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**Harmony Wealth
Strategies**

BUILDING AND SAFEGUARDING
YOUR FINANCIAL WORLD

Corporate-Owned Life Insurance (COLI)





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What is it?

Corporate-owned life insurance (COLI) is a life insurance policy that you take out on the life of one or more of your employees, whereby you are both the owner and the beneficiary of the policy. As owner of the policy, you're responsible for paying the premiums. As beneficiary of the policy, you retain all rights to the benefits under the policy. Other than being named as the insured, your employee has no interest in the policy. COLI can be used for a variety of reasons, and the use of COLI may or may not bear any relationship to the actual financial loss you may anticipate upon the covered employee's death. For example, COLI is commonly used as an informal funding vehicle for nonqualified deferred compensation (NQDC) plans. When used as an informal funding mechanism for a NQDC plan, you can borrow against the cash value that accumulates under the policy, and you can then use the borrowed funds to pay the COLI premium payments or to pay the NQDC plan benefits.

How does it work?

Typically, you (the employer) purchase cash value life insurance policies on individual employees and pay the premiums for the policies. You are the owner and beneficiary of the COLI policy. Thus, you retain all rights to the benefits under the policy, including the cash value buildup and the death proceeds. The employee has no interest in the policy (other than being named as the insured).

If structured properly, the cash value that accumulates under the policy will not be subject to federal income tax as it accumulates. You can also borrow against the policy. These borrowed funds then may be used to pay the policy premiums and/or to fund nonqualified plans. Furthermore, you may be able to deduct all or part of the interest you pay on a policy loan.

Caution: *In general, you must have an insurable interest in your employee in order to purchase life insurance on his or her life. This is a matter of state law, which varies widely. Some states prohibit so-called "janitor" or "dead peasant" COLI insurance, where an employer buys a COLI policy that covers many of its rank and file employees. Other states require that you notify employees, or that employees specifically consent to the COLI purchase.*

Caution: *The Pension Protection Act of 2006 contains rules that limit the amount an employer can receive from a COLI policy as a tax free death benefit in certain cases. See "Federal Income Tax Treatment" below.*

Why would you want to purchase COLI?

There are a number of reasons why an employer might wish to purchase COLI to informally fund a NQDC plan. COLI is attractive because it does the following:

- Provides psychological assurance to NQDC plan participants that their benefits will not be endangered by your cash flow demands
- Enables you to match assets to liabilities, thereby reducing or eliminating a financial strain on you when it is time for distributions to occur
- Provides potentially tax-free buildup of cash value
- Enables you to recover all or part of the cost of the nonqualified plan

Risks associated with COLI

There are a number of risks that are associated with using COLI to informally fund a NQDC plan. First, if the insurance company experiences severe financial difficulties, you may be unable to access the policy's cash value to pay the plan benefits. In addition, the disparity between the estimated earnings (earnings projected when the policy is issued) and the actual earnings may leave you with insufficient cash value to pay plan benefits when due. As a result, you should evaluate an insurance company's financial stability and earnings history before purchasing COLI.

Be aware, also, of the alternate minimum tax (AMT). If a corporate employer is the owner of a life insurance policy, the annual inside buildup (cash value) and death proceeds are among the factors that may subject the employer to the AMT.



Will use of a COLI policy to informally fund a NQDC plan cause the plan to be subject to extensive ERISA provisions?

No. If properly structured, use of a COLI policy to informally fund a NQDC plan will not subject the plan to extensive ERISA provisions. The Employee Retirement Income Security Act of 1974 (ERISA) imposes participation, vesting, funding, distribution, fiduciary, and reporting rules on employer qualified plans and other funded plans. For the most part, these rules do not apply to unfunded NQDC plans.

Using COLI to informally fund a NQDC plan will not cause the plan to be funded for ERISA purposes. More specifically, if the employer is the owner and beneficiary of the policy, and the NQDC plan benefits are paid directly out of the employer's general assets, and the employee participants do not have any contractual rights under the policy, the plan should be considered unfunded for ERISA purposes.

Federal income tax treatment

Deduction for payments made under a NQDC plan

You can deduct amounts paid to an employee under a NQDC plan that is informally funded by COLI. In general, you receive the deduction in the taxable year your contribution is included in your employee's gross income. This means that you receive the deduction in the year your employee actually receives the NQDC plan benefits. You can deduct the total amount paid to your employee, including any earnings on your contributions. The fact that the source of the funds used to pay the deferred compensation is indirectly a COLI policy does not change this result.

