GROOM LAW GROUP

MEMORANDUM TO CLIENTS

May 15, 2009

RE: New Obama Administration Tax Proposals Adversely Impact Corporate Owned Life Insurance (COLI)

On May 11, 2009, the Obama Administration proposed a change in the tax law which would adversely affect the use of corporate owned life insurance by businesses. The Administration has proposed this change as one of a number of tax proposals used to fund health insurance reform.

I. Use of COLI by Businesses

Businesses purchase life insurance and other insurance products for many reasons. The proceeds of a life insurance policy are generally not taxed to the recipient when paid on the death of the insured. The income generated inside a life insurance policy is also generally not taxed when earned unless those funds are accessed by the policy holder.

Some businesses purchase life insurance on the life of a substantial owner of the business as a way to finance the purchase of that owner's interest in the business from the owner's beneficiaries upon the death of the owner. In some instances, a company will purchase life insurance on the lives of employees as an investment to fund either non-qualified deferred compensation or other post retirement benefits that cannot be otherwise funded in a tax deferred manner. The earnings on the insurance policy are tax deferred until the funds are accessed from the policy (for example, at the time that the non-qualified deferred compensation payments are due) and the death benefit is tax free when paid at the employee's death. The amounts received from the policy are used to fund the non-qualified deferred compensation or post-retirement benefits.

II. Current Limitations on COLI

To limit some of the tax advantages of a company owning life insurance, no deduction is allowed on interest on indebtedness used to purchase corporate owned life insurance, except if the insurance is on the life of a key person in the business. A key person is a 20-percent owner of the business or one of the top officers of the business. Denial of the deduction on the indebtedness used to purchase the insurance prevents a perceived double benefit that comes from the fact that tax-free income is generated in the insurance policy.

A further restriction on COLI applies when the insurance is not on the life of a 20-percent owner or an officer, director or employee of business (at the time the policy is entered into). In that instance, a portion of the business's overall interest deduction will be disallowed, based on a formula taking into account the unborrowed cash surrender value of that policy and the assets of the business. Similar to the denial of the deduction for indebtedness used to directly purchase life insurance (Internal Revenue Code sec. 264 (a)), this pro-rated denial of the business's overall interest deduction limits the financial benefit that comes from owning a life insurance policy.

This provision was enacted in 1997 and meant to stop companies getting tax benefits from insuring individuals who were not employees (which Fannie Mae was doing on a broad basis).

III. Administration Proposals

The Obama Administration released a number of tax proposals earlier this week. One proposal would adversely impact COLI. The Administration has proposed legislation to deny a pro-rata portion of the interest deduction based on insurance held on any individual other than a 20-percent owner of the business. This greatly expands the current pro-rata denial of the interest expense deduction that currently applies to COLI on individuals who are not employees. By reducing the tax deduction for other interest paid by the business, the tax and economic benefits of purchasing life insurance on employees is severely diminished. Consequently, if this provision is enacted, companies probably will be less likely to use COLI to fund non-qualified deferred compensation or other retiree benefits.

The proposal states that it will be effective on a prospective basis, so current COLI policies will be grandfathered and not subject to this provision. Only newly purchased COLI policies will be subject to these new rules. There will likely be discussions on the extent to which existing COLI policies can be exchanged for new insurance policies and still be subject to the grandfather.

IV. Prognosis for Legislation

The Administration's proposal for COLI would raise approximately $8.5 billion in tax revenues over a ten year period. Similar proposals to restrict the use of COLI were advanced by the Treasury Department during the Clinton Administration. The life insurance industry mounted a vigorous defense of COLI at that time and the restrictions were not acted on by a Republican-controlled Congress. Given that the Congress is now controlled by Democrats and the revenue raised by this proposal is substantial in a period of budget deficits, there is a strong possibility that this provision could be enacted and, as a result, future sales of COLI policies could be limited.

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Please call one of the following, or the Groom attorney you regularly contact, if you have any questions about this or any other matter.

Eric Cotts	emc@groom.com	(202) 861-6616
Liz Dold	etd@groom.com	(202) 861-5406
Jeff Kroh	jwk@groom.com	(202) 861-5428
David Levine	dnl@groom.com	(202) 861-5436
Lou Mazawey	ltm@groom.com	(202) 861-6608
John McGuiness	jfm@groom.com	(202) 861-6625
David Powell	dwp@groom.com	(202) 861-6600
Bill Sweetnam	wfs@groom.com	(202) 861-5427
Brigen Winters	blw@groom.com	(202) 861-6618