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Bank-Owned Life Insurance: Much More than Just Janitors Insurance

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I. INTRODUCTION

How much should the death of a rank-and-file employee financially reward an employer? Although the answer to that question may depend on various factors, many feel that the answer should be: not at all.¹ Nonetheless, many employers have benefited from the deaths of a broad base of their employees since the 1980s through the use of insurance referred to as "corporate-owned life insurance" (COLI) or, when purchased by banks (a common use), "bank-owned life insurance" (BOLI).² Banks such as Bank of America, J.P. Morgan Chase, and Wachovia all expect to benefit when particular employees die, even though, in most cases, the employees' heirs will not receive any direct benefit under the BOLI policies the banks have procured.³

BOLI is a controversial topic, and to the layperson, it may seem as though banks are profiting from the deaths of employees merely to bolster their bottom lines, as suggested by recent press stories.⁴ In reality, however, most banks actually tie the gains (formally or informally) they receive when their employees die to the funding of pre- and post-retirement benefit obligations owed

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2. Valued Employees, supra note 1. While "broad-based" COLI came into existence only in the last few decades, other business uses of life insurance, such as coverage on "key persons" to the business' success or on business owners to facilitate ownership succession in the event of death, have much longer histories. Telephone Interview with Richard Mann, Principal Member, Mann, Conroy, Eisenberg & Assocs., LLC., in Greensboro, N.C. (Sept. 23, 2006).

3. See Big Banks, supra note 1.

4. Valued Employees, supra note 1; Many Banks, supra note 1; Big Banks, supra note 1.
to their employees. Even so, some banks’ and other companies’ abuse of this particular financial tool has caused public outcry, litigation, and legislation. Despite the controversy surrounding BOLI, banks should continue to use it cautiously in order to take advantage of the myriad of benefits that it offers as a legitimate investment.

Part II of this Note briefly discusses the mechanics of BOLI and why banks have invested in it so heavily. Part III examines the controversy surrounding BOLI, including unfavorable press reports along with litigation concerning a once-popular but now defunct version of COLI called “leveraged” COLI, and the administrative guidance that has governed bank purchases of BOLI. Part IV discusses the recent enactment of the Pension Protection Act of 2006 and how it affects BOLI. Finally, Part V analyzes BOLI in the current atmosphere and concludes that in many cases it continues to be a sound and appropriate investment for banks.

II. THE MECHANICS AND USES OF BOLI

Banks have used BOLI to take advantage of life insurance contracts as tax-favorable investments since the late 1980s. Before describing why and how banks have invested in BOLI, it is


8. See infra notes 13-76 and accompanying text.

9. See infra notes 77-120 and accompanying text.


11. See infra notes 121-41 and accompanying text.

12. See infra notes 142-147 and accompanying text.

13. Valued Employees, supra note 1.
appropriate to describe the investment characteristics of life insurance in general.

A. **Investing in Life Insurance**

Generally, death benefits from a life insurance contract are tax-exempt to the beneficiaries of the contract.\(^{14}\) Life insurance contracts typically involve (1) an insurer – the life insurance company that issues the contract, (2) a policyholder – the party that owns the contract, (3) the insured – the person whose life is insured by the contract, and (4) one or more beneficiaries – those parties that will receive proceeds from the insurer when the insured dies.\(^{15}\) There are several forms of life insurance, including term life insurance and permanent life insurance.\(^{16}\) This Note deals with permanent life insurance, as it is the type of life insurance that BOLI plans utilize.\(^{17}\)

Typically, with permanent life insurance, policyholders pay level premiums every year in order for the insured to remain covered.\(^{18}\) These premiums fund the contracted amount of death benefits that the beneficiaries will receive.\(^{19}\) They are determined by actuaries based on, among other factors, life expectancy, carrier profits, and carrier expenses.\(^{20}\) Once insurers receive premiums from policyholders, they invest them in order to increase the cash

