the individual insured continue, as distinguished from an interest which would arise only by, or would be enhanced in value by, the death, disablement, or injury of the individual insured." [§41-1804(3)(b)]	Written consent required, and group exception exists, but neither provision is specific to employer or trust owned insurance. - "No life or disability insurance contract upon an individual, except a contract of group life insurance or of group or blanket disability insurance, shall be made or effectuated unless at the time of the making of the contract the individual insured... applies therefor or has consented thereto in writing..." [§41-1808]

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State	Citation	Date of Enactment	Employer Insurable Interest	Employee Consent
Illinois **Pending Legislation**	215 Ill. § 5/224.1	§ 5/224.1 - 1937, 1992	Yes "Employer insurable interest. Notwithstanding any other Section of this Code, an employer or an employer sponsored trust for the benefit of its employees has an insurable interest in the lives of the employer's directors, officers, managers, nonmanagement employees, and retired employees and may insure those lives on an individual or group basis with the consent of the insured. The consent requirement will be satisfied if the insured is provided written notice of the coverage and does not reject such coverage within 30 days of receipt of such notice. The extent of the employer's or the trust's insurable interest for nonmanagement and retired employees shall be limited to an amount commensurate with the employer's projected unfunded liabilities to nonmanagement and retired employees for welfare benefit plans, as defined by the Employee Retirement Income Security Act of 1974..." [§ 5/224.1]	Written notice and negative consent required. "...The consent requirement will be satisfied if the insured is provided written notice of the coverage and does not reject such coverage within 30 days of receipt of such notice..." [§ 5/224.1]
Indiana	Ind. Code Ann. § 27-1-12-17.1	§ 27-1-12-17.1 - 1995	Yes. "An employer that provides life insurance, health insurance, disability insurance, retirement benefits, or similar benefits to an employee of the employer has an insurable interest in the life of the employee. The trustee of a trust established by an employer for the benefit of the employer has the same insurable interest as the employer in the life of an employee. The trustee of a trust established by an employer that provides life insurance, health insurance, disability insurance, retirement benefits, or similar benefits to an employee of the employer and acts in a fiduciary capacity with respect to that employee or the employee's dependents or beneficiaries has an insurable interest in the life of the employee for whom benefits are to be provided." [§ 27-1-12-17.1(c)]	Written notice and negative consent required. "An employer or the trustee of a trust established by the employer may acquire insurance upon an employee in whom the employer or the trustee of the trust has an insurable interest as determined under subsection (c) if the employee consents to be insured. An employee consents to be insured if the employee is provided written notice of the insurance coverage and does not object to the insurance coverage within thirty (30) days of receipt of the notice." [§ 27-1-12-17.1(d)]

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State	Citation	Date of Enactment	Employer Insurable Interest	Employee Consent
Iowa	Iowa Code Section 22 511.40	Section 22 511.40 2003	"1. As used in this section, "employees" includes officers, managers, and directors of an employer, and the shareholders, partners, members, proprietors, or other owners of the employer. 2. An employer and a trust established by the employer for the benefit of the employer or for the benefit of the employer's active or retired employees has an insurable interest in each of the lives of the employer's active or retired employees and may insure their lives on an individual or group basis." [Section 22 511.40]	"4. On and after July 1, 2003, an employer or trust shall obtain the written consent of each employee being insured by an employer and trust pursuant to this section before insuring the employee's life." [Section 22 511.40]
Kansas	Kansas Statute §40-452	§ 40-452 – 1993	Yes. "(a) An employer, or a trust which is sponsored by an employer for the benefit of its employees, shall have an insurable interest in each of the lives of the employer's employees, directors or retired employees...(c) The extent of the employer's or trust's insurable interest in nonmanagement and retired employees shall be limited to an amount commensurate with the aggregate projected liabilities to such employees under all employee welfare benefit plans..." [§40-452]	Written notice and negative consent required. "The consent requirement of subsection (a) shall be deemed to be satisfied if: (1) The employee, director or retired employee is provided with a written notice that the employer or trust intends to obtain life insurance coverage with respect to such person's life; and (2) the employee, director or retired employee fails to provide written notification to the employer or trust, within 30 days from the date that the notice was transmitted, that such person does not consent to the employer obtaining life insurance coverage on such person's life. [§40-452(b)]
Kentucky	Kentucky Revised Statutes §§ 304.14-040, 304.14-080	§ 304.14-040 – 1970, 1992, 1994 § 304.14-080 – 1970, 1994	Yes. "Any domestic or foreign corporation which provides its active or retired employees with benefits under a retirement or other employee benefit plan governed by the Federal Employee Retirement Income Security Act of 1974, as amended, has an insurable interest in the life, health, or bodily safety of any active or retired employee of the corporation or of any of its subsidiaries who is covered by a plan, and any trustee of a trust established by the corporation for the sole benefit of the corporation shall have the same insurable interest in the employee as the corporation itself." [§ 304.14-040(4)(d)]	Written consent required, and group exception exists, but neither provision is specific to employer or trust owned insurance. "No life or health insurance contract upon an individual, except a contract of group life insurance or of group or blanket health insurance, shall be made or effectuated unless at the time of the making of the contract the individual insured...applies therefore or has consented thereto in writing..." [§ 304.14-080]

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State	Citation	Date of Enactment	Employer Insurable Interest	Employee Consent
Louisiana	La. Rev. Stat. §§ 22:613 , 22:616	§ 22:613 – 1958, 1979, 1987, 1995 § 22:616 – 1958	"[Insurable Interest] In the case of other persons, a lawful and substantial economic interest in having the life, health or bodily safety of the individual insured continue, as distinguished from an interest which would arise only by, or would be enhanced in value by, the death, disablement or injury of the individual insured." [§22:613(c)(2)]	Written consent required, and group exception exists, but neither provision is specific to employer or trust owned insurance. "No life or health and accident insurance contract upon an individual, except a contract of group life insurance or of group or blanket health and accident insurance as defined in this Code, shall be made or effectuated unless at the time of the making of the contract the individual insured, being of competent legal capacity to contract, in writing applies therefor or consents thereto..." [§22:616]
Maine	Maine Revised Statutes Title 24A, Ch. 27, §§ 2404, 2408	§ 2404 – 1991, 2003 § 2408 – 1989	Yes. "A corporation has an insurable interest in the lives of its employees, former employees and retirees for the purpose of funding, in the aggregate, all or part of the corporation's cost for preretirement and postretirement medical, death, disability and pension benefits to its employees, former employees, retirees or their beneficiaries, provided that an insurance program used to finance these employee benefits includes former employees, retirees or a broad class of employees selected by objective standards related to age, service, sex or category of employment and that the proceeds created by that insurance program are used for the sole purpose of funding the corporations' preretirement or postretirement benefit programs." [§ 2404(3)(D)]	Written consent required. "No life or health insurance contract upon an individual, including contracts which may arise under section 2404, subsection 3, paragraph D, may be made or effectuated, unless at the time of the making of the contract the individual insured, being of competent legal capacity to contract, applies for coverage or has provided written consent..." [§2408(1)]

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State	Citation	Date of Enactment	Employer Insurable Interest	Employee Consent
Maryland	Md. Ins. Code §§ 12-201, 12-202	§ 12-201 – 1957, 1995, 2001 § 12-202 – 1957, 1995	Yes "(4)(i) This paragraph applies only to employees with respect to whom the corporate employer or an employer sponsored trust for the benefits of employees is the beneficiary under an insurance contract, if the employer is: 1. a private corporation; or 2. a public corporation, the stock of which is traded on a recognized stock exchange or traded in accordance with the NASDAQ Systems. (ii) A lawful and substantial economic interest exists in: 1. a key employee of a private corporation or a public corporation described in subparagraph (i) of this paragraph; and 2. a non-key employee of a public corporation described in subparagraph (i) of this paragraph if: A. the employee has been employed by the public corporation for at least 12 consecutive months and consents in writing to the insurance contract; and B. the amount of insurance coverage on the non-key employee does not exceed an amount commensurate with employer-provided benefits." [§12-201(b)(4)]	Written consent is required from a non-key employee of a public corporation. [§12-201(b)(4)(ii)(2)] A group exception exists, but is not specific to employer owned life insurance. "(a) *In general* (1) This subsection does not apply to a contract of group life insurance or group or blanket health insurance. (2) ...a life insurance or health insurance contract may not be made or put into effect unless at the time of making the contract the individual to be insured:... (ii) applies for or consents in writing to the contract." [§ 12-202]

