Corporate-Owned Life Insurance – COLI 101

Overview

COLI is a funding alternative that has been broadly utilized by public and private companies, financial institutions, banks and insurance companies as a means of financing executive benefit obligations. COLI offers death benefit protection with an array of unique and preferential tax and accounting opportunities.

What is COLI?

- COLI is a life insurance policy purchased by a corporation on the lives of its employees
- The corporation is the owner and beneficiary of the life insurance policy and has all rights associated with said policy
  - » Corporation may elect to extend some of the rights/benefits of the life insurance policy to the insured executive
- COLI differs from retail life insurance in that it offers:
  - » Institutional pricing specifically designed for the corporate marketplace
  - » Lower expenses, which are reflective of lower lapse rates
  - » Lower mortality charges resulting from the longer life expectancies of individuals typically insured under these types of arrangements
  - » Lower insurance carrier profit margins due to savings from economies of scale
  - » Enhanced early cash values to make it attractive relative to alternative funding arrangements
  - » Guaranteed Issue underwriting *(i.e., no medical examination required from executive)*
  - » A more sophisticated array of investment alternatives/subaccounts (variable COLI)

Why Do Companies Use COLI?

- COLI can reduce taxes on invested assets, increasing after-tax returns and enhancing shareholder value
- COLI receives favorable accounting and P&L treatment relative to taxable investments
- COLI offers unique tax advantages over other alternatives
  - » Tax-deferred growth of cash value[1,4]
  - » Tax-free reallocation within policy (variable COLI)[2]
  - » Tax-free receipt of death proceeds[3,4]
  - » Tax-free loans and withdrawals to basis[1,5,6]
    - - The ability to access COLI cash values via tax-free loans and withdrawals provides unique cash flow flexibility

1. Subject to qualification under Tax Code §72
2. Subject to qualification under §817(h)
3. Subject to qualification under §101
4. Subject to qualification under §7702
5. Subject to qualification under §7702A
6. Subject to qualification under §7702(f)(7)

TYPES OF COLI

Characteristic	General Account	Separate Account
Cash Value	Insurance company's General Account	Insurance company's Separate Account
Returns Derived From	Insurance company declared rate	Investments selected by policy owner
Investment Risk	Insurance company	Policy owner
Investment Control	Invested by insurance company as part of its General Account assets	Owner chooses among investment portfolios offered within Separate Account
Investment Return Guarantee	Guaranteed minimum yield (*generally 3%-4%)*	No guarantee on return
Investment Return	Based primarily on high-quality corporate bonds or Treasuries of 5-7-year duration	Potential for higher return based on equity components offered in Separate Account
Types of Investments	Regulatory restrictions imposed on insurance company	More flexibility
Asset Volatility	No mark-to-market risk (*asset values are more predictable*)	Asset values fluctuate with market value of portfolios (*potential for loss of principal*)
Asset Risk	Subject to carrier solvency (*assets are subject to claims of insurance company's general creditors*)	Separate Account protection (*assets are in Separate Account and are not available to insurance company's general creditors*)
Pricing/Expenses	Bundled and less explicit	Formula based and more explicit (*disclosed in Prospectus/Offering Memorandum*)

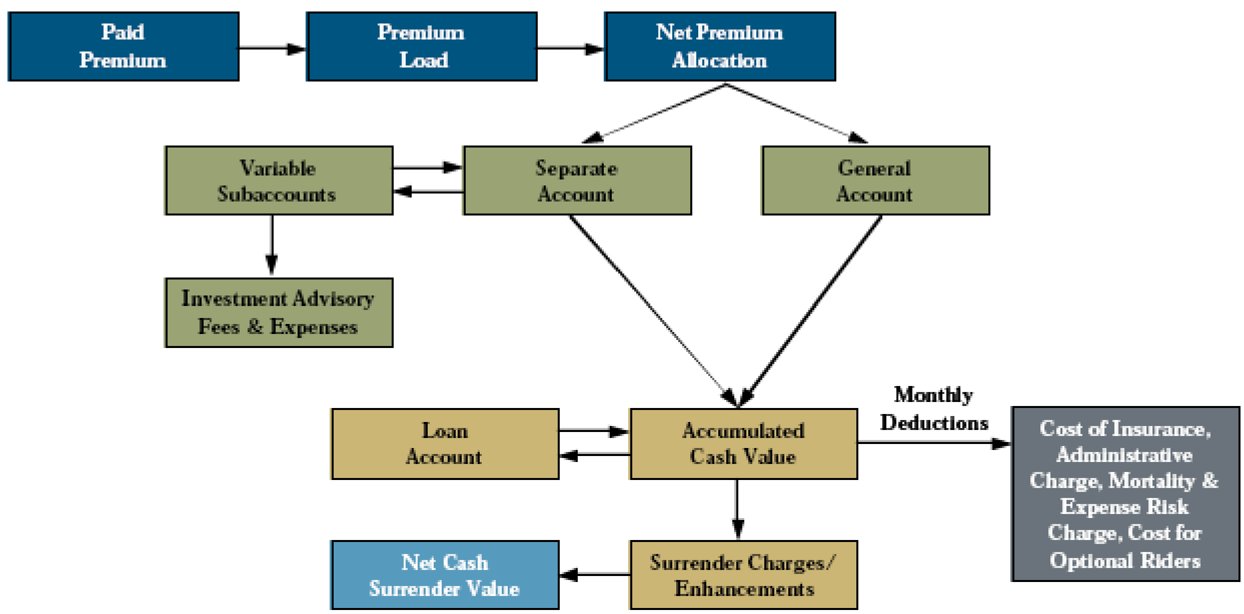
Variable life insurance products are long-term investments and may not be suitable for all investors. An investment in variable life insurance is subject to fluctuating values of the underlying investment options, and it entails risk, including the possible loss of principal.