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16. *Id.* Term insurance involves an insured whose life is only insured for an agreed-upon duration of time. *Id.* at § 173.05(A). With this type of insurance, once the insured survives past the agreed-upon date, his or her life is no longer insured. *Id.*
17. OCC 2004-56, *supra* note 5, at 23; Telephone Interview with Richard Mann, *supra* note 2. This is perhaps a simplification for the ease of the reader. In reality, BOLI plans usually utilize universal life insurance or, in some cases, whole life insurance, which are particular types of permanent life insurance. OCC 2004-56, *supra* note 5, at 22. In general, permanent life insurance is intended to provide coverage for the entire life of the person insured, whereas term life insurance, as the name suggests, provides coverage only for a defined term. *Id.*
19. *Id.*
values of the policies, with the expectation that, with continued premium payments and interest accrual, the cash values will be adequate to cover the agreed upon death benefits when the insureds are expected to die.\textsuperscript{21} Such an increase in a policy’s cash value is the life insurance contract’s inside “build-up.”\textsuperscript{22} This build-up is not currently taxable to beneficiaries or policyholders, as it will only later pay the death benefits when the insureds die.\textsuperscript{23} The concept of the cash value of insurance policies is very important and can be described as an actuarially-determined combination of (1) premiums paid into the contract, (2) compound interest gained every year on those premiums, and (3) the value of the remaining coverage to the insured, with the insurers’ costs of providing such coverage being subtracted out each year.\textsuperscript{24} In understanding the attractiveness of BOLI as an investment, the important consideration is not exactly how the cash value accumulates, but rather that it accumulates on a tax-deferred basis and ultimately passes tax-free when paid out as death benefits.\textsuperscript{25}

As indicated above, banks and other corporations invest in BOLI and COLI primarily to fund pre- and post-retirement benefits owed to their employees.\textsuperscript{26} “These benefits typically include ‘welfare’ benefits such as the payment or coverage of retiree health care expenses.”\textsuperscript{27} A discussion of the events leading up to the creation of BOLI helps demonstrate the product’s usefulness.

\textsuperscript{21} Appleman, supra note 15, at § 173.05(C); Telephone Interview with Richard Mann, supra note 2.
\textsuperscript{22} Appleman, supra note 15, at § 173.05(H)(1).
\textsuperscript{23} William A. Klein et al., Federal Income Taxation 110 (14th ed. 2006). While the inside build-up is not taxable if it remains in the policy until death proceeds are paid out, if a life insurance policy is surrendered before the insured dies, any amount received over and above the investment (premiums) in the policy are taxable when the policy is surrendered. Id. at 114.
\textsuperscript{24} Appleman, supra note 15, at § 173.05(C)(3)(a). Cost of Insurance (COI) can include administrative costs as well as profit for the insurance company. Klein et al., supra note 23, at 110. The COI element of life insurance became very important to banks in determining how to structure their BOLI plans. See Telephone Interview with Richard Mann, supra note 2.
\textsuperscript{25} See supra notes 18-24 and accompanying text.
\textsuperscript{26} See OCC 2004-56, supra note 5, at 1; Adney et al., supra note 5, at 44.
\textsuperscript{27} Adney et al., supra note 5, at 41.
B. Developments Leading to the Creation of BOLI

Entrepreneurs created BOLI largely as a result of two developments in the 1980s that affected the attractiveness of municipal bonds as investments and how banks were to account for certain expenses. The first development was the Tax Reform Act of 1986 (TRA), which, among other things, altered the federal income tax treatment of bank investments in municipal bonds. Municipal bonds have tax-exempt returns that encourage investment in them. Although municipal bonds typically have low before-tax returns, their after-tax returns are sometimes comparable with the after-tax returns of other taxable bonds. At the same time, municipal bonds are generally much safer investments than taxable corporate bonds. Before TRA, banks were able to take out loans that indirectly funded the purchase of municipal bonds and deduct the interest payments on those loans. Banks, which, due to regulatory requirements generally, can invest only in high quality “bank eligible” securities, took advantage of the financial benefits of such investments and thus became the largest investor in municipal bonds by the 1980s. This changed, however, when Congress passed TRA, which “placed a severe limit on the amount banks could deduct – eighty percent of the costs of purchasing and carrying bonds of issuers that do not issue more than $10 million of bonds annually.”

28. Telephone Interview with Richard Mann, supra note 2.
32. See KLEIN ET AL., supra note 23, at 185.
33. Id.
34. Hearing, supra note 30, at 38.
35. See id.
36. Id. A similar arbitrage issue was later presented by “leveraged” COLI plans, which was the subject of litigation discussed later in this Note. See notes 97-103 and accompanying text.
bonds were no longer as attractive as investments and banks willingly considered other financing alternatives.\textsuperscript{37}

The second blow to banks, as well as all publicly held companies, came with the Financial Accounting Standards Board's Statement Number 106 (FAS 106) issued in December of 1990.\textsuperscript{38} FAS 106 required employers to currently account for future post-retirement liabilities they would later owe to their employees.\textsuperscript{39} Thus, banks had to determine such future liabilities, discount them to present value with an appropriate interest rate, and account for them over time on their books as current expenses.\textsuperscript{40} This new accounting requirement greatly reduced banks' earnings, which made them look relatively worse to stockholders.\textsuperscript{41} This development left banks with a desire to consider arrangements that would increase earnings in order to help offset the new accounting requirement.\textsuperscript{42}