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State	Citation	Date of Enactment	Employer Insurable Interest	Employee Consent
Massachusetts	Mass. Gen. Laws Ch. 175:123A , 175:123		Yes. "A corporation, foreign or domestic shall be deemed to have an insurable interest, including without limitation, in the life or physical or mental ability of: (i) any of its directors, officers, or employees or the directors, officers, or employees of any of its subsidiaries; (ii) any other person whose death or physical or mental disability might cause financial loss to the corporation; (iii) a shareholder pursuant to any contractual arrangement with said shareholder concerning the reacquisition of shares owned by him at the time of his death or disability or (iv) the principal obligor pursuant to a contract obligating the corporation as part of compensation arrangements or pursuant to a contract obligating the corporation as guarantor or surety..." [Ch.175: §123A (1)]	Written consent required, and group exception exists, but neither provision is specific to employer or trust owned insurance. "No life company shall issue any policy of life or endowment insurance in this commonwealth except upon a written application therefor signed or assented to in writing by the person to be insured... This section shall not apply to contracts based upon the continuance of life, such as annuity or pure endowment contracts...nor shall it apply to contracts of group life insurance..." [Ch.175: §123]
Michigan	Michigan Compiled Laws §500.2210	§500.2210 - 1990, 1994, 1998	Yes. "...an employer or a trust has an insurable interest in, and may, with the written consent of the insured, insure on an individual or group basis for its benefit the lives of the employer's directors, officers, managers, nonmanagement employees, and retired employees. An employer or a trust may insure the lives of the employer's nonmanagement employees and its retired employees only if those persons give written consent to be insured and the coverage is limited to an amount reasonably commensurate with the employer's projected unfunded liabilities to nonmanagement and retired employees for employee benefit plans..." [§500.2210 (2)]	Written consent required. [§500.2210 (2)] Written notice and negative written consent required for a trust maintained for the purpose of providing the cost of benefits under an employee benefit plan. [§500.2210 (3)]

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State	Citation	Date of Enactment	Employer Insurable Interest	Employee Consent
Minnesota	Minn. Stat. § 61A.074, subdiv. 1	§ 61A.074, subdiv. 1 – 1992, 1994	Yes. "A corporation or the trustee of a trust providing life, annuity, health, disability, retirement, or similar benefits to employees of one or more corporations, and acting in a fiduciary capacity with respect to the employees, retired employees, or their dependents or beneficiaries, has an insurable interest in the lives of employees for whom the benefits are to be provided. The written consent of the insured is required if the insurance purchased under this subdivision is payable to the corporation or to the trustee." [§61A.074, subdiv. 1]	Written consent is required. [§61A.074 subdiv. 1]
Mississippi	Miss. Code §§ 83-5-251, 83-5-253	§ 83-5-251 – 1992, 1993 § 83-5-253 – 1992	Yes There is an insurable interest if, "the person has a lawful and substantial economic interest in having the life, health or bodily safety of the insured continue, as distinguished from an interest which would arise only by, or would be enhanced in value by, the death, disablement or injury of the insured;" [§ 83-5-251(3)(b)] ""Person" as used herein means artificial as well as natural persons, includes all public and private corporations as well as individuals, and includes a trust whose principal beneficiaries have an "insurable interest" as used herein. Any trust with policies issued after July 1, 1992, shall be deemed persons under this section." [§83-5-251(5)]	Written consent required, and group exception exists, but neither provision is specific to employer or trust owned insurance. "No life or health insurance contract upon an individual, except a contract of group life insurance or annuity or of group health insurance, or replacement contracts, shall be made or effectuated, unless at the time of the making of the contract the insured, applies therefor or has consented thereto in writing or has had the application acknowledged in writing by the insurance company..." [§83-5-253]

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State	Citation	Date of Enactment	Employer Insurable Interest	Employee Consent
Missouri	Missouri Revised Statutes §376.531	§ 376.531 – 1992, 1994	Yes "2. An employer, or a trust which is sponsored by an employer for the benefit of its employees, shall have an insurable interest in each of the lives of the employer's employees, directors or retired employees...the employer or trust may insure such employees', directors' or retired employees' lives for such employer's or trust's benefit on an individual or group basis with the consent of the insured. The consent requirement shall be deemed to be satisfied if: (1) The employee, director or retired employee is provided with a written notice that the employer or trust intends to obtain life insurance coverage with respect to such person's life; and (2) The employee, director or retired employee fails to provide written notification to the employer or trust, within thirty days from the date that the notice was transmitted, that such person does not consent to the employer obtaining life insurance coverage on such person's life... 3. The employer's or trust's insurable interest in nonmanagement and retired employees shall be limited to an amount of aggregate projected death benefits commensurate with the aggregate projected liabilities to such employees under all employee welfare benefit plans" [§ 376.531]	Written notification and negative written consent is required.
Montana	Montana Code Annotated § 33-15-201, 33-15-401	§ 33-15-201 – 1959, 1981, 1991 § 33-15-401 – 1959	Insurable interest includes, "in the case of other persons, a lawful and substantial economic interest in having the life, health, or bodily safety of the individual insured continue, as distinguished from an interest which would arise only by or would be enhanced in value by the death, disablement, or injury of the individual insured." [§ 33-15-201(3)(b)]	Written consent required, and group exception exists, but neither provision is specific to employer or trust owned insurance "No life or disability insurance contract upon an individual, except a contract of group life insurance or of group or blanket disability insurance, shall be made or effectuated unless at the time of the making of the contract the individual insured, being of competent legal capacity to contract, applies therefor or has consented thereto in writing..." [§ 33-15-401]

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State	Citation	Date of Enactment	Employer Insurable Interest	Employee Consent
Nebraska	Nebraska Statutes §44-103, §44-704	§44-103 – 1913, 1919, 1984, 1989, 2001 §44-704 – 1913, 1919, 1925, 1933, 1937, 1941, 1957, 1992, 1995	"Insurable interest, in the matter of life and health insurance, exists when the beneficiary because of relationship, either pecuniary or from ties of blood or marriage, has reason to expect some benefit from the continuance of the life of the insured;" [44-103(13)(b)]	Written consent required, and group exception exists, but neither provision is specific to employer or trust owned insurance. "...no policy of insurance shall be issued upon the person of any individual except upon the application of the individual insured or with the written consent of the individual insured... The term policy of insurance as used in this section shall include any life insurance policy, annuity contract, and contract of sickness and accident insurance but shall not include a contract of group life insurance or a contract of blanket or group sickness and accident insurance." [§44-704]
Nevada	Nevada Revised Statutes §§ 687B.040, 687B.080	§ 687B.040 – 1971, 1997 § 687B.080 – 1971, 1993	"[Insurable interest exists] In the case of other persons, a lawful and substantial economic interest in having the life, health or bodily safety of the person insured continue, as distinguished from an interest which would arise only by, or would be enhanced in value by, the death, disablement or injury of the person insured." [§ 687B.040(3)(b)]	Written consent required, and group exception exists, but neither provision is specific to employer or trust owned insurance. "...no life or health insurance contract upon a person, except a contract of group life insurance or of group or blanket health insurance, may be made or effectuated unless at the time of the making of the contract the person insured, being of competent legal capacity to contract, applies therefor or has consented thereto in writing." [§ 687B.080(1)]
New Hampshire	N.H. Rev. Stat. § 408:2-a	§ 408:2-a – 1993	"Nothing in this section shall affect the right of any person to effectuate life insurance on such person's own life, or by a person or any business entity on another life if there exists any reasonable expectation of pecuniary benefit or advantage, direct or indirect, in the continued life of the other person." [§408:2-a (III)]	Written consent required. Not specific to employer owned insurance policies. "No life insurance policy may be issued under this section unless the insured has consented in writing to the issuance of such policy." [§408:2-a (IV)]

