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Managing COLI As Benefit Obligations Shrink

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Financial executives of companies that sponsor nonqualified plans are beginning to have a new perspective on financing these plans. Companies have seen deferrals decline and plan distributions increase as their executive population ages. Lately, however, it's not just changing demographics that are driving these changes; some financial advisors are discouraging their executive clients from future deferrals amid concerns that tax rates will increase. Furthermore, executives are increasingly concerned about benefit security. Other executives simply dislike the IRC § 409A restrictions on the timing of payouts. In sum, all of these factors contribute to the recent declines in plan deferrals and increase in plan distributions.

Many companies purchased Corporate Owned Life Insurance (COLI) to finance obligations with a tax efficient vehicle and brought multiple tranches over the years to keep up with ever increasing deferrals (relative to plan distributions). Now that the balance between deferrals and plan distributions is changing for some companies, there is increased discussion on how to manage COLI in the context of shrinking plans.

HOW MUCH IS TOO MUCH COLI?

At the most basic level, many companies want to limit COLI cash surrender value (CSV) to the amount of pre-tax benefit obligations. CSV substantially in excess of benefit liability is no longer benefit financing but an investment. Although banks and other financial institutions hold cash value life insurance as a tax-efficient alternative to taxable fixed income investments, most nonfinancial institutions limit COLI CSV to the amount of pre-tax benefit obligations. To paraphrase the Chief Financial Officer of a manufacturer, "excess COLI moves us from the widget business into the COLI business—that's not why investors buy our stock." Financial executives from some nonfinancial institutions shun COLI in excess of plan obligations even when annual COLI gains exceed the cost of funds. These financial executives point out that the cost of funds is more than just the after-tax cost of borrowing. Carrying debt to finance COLI increases leverage. Leverage equals risk. More importantly, credit lines have limits. Of course capital is not limited to debt. Tying excess COLI to equity capital, however, is even more unlikely: Most investors do not buy stock in a non-financial company expecting that significant assets will be invested in COLI.

WHAT CAUSES COLI CSV TO EXCEED THE BENEFIT OBLIGATION?

When companies pay benefits out of working capital, the benefit liability reduces, but the COLI CSV continues to grow. Companies pay benefits in cash because distributions from COLI can reduce COLI performance (as measured by the internal rate of return on cash flow at death). COLI distributions include withdrawals, partial surrenders, and policy loans. During the first few years, withdrawals and partial surrenders are subject to surrender charges. Even after surrender charges no longer apply, withdrawals and partial surrenders during the first fifteen years can be subject to partial taxation in some circumstances. Finally, any distributions from policies classified as Modified Endowment Contracts (MECs), which are popular with banks and almost synonymous with Bank Owned Life Insurance (BOLI), are always on a gains first basis. Because of these restrictions, companies often pay benefits from working capital rather than COLI CSV. Sometimes companies become so accustomed to paying benefits from working capital that they continue to do so, even when depleting working capital is no longer necessary.

WHAT NEEDS TO BE CONSIDERED IN REDUCING COLI TO AN APPROPRIATE LEVEL?

Companies can manage the relationship between COLI CSV and benefit obligations by netting deferrals against benefit payouts. In other words, cash compensation deferred by one employee finances the benefit payout of employees receiving benefit payouts. For COLI CSV that already exceeds the appropriate amount, the primary considerations for reducing COLI are minimizing taxes, maximizing future cash value growth, and preserving certain death benefits.

Minimizing Taxes

The first step in minimizing taxes is determining whether any policies are MECs. MECs emphasize cash value growth, but this growth comes at the expense of liquidity. Distributions from MECs are taxable to the extent of gain and assume the withdrawal of gains before tax basis. Gains are also subject to an additional 10% penalty tax. Furthermore, all MECs issued by the same carrier to the same taxpayer in the same year are aggregated for purposes of calculating gains. This unfavorable taxation makes it difficult to reduce the CSV of MECs. Death proceeds from MECs are treated the same as non-MECs—generally income tax free. The tax restrictions limit the liquidity of MEC contracts. Death proceeds are generally the only feasible method of receiving money from MEC contracts as long as the company pays taxes.

For non-MECs, the general rule is that taxpayers may withdraw the tax basis of the contract first. The withdrawal of tax basis is income tax-free. The term "tax basis" essentially refers to cumulative premiums net of any withdrawals or surrenders. Yet, there are exceptions to the general rule: withdrawals or partial surrenders during the first fifteen years may be subject to gain first taxation, especially when such distributions are combined with reductions in death benefits. [*See* IRC § 7702(f)(7).] Subject to certain restrictions, the tax basis of non-MEC policies is an important measure of the liquidity of COLI.

Employers that have exhausted the tax basis of non-MEC policies can consider policy loans to trim COLI CSV further. Policy loan proceeds are not taxable, and policy loan balances directly offset COLI CSV for accounting purposes. [*See* FASB Financial Interpretation No. 39.] Policy loans further diminish COLI returns and insufficient policy values can risk lapse of the policy.

Maximizing Future Cash Value Growth

The second consideration in minimizing COLI cash value is maximizing future cash value growth. Though distributions from the contracts may reduce future growth, efforts should be taken to minimize the negative growth impact. Rarely do all COLI policies grow at the same rate, and the rate of growth for the past year may not be indicative of the rate of growth for the following year. For example, a policy in the process of amortizing early surrender charges may grow more quickly in the future. Likewise, a policy that just received a special interest credit that is paid only in the 10th policy year may not grow as quickly in year 11. For dividend paying policies, partial surrenders should be deferred until the policy anniversary to receive the full dividend—policy dividends are not earned on a prorate basis. When cash value growth is important, the key is reducing those policies with the slowest future growth potential.