BOLI arose as a response to the combination of these two occurrences, which seemed to fill both the tax-favorable investment gap as well as the need to increase earnings immediately.\textsuperscript{43} BOLI permitted tax-deferred returns to build-up in the policy and provided a mechanism with which banks could help offset their post-retirement benefits expenses without suffering an immediate expense and reduction of current earnings.\textsuperscript{44}

\textbf{C. The Mechanics of BOLI}

BOLI is composed of life insurance contracts covering the lives of banks' employees – sometimes many thousands of

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\textsuperscript{38} STATEMENT OF FINANCIAL ACCOUNTING STANDARDS NO. 106, EMPLOYERS’ ACCOUNTING FOR POSTRETIREMENT BENEFITS OTHER THAN PENSIONS, FIN. ACCOUNTING STANDARDS BD., Dec. 1990.

\textsuperscript{39} ld. at 5.

\textsuperscript{40} See id.

\textsuperscript{41} Telephone Interview with Richard Mann, supra note 2.

\textsuperscript{42} ld.

\textsuperscript{43} See supra notes 28-42 and accompanying text.

\textsuperscript{44} See infra notes 45-51 and accompanying text.
employees— in which the banks are the sole beneficiaries. Thus, when the insured employees die, the banks receive the tax-free death benefits. Each year, as the cash values of the life insurance policies grow, the bank-beneficiaries account for these increases in value on a tax-deferred basis on their income statements. Banks nominally tie these earnings to the post-retirement employee benefits, for which they must now account. This effectively allows banks to net the inside build-up earnings against the future liabilities and thus reduce some of the expense line from their income statement altogether. With a new tax-free investment alternative to municipal bonds that actually helped to solve their future liabilities expense-reporting problem, banks turned to BOLI in droves in the early 1990s.

Four additional benefits make investing in BOLI more favorable than investing in municipal bonds. First, BOLI plans can yield higher returns than municipal bonds. This is because insurance companies invest in underlying assets such as corporate bonds that fuel the inside build-up of the cash value of the insurance policies. Second, BOLI investments generally last

45. See Valued Employees, supra note 1.
46. Many Banks, supra note 1; see also Telephone Interview with Richard Mann, supra note 2 (describing BOLI as such).
47. See APPLEMAN, supra note 15, at § 173.05(H).
48. Id.
50. Id. Also, banks tied the investments to the post-retirement liabilities in order to placate the Office of the Comptroller of the Currency (OCC), which oversees banks with a national charter. Id.
51. See Big Banks, supra note 1 (discussing extent to which banks invested in BOLI); Telephone Interview with Richard Mann, supra note 2.
52. See infra notes 53-63 and accompanying text.
54. OCC 2004-56, supra note 5, at 20; Telephone Interview with Richard Mann, supra note 2. Although municipal bonds may have similar returns to the after-tax returns corporate bonds yield, the fact that the underlying investment in the corporate bond is made for the accrual of interest to pay an insurance death benefit removes the tax consideration from the corporate bond return altogether and thus results in a tax-free return of the corporate bond outpacing that of a municipal bond. Id.
much longer than the life of municipal bond investments. While municipal bonds might mature five, ten, or even twenty years after their purchase, BOLI contracts do not mature until the death of the insured employee, which in many cases can be as late as forty or more years after the purchase date. Obviously, the longer banks can profit from sound, tax-favored investments, the better. Third, the death proceeds from BOLI plans tend to very closely match the timing of employer health care costs, which seem to increase sharply near the time of death. Finally, BOLI plans are somewhat insulated from the interest rate risk associated with long-term, fixed-income investments. This is due to insurance companies' utilization of corporate bonds and other investments as the source of the policies' inside build-up. Instead of investing only in long-term bonds, insurance companies typically invest in relatively shorter-term debt instruments, perhaps with durations of around five years. Thus, even if interest rates in general were to rise rapidly, the loss to the underlying corporate bonds' value would be minimized due to their shorter average life spans. Once those bonds mature, insurance companies can simply re-invest in new bonds and take advantage of the potentially higher interest rates. In short, the insurance contracts' buffers allow banks to have long-term investments with relatively low interest rate movement risk.