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State	Citation	Date of Enactment	Employer Insurable Interest	Employee Consent
New Jersey	New Jersey Statutes §17B: 24-1.1	§ 17B: 24-1.1 – 1991, 1992	Yes "A corporation has an insurable interest: (a) in the life or physical or mental ability of any of its directors, officers, or employees, or the directors, officers, or employees of any of its subsidiaries or any other person whose death or physical or mental disability might cause financial loss to the corporation; (b) pursuant to any contractual arrangement with any shareholder concerning the reacquisition of shares owned by him at the time of his death or disability, in the life or physical or mental ability of that shareholder for the purpose of carrying out that contractual arrangement; (c) pursuant to any contract obligating the corporation as part of compensation arrangements, in the life of the individual for whom compensation is to be provided; or (d) pursuant to a contract obligating the corporation as guarantor or surety, in the life of the principal obligor..." [§17B: 24-1.1(4)]	No provisions.
New Mexico	N.M. Stat. Ann. §§ 59A-18-4, 59A-18-8	§ 59A-18-4 – 1984 § 59A-18-8 – 1984	"[Insurable interest exists] in the case of other persons, a lawful and substantial economic interest in having the life, health or bodily safety of the insured individual continue, as distinguished from an interest which would arise only, or would be enhanced in value, by the death, disablement or injury of the individual insured." [§59A-18-4(C)(2)]	Written consent required, and group exception exists, but neither provision is specific to employer owned insurance. "No life or health insurance contract upon an individual, except a contract of group life insurance or of group or blanket health insurance, shall be made or effectuated unless at the time of the making of the contract, such individual applies therefor or has consented thereto in writing." [§ 59A-18-8]

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New York	N.Y. Ins. Law §3205		Yes. "In addition to any other basis under which either an employer, or an irrevocable trust established by one or more employers or one or more employers and one or more labor unions, have an insurable interest in the lives of any of its employees or retirees or those of its subsidiaries or affiliated companies, an employer or such a trust shall have an insurable interest in the lives of any such employees or retirees who are participants or who are eligible to participate, upon the satisfaction of age, service or similar eligibility criteria, in an employee benefit plan, established or maintained by an employer as defined by the federal Employee Retirement Income Security Act of 1974." [§3205(d)]	Written consent required. "The employer...prior to or at the commencement of any such coverage notifies prospective insureds in writing that coverage is being obtained on their lives, requires that prospective insureds consent in writing to such coverage, provides each consenting insured the right to have any coverage on his/her life issued under the authority of this subsection discontinued at any time and describes in the notice the method the insured may use to terminate coverage..." [§3205(d)(1)]
North Carolina **Pending Legislation**	N.C. Gen. Stat. §§ 58-58-75; 58-58-85	§ 58-58-75 - 1951, 1957 § 58-58-85 - 1951	Yes. "An employer, whether a partnership, joint venture, business trust, mutual association, corporation, any other form of business organization, or one or more individuals, or any religious, educational, or charitable corporation, institution or body, has an insurable interest in and the right to insure the physical ability or the life, or both the physical ability and the life, of an employee for the benefit of such employer. Any principal shall have a life insurable interest in and the right to insure the physical ability or the life, or both the physical ability and the life, of an agent for the benefit of such principal." [§ 58-58-75]	No provisions.

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North Dakota	N.D. Cent. Code § 26.1-29-09.1	§ 26.1-29-09.1 – 1985, 1987, 1989, 1993, 1995, March 26, 2003	"[Insurable interest] In the case of a corporation or the trustee of a trust providing life, health, disability, retirement, or similar benefits to employees of one or more corporations, and acting in a fiduciary capacity with respect to the employees, retired employees, or their dependents or beneficiaries, a corporation or the trustee of a trust has an insurable interest in the lives of employees for whom the benefits are to be provided and the corporation or trustee of a trust may purchase, accept, or otherwise acquire an interest in personal insurance as a beneficiary or owner. Written consent of the insured individual is required if the personal insurance purchased names the corporation or the trustee of a trust as a beneficiary." [§ 26.1-29-09.1(3)(e)]	Written notice and affirmative consent required. "...Written consent of the insured individual is required if the personal insurance purchased names the corporation or the trustee of a trust as a beneficiary." [§ 26.1-29-09.1(3)(e)]
Ohio	Ohio Rev. Code §3911.091	§3911.091 – 1995	Yes. "An employer, or a trust that is sponsored by an employer for the benefit of its employees, has an insurable interest in each of the lives of its employees, directors, and retired employees [§3911.091(B)]... An employer's or trust's insurable interest in the lives of its nonmanagement and retired employees is limited to an amount of aggregate projected death benefits commensurate with the aggregate projected gross liabilities for such employees under all employee benefit plans..." [§3911.091(C)]	Written notice and written consent required. "...an employer or trust may insure for its own benefit the lives of its employees, directors, or retired employees, on an individual or group basis, with the prior written consent of the prospective insured. At the time the employer or trust seeks the consent of the prospective insured, the employer or trust shall disclose in writing to the prospective insured that the employer or trust may maintain the proposed life insurance in force after the insured's employment terminates or the insured's retirement benefits expire." [§3911.091(B)]

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Oklahoma	Okla. Stat. Ann. tit. 36 §3604	§ 3604 – 1957, 1989, 1991, 1994, 1999	Yes. "An employer, or a trust which is sponsored by an employer for the benefit of its employees, shall have an insurable interest in each of the lives of the employees, directors, or retired employees of the employer...the employer or trust may insure the life of any employee, director, or retired employee for the benefit of the employer or trust on an individual or group basis only with the written consent of the insured." [§36-3604(C)(4)(a)] "The insurable interest of the employer or trust in nonmanagement and retired employees shall be limited to an amount agreed to by the employee or, in the absence of an agreement, an amount of aggregate projected death benefits commensurate with the aggregate projected liabilities to the employee under all employee welfare benefit plans..." [§36-3604(C)(4)(d)]	"The consent requirement... shall be accomplished as follows: (1) the employer shall notify the employee, director, or retired employee by a written notice that the employer or trust would like to obtain life insurance coverage with respect to the person's life, and (2) if the employee, director, or retired employee fails to provide written consent to the employer or trust, the employer or trust shall not purchase or obtain such insurance." [§36-3604(C)(4)(b)]
Oregon	Oregon Revised Statutes §§ 743.024, 743.027	§ 743.024 – 1967 § 743.027 – 1967, 1991	"Any individual of competent legal capacity may procure or effect an insurance policy on the individual's own life or body for the benefit of any person...no person shall procure or cause to be procured any insurance policy upon the life or body of another unless the benefits under such policy are payable to the individual insured or the personal representatives of the individual, or to a person having, at the time such policy was entered into, an insurable interest in the individual insured." [§ 743.024(1)] "An insurer shall be entitled to rely upon all statements, declarations and representations made by an applicant for insurance relative to the matter of insurable interest. No insurer shall incur legal liability, except as set forth in the policy, by virtue of any untrue statements, declarations or representations so relied upon in good faith by the insurer." [§ 743.024(3)]	Written consent required, and group exception exists, but neither provision is specific to employer or trust owned insurance. "No life or health insurance policy upon an individual, except a policy of group life insurance or of group or blanket health insurance, shall be made or effectuated unless at the time of the making of the policy the individual insured, being of competent legal capacity to contract, applies therefor or has consented thereto in writing..." [§ 743.027]

