Understanding Corporate-Owned Life Insurance (COLI)

EXECUTIVE SUMMARY

Many companies offer valued executives nonqualified benefits programs such as deferred compensation. While these programs are not eligible for funding through secured qualified plans, companies can opt to informally fund them to improve benefit security, minimize P&L volatility and maintain accountability. Corporate-owned life insurance (COLI) is an important informal funding option due to its significant tax advantages.

To fund these programs, a company purchases and holds life insurance policies for plan participants. The company pays the premium, owns the cash value of the policy, and becomes the beneficiary of the insurance. Like any financial instrument, COLI has potential risks that must be balanced with the important advantages it offers companies and plan participants.

INTRODUCTION

Large and medium-sized corporations frequently offer various nonqualified benefit programs such as deferred compensation plans to their valued executives. For the company, the liabilities resulting from these plans can start out small, but often grow exponentially within a short period. To offset the impact of these liabilities, many employers have chosen to informally fund their nonqualified benefit programs with corporate-owned life insurance (COLI).

COLI can provide everyone a sense of security.
Executives can take comfort in knowing their company has taken proactive steps to try and balance cash flow demands with benefit obligations, while employers know that assets are targeted for distribution.

WHY INFORMALLY FUND EXECUTIVE BENEFITS?

Before looking at COLI specifically, it is important to understand why employers choose to fund nonqualified plans in the first place. There are three primary reasons:

1. Provide a Competitive, Secure Benefits Package
   The federal government limits a company's ability to provide executive benefits through fully funded and secured qualified plans. As a result, corporations must find other ways to deliver benefit security to valued executives and ensure the competitiveness of their compensation plan. Unfunded nonqualified plans are an option, but they do present the risk that adequate funds will not be available at the time the executive wants to receive the monies. For an executive who may have more than 90% of his total retirement income at stake in this kind of plan, funding provides important peace of mind.

2. Minimize P&L Volatility
   Unlike qualified plans, nonqualified plans cannot be formally funded via segregated trust assets. As a result, companies must separately maintain the benefit liabilities and accruals on the books without a direct financing offset. By informally funding (also referred to as financing or hedging) these costs, companies can minimize the impact of equity market volatility, which could negatively impact shareholder value by rattling a company's P&L during a given reporting period. The assets used to hedge also typically mirror the costs associated with the benefit liabilities which results in no net impact to the P&L.

3. Maintain Accountability
   While companies are not required to set aside or earmark assets to pay future benefit promises, many feel it is the right thing to do. This approach avoids "Social Security syndrome," minimizes burden on future management to pay benefits, and reduces the risk that cash will not be available.

WHY INFORMALLY FUND NONQUALIFIED LIABILITIES WITH COLI?

When funding nonqualified liabilities, using products that offer a tax-advantaged yield makes sense. The tax benefits of COLI include:

- Reducing taxes on invested assets, increasing after-tax returns and enhancing shareholder value.
- Income tax advantages over alternative investment options1 including:
  - Tax-deferred growth of cash value[2]
  - Tax-free reallocation within the policy[3]
  - Tax-free receipt of death proceeds[4]
  - Low net-cost loans and withdrawals[5]
- The ability to access COLI cash values via tax-free loans and withdrawals for cash flow flexibility
- Favorable accounting and P&L treatment relative to taxable investments

In general, the reaction to COLI is postive. Executives can take comfort in knowing that a company's cash flow demands won't disrupt their benefits, while employers know that assets will be available for distribution. The coverage costs the employees nothing, but makes the employer more financially viable. As a result, when employees are asked for the required consent to coverage, a high majority of them do so without issue.

HOW DOES COLI WORK?

While each plan design is unique, COLI is a financial instrument that can be applied to a wide range of plans, such as:

- Voluntary Compensation Plans: Giving executives an opportunity to defer income in excess of their 401(k) limits
- Supplemental Executive Retirement Plans (SERPs): Providing executives with extra retirement income
- Post-Retirement Benefits: Funding post-retirement medical and life benefits
- Performance-Based Plans: Including phantom stock plans and performance-based SERPs

HOW DOES COLI IMPACT OUR FINANCIALS?

The purchase of any investment or financial instrument has associated costs. An employer typically purchases COLI through cash flow funds. There is no immediate change to the balance sheet because both are assets. Over time, because COLI earns an after-tax rate of return that may be higher than similar investments, income statements will indicate additional income that translates into increased net worth.

A company earns COLI income from two sources: (1) any growth of the cash value of the policy and (2) the insurance proceeds paid to the company when insured employees die. From an accounting standpoint, these are typically recorded as "Other Assets" and "Other Income." COLI policies produce financial statement income for the company if the cash surrender value exceeds the cumulative premiums paid. The net after-tax income earned may be higher than the return available of that for many alternative investment products.