55. OCC 2004-56, supra note 5, at 15 (stating that “[m]ost BOLI products have very long-term (30- to 40-year) expected time frames for full collection of cash proceeds, i.e., the death benefit”).
56. Id.; Telephone Interview with Richard Mann, supra note 2.
57. Adney et al., supra note 5, at 45. (citing James D. Lubitz & Ronald Prihoda, The Use and Costs of Medicare Services in the Last 2 Years of Life, HEALTH CARE FIN. REV. 5 (Spring 1984)).
58. Telephone Interview with Richard Mann, supra note 2. Described briefly, “interest rate risk is the risk to earnings and capital arising from movements in interest rates.” OCC 2004-56, supra note 5, at 16. For example, a bank is exposed to an interest rate risk when it invests in a long-term, fixed-rate bond. If interest rates rise rapidly before the bond matures, the value of the bond decreases rapidly as investors could yield higher returns by purchasing other bonds with similar risk characteristics.
59. Telephone Interview with Richard Mann, supra note 2.
60. OCC 2004-56, supra note 5, at 16.
61. Id.
62. Id.
63. Id.
D. The Evolution of BOLI

Although BOLI began as a fairly straightforward product, it was not long until the market saw new variations of the product. The first renditions of BOLI involved general-account life insurance policies. The term "general-account" refers to the fact that the inside build-up increased at rates reflecting the returns generated by a mix of investments in the carrier’s general portfolio and that the life insurance company guaranteed a certain floor below which the cash value of the policy could not drop. Despite this guaranteed floor, the bank policyholders were subject to the credit risk of the carrier as general creditors. These risks were reduced, however, by the existence of states’ guarantee funds, which provided limited protection for policyholders of insurance contracts in the event of a carrier’s insolvency.

As tax planners became more sophisticated, new variable-life, separate account BOLI plans emerged which advertised either higher yields or lower costs for banks. For example, variable-life, separate account BOLI plans, as the name implies, included a variable rate of inside build-up based on the performance of various investments in which the life insurance company invested. In some cases, in order to feel secure in the soundness of these underlying investments, the plan permitted banks to select among the carrier’s available investment options that would vary in terms

64. See id.
69. OCC 2004-56, supra note 5, at 28; Telephone Interview with Richard Mann, supra note 2.
of risk and reward structures. With these variable-life, separate account BOLI plans, there was no guarantee from the insurer that the cash value of the policies would not dip below a certain amount. As a result, because of banks’ desire to develop stable earnings from these products, they would buy “stable value product” features in their plans. These features effectively smoothed out market value fluctuations of the underlying investment to maintain stable, non-volatile, and reasonably predictable earnings for the banks.

Overall, BOLI is a quite sophisticated and complex product that allows banks and other companies to receive tax-free (1) the inside build-up on the life insurance policy and (2) the death benefit when the insured employee dies. Because some might find the practice of an employer benefiting from the death of its employees suspect, it comes as no surprise that controversy concerning BOLI and COLI arose as the popularity of these products increased.

III. CONTROVERSY SURROUNDING BOLI

A. Janitors Insurance

In the spring of 2002, The Wall Street Journal began attacking BOLI and COLI as being unethical in nature. Although banks were taking out insurance contracts on the lives of their employees, not all BOLI purchasers were actually informing

70. McCarter, supra note 68.
71. See id.; OCC 2004-56, supra note 5, at 10; Telephone Interview with Richard Mann, supra note 2.
72. Telephone Interview with Richard Mann, supra note 2.
74. See supra notes 18-24 and accompanying text.
75. Valued Employees, supra note 1; Many Banks, supra note 1; Big Banks, supra note 1.
76. See infra notes 77-105 and accompanying text.
77. Valued Employees, supra note 1; Many Banks, supra note 1; Big Banks, supra note 1.
their employees of the coverage, sometimes contrary to state law.\textsuperscript{78} According to the press reports, this was largely due to the banks' and other companies' realistic supposition that at least some employees would object to BOLI and COLI.\textsuperscript{79} Once a few employees learned that their employers, or in many cases, ex-employers, would benefit from their deaths, they went to the press seeking exposure.\textsuperscript{80} \textit{The Wall Street Journal} ran several articles that criticized companies and banks for benefiting from their employees' deaths,\textsuperscript{81} describing the practice of investing in BOLI or COLI as unfair and calling the type of insurance "janitors insurance" or "dead peasants policies."\textsuperscript{82}

While some of the BOLI and COLI plans described in the articles did not seem particularly attractive, the articles failed to mention that the cases described were not the typical BOLI and COLI practices of the time.\textsuperscript{83} In fact, many companies that took out insurance coverage on their employees did so only with the consent of the employee.\textsuperscript{84} Further, \textit{The Wall Street Journal} failed to mention that the purpose of most BOLI and COLI plans is to fund pre- and post-retirement benefit obligations that employers owe to their employees.\textsuperscript{85} Thus, even though certain employees may not want their employers to profit from their deaths, the death benefits help to fund pre- and post-retirement employee benefits provided to the employees.\textsuperscript{86} Therefore, in aggregate BOLI and COLI help both employers and employees. Nevertheless, \textit{The Wall Street Journal}'s unfavorable view of BOLI and COLI likely influenced Congress to bring about the employer-
owned life insurance reforms of the Pension Protection Act of 2006 discussed later in this Note.  