Preserving Certain Death Benefits

The third consideration in minimizing COLI cash value is preserving certain death benefits. Some companies have agreed to endorse a portion of certain policies as part of an executive life plan. COLI coverage that is necessary and not easily replaceable must be preserved. Also, coverage on executives with short life expectancies can create windfalls unless the coverage is experience rated. These issues make it important to analyze the effects policy distributions will have on the COLI coverage amounts.

Control of COLI Distribution Proceeds

The fourth consideration is control of COLI distribution proceeds. When a Rabbi Trust owns COLI policies, distributions from these policies are payable to the Rabbi Trustee. Cash owned by the Rabbi Trust is not available for working capital. Companies that want to take distributions from Rabbi Trust owned life insurance should review their Rabbi Trust agreement to determine the company's right to reimbursement for benefits already paid directly by the company, reversion provisions, and distribution of Rabbi Trust income.

FACTORS THAT AREN'T CONSIDERATIONS

There are many factors that are mistakenly thought of as key considerations for managing COLI liquidity. Two of the more common misconceptions are tying specific policies to the liabilities on individual lives and attempting to sell COLI on the life settlement market.

Regarding the first misconception, most companies no longer link the cash value on an individual executive's life and the benefit obligation on that same executive. Matching cash value and benefit obligations by individual does not increase benefit security but unnecessarily restricts access to funds. Modern COLI financing is managed in the aggregate. Companies are not limited to the cash value of the policy insuring an executive when considering sources of funds to pay benefits to that same executive; the funds can come from any policy. This increases the flexibility and efficiency of COLI financing.

Concerning the second misconception, selling COLI policies on the life settlement market is generally not a feasible liquidity strategy. Recent newspaper headlines have reported the popularity of a secondary market for life insurance. Sell policies you no longer need to companies that specialize in buying such policies and receive more than the cash surrender value—in some cases substantially more, depending on the health of the insured—so the headlines read. The challenge with selling COLI on the life settlement market is that life settlement pricing relies on reverse underwriting—reverse because the shortest life expectancies receive the best pricing. Estimating life expectancy requires current medical information on the insured, and only the insured inidividual has the authority to release such information. Those insured employees with the shortest life expectancies are likely to be the least willing to release medical information without compensation. Compensating the insured employee for the release of the medical information reduces any potential gains to the employer. Worse, the employee (or former employee) may associate the sale of the policy with the reduction of benefits. Employers contemplating the life settlement of COLI policies should brace themselves for open hostility from the insured individuals and their families. As a result of all these factors, the sale of COLI policies in the life settlement market is limited to large, medically underwritten policies in the small business market, where management's intention is to use life settlement proceeds in excess of surrender values to compensate insured employees.

HOW SHOULD THE LIABILITY BE PROPERLY FUNDED?

Companies that are seriously concerned about benefit security should fund a Rabbi Trust sufficiently to pay benefits in the event that current or future management refuses to pay such benefits. This concern is the risk of not receiving benefits because of a change of heart or change of control. Rabbi Trust assets must be explicitly available to corporate creditors in the event of the employer's bankruptcy to avoid taxation under the economic benefit doctrine and to exempt the plan from Title 1 of ERISA. Rabbi Trusts commonly own COLI as long as the company continues to pay benefits.

Deferred tax assets, on the other hand, don't provide benefit security, as they represent future tax savings on benefit payments. It is impractical for a Rabbi Trust to own such assets because these assets are purely an accounting concept, not a financial asset that can be sold or assigned. Executives do not want to depend on future tax savings to fund benefit payments. Although deferred tax assets provide some comfort that a company is profitable enough to realize these future deductions, deferred tax assets are no substitute for financial assets when it comes to benefit security.

COLI VS. TAXABLE INVESTMENTS

Of course, the Rabbi Trust doesn't have to own COLI. Almost any financial asset that can be turned to cash is a candidate for nonqualified benefit funding, but mutual funds are the most common alternative. Obviously, COLI saves taxes in up markets for companies that pay taxes, but what are some of the other issues that financial executives should consider in deciding on the appropriate mix of COLI and mutual funds?

- Liquidity: consider how benefits paid in the near term will be paid. If the COLI policies are the source of funds for benefit payments, consider taking an income tax-free distribution from the policies to pay any benefits due in the short term. These balances are likely invested in low-risk low-return investment funds, which do not benefit as much from COLI tax benefits as higher-risk higher-return investment funds. Higher returns in taxable investments generate higher tax bills. The value of tax treatment is directly proportionate to the taxes saved.

- P&L volatility: COLI improves after-tax income (at the expense of EBITDA) in up-markets for tax paying corporations. Up markets increase benefit liabilities and related benefit expense. Deferred tax savings mitigate this expense. COLI creates no related deferred tax, so the deferred tax savings in up-markets usually exceed any erosion of EBITDA. Conversely, down markets reduce benefit liabilities and benefit expense. Deferred taxes offset these savings. COLI losses create no related deferred tax savings, so the deferred tax expense aggravates the EBITDA loss. This volatility results from tax leverage. Employers can control this volatility by limiting leverage—limiting COLI to the benefit liability net of the deferred tax asset, especially for the most volatile investment funds.

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