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State	Citation	Date of Enactment	Employer Insurable Interest	Employee Consent
Pennsylvania **Legislation Pending**	Penn. Stat. Title 40, Art. IV §512	§512 – 1921, 1951, 1992	Yes. "...corporations may insure the lives and health of officers, directors, principals, partners, and employees, without the signing of a personal application as hereinbefore required...The term "insurable interest" is defined as meaning...in the case of other persons, a lawful economic interest in having the life of the insured continue, as distinguished from an interest which would arise only by the death of the insured..."	No consent required.
Puerto Rico				
Rhode Island	R.I. Gen. Laws § 27-4-27	§ 27-4-27 – 1990, 1992	Yes. "In the case of employees of public and private corporations, with respect to whom the corporate employer or an employer-sponsored trust is the beneficiary under the insurance contract, a lawful and substantial economic interest exists in: (i) Key employees; and (ii) Employees other than those identified in subdivision (c)(3)(i), and former employees and retirees for the purpose of funding, in the aggregate, all or part of the corporation's cost for preretirement and postretirement benefits; provided, (A) that the amount of insurance coverage on these employees will be limited to an amount commensurate with employer-provided benefits to those employees, (B) that an insurance program used to finance these employee benefits includes former employees, retirees, or a broad class of employees selected by objective standards related to age, service, sex, or category of employment, and (C) that the proceeds created by that insurance program used for the sole purpose of funding the corporation's preretirement or postretirement benefit programs..." [§ 27-4-27(c)(3)]	Consent required, not specific to employer owned policies. "...Any life insurance company doing business within the state may issue policies of insurance predicated upon the life or lives of any person or persons with the consent of the insured or insureds..."[§ 27-4-27(a)]

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State	Citation	Date of Enactment	Employer Insurable Interest	Employee Consent
South Carolina	S.C. Stat. § 38-63-100	§ 38-63-100 – 1992	Common Law Insurable Interest Certain charities and nonprofit corporations have an insurable interest. "Notwithstanding any other provision of law, a bona fide charity or nonprofit corporation which is in compliance with the "Solicitation of Charitable Funds Act" (Chapter 55 of Title 33) has an insurable interest in the life of an insured under a policy in which the charity or corporation is irrevocably named as a beneficiary provided that the application for insurance is signed by the insured. The provisions of this section do not limit or abridge any insurable interest or right to insure now existing at common law or by statute, shall be construed liberally to sustain insurable interest, and shall stand as a declaration of existing law applicable to all life insurance policies in existence on or after the effective date of this section." [§ 38-63-100]	Consent required. Ramey v. Carolina Life Ins., 135 S.E.2d 362 (1964), Held: A policy of insurance on the life of the insured without the insured's knowledge or consent is against public policy and void.
South Dakota	S.D. Codified Laws §§ 58-10-4, 58-10-6	§ 58-10-4 – 1966, 1989, 1992 § 58-10-6 – 1966	"[Insurable interest] For other persons, a lawful and substantial economic interest in having the life, health, or bodily safety of the individual insured continue, as distinguished from an interest which would arise only by, or would be enhanced in value by, the death, disablement, or injury of the individual insured..." [§ 58-10-4(2)]	Written consent required, and group exception exists, but neither provision is specific to employer or trust owned insurance. "No life or health insurance contract upon an individual, except a contract of group life insurance or of group or blanket health insurance, shall be made or become effective unless at the time of the making of the contract such individual applies therefor or has consented thereto in writing..." [§ 58-10-6]

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State	Citation	Date of Enactment	Employer Insurable Interest	Employee Consent
Tennessee	Tenn. Code § 56-7-314	§ 56-7-314 – 1992	Common Law insurable interest. "If an organization described in either § 501(c)(3) or § 170(c) of the Internal Revenue Code of 1986, as amended, purchases or receives by assignment, before, on or after April 23, 1992, life insurance on an insured who consents to the purchase or assignment, the organization is deemed to have or to have had an insurable interest in the insured person's life on the date of purchase or assignment. This section does not limit or abridge any insurable interest existing on April 23, 1992, at common law or by statute." [§ 56-7-314]	Consent required, but not defined. Interstate Life & Accident v. Cook, 865 S.W. 2d 887 (1935), held: irrespective of existence of insurable interest, life policy procured without consent of insured is void as against public policy, even if insurer knew at time it issued policy that the insured did not know it.
Texas	Tex. Ins. Code § 3.49-1, sec. 3	§ 3.49-1, sec.3 – 1953, 1999	Yes. "Any person of legal age may consent in writing to the purchase of or the application for an individual or group insurance policy or policies issued by any legal reserve or mutual assessment life insurance company by a third party or parties and in such written document consent to or designate any person, persons, partnership, association, corporation or other legal entity, or any combination thereof, as the absolute or partial owner or owners or beneficiary, or any combination thereof, of any policy or policies issued in connection with such consent or designation; and with respect to any such policy or policies any such owner or beneficiary shall at all times thereafter have an insurable interest in the life of such person, [except for persons involved in burying the dead]." [§ 3.49-1, sec. 3]	Written consent required. See employer insurable interest.

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State	Citation	Date of Enactment	Employer Insurable Interest	Employee Consent
Utah	Utah Code §31a-21-104	§31a-21-104 – 1953, 1985, 1986, 1991, 1993, 1994, 1996, 2001, 2002	""Insurable interest" in a person means...in the case of other persons, a lawful and substantial interest in having the life, health, and bodily safety of the person insured continue..." [§31a-21-104(2)(a)(i)(B)]	Written consent required, not specific to employer owned life insurance. "...an insurer may not knowingly issue an individual life or accident and health insurance policy to a person other than the one whose life or health is at risk unless that person...has given written consent to the issuance of the policy. The person shall express consent either by signing an application for the insurance with knowledge of the nature of the document, or in any other reasonable way..." [§31a-21-104(3)]
Vermont	No provisions			
Virginia	Va. Code Ann. §§ 38.2-301, 38.2-302	§ 38.2-301 – 1952, 1986, 1988, 1992, 1993 § 38.2-302 – 1952, 1986, 1988, 1993	Yes. "[Insurable Interest] In the case of employees of corporations, with respect to whom the corporate employer or an employee benefit trust is the beneficiary under an insurance contract, the lawful and substantial economic interest required in subdivision 2 of this subsection shall be deemed to exist in (i) key employees; and (ii) other employees who have been employed by the corporation for twelve consecutive months, provided that the amount of insurance coverage on such other employees shall be limited to an amount which is commensurate with employer-provided benefits to such employees..." [§ 38.2-301(B)(3)]	Written notice is required. "A corporate employer or an employee benefit trust having the insurable interest described in subdivision 3 of subsection B of § 38.2-301, may effect an insurance contract upon the lives of such employees, provided that the employer or trust provides the employee with notice in writing that such insurance has been purchased, the amount of such coverage, and to whom benefits are payable in the event of the employee's death." [§ 38.2-302(A)(3)]
Washington **Legislation Pending**	Wash. Rev. Code §§ 48.18.030, 48.18.060	§ 48.18.030 – 1947, 1973, 1992 § 48.18.060 -- 1947	"[Insurable interest] In the case of other persons, a lawful and substantial economic interest in having the life, health or bodily safety of the individual insured continue, as distinguished from an interest which would arise only by, or would be enhanced in value by, the death, disablement or injury of the individual insured." [§ 48.18.030(3)(b)]	Written consent required, and group exception exists, but neither provision is specific to employer or trust owned insurance. "No life or disability insurance contract upon an individual, except a contract of group life insurance or of group or blanket disability insurance as defined in this code, shall be made or effectuated unless at the time of the making of the contract the individual insured, being of competent legal capacity to contract, in writing applies therefor or consents thereto..." [§ 48.18.060]