B. Litigation Surrounding BOLI and COLI

Coincidental with the unfavorable press coverage, courts found some older COLI plans for large corporations such as Winn-Dixie,88 Wal-Mart,89 and, more recently, Dow Chemical90 invalid and thus not subject to favorable tax treatment. The two main reasons for holding that the plans were impermissible were (1) that the investing company lacked an insurable interest in some or all of the insured employees,91 and (2) that the COLI plans were economic shams.92 State law determines whether an entity has an insurable interest in an insured, as the states are the primary regulators of insurance companies and insurance contracts.93 In Mayo v. Hartford Life Ins. Co., the court stated that Wal-Mart would have an insurable interest in its employees if it “possess[ed] a reasonable expectation of pecuniary benefit or advantage from the continued life of [its employees].”94 The court further explained this requirement by suggesting it would be satisfied if Wal-Mart would be in a better economic position if its employee lived rather than died.95 Wal-Mart was determined to lack an insurable interest in the 350,000 employees it had covered in its

87. See infra notes 121-41 and accompanying text.
92. See, e.g., Dow, 435 F.3d 594; Am. Elec. Power, Inc. v. United States, 326 F.3d 737 (6th Cir. 2003); In re CM Holdings, 301 F.3d 96 (3d Cir. 2002). Described briefly, an economic sham is a transaction that has no “practicable economic effects other than the creation of income tax losses.” Dow, 435 F.3d at 599 (citing Rose v. Comm’r, 868 F.2d 851, 853 (6th Cir. 1989)).
93. See Adney et al., supra note 5, at 46 (noting that states vary considerably as to what constitutes an insurable interest in an employee).
95. See id. at 799. There is a “key man” exception to this rule where a company has an insurable interest in the lives of particular persons to whom stockholders look for the overall success of a business. Id. at n.11.
COLI plan and, thus, the proceeds from the insurance contracts were distributed to the insured employees' estates. 96

In contrast to insurable interest, federal law governs what constitutes economic shams for purposes of claiming favorable federal income tax treatment. 97 Much more litigation centered on the economic sham argument, which resulted in large tax liabilities for companies abusing COLI in this manner. 98 The type of COLI that courts found to be economic shams was called "leveraged" COLI. 99 The companies that owned leveraged COLI borrowed against the cash values in the policies in order to pay for the premiums. 100 It was this borrowing of all cash values in the policies coupled with interest deductions claimed for such borrowing that led to the "sham" conclusions. 101 However, Congress added interest deduction rules to the tax code in 1996 and 1997 that shut down this "leveraged" product. 102 Therefore, companies no longer use this abusive type of COLI. 103

BOLI is not subject to the same economic sham arguments that the government used to defeat the older "leveraged" COLI plans because banks generally do not borrow against the policies in order to fund premium payments. 104 Nevertheless, while the holdings from the economic sham cases do not affect banks directly because they have purchased plans that do not exhibit the same characteristics that courts found abusive in the leveraged COLI cases, the negative perception of COLI that such cases precipitated may still injure the reputation of banks that appropriately hold non-abusive BOLI. 105

96. Id. at 808-09; Adney et al., supra note 5, at 47.
97. Adney et al., supra note 5, at 51.
99. Id.
100. Adney et al., supra note 5, at 51; Telephone Interview with Richard Mann, supra note 2.
101. Adney et al., supra note 5, at 51.
102. Id. at 51-52; Katz, supra note 98.
103. Adney et al., supra note 5, at 51-52.
Banks are highly regulated institutions. Since December 2004, they have also had the benefit of an interagency statement on the purchase and risk management of BOLI (the Guidance) issued by the federal banking regulators, which supersedes the previous guidelines of OCC Bulletin 2000-23. The Guidance sets forth guidelines that banks must follow when determining whether to purchase BOLI and when assessing risk while they hold BOLI plans. Before purchasing BOLI, banks must undergo an intensive “pre-purchase analysis” of the product. Along with other considerations, the analysis should include matching the need for insurance with the appropriate type of BOLI product, determining the appropriate amount of insurance needed, “assessing vendor qualifications,” and evaluating alternative investments that might meet the bank’s needs. The Guidance also requires banks to perform ongoing risk evaluations while they hold BOLI plans. The OCC determined that banks must consider several categories of risks to which BOLI might expose them, including “Tax and Insurable Interest Implications” and “Reputation Risk.” The Guidance emphasizes the importance of favorable tax treatment to the profitability of BOLI plans and warns that either “investor control” or the lack of an insurable interest would result in the loss of such treatment. 


