

Frequently Asked Questions About Company-Owned Life Insurance (“COLI”)

Q: *Why do companies institute COLI programs?*

A: Primarily to finance employee benefit plan expenses and increase net income. For example, companies have substantial costs for medical, group life, and other basic insurance as well as qualified and nonqualified benefit plan expenses that can be financed with COLI. The reasons companies use COLI for these costs include:

- ❑ COLI can earn a higher after-tax yield than many other investments.
- ❑ COLI matches the long-term nature of benefit plan expenses.
- ❑ COLI assets can be matched with benefit liabilities to offset the impact on earnings created by the benefit liabilities.

Q: *Do many companies have COLI plans today?*

A: Based on industry surveys from 1999, 68% of the Fortune 1000 companies finance their SERP obligations with COLI programs; and of the 50 top banks and thrift institutions in the United States, 43 have implemented COLI programs.

Q: *How does COLI work?*

A: The company purchases insurance on a group of employees. The insureds usually include a group of highly compensated management employees, e.g., assistant vice presidents and above.

The company pays the premium(s) and owns the cash value of the policies. The company is also the beneficiary of the insurance. The insured employees do not receive any of the insurance benefits directly, nor do they pay any of the premiums. The coverage does not replace or interfere with any other insurance provided by the company (e.g., group-term life insurance).

The COLI policies produce financial statement income for the company as the credited cash value increases exceed the premiums paid. The net after tax income earned may be higher than the return available on many alternative investments.

Q: *Do the policies actually fund the benefits like a pension plan funds retirement benefits?*

A: No. The policies are part of the general assets of the company. Properly stated, the insurance informally finances the cost of the benefits. The policies can either be put in a grantor trust (generally a “rabbi” trust), which remains an asset of the company, or they can be held by the company and not otherwise segregated.

Q: *What are the different types of COLI policies?*

A: Two basic types are characterized as:

1. **General Account COLI.** Credits a fixed interest rate annually to each policy. The interest rate credited is based on the expected return of the assets purchased by the insurance company less a margin for expenses. The assets are held in the general account of the insurance carrier. Either a “new money” approach or a “portfolio” (both described later) approach is used to determine credited interest rates. General Account COLI policies provide minimum annual interest guarantees in addition to full book value (cash value) guarantees and asset default protection.
2. **Separate Account COLI.** The interest rate credited to a Separate Account COLI policy is a variable yield that is based on the return on the underlying policy assets less a margin for expenses. Such assets are held in separate accounts of the insurance company. The separate account assets are sheltered from the general creditors of the insurance company in the unlikely event of the insurance company’s insolvency. A Separate Account COLI is a variable life insurance policy. Unlike a General Account contract, the cash values of a Separate Account contract will fluctuate with the market value of the underlying assets and are fully subject to the risk of asset default. These fluctuations have a direct impact on the purchaser’s balance sheet and income statement, since the cash value represents the book value of the life insurance contract. Some carriers employ a hedge strategy to smooth the annual returns.

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Q: *Is one type of COLI policy better than another?*

A: The answer depends on a company's desire to participate in selecting the investment mix of the funds underlying the COLI policy values. If the company does not want the burden of selecting the investment mix and accepting the risks associated with the investment results, General Account COLI is preferable. There are no investment decisions for the company to make, and it will have the underlying protection of a minimum interest guarantee. On the other hand, if the company is confident that it can select an investment mix likely to outperform the investment results of the insurance carrier's general account, and is willing to accept full risk for investment results, the Separate Account COLI policy may be preferable. Some companies split their coverage so that a portion of the company's contributions is allocated to each type of policy.

Q: *What are the differences between a "New Money" rate product and a "Portfolio" rate product?*

A: "New Money" and "Portfolio" describe the two philosophies or methods used by insurance companies in setting credited rates on their insurance policies. A New Money philosophy credits each policy with an interest rate based on assets available specifically at the time of purchase. These assets are tracked and determine the future interest of each specific case. A Portfolio approach is based on a pooling philosophy. The insurer pools all its assets and all its policies and determines a rate for all policyholders regardless of when the policies were purchased. While the New Money policies are more responsive to changes in interest rates than the Portfolio policies over a longer period of time, ultimately the performance will be similar.