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State	Citation	Date of Enactment	Employer Insurable Interest	Employee Consent
West Virginia	W. Va. Code §§ 33-6-2, 33-6-5	§33-6-2 – 1957, 1992 §33-6-5 – 1957	"[Insurable interest] In the case of other persons, a lawful and substantial economic interest in having the life, health, or bodily safety of the individual insured continue, as distinguished from an interest which would arise only by, or would be enhanced in value by, the death, disablement or injury of the individual insured." [§33-6-2(c)(2)]	Consent required, and group exception exists, but neither provision is specific to employer or trust owned insurance. "No life or accident and sickness insurance contract upon an individual, except a contract of group life insurance or of group accident and sickness insurance, shall be made unless at the time of the making of the contract the individual insured, being of competent legal capacity to contract, applies therefor or consents thereto..." [§33-6-5]
Wisconsin	Wis. Stat. §631.07	§631.07 – 1975, 1977, 1989, 1999, 2001	Insurable interest is not defined. "No insurer may knowingly issue a policy to a person without an insurable interest in the subject of the insurance." [§631.07(1)]	Written consent required, not specific to employer owned insurance. "...no insurer may knowingly issue an individual life or disability insurance policy to a person other than the one whose life or health is at risk unless the latter has given written consent to the issuance of the policy. Consent may be expressed by knowingly signing the application for the insurance with knowledge of the nature of the document, or in any other reasonable way." [§631.07(2)]
Wyoming	Wyo. Stat. Ann. §§ 26-15-102, 26-15-106	§26-15-102 – 1967, 1983 §26-15-106 – 1967, 1983	"[Insurable interest] In the case of other persons, a lawful and substantial economic interest in having the life, health or bodily safety of the individual insured continue, as distinguished from an interest arising only by, or enhanced in value by, the death, disablement or injury of the individual insured..." [§26-15-102(c)(ii)]	Written consent required, and group exception exists, but neither provision is specific to employer or trust owned insurance "No life or disability insurance contract upon an individual, except a contract of group life insurance or of group or blanket disability insurance, shall be made or carried out unless at the time of the making of the contract the individual insured, being of competent legal capacity to contract, applies therefor or has consented thereto in writing..." [§26-15-106(a)]

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Responses to Questions from Stanley B. Tulin

Questions from Senator Smith:

1. If we limit the use of COLI, will we be eliminating a financial tool used by many businesses to bridge the death of a key employee or to pay for commitments the company makes to its employees – like health insurance or compensation? Can you give us a sense of what these companies will do if we eliminate COLI as an option?

   Answer:

   I believe that limiting the use of COLI will increase the cost to companies of providing employee benefits. This will impact the willingness of companies to continue employee benefits they presently provide. To be sure, not all companies will react in the same way. Some companies may continue the benefits unfunded, and some companies may find alternative funding vehicles. But some companies will surely choose to eliminate or reduce benefits in the absence of COLI.

2. I understand that Congress made some significant changes in 1986, 1996 and 1997 to limit the perceived abuses by companies of COLI, like extensive loans against the COLI contracts. And yet we continue to see press reports. What else can be done in the area of COLI tax treatment?

   Answer:

   The principal perceived abuses related to leveraged COLI which were eliminated by the 1986, 1996 and 1997 amendments. While all of the COLI sold today by Equitable Life is done with the employee's consent, I believe that it would be appropriate to ensure by law that in all cases COLI can be purchased on an employee only with the employee's explicit consent. I also believe that COLI need not be allowed with respect to hourly paid employees.

3. Would you agree that businesses also have an economic interest in their former employees and thus should be able to own life insurance policies on their lives? Can you provide this committee with some examples of benefits that could be funded by COLI that would go to former employees? What would be the consequence of allowing insurance only on current employees?

   Answer:

   I believe that the only appropriate time to consider the relationship between the employer and employee is when the contract is purchased. First, some benefits funded by COLI are intended to be provided to the employee after he leaves the company, such as retiree health benefits or deferred compensation paid after retirement. It makes no sense to take away the tax benefits of COLI in those circumstances. Second, the use of COLI as a funding vehicle for benefits such as retiree health uses actuarially derived aggregate funding principles. It is predicated on the long term reliability of the funding and the predictability of cash flows based the mortality of a designated group. Tax rules which made it uneconomic to continue COLI policies if an employee left the company would add great uncertainty and volatility to the program and make delivery of the benefits more expensive.

RICHARD E. NEAL
SECOND DISTRICT, MASSACHUSETTS
WHIP-AT-LARGE

COMMITTEE ON WAYS AND MEANS
SUBCOMMITTEE ON TRADE
COMMITTEE ON BUDGET

Congress of the United States
House of Representatives
Washington, DC 20515

Statement for the Record of Representative Richard Neal (D-MA)
Hearing on Company-Owned Life Insurance
Senate Finance Committee
October 23, 2003

Mr. Chairman, Mr. Baucus, and members of the Committee, thank you for the opportunity to submit comments as part of your hearing into Company-Owned Life Insurance (COLI). The Committee, following the lead of Senator Bingaman, is to be commended for asking that the uses of COLI be reviewed in light of the recent media stories. However, as I am sure the Committee recognizes, there are beneficial uses of COLI that have not been focused on in the media stories. I am hopeful that the Committee will craft a compromise ending the egregious abuses as reported, while still allowing these legitimate insurance products to continue.

My understanding of the COLI market is through the practices of my constituent MassMutual Financial Services, which has always focused COLI sales in a more limited market. MassMutual's business and underwriting standards always kept it out of the broad-based market, the subject of many of these news stories. The company has always required notice and written consent of the employee to become insured under an insurance contract owned by the employer. MassMutual COLI cases typically cover as few as 100 lives, are individually underwritten, and only cover officers or senior employees of the employer. Moreover, MassMutual requires that the coverage obtained be supported by projected benefits offered to covered employees. I understand that MassMutual practices have increasingly become the standard in the industry, as states have been tightening their insurable interest laws to require the written consent of the insured employee and to require either that the coverage be tied to benefits that the insured employee is eligible to receive or that the insured employee be more senior than "rank and file."

As the hearing today will surely highlight, COLI is a uniquely attractive financial product to meet future needs of a business: policy values grow over time commensurate with the projected expenses of benefit liabilities, and death benefits are guaranteed. Continuation of employee welfare benefits is a major public policy issue that has been a focus of concern in recent years for both the Senate Finance Committee and the House Ways and Means Committee, on which I serve. One prominent example is health insurance for retirees. Health benefits get costlier over time and are particularly so for older workers and retirees, whose health demands are substantial. Tax efficient sources of funds to pay for these benefits should be preserved as the means to encourage the continuation of these benefits. COLI serves as such a source.

It is certainly timely for the Committee to investigate and support proposals to curtail abuses in the COLI market, such as the proposal by Senator Conrad. The concepts embodied in Senator Conrad's proposal are sound, balancing Senator Bingaman's well-founded concerns about ending

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abusive uses of COLI, with the desirability of preserving COLI's beneficial uses. Senator Conrad's proposal builds on the amendment proposed by Senator Bingaman, and includes important provisions, such as: employee written consent, permitting employers to purchase life insurance on the lives of highly compensated employees (using the definition already in law), an exception for contracts meeting specified employee funding requirements, and a prospective application for these changes.

I strongly believe that life insurance policies play an important role in helping businesses protect their financial interests. The reasoned concepts included in the proposal offered by Senator Conrad will permit businesses to use life insurance to protect against financial loss from the deaths of key employees. In addition, businesses will be permitted to use life insurance to fund benefit programs. Like Senator Bingaman's proposals, the use of life insurance as a tax motivated corporate financing arrangement would be curtailed. I commend both Senators Bingaman and Conrad for their work on this issue and encourage the Finance Committee to work towards a bipartisan compromise eliminating the abusive practices, while preserving the market for legitimate company-owned life insurance.