109. Id. at 6.

110. Id. at 6-10.

111. Id. at 10.

112. Id. at 11-19. “Reputation Risk” is a new category of risk that was not present in OCC Bulletin 2000-23 and was likely included in the Guidance on account of the negative publicity and litigation surrounding COLI and BOLI. Regulatory Alert on BOLI Guidance, supra note 107.

control is only an issue with separate account, variable BOLI products, and thus banks purchasing separate account BOLI plans should pay close attention to tax laws concerning investor control.\textsuperscript{114} Banks should also obtain legal counsel in order to comply with state insurable interest laws, as compliance with the Guidance may not fulfill them.\textsuperscript{115} Therefore, although the guidelines set forth in the Guidance help banks avoid supervisory action, banks must still consider tax laws and insurable interest laws in order to avoid the abuses at issue in the previously mentioned cases.\textsuperscript{116}

Banks must also assess the reputation risk that these cases may carry for them.\textsuperscript{117} As publications like \textit{The Wall Street Journal} have characterized all BOLI and COLI plans as largely the same,\textsuperscript{118} customers and employees may regard BOLI as improper or unfair. Consequently, banks should encourage positive press concerning the way that they properly invest in BOLI and their purpose for doing so. The approach suggested by the Guidance is to obtain formal employee consent before insuring his life.\textsuperscript{119} Employee consent would likely decrease lawsuits as well as mitigate the unfavorable perception of BOLI described in \textit{The Wall Street Journal} articles.\textsuperscript{120} In addition, such consent is now required pursuant to the Pension Protection Act of 2006, discussed next.

\section*{IV. The Pension Protection Act of 2006}

In response to the controversy surrounding BOLI and COLI, Congress enacted section 863 of the Pension Protection Act of 2006 (the Act),\textsuperscript{121} which President Bush signed into law on

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\textsuperscript{114} Id. at 13.
\textsuperscript{115} Id. The Guidance asserts that "[c]ompliance with the supervisory guidance in this interagency statement . . . does not determine whether the policy satisfies state insurable interest requirements." Id. at 1.
\textsuperscript{116} See supra notes 91-102 and accompanying text.
\textsuperscript{117} OCC 2004-56, supra note 5, at 14.
\textsuperscript{118} See Adney et al., supra note 5, at 49-50.
\textsuperscript{119} OCC 2004-56, supra note 5, at 14.
\textsuperscript{120} See \textit{Valued Employees}, supra note 1; \textit{Many Banks}, supra note 1; \textit{Big Banks}, supra note 1.
\end{flushleft}
August 17, 2006. Section 863 of the Act adds section 101(j) to the Internal Revenue Code, which creates a broad rule that prevents employers from excluding from taxable income any death benefits that result from an insurance policy under which an employee of the employer is an insured. The result of this rule, if there were no exceptions, would be that employers owning BOLI or COLI policies could no longer enjoy the tax benefits that normally accompany such policies. Fortunately, section 101(j) carves out several exceptions that permit the tax-free benefits resulting from policies insuring particular employees.

Under section 101(j)(2)(A), an employer may exclude proceeds from a life insurance contract it owns on its employee if any time during the year prior to the employee’s death the insured was an employee, or if, at the time the contract is issued, the employee was (1) a “director,” (2) a “highly compensated employee,” or (3) a “highly compensated individual.” Both “highly compensated employee” and “highly compensated individual” have specific statutory definitions, but they generally refer to employees who are either compensated over $100,000 (adjusted for inflation) or are among the thirty-five percent most highly paid employees. The latter exceptions to the general exclusion disallowance rule acknowledge the long-accepted practice of insuring “key persons” – those employees, such as directors and other important employees, that have such an impact.

122. Unless otherwise indicated, all references to sections are to sections of the Internal Revenue Code of 1986, as amended (the Code).
123. I.R.C. § 101(j)(1) (LEXIS through 2006 Sess.).
124. Although § 101(j) refers specifically to an “employer-owned insurance contract,” its definition under § 101(j)(3)(A) is such that it may be equated with BOLI and COLI for the purposes of this Note.
125. § 101(j)(2)(A). There are also exceptions to the general rule based on amounts paid to an insured’s heirs under an employer-owned life insurance contract. § 101(j)(2)(B).
127. For “highly compensated employee,” see I.R.C. § 414(q) (2006) (generally describing a highly compensated employee to be a 5% owner or an employee who made over $80,000 in the previous year). For “highly compensated individual,” see § 105(h)(5) (2006) (describing a highly compensated individual to be one of the five highest paid officers, a shareholder owning more than 10% of the company’s stock, or among the 25% most highly paid employees in that taxable year (which is adjusted upward to thirty-five percent by § 101(j)(2)(A)(ii)(III))).
128. See §§ 105(h)(5), 414(q).
on their employer’s day-to-day activities that their deaths should be insured against in order to mitigate losses. In doing so, the provisions essentially limit COLI and BOLI tax benefits to plans that follow this “key person” formula, thus mitigating the perceived abuse of insuring the lives of low-level employees – the prototypical janitors – in whom the employers may not have insurable interests anyway.