HOW DOES A COLI ACQUISITION WORK?

- The employer is the applicant for the life insurance policies being acquired
  - » The employer is the applicant, owner and beneficiary of each policy
  - » "Key employees" are the insureds under the life insurance policies *(e.g., executives, managers, officers, etc.)*
- For federal tax purposes, the critical requirements are having insurable interest under state law and meeting the new procedural requirements of IRC §101(j)
- Only key employees who provide written consent will be insured
  - » Designated key employees are asked to sign a Consent to Insurance form
    - No medical exam is usually required
    - "Actively at work" verification (e.g., not absent from work more than 3 consecutive days in the past 90 days)
  - » Employers may offer a survivor benefit to those employees who consent to be insured
- Having an articulated business purpose is consistent with the traditional (*and favorable*) treatment life insurance has been given vis-à-vis pure investments. Such purposes include:
  - » "Offsetting" or "recovering" employee benefit costs
  - » Being part of a company program designed to ensure continued company operations in the event of catastrophic loss of management personnel from terrorist activities or a pandemic

COLI Pricing Structure

- **Front End Loads –** State premium taxes, federal deferred acquisition cost (DAC) tax and sales loads/expenses
- **Monthly Charges –** Policy administration fees (*which are typically a fixed dollar amount*), cost of insurance (COI) charges (*which fluctuate based on the age of the insured and net amount at risk*)
- **Fund Charges/Expenses –** Such as investment management fees (IAF) for Separate Account (*Variable*) life insurance
- **Mortality & Expense (M&E) Risk Charges –** Typically a percentage charge based on the account value of the policy; may be included as either a monthly policy charge or charged at the investment level (*typically only found in Separate Account (Variable) life insurance*)
- **Back End Loads –** Policy surrender charges (*most competitive COLI products do not have any surrender charges*)
- **Other Charges –** Some insurance products assess miscellaneous charges such as “death benefit per $1,000” charge



Risks of COLI

- **Change to the taxation of life insurance**
  - » Congress added §101(j) to the IRC which clarifies an employer’s right to receive the normal tax benefits of life insurance ownership when insuring employees
  - » When tax changes have been made in the past, existing policies have generally been “grandfathered” (i.e., tax changes apply prospectively to new policies purchased after legislative enactment)
- **Carrier Insolvency** – General Account policy assets are subject to the claims of the insurance company’s general creditors in the event of bankruptcy, whereas variable life insurance policy assets are held in a Separate Account and are not subject to the claims of general creditors
- **Definition of Life Insurance** – Carrier certifies that the policy qualifies as life insurance under current regulations
- **Performance of chosen product/carrier** – May transfer to another policy/carrier via IRC §1035 tax-free exchange
- **Inability to deduct losses in a down market** – COLI is a long-term investment and the inability to deduct short term losses in a down market is mitigated by the long-term advantage of tax-deferred buildup on gains in an up market

COLI Legislation

COLI Best Practices Measure

The COLI Best Practices measure included in “The Pension Protection Act of 2006” defined the requirements necessary in order for COLI to continue to receive the accounting and tax benefits outlined in this summary:

- **Notice and Consent Requirements**
  - Before a COLI contract can be issued, a written notice and consent is required to include:
    1. The employee’s consent to be insured under the contract ***and***
    2. Acknowledgment that such coverage may continue after the employee terminates employment
- **Eligible Insureds**
  - A Director, or
  - A 5 percent or greater owner of the business at any time during the preceding year, or
  - Those compensated in excess of $95,000 in the preceding year (2005 figure, to be adjusted for future inflation), or
  - Among the highest-paid 35 percent of all employees, or
  - One of the five highest paid officers
- **Reporting and Record Maintenance Requirements**

The new rules will generally apply to COLI contracts issued after **August 17, 2006** (*the date of enactment*) except for contracts issued pursuant to a 1035 exchange of a contract issued on or before the effective date.

FINANCIAL & INSURANCE ANALYSIS

Prior to any COLI purchase, it is in the best interest of every company to take sufficient steps to ensure it understands what it is buying and how the insurance works. As part of its due diligence process, a company should follow such protocols as:

- Selecting an insurance broker/plan administrator based upon a proven track record and solid, reliable referrals
- Developing assumptions and methodologies to estimate the potential impact of any liabilities that the COLI will be informally funding, and the results a COLI acquisition will have on the Company’s financial statements
- Undertaking a comprehensive review of appropriate insurance products that are available in the market