-End-

Statement of Andrew D. Pike[*]
Associate Dean for Academic Affairs and Professor of Law
American University, Washington College of Law
before the
Senate Finance Committee
October 24, 2003

Mr. Chairman and Members of the Committee:

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

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

Summary and Conclusions

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

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

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

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

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

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

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

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

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

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

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

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

In recent years, large corporations have purchased life insurance contracts that insure the lives of large numbers of their employees. Reports in the Wall Street Journal and other newspapers have referred to these arrangements as "janitor's insurance." According to these

reports, the employees were not notified that their employer had purchased life insurance on their lives.

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

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

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

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

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

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

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

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

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

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

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

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

Third, if Congress determines that corporations should be able to earn tax-free earnings on funds set aside to pay employee benefits, it should do so in a manner that encourages sound

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

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

- test 1: the death benefits are either (1) payable to a member of the insured's family (or a trust for such a family member) or the insured's estate or (2) are used to purchase an equity interest in the employer from a family member, trust for a family member or the insured's estate.
- test 2: the life insurance contract covers highly compensated employees, as defined in section 414(q).
- test 3: each insured employee consents to the issuance of the life insurance contract and:
  - the insured is an employee who is eligible to participate in any employee pension plan (other than a qualified plan described in section 401(a) or other benefit plan under which benefits are payable to a participant (or a beneficiary designated by the participated);
  - the aggregate amount of death benefits under the COLI arrangements must be "reasonably related" to the current and projected future costs of the benefits established by the employer; and
  - the contract is placed in trust for the exclusive purpose of funding the employee benefit plans.

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

Specifically, under test 2 large corporations will be able to purchase life insurance insuring all the employees who are "highly qualified employees" of the employer (or any

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

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

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

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

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

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

The Tax Court concluded that this arrangement was a sham transaction. Under the sham transaction doctrine, tax benefits are disallowed if the transaction lacks economic effects or substance other than the generation of tax benefits. As a consequence, the court determined that

the taxpayer was not entitled to the claimed tax benefits.

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

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

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

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

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

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

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

of $10 billion. The unborrowed cash value represents ten percent of the bank's assets. In this example, IRC section 264(f) would disallow ten percent of the bank's interest expense.

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

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

TESTIMONY OF

ROBERT PLYBON

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]

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[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

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[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 disadvantageous 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. BROAD BENEFITS OF COLI TO EMPLOYEES

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

[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. This was a proper business purpose. [emphasis 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

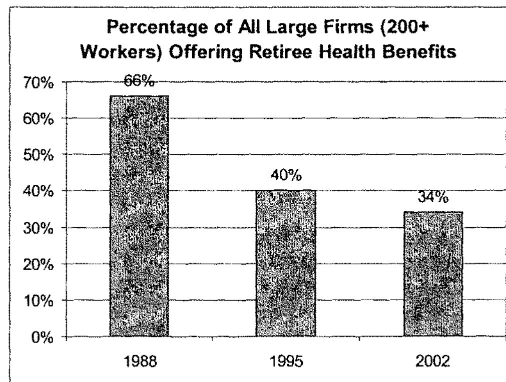
[11] Id. at 10.

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.



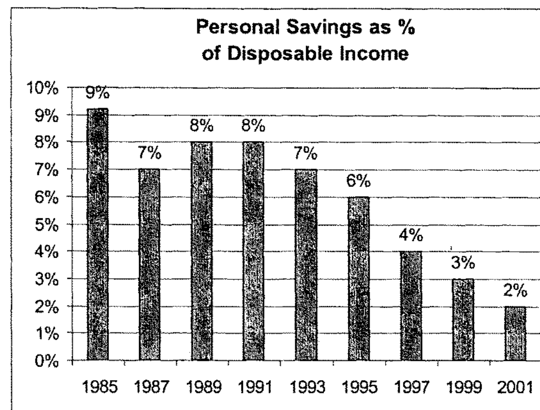
Source: *Employer Health Benefits – 2002 Annual Survey – Retiree Health Benefits*; The Kaiser Family Foundation and Health Research and Educational Trust

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.

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November 3, 2003

Dear Chairman Grassley,

Thank you for the opportunity to come before your committee and provide my thoughts on the importance of business owned life insurance. The questions the committee members asked were insightful, and I applaud your leadership in establishing a forum that we can openly discuss the facts on this important product.

I have enclosed for your review, and for the review of your committee, answers to the questions Senator Smith submitted for the record. Please let me know if you have any further questions or if you would like any additional comments.

Thank you once again for your continued leadership on this important issue.

Sincerely,

Bob Plybon
President, Association for Advanced Life Underwriting

Questions from Senator Smith & AALU Responses:

1. If we limit the use of COLI, will we be eliminating a financial tool used by many businesses to bridge the death of a key employee or to pay for commitments the company makes to its employees – like health insurance or compensation? Can you give us a sense of what these companies will do if we eliminate COLI as an option?

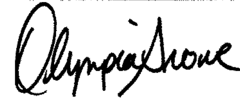
The proposal advanced by Sen. Jeff Bingaman (D-NM) (and adopted by the Finance Committee on September 17) would eliminate many important uses of business-owned life insurance, including use as a mechanism to fund employee benefit programs. If the Bingaman proposal were adopted, fewer companies would be able to offer health benefit and supplemental retirement income programs. Further, for benefit programs that are now in place, the risk would increase that businesses ultimately would lack funds necessary to honor these obligations to employees.

2. I understand that Congress made some significant changes in 1986, 1996 and 1997 to limit the perceived abuses by companies of COLI, like extensive loans against the COLI contracts. And yet we continue to see press reports. What else can be done in the area of COLI tax treatment?

The press reports that you reference have centered largely on the type of leveraged COLI arrangements that were ended by legislation enacted in 1996. Press reports have ignored the positive uses of business-owned life insurance today as a means of funding employee benefit programs. The basic tax treatment of business-owned life insurance today (e.g., tax-free death benefits) is proper. However, the insurance industry strongly supports legislation advanced by Sen. Kent Conrad (D-ND) that would ensure that the best business practices are followed by companies buying life insurance. For example, the Conrad amendment would require companies to obtain consent of employees before purchasing insurance on their lives.

3. Would you agree that businesses also have an economic interest in their former employees and thus should be able to own life insurance policies on their lives? Can you provide this committee with some examples of benefits that could be funded by COLI that would go to former employees? What would be the consequences of allowing insurance only on current employees?

I agree completely. State insurable interest laws have long recognized that businesses have an economic stake in their employees. The question whether an insurable interest is present is made at the time the insurance is purchased. Business-owned life insurance policies remain valid even after the employee retires. In many cases, programs that are funded by business-owned life insurance are designed specifically to benefit workers after they retire. Examples include nonqualified deferred compensation programs and retiree health benefits. If business-owned life insurance policies had to be surrendered when the covered employee retired, the economics of these programs would unravel. Under current practice, 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. Enactment of the Bingaman proposal would destroy the pooled funding approach relied upon today.



STATEMENT FOR SENATE FINANCE COMMITTEE
CORPORATE OWNED LIFE INSURANCE HEARING
Senator Olympia J. Snowe
October 23, 2003

Thank you Mr. Chairman.

I am grateful that you are holding this hearing today to discuss the issue of corporate owned life insurance (COLI). Given the nature of the jurisdiction of the Finance Committee, a number of intricate tax issues are routinely placed before the Members of this Committee.

As such, it is important that complex issues such as the one before us on corporate owned life insurance receive a thorough review so that both Members and the public can be fully informed about the varied viewpoints on the topic and that Congress can take appropriate and measured action if necessary.

Most people are familiar with the basics of life insurance. It has been an important part of our financial system for decades and is used by millions of taxpayers to protect against the loss of a loved one. However, it is undeniable that corporate owned life insurance, or life insurance a company buys on the life of its employees, has had a mixed history.

Many people will remember that in 1996 and again in 1997, Congress became aware of several abusive uses of COLI that involved the combination of debt and life insurance to avoid taxes. As a result, this Committee and Congress took action to closed down these "leveraged COLI" transactions and prevent taxpayers from abusing this product.

