Joint Committee on Taxation
January 29, 2004
JCX-4-04

DESCRIPTION OF CHAIRMAN'S MODIFICATION TO THE "NATIONAL EMPLOYEE SAVINGS AND TRUST EQUITY GUARANTEE ACT OF 2003" AS MARKED UP SEPTEMBER 17, 2003, AS SCHEDULED FOR MARKUP BY THE SENATE COMMITTEE ON FINANCE ON FEBRUARY 2, 2004

I. MODIFICATIONS TO PROVISIONS IN THE BILL AS MARKED UP

The amendment adopted by the Committee relating to company-owned life insurance is deleted from the bill, and the following provision is substituted.

A. Tax Treatment of Company-Owned Life Insurance ("COLI")

Present Law

Amounts received under a life insurance contract

Amounts received under a life insurance contract paid by reason of the death of the insured are not includible in gross income for Federal tax purposes.[1] No Federal income tax generally is imposed on a policyholder with respect to the earnings under a life insurance contract (inside buildup).[2]

Distributions from a life insurance contract (other than a modified endowment contract) that are made prior to the death of the insured generally are includible in income to the extent that the amounts distributed exceed the taxpayer's investment in the contract (i.e., basis). Such distributions generally are treated first as a tax-free recovery of basis, and then as income.[3]

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[1] Sec. 101(a).

[2] This favorable tax treatment is available only if a life insurance contract meets certain requirements designed to limit the investment character of the contract (sec. 7702).

[3] Sec. 72(e). In the case of a modified endowment contract, however, in general, distributions are treated as income first, loans are treated as distributions (i.e., income rather than basis recovery first), and an additional 10-percent tax is imposed on the income portion of distributions made before age 59-1/2 and in certain other circumstances (secs. 72(e) and (v)). A

Premium and interest deduction limitations[4]

Premiums

Under present law, no deduction is permitted for premiums paid on any life insurance, annuity or endowment contract, if the taxpayer is directly or indirectly a beneficiary under the contract.[5]

Interest paid or accrued with respect to the contract.

No deduction generally is allowed for interest paid or accrued on any debt with respect to a life insurance, annuity or endowment contract covering the life of any individual.[6] An exception is provided under this provision for insurance of key persons.

Interest that is otherwise deductible (e.g., is not disallowed under other applicable rules or general principles of tax law) may be deductible under the key person exception, to the extent that the aggregate amount of the debt does not exceed $50,000 per insured individual. The deductible interest may not exceed the amount determined by applying a rate based on a Moody's Corporate Bond Yield Average-Monthly Average Corporates. A key person is an individual who is either an officer or a 20-percent owner of the taxpayer. The number of individuals that can be treated as key persons may not exceed the greater of (1) five individuals, or (2) the lesser of five percent of the total number of officers and employees of the taxpayer, or 20 individuals.[7]

Pro rata interest limitation

A pro rata interest deduction disallowance rule also applies. Under this rule, in the case of a taxpayer other than a natural person, no deduction is allowed for the portion of the

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modified endowment contract is a life insurance contract that does not meet a statutory "7-pay" test, i.e., generally is funded more rapidly than seven annual level premiums (sec. 7702A).

[4] In addition to the statutory limitations described below, interest deductions under company-owned life insurance arrangements have also been limited by recent cases applying general principles of tax law. *See Winn-Dixie Stores, Inc. v. Commissioner,* 113 T.C. 254 (1999), *aff'd* 254 F.3d 1313 (11th Cir. 2001), *cert. denied*, April 15, 2002; *Internal Revenue Service v. CM Holdings, Inc.*, 254 B.R. 578 (D. Del. 2000), *aff'd*, 301 F.3d 96 (3d Cir. 2002); *American Electric Power, Inc. v. U.S.*, 136 F.Supp. 2d 762 (S. D. Ohio 2001), *aff'd*, 326 F.3d 737 (6th Cir. 2003), *reh. denied*, 338 F.3d 534 (6th Cir. 2003), *cert. denied*, U.S. No. 03-529 (Jan. 12, 2004); *but see Dow Chemical Company v. U.S.*, 250 F. Supp.2d 748 (E.D. Mich. 2003), *modified*, Case No. 00-10331-BC, E. D. Mich., Aug. 12, 2003.

