

May 25, 2001



Bank Owned Life Insurance

Bank Owned Life Insurance (BOLI) and its leveraged cousin Corporate Owned Life Insurance (COLI) have been hot issues in the tax world recently. You may have seen high profile federal court decisions on COLI, or heard about increased IRS audit approaches on BOLI, as well as the recurring proposals for new legislation on BOLI and COLI. This report is intended to provide an overview of the developments that should be of interest to all banks that have purchased BOLI or COLI or might be doing so in the future.¹

Many banks have purchased life insurance over the last few years to offset the costs of post-retirement employee benefits and to insure against the risk of loss of key officers or employees. Typically banks have purchased single premium BOLI policies that provide for investment of the funds in either the general account of the insurance company or a separate account. The OCC provided guidance concerning the supervisory considerations for banks purchasing insurance on the lives of their employees, most recently in OCC Bulletin 2000-23. Recent IRS audit initiatives on BOLI, however, highlight important legal and tax aspects of BOLI purchases on which all banks should be well advised.

Recommendations:

1. Banks that have purchased, or intend to purchase, BOLI policies should be prepared for the new IRS tax audit initiative. For new BOLI policies, bankers should take steps to protect themselves from the loss of tax benefits of BOLI if they address the Federal tax issues *before the time of the purchase*. For existing BOLI policies, banks should locate supporting documentation on topics such as insurable interest, funding of the premium payments or their business purpose for the policies.
2. There is an array of BOLI policies available, not all of which may be valid under the new court decisions and increased IRS scrutiny. Consult your tax department or your tax advisor to make sure you are making a well-informed decision. For example, if you are considering a separate account product, make sure that the relationship arrangement complies with the tax law requirements that proscribe certain types of investor control.
3. Bankers should be attentive to possible future Federal legislative changes affecting BOLI. In recent years, Congress has considered tax law changes governing both COLI and BOLI. If future changes are made, it is not certain that the changes would apply only to new policies purchased after enactment.

¹ This publication is not intended to provide legal, tax or accounting advice. Should legal, tax or accounting advice be required, please consult your professional advisor.

4. You may want to contact the ABA to find out the latest developments from the IRS and Capitol Hill prior to new purchases.

IRS Audit Initiative

In Fall 2000, the IRS began using a comprehensive set of information document requests (IDRs) when auditing banks which had purchased BOLI. These IDRs require the production of all BOLI policies and related documents and inquire into every aspect of the bank's consideration of BOLI. For example, the document requests include:

1. Provide copies of policies and materials to explain the plan and its terms. Provide copies of any side agreements or memoranda of understanding and copies of all prospectus, offering materials, confidentiality agreements with any party, and correspondence with any party explaining the tax efficient features of the BOLI policy.
2. Provide copies of any report (internal or external) on the pros and cons of a BOLI plan including the tax benefits or risks of the plan. Provide all handouts, presentation materials, flow charts and other documents used to request management or Board approval of policy.
3. Provide all internal documents and memos, notes, briefing papers, meeting minutes, forecasts, spreadsheets and due diligence reports prepared internally during the time the BOLI plan was being reviewed. Include any subsequent reports or memos on BOLI's performance and expected benefits.

This is not a routine IRS inquiry. Indeed, experienced professionals believe the IRS is collecting information in anticipation of litigating whether, based on all the facts and circumstances, the bank is entitled to the favorable tax treatment of BOLI. Based on the standard IDRs, the IRS will examine the validity of the contract as insurance under state law and the federal tax code. Moreover, at a recent bank tax conference, IRS representatives acknowledged the increased audit activity. The IRS has hired a Private Placement Insurance Specialist to focus on "separate account" policies purchased by banks and thrifts.

The IRS initiative on BOLI is inspired by, but separate from, its recent successful challenges to certain leveraged corporate owned life insurance (COLI), bought primarily by non-financial corporations. See Winn-Dixie Stores, Inc. v. Commissioner, (U.S. Tax Court, October 19, 1999); IRS v. CM Holdings (U.S. District Court, Delaware, October 16, 2000) and American Electric Power v. U.S., (Southern District of Ohio, February 20, 2001). There are several key differences between BOLI and COLI policies. (See separate discussion as attachment.) Thus, the IRS challenge on BOLI will have to be different in some respects than the court cases involving COLI. Nonetheless, the recent court cases are instructive on the depth of the inquiry into (1) the clarity and documentation of the business purpose for purchasing the policies, and (2) the true economic effect of the features of the policies including policy loans and loading dividends.

Valid life insurance contract

The term “life insurance contract” is defined in Internal Revenue Code Section 7702. The provision was added in 1984 to distinguish investment oriented products from contracts that qualify for the exclusion of death benefits from income. Section 7702 requires that the contract be life insurance under “applicable law”, which refers to state insurance law, but the key determinants are either (1) the cash value accumulation test, or a guideline premium requirement and a cash value corridor requirement. Usually, insurance carriers will provide assurances that the contract meets the Section 7702 requirements. That assurance, however, is not the end of the discussion.