The other, more important, side of history is the fact that COLI can and is being used for legitimate and necessary business purposes. It is a well settled area of the law that a company has a business interest in protecting itself from the loss

that would occur if its top employees unexpectedly pass away. This can be particularly devastating for a small business or a family owned business. Many small business owners and their families rely on COLI to protect against these unexpected events and to ensure the continuation of the business.

It is with these taxpayers and legitimate uses in mind that we should approach further changes to the law with caution.

Last month, as part of a broader pension reform bill, this Committee took action on a provision to modify the tax treatment of corporate owned life insurance policies. As we all know, with some exceptions, that provision would limit tax benefits of certain company owned life insurance policies on the lives of former employees. Of particular concern to many was the September 17 effective date of the provision that had the effect of putting a freeze on the market for these policies.

Mr. Chairman, I support you in your decision to revisit this issue in Committee. I believe that after this hearing we will be able to make a more informed decision about how best to proceed, whether or not we should change the tax treatment of COLI and what changes may need to be made in this area.

I am grateful that representatives of the insurance industry are here today and other knowledgeable witnesses to walk us through the history and details of this financial product and to educate us on what is happening in the marketplace.

I look forward to hearing from our witnesses today. Thank you.

United States Senate

Senate Committee on Finance COLI Hearing

Spencer Tillman/Testimony

Mr. Chairman, members of the committee, my name is Spencer Tillman, a businessman and analyst for CBS Sports.

I'm here to offer my thoughts on the matter of corporate owned life insurance.

When my brother Felipe died in 1992, his former employer, Camelot Music, and its parent company CM Holdings Inc. cashed in an insurance policy on his life, enriching themselves by nearly $340,000.

In a similar case, in which the courts found in favor of the deceased family, IRS records presented as evidence detail specifically where the money went. Here are the facts: they used the money to pay their executives more money. Felipe had long since left that company, which raises a red flag concerning CMs' ongoing insurable interest. I found it note-worthy that by the companies' own admission; the amount spent training employees for this low-level position was less than $500.

What is more, Felipe was not operating in a key executive position. The policy on his life was unknown to him and our family. This company as many others today, used Felipe's life as a means to help the company boost its bottom line--a fact myself and my family finds as callous and unethical as can be conceived.

The act of profiting from death and the dying is unavoidable. But this "comprehensive employee life insurance" tactic gambles with employee's lives to profit--hedging their bets--rather than concentrating on good management and sound business principles to turn a profit.

My take on this, ladies and gentlemen, is this practice is nothing more than a sophisticated form of "bounty hunting." Men and women go to work, in effect, with a bounty on their heads. They die, for whatever cause and the bounty flows into the coffers of corporations to be used as the executives see fit. The difference is that workers aren't guilty of any crime and function, in this context, as a commodity to be gambled and bartered. Does it not seem possible, that a business practice which propagates the concept of employees as profitable whether they are employed and working, or dead, would not result eventually in management principles bordering on the unethical?

At the very least, an employee who has a price on their head should at least know what the price is, have to agree to having it placed there, be allowed to have a portion go to their family should they die, and last, should be able to have the insurance policy discontinued if their employment is discontinued.

I didn't come here to rail against corporations or profits. As a former NFL player I know full well the meaning of fierce and violent competition. But there is more to sports and more to business competition than the bottom line, ladies and gentlemen.

The issue is whether using human deaths as a responsible means of gain is immoral and unethical.

As we experience the fallout of shareholder robbery by some of the once most respected corporations in this country, including the financial community, executives are now headed for jail

where they belong. Many corporations are changing their operating procedures, adopting, and I stress enforcing, a code of ethics while adhering to a value system that sets an example of honesty and integrity.

What Felipe's company did to him and our family, and what some of America's Blue Ribbon corporations institute everyday in the name of sound business practice is nothing less than operating in the gutter. What needs to be done is twofold: the media should give these neo-bounty hunters the scrutiny they deserve and bring these practices to the attention of the public more extensively than they already have. Second, Congress needs to pass legislation to put a stop to this robbing of a disproportionately poor Peter to pay and already prosperous Paul -- the same kind of oversight it demonstrated during the age of Enron. Not to do so would be ethically questionable and morally untenable.

Thank you very much for this opportunity. I will be delighted to answer your questions.

COMMUNICATIONS

Statement of

America's Community Bankers

on

Company Owned Life Insurance

before the

Committee on Finance

of the

United States Senate

on

October 23, 2003

America's Community Bankers

Washington, DC

America's Community Bankers is pleased to submit this statement for the record of the Senate Finance Committee October 23, 2003 hearing on "Company Owned Life Insurance". ACB members include state and federally chartered savings institutions and commercial banks. Our members are both stock- and mutually owned. ACB member institutions are integral parts of their communities, serving the financial needs of businesses and individuals.

BOLI

Bank owned life insurance (BOLI) is one of the tools available to community banks to manage risk and finance benefits that attract top notch employees. BOLI helps banks protect themselves against the catastrophic loss of key employees. To enhance the competitiveness of community banks, ACB Business Partners, Inc. offers a BOLI product to ACB community bank members through an alliance with Meyer Chatfield, a leading provider of BOLI products. ACB and its partners consulted closely with the banking regulators and worked hard to assure that the final product meets both their requirements and IRS standards. Banks use of BOLI is closely regulated by the banking regulators, who have set forth requirements for banks to follow as they consider purchasing BOLI. The regulators monitor banks' use of BOLI through the examination process. The GAO recently interviewed banking regulators about banks' use of BOLI and were told that the regulators had reviewed the holdings of banks with significant amounts of BOLI and concluded that supervisory concerns do not exist.

Bingaman Amendment

The amendment to restrict corporate owned life insurance (COLI) offered by Senator Bingaman and adopted by the Finance Committee on September 17, 2003, with its immediate effective date, adversely affected the market for COLI and BOLI. ACB commends Committee members for taking action on October 1, 2003 to modify the effective date of the Bingaman amendment. The change from the September 17, 2003 date to date of enactment was critical. While this action alleviated the immediate negative effect on the market for COLI and BOLI policies, other parts of the Bingaman amendment remain troublesome. They will prevent the effective use of this important business tool. We urge the Committee to make additional modifications to the COLI provisions adopted by the Committee on September 17, 2003.

Conrad Amendment

Senator Conrad has developed an alternative to the Bingaman amendment that will permit businesses to continue to use properly constructed COLI/BOLI policies for managing risk, while addressing perceived abuses. Senator Conrad's amendment focuses on the best practices of the industry. The amendment addresses the highly criticized "janitors insurance," and requires notice and consent of employees who are insured by employers. It would restrict COLI to salaried employees and require that the amount of insurance be reasonably related to the level of corresponding benefit. The Conrad amendment also addresses the definition of "key person," tying it to a definition of highly compensated employee.

Small Business "Key Persons"

While ACB supports the Conrad amendment, we believe that it can be improved to assure that the benefits of COLI/BOLI continue to flow to medium- and small banks and businesses whose compensation structures are below the $90,000 limit contained in the definition of "highly compensated employee." ACB conducts an annual compensation survey of community banks nationwide. The 2003 Compensation Survey shows that the base salary of some community bank executives who would be "key persons" falls below the $90,000 limit. This is especially true for institutions with up to $50 to $100 million in assets and in certain regions of the country where average salaries are generally lower. We suspect the lower compensation levels also are true for other types of businesses. ACB suggests that the definition be modified to include certain officers and directors without a specified compensation level to ensure that those individuals with regular, ongoing executive management authority are not arbitrarily excluded. At a minimum, this type of requirement should be applied to smaller businesses. COLI and BOLI can be of particular benefit to small businesses where the loss of a "key person" can threaten the survival of the business. We also suggest that the Committee consider the definition of "key person" included in guidance issued by the Office of Controller of the Currency (OCC) in OCC Bulletin 2000-23. That definition focuses not on titles or compensation, but on the economic contribution of the employee to the bank. A "key person" is an employee whose absence for an extended period of time would result in a significant loss of income for the bank.