Q: *If this were an opportunity for a company to make more money and finance benefit expenses at the same time, why wouldn't every company do it?*

A: Every company should buy COLI if it has these three characteristics:

1. The company is profitable
2. It has reasonable liquidity
3. It has employee benefit liabilities

MAKING A COLI PLAN WORK

Q: *Do the insurance policies have to be put into a separate account or trust?*

A: No, the policies are part of the general assets of the company. For administrative or other reasons, the company may choose to implement a grantor trust to hold the policies.

Q: *Does the company keep the coverage when the insured employees terminate or retire?*

A: Yes. The coverage on each individual insured is carried as part of an aggregate COLI pool. To make sure death benefits are collected on a timely basis, we track all covered employees in COLI pools administered by NYLEX Benefits via the Social Security System. At present, the system we use tracks over 200,000 employees. When the employee dies we access information via the Social Security System to file the death claim with the carrier.

Q: *What has been the employee reaction to the plans?*

A: Very favorable. Keep in mind, the coverage does not cost the employees anything. It makes their employer more financially viable and it is a plan that has been implemented by many of the country's largest and most reputable companies. While an employee cannot be forced to be covered within the COLI pool, our experience is that well in excess of 90% do participate.

Q: *Do the employees receive any of the cash benefits from COLI?*

A: Generally, no. However, some companies provide some additional death benefits to insured COLI participants by allocating a stated portion of the proceeds for the benefit of the participant's designated beneficiaries.

Q: *Does the company profit from the death of insured COLI participants?*

A: The company will generally earn more money if the employees never die. For example, when an employee dies, the company receives a death benefit but loses the future tax benefits of the policy. Mathematically, it would be better for the employees to never die as the insurance policies earn an after tax rate of return higher than the company can earn elsewhere, ignoring the ultimate value of the insurance death proceeds.

Q: *How long does it take to implement a COLI arrangement?*

A: Normally 2 to 3 months from start to finish.

COLI FINANCIAL IMPACT

Q: *Will COLI have an impact on a company's financial performance?*

A: COLI will favorably impact a company's financial performance by creating higher net after tax income without increasing the current tax liability. The result is an increase in earnings per share.

Q: *Are COLI premiums deductible to the purchasing company?*

A: No. The cash paid for COLI premiums is purchasing a company asset, and the cash value is credited to the company on a tax-deferred basis. COLI premiums (except for the recognition of any early surrender charges) require a cash flow outlay, but over time enhance earnings.

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Q: *What are the current earnings rates of COLI?*

A: The rate of return is a function of the type of policy purchased and the interest crediting approach (“New Money” vs. “Portfolio”) for General Account COLI arrangement, and based on the investment results of the separate accounts in a Separate Account COLI arrangement. Common structural elements are:

- ❑ All policies will have a rate based on the expected performance of the underlying assets in a General Account arrangement and based on the actual performance of the underlying assets in a Separate Account arrangement, less, in either arrangement, a margin for carrier expenses.
- ❑ Product expenses will be similar.
- ❑ Each carrier incurs approximately the same charges for premium tax, general administration, the federal Deferred Acquisition Cost (“DAC”) tax, and expected mortality and investment expense.

Therefore, the return is primarily a function of the assets supporting the COLI arrangement. When reviewing a COLI purchase, NYLEX Benefits will ensure that the company understands the underlying investment philosophy and is comfortable that the philosophy can support the interest rates being illustrated over the long term.

Q: *Is COLI liquid?*

A: Yes. COLI policies allow the company to borrow against the cash value, and the policies can be surrendered at any time and the cash value will be paid to the company. In very large COLI programs, some carriers may require a 4 to 5 year surrender period to allow them to gradually wind down their investment in the arrangement.

Q: *What happens if the coverage is surrendered?*

A: The carrier pays the company the cash value of the policies. The company must recognize a gain for income tax purposes on the amount of cash value received in excess of the sum of premiums paid. For example, if the cash value is \$6 million, and the amount of premiums paid is \$5 million, the company would recognize \$1 million of taxable income upon surrender. This would be taxed at normal rates. If, as may be attractive in certain special circumstance, the COLI arrangement were structured as a Modified Endowment Contract (“MEC”), as defined in the Internal Revenue Code, there would be an additional penalty of 10%.