The bank employer must have an “insurable interest” under state insurance law. In light of the reference to “applicable law” in Section 7702, it is clear that a contract must meet the requirements of state insurance law in order to qualify for tax free insurance proceeds. Advice from either internal or external legal counsel may be needed here to establish insurable interest. In the case of bank owned life insurance, the fact that the insurance policy qualifies under OCC guidance (or similar rule from state bank regulatory authorities) may not satisfy the insurable interest requirement for tax purposes. Similarly, assurance from the insurance carrier that it will not contest the policy holder’s right to insure the employee or collect the death benefits may not be sufficient to satisfy the tax requirements for insurance under “applicable law”.

Finally, IRS representatives have expressed concern publicly about cases where a “29 year old employee who is making \$30,000 and is insured under a BOLI policy for \$4 million”. There is no clear bright line test in the federal tax law limiting the amount of insurance that an employer can buy on its employees. Nonetheless, IRS may argue that policy coverage far in excess of the risk of loss of the bank may belie the intended business purpose for purchasing the policies. As noted above, the fact that a given amount of the BOLI is permitted under OCC guidance may not, by itself, protect the bank from the IRS challenge.

Business Purpose

In addition to the statutory rules for the definition of insurance, the IRS and the courts continue to apply common law principles to analyze various life insurance and annuity arrangements to determine if the transactions lack economic substance and were undertaken for the purpose of making an investment while also deriving favorable tax treatment for insurance proceeds. In the case of bank owned life insurance, the business purpose generally involves: (1) to protect the bank employer against the costs/loss due to the death of key employees, and (2) to offset the bank’s future obligations to its employees under the retirement and benefit plans. IRS will be looking for banks to have documented their non-tax business purposes for purchasing BOLI policies. Once that is accomplished, then it is appropriate for a bank to be fully aware of the tax benefits associated with purchasing BOLI, and the after tax return on the policy, based on an assumed level of mortality.

The recent court decision in the American Electric Power case involving COLI is instructive on how the court inquired into the expressed business purpose of the employer. At the time of the purchase of the policies, the company selected a relatively high interest rate for its policy loans, and did so because it would have the benefit of a relatively higher crediting rate on the policy which would be reflected in the cash surrender value of the policy as shown on the company’s balance

sheet. The court dismissed the stated business purpose of having a larger asset on its balance sheet, because the company had borrowed against the policy so much that it really did not benefit from the higher crediting rate. In effect, the court said the company's real purpose was the tax deduction for the interest expense paid on the policy loans.

The new OCC guidelines contain language indicating that the amount of life insurance purchased must be related to the estimated amount of the obligation for employee compensation and benefit plans or the risk of loss to the bank in the event of the death of the covered employee. This standard is relevant to the determination of whether a policy will avoid being labeled as sham for tax purposes, but it is not determinative.

Separate Accounts

Many of the policies sold in the BOLI market today are separate account products, meaning that the cash values are not invested within the general account of the life insurance company. In order for a bank to enjoy tax-deferred build-up of the BOLI cash value, the separate accounts must be under the ownership of the insurer and not the bank. The bank can have no control over individual investment decisions. Initially, this concern seems to be associated with flexible premium variable universal life products that permit the bank to allocate and reallocate the BOLI cash values among various funds that have differing investment objectives. However, in certain circumstances, this concern could also attach itself to products that use a separate account but supposedly give the bank no say in the investment decisions. With respect to the variable policies, the IRS has held in a series of Revenue Rulings and private letter rulings (notably PLR 9433030) that a policyholder's ability to direct the broad allocation among the funds either at time of purchase or subsequent thereto does not constitute sufficient control over individual investment decisions so as to cause ownership of the funds to be attributable to the policyholder. The IRS has lately focused on Rev. Proc. 99-44 as establishing the criteria for separate account policies. There is a substantial body of tax law on investor control that is more on point. The tax treatment of separate account arrangements is highly dependent on the specific facts and circumstances and should be reviewed by a tax advisor.

Congressional Activity

In recent years, Congress has considered many proposals to amend the tax provision that applies to both COLI and BOLI, having adopted some and rejected others. Usually, these proposals have been prospective only, that is applying only to new contracts purchased after a date of enactment or date on which the provision was first made public by the Congressional Committees (date of first committee action). There has been at least one instance, however, when Congress changed a COLI rule and applied it to existing policies. Therefore, there is no guarantee that Congress will apply any new requirements on a prospective basis.

The most significant proposal affecting BOLI was advanced several times by the Clinton Administration. The proposal, which was never adopted, would have imposed a pro-rata interest expense disallowance on banks that owned BOLI, comparable to the current rule that applies to bank holdings of most state and municipal bonds. Under that proposal, banks would have suffered an interest expense disallowance even though there was no borrowing directly or indirectly traced to the BOLI premium payment. While the Bush Administration has not advanced any similar BOLI proposal yet, it is possible that Congress might consider this or other proposals in the future.

During consideration of the 1999 budget proposal, ABA vigorously opposed legislative efforts to change to the treatment of COLI. However, as a safety measure, in the event that Congress had reached a decision to move such legislation, ABA developed several principles to be used to minimize harm from any such change in the tax treatment of COLI.