Conclusion

ACB appreciates the willingness of the Senate Finance Committee members to review the effects of the Bingaman amendment on the ability of community banks and other businesses to use COLI and BOLI to manage risk and fund employee benefits. We also are grateful for the recent vote making contemplated changes prospective. ACB urges the Committee to approve the amendment offered by Senator Conrad and modify the language of the Bingaman amendment adopted on September 17, 2003. We also ask you to make certain that COLI and BOLI continue to be available to smaller businesses.

ACB looks forward to working with the Committee to achieve these important goals.

Chamber of Commerce
of the
United States of America

R. Bruce Josten
Executive Vice President
Government Affairs

1615 H Street, N.W.
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202/463-5310

October 21, 2003

The Honorable Charles Grassley
United States Senate
Washington, DC 20510

Dear Mr. Chairman:

On behalf of the U.S. Chamber of Commerce, the world's largest business federation representing more than three million businesses of every size, sector and region, I write regarding the Chamber's concerns with legislative proposals to restrict the use of corporate-owned life insurance (COLI).

COLI provides some very important benefits for employers and employees. A basic one ensures a source of protection for businesses against the loss of key employees. COLI also enables companies to finance many employee benefits, including retiree health insurance.

Congress has scrutinized the uses of COLI frequently in recent years. In the 1990s Congress passed legislation to end perceived abuses of COLI. At the same time, Congress recognized the important benefits COLI can provide to employers and allowed its continued use, within the new guidelines. States also regulate COLI as part of their oversight of the insurance industry.

With this in mind, we are concerned about recent action by the Senate Committee on Finance that would even further restrict, if not eliminate, the remaining uses of COLI by employers. Specifically, we ask you to improve the COLI amendment adopted by the Committee during consideration of the National Employee Savings and Trust Equity Guarantee Act (NESTEG) in September.

The Chamber would prefer no further restrictions on the use of COLI. However, at a minimum, we urge the Committee to support the amendment of Senator Conrad (D-ND) to improve upon the language of the NESTEG bill. The Conrad amendment provides appropriate limits on COLI by codifying the best practices of the industry.

I thank you in advance for your consideration of our concerns.

Sincerely,

R. Bruce Josten

Joint Statement
Honorable Rahm Emanuel
Honorable Gene Green
Hearing of the Senate Committee on Finance
October 23, 2003

"Company-Owned Life Insurance"

Chairman Grassley, Ranking Member Baucus, and distinguished members of this Committee, we commend you for holding this important hearing on the tax treatment of company-owned life insurance (COLI). Two days ago, this Committee held a hearing on initiating efforts to crack down on the widespread use of corporate tax shelters which now cost the Federal government $18 billion annually. We fully support these efforts to restore fairness and accountability to the tax system.

In addition to the schemes highlighted at Monday's hearing, however, are other nefarious tax shelters that should be eliminated, including the tax breaks companies receive when they purchase a type of COLI known as "janitors insurance." These COLI loopholes will cost U.S. taxpayers $1.9 billion in 2004 and $9.2 billion over the next five years, more than the tax breaks for economic empowerment zones or interest paid on student loans during the same period.

Members including ourselves and those in this chamber who want to close the janitors insurance loopholes have been attacked by the industry with the false implication that we are trying to eliminate all COLI. That is simply untrue. Let us be clear: Congress should not prohibit insurance companies from selling COLI or companies from buying it. But there is just no reason for U.S. taxpayers to be subsidizing these private business transactions.

Sadly, tax strategy rather than legitimate business considerations drives the popularity of janitors insurance. Here is how the tax dodge works. When companies buy janitors insurance, the premiums they pay for these policies grow tax-free, and the company enjoys the tax exemption on life insurance investment gains, or "inside buildup." Any annual gains flow directly to the company's income statement. Then, once the insured worker dies, the company receives the tax-free death benefit. Rarely does the benefit go to the family or the intended beneficiary. Tax courts have called the tax benefits derived under these policies "tax shams," and have ruled that these arrangements serve "no legitimate business purpose."

We congratulate Senator Bingaman for his successful janitors insurance amendment to the pension reform legislation during the September 17, 2003 markup held by this Committee. We strongly encourage you to resist efforts to weaken or defeat this bipartisan improvement to the bill.

Mr. Chairman, we look forward to working with the members of this Committee and with nineteen of our colleagues in the House who have cosponsored this bipartisan legislation, the "*Taxpayer Savings and Employee Notification Act of 2003.*" We must be steadfast in our goal and our resolve to eliminate this costly and egregious tax shelter, to strengthen COLI for its legitimate and intended objective, and to restore some fairness to the tax code. Again, thank you for inviting us to submit our statement for this important hearing.

A Wal-Mart Wife's Story of Greed and Death

Submitted Testimony by Vicki Rice

My wonderful husband Mike Rice, and I were married 27 years. Mike was in Wal-Mart store management the last 10 years of his life. The last 4 years of Mike's life, the workload became brutal. Mike was working 75, 80, 90-hour weeks. Twice in New York, I saw him work over 24 hours around the clock because he was told; "I don't care what it takes just get the job done." This quote is Wal-Marts new motto, not respect for the individual.

On Aug. 31, 1999 Mike suffered a massive heart attack after calling 3 times for help. Mike had a lady customer who needed one of the larger t.v.'s put in her car. The store was short staffed as always, so Mike loaded the t.v. by himself. Sadly Mike got only about 20 feet back inside his Tilton, N.H. Wal-Mart store, before collapsing from a massive heart attack.

My husband, and the father of our two sons, had passed a physical and stress test just 5 months earlier. Mike was just 48 years old.

On the evening of Aug. 31, Mike was given CPR for 40 mins. , before his heart was stablized. His heartbeat was strong for the next 8 days, but Mike was totally, irrevocably brain dead, from not enough oxygen. I was then forced to make the most difficult and heart- breaking decision of my life.

Mike Rice died Sept. 7, 1999. I climbed on the hospital bed and held my husband for the last 55mins. of his life, as my decision was to let him be with God. When I told Mike I love you, go be with the Lord today, as He wants you to have a beautiful, and joyful day, one tear fell from each closed eye.

A couple of months later, I found out that Wal-mart was not going to pay me and my family the death benefits we were owed under New Hampshire law. With no other choices, we hired a

lawyer who filed a workman's comp. claim. We won that suit proving Mike's heart attack was from over exertion, brutal work hours, and enormous job stress.

Last Spring in March, I received an e-mail from a good friend about the Houston Chronicle's story on dead peasant policies. The story was so disturbing I was crying. I felt my Mike might have been targeted, as we had our health insurance with Wal-Mart. Now I am the lead plaintiff in a N.H., class action suit fighting what I know will be a difficult battle against Wal-Mart, Hartford Ins., and AIG.

My dear husband never knew there was a secret life insurance policy on him, and I didn't know. We would have been so afraid, as we were already scared of the terrible changes, and working conditions we had witnessed in Wal-Mart. My Mike, age 48, didn't live to enjoy his retirement. We didn't even get to enjoy the 9 weeks vacation time he was strongly encouraged not to take, due to the furious pace. Wal-Mart never pays for the unused vacation time they make impossible for you to use.

Just the words dead peasant, dead janitor, tells you what Wal-Mart really thinks of their associates. What incentive is there to have a safe working environment, if a company like Wal-Mart can put insurance policies on low-level employees?

I hope you are upset, and outraged by my story. I pray the American public, who are moral, just, and courageous will let Wal-Mart know, it's wrong to work a good man to death, and then go collect $300,000.

My once proud Wal-Mart family was destroyed by the company they had loved and trusted, and everyone who knew Mike Rice and loved him, knew without any doubts he was a King not a Wal-Mart peasant.

Thank you.