Q: *What is the credit risk of a COLI program?*

A: Prior to any COLI purchase, the company should carefully review (with our help) the financial strength of each proposed carrier, as well as its track record in the market. Regardless of product type, the financial strength and reputation of a carrier is critical to the future viability and

credibility of a COLI program. Separate account products minimize the credit risk in the event the carrier becomes insolvent as the assets are protected in a separate account. However, insolvency is an infrequent event.

Q: *How does the COLI insurance carrier make money?*

A: The carriers recover expenses and make a profit on the difference between the income and outflow from the product. The majority of income is from the interest earned on the assets backing the policies.

Q: *How does the COLI insurance carrier recover expenses incurred and what do they include?*

A: Most carriers recover expenses through an interest margin. Some carriers may also charge an administrative fee, costs of insurance for mortality and even a front-end load. These recoveries may be in different proportions between products but in total they need to recover the same basic expenses regardless of the type of product. These expenses that a carrier must cover include: state premium tax; federal DAC tax; marketing expenses; interest credited to cash value (in a General Account product); administrative costs; death benefits; profit; Risk-Based Capital (“RBC”). The RBC cost component varies significantly between products. The Separate Account policies will have lower RBC as the risks for market value accounting, minimum interest guarantees and asset defaults are passed on to the policyholder under this product.

Q: *What happens if the COLI insurance carrier has financial trouble?*

A: In such a situation, the coverage can usually be transferred to another carrier via an IRC Section 1035 tax-free exchange. IRC Section 1035 allows for a tax-free exchange of “like property” without tax.

Q: *What is the effect of a policyholder merger on COLI plans?*

A: Merger and acquisition activity has no direct impact on the COLI plan performance. However, for an acquiring company, the COLI from the acquisition should be a beneficial addition to its existing portfolio. It will be reviewed in terms of concentration and credit for the newly merged entity. If the company is being acquired, COLI is an attractive balance sheet asset and will enhance the net worth and earnings per share results.

COLI ACCOUNTING TREATMENT

Q: *How is the income earned and recorded?*

A: The company earns income in a COLI arrangement from two sources. The first is from the growth of the cash value of the policy. While the full cash value works for the company, the company records as an asset the cash surrender

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value (the full cash value less any applicable surrender charges in the event the contract is surrendered in the year being recorded). The cash value increases each year as the insurance carrier credits interest or as the separate account increases in value. The second source of income comes from the insurance proceeds paid to the company when insured employees die. The accounting treatment for a typical COLI plan can be summarized as follows:

- ❑ COLI purchase is reflected as an OTHER ASSET.
- ❑ Earnings (increases to cash surrender value) will be recorded as an after tax credit to an income account (OTHER INCOME).
- ❑ Receipt of the net-at-risk portion of death proceeds are also reflected as an after tax credit to an income account (OTHER INCOME).

Q: *How does the balance sheet change with the purchase of COLI?*

A: The company will normally use funds generated through cash flow to purchase COLI. Since both are assets, there is no initial change to the balance sheet (other than the possible recognition of an early year COLI surrender charge). However, since COLI will earn an after tax rate of return which may be higher than other similar type investments, the income statement will show additional income which translates into increased net worth.

Q: *What impact does alternative minimum tax ("AMT") have on the transaction?*

A: If a company is in AMT, taxes may have to be paid on the cash value growth and a portion of the death proceeds at the AMT rate. The AMT is carried forward as a credit and reversed when the company returns to a full tax-paying status. The effect, therefore, is simply a timing difference for financial statement purposes. The income statement is unaffected and the balance sheet would reflect a credit for the amount of AMT paid until such time as the item reverses itself.

About NYLEX Benefits

NYL Executive Benefits LLC ("NYLEX Benefits") provides supplemental executive benefit programs to a wide range of commercial clients. We focus on developing cost effective executive benefit solutions that are designed to attract, reward and retain key employees.

Our services are designed to assist clients at all stages in the adoption and operation of executive benefit programs and include:

- Initial assessment
- Plan design
- Funding
- Plan implementation
- Ongoing administration

NYLEX Benefits' professional staff includes the following professional disciplines, all dedicated to supporting our client's programs, processes, systems and services:

- Accountants
- Actuaries
- Attorneys
- Benefit specialists
- Insurance specialists

We take great care to assure that client programs are practical and cost effective and that they are designed to achieve our clients' strategic and operational goals.

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