Principles:

- **Any provision changing the tax treatment of COLI should be prospective and should not put businesses that made decisions based on existing law in a disadvantaged position.**

The proposal should only apply to contracts entered into after the date of enactment. Any premiums paid after the date of enactment with respect to contracts written prior to the date of enactment should be grandfathered.

- **The proposal should continue to allow tax-free exchange of insurance contracts.**

The proposal should allow a carryover of grandfather status on a section 1035 exchange.

- **The proposal should create a “safe harbor” exception to general interest disallowance for COLI to protect a certain level of COLI.**

There should be an exception from general interest disallowance for premium payments on contracts issued after the effective date of the new law for a certain volume of business.

- **Any new rule should apply equally to all businesses purchasing COLI. Banks should not be solely targeted.**

For More Information

If you need additional information or assistance from the ABA, feel free to contact us:

Mark Baran – Sr. Counsel, mbaran@aba.com, 202-663-5317

Leon Peace – Sr. Counsel - Legislation, lpeace@aba.com, 202-663-5322

Donna Fisher – Director of Tax and Accounting, dfisher@aba.com, 202-663-5318

Discussion 1 - BOLI v. COLI

BOLI policies are not leveraged, in that there is no direct or indirect borrowing to fund the premium payment. Usually, the premium is a single payment made up front. In contrast, the COLI policies that have been challenged by the IRS in court are leveraged policies. Indeed, the COLI policies were touted to the purchasers as "cashless COLI" because they were structured so that after the first three years of the policy where borrowing to fund COLI is permitted, the policyholder would receive dividends under the policy that effectively covered the cost of the next annual premium. The federal court in the AEP case described the arrangement as follows:

"The COLI policies were designed so that in years four through seven, most of the annual premiums and accrued loan interest would be paid by dividends and partial withdrawals in simultaneous netting transactions, which would occur on the first day of each of those policy years. In these annual transactions, approximately ninety-five percent of the annual premium was considered taken by MBL as an expense charge. After setting aside amounts sufficient to cover MBL's actual expense charges, the remainder was returned to AEP as a "loading dividend" offsetting ninety-five percent of the premiums due."

Thus, in a typical BOLI contract requires that employer to make a significant single premium payment, unlike the cashless COLI arrangements. A single premium insurance policy is treated as a "modified endowment contract" under IRC section 7702A. This means that there are substantial negative tax consequences in the event that the policyholder wants to cancel the policy. These tax consequences in the event of withdrawal are: (1) any income deferred while in the insurance was in effect would become immediately taxable, and (2) there is an additional 10 percent tax for taxable distributions, under the same rules that apply for annuities. In effect, those negative consequences serve to underscore that a BOLI purchaser has made a serious business and financial committed by purchasing the policy. Moreover, the large cash outlay at the start has real economic substance, in contrast to the "cashless COLI" in the three recent cases that the government has won in court.

On a more technical aspect, the provision of the tax code that imposes an interest expense disallowance on BOLI policies is IRC sec 264(a)(2). In contrast, COLI policies are covered by the so-called "4 in 7" rule in IRC sec 264(d). Once the IRS persuaded the courts that the purchasers of leveraged COLI had flunked the 4 in 7 test, the negative outcome was ordained. BOLI cases do not have that concern.

In spite of these significant tax differences between BOLI and COLI policies, there are some lessons to be learned from the recent COLI cases. The IRS and the courts have demonstrated an ability to inquire into the business purpose for purchasing the policies. In the Winn-Dixie case, the taxpayer stated that their business purpose was to use the benefits of the COLI policy to offset the cost of their employee benefits program. Winn-Dixie did not, however, provide adequate documentation on business purpose that was contemporaneous in time with the business decision to purchase the policies. Moreover, the IRS and the Court have effectively analyzed the economic effect of the COLI policies and determined that certain policies were not valid insurance. While that should not be a problem in the typical BOLI product, bankers are advised to examine closely the details of their policies.

Discussion 2 - Recent Legislation

- In 1986, Congress limited a corporation's interest deduction for indebtedness that was incurred to purchase or carry COLI. That legislation limited interest deductions on borrowings that exceeded \$50,000 per insured life.
- In 1996, Congress limited a corporation's interest deduction on all debt that could be directly traced to an investment in COLI, with a limited exception for \$50,000 of indebtedness with respect to up to 20 policies.
- In 1997, the Treasury Department and Congress was concerned that some businesses planned to invest in cash value life insurance policies on the lives of their customers. Congress disallowed interest deductions on non-traceable indebtedness allocable to investments in cash value life insurance, to the extent that the policies did not insure the lives of the employees (using a *pro rata* disallowance rule).
Congress imposed no corresponding limits on the indirect financing of premium investments in policies that named employees as the insureds. Congress also imposed no dollar limit on the amount of nontraceable indebtedness allocable to investments in cash value life insurance on the lives of employees.
- In 1998 and 1999, the Administration's budget *included* a proposal to extend that *pro rata* disallowance rule to investments in cash value life insurance on the lives of employees and officers, other than 20 percent or greater shareholders in the business. None of the provisions were enacted.