In addition to limiting the types of employees that employers can insure, section 101(j) also imposes “notice and consent requirements” that employers must meet in order for any benefit from BOLI or COLI to be excluded from taxable income. In order to benefit from the tax advantages of BOLI or COLI, banks or other companies must take care that, before the life insurance contracts are issued, an employee:

1. is notified in writing that the applicable policyholder intends to insure the employee’s life and the maximum face amount for which the employee could be insured at the time the contract was issued; (2) provides written consent to being insured under the contract and that such coverage may continue after the insured terminates employment; and (3) is informed in writing that an applicable policyholder will be a beneficiary of any proceeds payable upon the death of the employee.

The employer must also report on BOLI and COLI annually to the Internal Revenue Service (IRS) and meet certain internal recordkeeping requirements related to the policies.

129. See Adney et al., supra note 5, at 43.
130. See supra notes 91, 93-96 and accompanying text.
131. I.R.C. § 101(j)(4) (LEXIS through 2006 Sess.).
132. Id. The term “applicable policyholder” refers to the bank or other company that owns the life insurance contract. § 101(j)(3)(B).
133. § 6039I. Briefly, section 6039I requires that any employer owning one or more employer-owned life insurance contract must report to the IRS (1) the number of its employees at the end of the year, (2) the number of those employees who are insured, (3) the total amount of insurance on those employees, (4) its “name, address, and taxpayer identification number” and its “type of business,” and (5) evidence that consent has been given on each insurance contract. Id. Further, any such employer
The Act only applies to BOLI or COLI contracts issued after August 17, 2006. This "grandfather clause" allows all BOLI and COLI contracts issued before the enactment of the Act to be exempt from its rules. Second, section 863 of the Act provides that the Act will not apply to a life insurance contract issued pursuant to section 1035 in exchange for a life insurance contract issued prior to August 17, 2006. The result of a "1035 exchange" is that policyholders may exchange an insurance policy insuring a particular person for a different insurance contract insuring the same person. Pursuant to section 1035, there is no recognition of gain or loss with such an exchange and thus there is no taxable event. Section 863 of the Act goes on to state that "any material increase in the death benefit or other material change shall cause the contract to be treated as a new contract." Thus, the IRS will treat any 1035 exchange that includes a "material change" in the life insurance contract as a new contract subject to section 101(j).

must keep sufficient records to show that these requirements and those set forth in section 101(j) are satisfied. Id.

134. Pension Protection Act of 2006, Pub. L. No. 109-280, § 863(d), 120 Stat. 780, 1024 (2006). The Act and limitations and requirements thereunder “apply to life insurance contracts issued after the date of the enactment of [the] Act, except for a contract issued after such date pursuant to an exchange described in section 1035 of [the Code] for a contract issued on or prior to that date.” Id.

135. See BLACK'S LAW DICTIONARY 718 (8th ed. 2004) (defining grandfather clause as “[a] provision that creates an exemption from the law's effect for something that existed before the law's effective date”).

136. See Pension Protection Act of 2006 § 863(d).

137. Id.


139. Id.

140. Pension Protection Act of 2006 § 863(d). There is an exception in the clause, but it is beyond the scope of this Note.

141. Id. The Supreme Court has held that properties "are ‘different’ in the sense that is ‘material’ to the Internal Revenue Code so long as their respective possessors enjoy legal entitlements that are different in kind or extent.” Cottage Sav. Ass'n v. Comm'r, 499 U.S. 554, 565 (1991). Thus, any difference between insurance policies involved in an exchange will result in the new contract as being subject to section 101(j) if such differences alter the legal entitlements of the parties in a manner described by the Court in Cottage Savings.
The Act certainly restricts BOLI plans, as it removes the favorable tax treatment of such plans insuring employees outside of the statutory limits, regardless of state insurable interest laws.\textsuperscript{142} Thus, to the extent that they were insuring employees outside of the new limits, banks may reduce the number of employees covered by BOLI going forward. Because pre-existing BOLI plans have been "grandfathered,"\textsuperscript{143} banks may continue to benefit from broader-based BOLI plans that insure hundreds, possibly thousands, of their employees.\textsuperscript{144} Nevertheless, banks should be cautious of the 1035 exchange and material change language contained in the Act.\textsuperscript{145} If new BOLI investments are made for new employees or to fund ever-increasing pre- and post-retirement employee benefits, banks must be sure to comply with the new notice, consent, reporting, and recordkeeping requirements set forth by the Act.\textsuperscript{146}