[1] Assuming a regular tax situation
[2] Subject to IRC §§7702 and 817
[3] Rev. Rul 82-54
[4] Subject to IRC §§7702 and 101
[5] Subject to IRC §§7702, 7702A and 72

COMPARING COLI TO TAXABLE INVESTMENTS[6]

	TAXABLE INVESTMENTS	VARIABLE CORPORATE-OWNED LIFE INSURANCE
General	Hypothetical taxable investment Monies invested in an array of taxable investment vehicles (equity based, bond based, etc.) at investment owner's discretion	Individual life insurance contracts Cash value invested in sub-accounts (equity based, bond based, etc.) at policy-owner discretion
Taxation		
▪ Earnings	Realized gains are taxable	Not taxable unless policy is surrendered
▪ Reallocation among funds	Previously unrealized gains are realized and taxable	Not taxable
▪ Dividends	Partial tax exclusion may be available	Not taxable
▪ Proceeds at liquidation/death	At liquidation, previously unrealized gains are realized and taxable	At death, proceeds are received income-tax free (significant reduction of long-term plan costs)
Earnings Impact	Realized and unrealized gains flow through to Income Statement, also deferred tax liability booked on unrealized gains[7]	All earnings flow through to income statement (offsetting annual benefit costs) although no tax-deferred liability is booked Death proceeds in excess of already recognized cash surrender value are recognized in earnings
Rabbi Trust Inclusion	Favorable IRS ruling	Favorable IRS ruling
Liquidity	Yes	Yes[8]
Tax Efficiency	Can be structured to be more tax efficient, but the investor gives up direct control	Life insurance is inherently efficient from both a tax and an earnings perspective

[6] *Assuming a regular tax situation, and subject to IRC §§7702, 7702A, 101, 72, and 817, FTB 85-4, and Rev. Rul. 82-54*

[7] *When assets are categorized as "Trading." However, in an effort to be more conservative, accounting firms are increasingly requiring that the hypothetical investment be classified as "Available for Sale," resulting in only realized gains flowing through P&L.*

[8] *Life insurance provides liquidity upon death of the insured. Policy loans and/or withdrawals are available, but can reduce benefits received upon death. In addition, early withdrawals may trigger tax penalties.*

THE RISKS OF COLI

As with any financial vehicle, COLI has potential risks that balance its rewards. Companies should consider:

- Possible changes to the taxation of life insurance

  Historically, life insurance has generally enjoyed "grandfathering," where tax changes apply prospectively to new policies acquired after the date the legislation is enacted.

- Carrier insolvency

  Variable life policy assets are held in a separate account and are not subject to the claims of general creditors.

- The performance of a chosen product/carrier

  This is mitigated by the fact that companies transfer from one COLI policy/carrier to another via IRC §1035 tax-free exchange.

- The inability to deduct losses in a down market

  COLI is a long-term investment. The lack of short-term deductions is offset by the long-term advantage of tax-deferred buildup on gains.

- The definition of life insurance

  The carrier will certify that the policy qualifies as a contract of life insurance under current regulations.

DO COMPANIES PROFIT FROM DEATH BENEFITS?

One concern around COLI stems from the perception that a company "profits" from the death of its executives. Ultimately, the employer does receive a tax-free death benefit, which it is legally entitled to given the consents it must receive from the executives it insures. The benefit is then used to finance nonqualified executive benefits that cannot be formally funded, which is to say, to make payments to executives due distributions from their plan. Once a death benefit is paid, the company loses the future tax benefits of the policy.

Additionally, life insurance is a known retirement savings vehicle. Many executives employed by smaller companies have independently purchased individual life insurance with the idea of using the tax-advantaged cash value to save for retirement. In fact, life insurance tax law recognizes this legitimate use of insurance. By doing the same thing as an executive group within a larger corporation, additional advantages accrue to the executive and the company — product pricing and distribution costs are typically improved and guaranteed issue insurance is usually available. Moreover, in a group situation, the company will typically recover many of its costs from the death benefit. Because COLI can reduce taxes on invested assets – essentially increasing after-tax returns and enhancing shareholder value – the company is taking a more efficient approach to something executives might choose to do on their own.

CONCLUSION

As companies evaluate nonqualified plan funding vehicles, most find that practicality narrows the field to either taxable investments or COLI. With its tax advantages and ability to deliver value to participants, many employers have found COLI to be the preferred choice for informal funding of nonqualified benefits plan liabilities.

Investors should consider the investment objectives, risks, charges and expenses of any variable life insurance product carefully before investing. This and other important information about the investment company is contained in each fund's prospectus, which can be obtained by calling 310-473-0060. Please read it carefully before you invest.

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.

Product guarantees, including the death benefit, are subject to the claims-paying ability of the issuing insurance company.

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