Deduction of premiums paid

Premiums are not deductible when they're paid on any life insurance policy that covers any officer or employee of the employer when the employer is directly or indirectly a beneficiary under the policy. Since you are the direct beneficiary of a COLI policy, you can't claim a deduction for the premiums paid.

Deduction of interest paid on loans

If you borrow against the cash value that accumulates in a COLI, you may be able to deduct the loan interest. If four of the first seven years' policy premiums have been paid without borrowing from the policy, any interest you pay on the loans is, to a certain extent, deductible. However, if a policy was purchased after June 20, 1986, no deduction is allowed for interest on loans that total more than \$50,000 per insured individual under policies covering the lives of officers, employees, and other financially-interested parties. In other words, you can purchase separate COLI policies on any number of employees and deduct the interest on a loan of up to \$50,000 from each policy.

Treatment of cash value buildup

Generally, the COLI policy's accumulated cash value is not currently taxed. You, as policyholder, can accumulate cash value in the policy free of taxation as long as you allow the cash value to accumulate inside the contract. Note: The accumulation of cash value in the policy may be subject to the AMT.

Treatment of policy withdrawals and loan proceeds

If you withdraw the cash value that accumulates within a COLI policy, the IRS treats the withdrawal as a nontaxable recovery of investment in the contract (i.e., premiums paid minus dividends and prior cash distributions). However, withdrawals that exceed your investment in the contract will be treated as income to you, the employer. Loan proceeds borrowed against the cash value that accumulates within the COLI policy aren't treated as distributions under the policy, and therefore aren't subject to taxation.

Caution: *It's sometimes possible for a COLI policy to be treated as a modified endowment contract. If a COLI is treated as a modified endowment contract, it doesn't receive the tax benefits that usually are afforded to life insurance contracts. As a result, you should try to avoid modified endowment contract status whenever possible.*

Death benefits

In general, the death benefits you receive from a COLI policy are free from federal income tax. However, Internal Revenue Code



Section 101(j), enacted as part of the Pension Protection Act of 2006, limits the amount you, as an employer can receive as a tax free death benefit in certain circumstances. In general, unless an exception applies, the amount you can exclude from income as a death benefit from an employer-owned life insurance contract can't exceed the premiums and other amounts you've paid for the contract. Any death benefit in excess of this amount is included in income. These rules apply to contracts issued after August 17, 2006 (except for a contract issued in a section 1035 exchange for a pre-August 18, 2006, contract.)

Tip: The IRS has issued Notice 2009-48, which provides guidance on IRC Section 101(j) in question and answer format.

An employer-owned life insurance contract is defined as a life insurance contract (including a split dollar life insurance contract) which (1) is owned by a person engaged in a trade or business and that person (or a related person) is directly or indirectly a beneficiary under the contract, and (2) covers the life of an individual who is an employee with respect to the trade or business on the date the contract is issued.

The Act provides several important exceptions to the general rule:

- If notice and consent requirements are met, the income inclusion rule doesn't apply if the deceased individual was your employee at any time during the 12-month period before his or her death, or, at the time the contract was issued, the individual was a director or "highly compensated employee" or "highly compensated individual."

Technical Note: A "highly compensated employee" is defined under the rules relating to qualified retirement plans, determined without regard to the election regarding the top-paid 20 percent of employees. A "highly compensated individual" is defined under the rules relating to self-insured medical reimbursement plans, determined by substituting the highest-paid 35 percent of employees for the highest-paid 25 percent of employees.

- If notice and consent requirements are met, the income inclusion rule doesn't apply to death benefits to the extent the amount is (1) paid to a member of the family of the decedent, to an individual who is the designated beneficiary of the decedent under the contract (other than the employer), to a trust established for the benefit of any such member of the family or designated beneficiary, or to the estate of the decedent; or (2) used to purchase an equity (or partnership capital or profits) interest in the employer from such a family member, beneficiary, trust or estate.

The Act's notice and consent requirements are satisfied if, before the contract is issued, (1) you notify the employee in writing that you intend to insure the employee's life, and inform the employee of the maximum amount of life insurance that you might take out on his or her life, (2) the employee provides written consent to being insured under the contract and that such coverage may continue after the insured terminates employment, and (3) you inform the employee in writing that you will be a beneficiary of any proceeds payable on the death of the employee.

IMPORTANT DISCLOSURES

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