Further, even though controversy that may expose investing banks to reputation risks still surrounds BOLI,\textsuperscript{147} banks should continue to invest in BOLI while encouraging and contributing accurate press about the issue. One or two positive articles in major publications discussing the new requirements under the Act and the reputable practices complying entities undergo with regard to BOLI may help the public begin to view the issue in a more favorable light. If a discourse couples the requirements of the Act with an in-depth discussion of the benefits that BOLI provides to bank employees, the public may even encourage the practice. At the very least, informed employees should be much more willing to give their consent to an investment described as above.

\textsuperscript{142} See supra notes 123-30 and accompanying text.
\textsuperscript{143} See supra notes 134-36 and accompanying text.
\textsuperscript{144} As BOLI investments have relatively long terms, it can be expected that those banks that invested in BOLI previously will continue to benefit similarly as they have in the past for possibly the next thirty to forty years. See supra notes 53-54 and accompanying text.
\textsuperscript{145} See supra notes 137-41 and accompanying text.
\textsuperscript{146} See supra notes 131-33 and accompanying text.
\textsuperscript{147} OCC 2004-56, supra note 5, at 14.
VI. CONCLUSION

BOLI is a sophisticated financial product that allows banks to fund their pre- and post-retirement employee benefit obligations. 148 Banks have been able to use BOLI by employing some of the investment properties of life insurance in general and the favorable tax treatment thereof. 149 Although the potential for investing in life insurance long preceded the widespread use of BOLI, certain developments in financial accounting standards and tax treatment reform of municipal bonds spurred entrepreneurs to create this complicated and lucrative vehicle. 150 Through its use, banks and marketers alike became more familiar with the mechanisms of BOLI and began to expand the original idea of a general account model, thus resulting in large numbers of banks investing in BOLI. 151

Due to the widespread use of BOLI and COLI, as well as abuses of the products, publications such as The Wall Street Journal brought the issue to the attention of the public, coining terms such as “janitors insurance” to describe company-owned insurance on as many employees as possible. 152 Contemporaneously, several cases involving BOLI and COLI were litigated in state and federal courts. 153 In holding that the plans were economic shams or otherwise that the employer lacked an insurable interest in the employee, the courts added to the controversy surrounding the subject. 154 Most banks, however, were able to avoid litigation by following guidelines set forth in OCC Bulletin 2000-23 and later OCC Bulletin 2004-56. 155 In response to the controversy, and in an effort to curb abuses, Congress added section 863 to the Pension Protection Act of 2006. 156 This

148. See supra note 5 and accompanying text.
149. See supra notes 18-25 and accompanying text.
150. See supra notes 28-42 and accompanying text.
151. See supra notes 64-73 and accompanying text.
152. See supra notes 77-82 and accompanying text.
153. See supra notes 88-96 and accompanying text.
154. See supra notes 86-103 and accompanying text.
155. See supra notes 107-20 and accompanying text.
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legislation will likely be highly effective in curbing BOLI and COLI abuses going forward.\textsuperscript{157}

Even though controversy has surrounded BOLI, banks should continue to use it to fund their pre- and post-retirement employee benefit obligations while promoting greater understanding of the product. BOLI benefits both banks and their employees by providing a unique deferred-tax investment that banks use to fund pre- and post-retirement benefits.\textsuperscript{158} By utilizing BOLI as an effective investment strategy, banks should be more willing to offer their employees more and better benefits that might not otherwise be feasible.\textsuperscript{159} As such, this valuable investment tool should not be discarded because of negative press due to previous abuses of BOLI and COLI.\textsuperscript{160} Banks should continue to use BOLI to fund their pre- and post-retirement benefit obligations, but they should also be sure to pay close attention to the Act\textsuperscript{161} and to understand that they may need to implement public relations strategies to inform the public that BOLI benefits the insured employees by allowing for superior employee benefits.\textsuperscript{162}

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\textsuperscript{157} See supra notes 124-33 and accompanying text.
\textsuperscript{158} See supra notes 14-27 and accompanying text.
\textsuperscript{159} See supra notes 47-53 and accompanying text.
\textsuperscript{160} See supra notes 88-101 and accompanying text.
\textsuperscript{161} See supra notes 121-41 and accompanying text.
\textsuperscript{162} See supra notes 117-20 and accompanying text.