Recent Rule Changes for Corporate-Owned Life Insurance Policies

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As part of the just signed Pension Protection Act of 2006, there are new rules concerning corporate-owned life insurance (COLI) policies. These new rules are called the COLI Best Practice Rules. The new rules limit the types of employees that can be covered by these policies and establish notice, consent, disclosure, and reporting requirements for the companies that own the policies.

COLI policies have been a favorite method to provide "funded" deferred compensation for select key employees. Cash value builds up in the policies and this cash value is eventually used to provide additional, long-term compensation for employees when they retire. Often, companies keep the policies in force after an employee retires and the eventual death benefits reimburse the company for the premiums paid. COLI policies are also used for key-man insurance to reimburse a company upon the untimely death of a key employee.

The COLI Best Practice Rules specify the following requirements.

- COLI policies are now restricted to a select group of highly compensated employees.

  To be eligible, an employee must have worked for the company in the 12 months preceding his or her death. Alternatively, the insured must have been, at the time the policy was issued, a director, among the highest paid 35% of all employees working for the company, or a "highly compensated" employee as defined by Internal Revenue Code (IRC) section 414(q). IRC section 414(q) defines a highly compensated employee as at least a 5% owner and employees with total compensation above $100,000. These employees are similar to the group of highly compensated employees that are eligible for Top Hat deferred compensation plans.

- An employer is required to provide notice to an insured employee and to obtain the employee's written consent to being insured.

  Under this provision, life insurance death benefits received by an employer on the life of an employee are taxable under IRC section 101(j) unless, before the contract is issued, the employee is notified in writing that the employer intends to insure the employee's life. The employee must provide written consent to being insured and that the coverage may continue after the employee terminates employment. Also, the employee must be informed in

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writing that the employer will be the beneficiary of any insurance benefits payable at the employee's death.

Many companies are already using consent forms, but the new rules will require that forms specify the maximum policy face amount for which the employee could be insured at the time the policy is issued.

- An employer must disclose that it holds COLI policies and keeps records regarding Best Practice Rules compliance.

  An employer owning one or more COLI policies during any year is required to keep records as may be necessary to determine whether the Best Practice Rules are met. As currently written, the Best Practice Rules apply to life insurance contracts issued after August 16, 2006. If a previous policy is exchanged using IRC section 1035 after August 16, 2006, the new policy is grandfathered under previous rules for COLI policies. A possible exception to this grandfathering is if the exchanged policy is "materially changed", such as a material increase in death benefits. A materially changed policy must then meet the Best Practice Rules.

  The new rules require a policyholder owning a life insurance contract on the life of an employee to file an annual tax return showing the number of employees at the end of the year; the number of insured employees; the total amount of insurance in force at the end of the year under such contracts; the employer's name, address, and tax identification number; the type of business engaged in; and that the employer has a valid consent for each insured.

The Best Practice Rules are generally regarded as a positive step to ensure the responsible use of COLI policies by employers. Any life insurance benefits received by an employer on the life of an employee would be taxable (benefits above cost basis) if the Best Practice Rules are not fully satisfied.

The application of the Best Practice Rules will need to be clarified through additional IRS rulings or clarification letters. Unfortunately, the new rules seem to unintentionally affect even the smallest of companies when the intent was most likely to apply to broad-based COLI programs at larger companies.

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