[5] Sec. 264(a)(1).

[6] Sec. 264(a)(4).

[7] Sec. 264(e)(3).

taxpayer's interest expense that is allocable to unborrowed policy cash surrender values.[8] Interest expense is allocable to unborrowed policy cash values based on the ratio of (1) the taxpayer's average unborrowed policy cash values of life insurance, annuity and endowment contracts, to (2) the sum of the average unborrowed cash values (or average adjusted bases, for other assets) of all the taxpayer's assets.

Under the pro rata interest disallowance rule, an exception is provided for any contract owned by an entity engaged in a trade or business, if the contract covers an individual who is a 20-percent owner of the entity, or an officer, director, or employee of the trade or business. The exception also applies to a joint-life contract covering a 20-percent owner and his or her spouse.

"Single premium" and "4-out-of-7" limitations

Other interest deduction limitation rules also apply with respect to life insurance, annuity and endowment contracts. Present law provides that no deduction is allowed for any amount paid or accrued on debt incurred or continued to purchase or carry a single premium life insurance, annuity or endowment contract.[9] In addition, present law provides that no deduction is allowed for any amount paid or accrued on debt incurred or continued to purchase or carry a life insurance, annuity or endowment contract pursuant to a plan of purchase that contemplates the systematic direct or indirect borrowing of part or all of the increases in the cash value of the contract (either from the insurer or otherwise).[10] Under this rule, several exceptions are provided, including an exception if no part of four of the annual premiums due during the initial seven-year period is paid by means of such debt (known as the "4-out-of-7 rule").

Definitions of highly compensated employee

Present law defines highly compensated employees and individuals for various purposes. For purposes of nondiscrimination rules relating to qualified retirement plans, an employee, including a self-employed individual, is treated as highly compensated with respect to a year if the employee (1) was a five-percent owner of the employer at any time during the year or the preceding year or (2) either (a) had compensation for the preceding year in excess of $90,000 (for 2004) or (b) at the election of the employer had compensation in excess of $90,000 (for 2004) and was in the top 20 percent of employees by compensation for such year.[11] The $90,000 dollar amount is indexed for inflation.

For purposes of nondiscrimination rules relating to self-insured medical reimbursement plans, a highly compensated individual is an employee who is one of the five highest paid

[8] Sec. 264(f). This applies to any life insurance, annuity or endowment contract issued after June 8, 1997.

[9] Sec. 264(a)(2).

[10] Sec. 264(a)(3).

[11] Sec. 414(q). For purposes of determining the top-paid 20 percent of employees, certain employees, such as employees subject to a collective bargaining agreement, are disregarded.

officers of the employer, a shareholder who owns more than 10 percent of the value of the stock of the employer, or is among the highest paid 25 percent of all employees.[12]

Description of Proposal

The proposal provides generally that, in the case of an employer-owned life insurance contract, the amount excluded from income as a death benefit cannot exceed the premiums or other amounts paid for the contract. The excess death benefit is included in income of the employer. Generally, insurance of highly compensated employees (as defined in the proposal) is not employer-owned life insurance subject to this income inclusion rule.

An employer-owned life insurance contract is defined under the proposal as a life insurance contract (1) that is owned by an entity engaged in a trade or business and of which the entity or trade or business is the direct or indirect beneficiary, and (2) that insures the life of an individual who is an employee with respect to the trade or business of the entity (including affiliates) when the contract is issued.

An employer-owned life insurance contract does not include any contract insuring a highly compensated individual if the notice and consent requirements under the proposal are met. For this purpose, such an individual is one who is either: (1) a highly compensated employee as defined under the rules relating to qualified retirement plans, determined without regard to the election regarding the top-paid 20 percent of employees; or (2) a highly compensated individual as 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.[13]

Under the proposal, the income inclusion rule does not apply to certain employer-owned life insurance contracts if the notice and consent requirements are met. First, the income inclusion rule does not apply in the case in which the insured individual was an employee of the policyholder (or affiliate) at any time during the twelve-month period prior to the individual's death. In addition, the rule does not apply to the extent the insurance proceeds are (1) payable to a member of the insured person's family (within the meaning of section 267(c)(4)), (2) payable to any individual who is the designated beneficiary of the insured under the contract (other than the employer or its affiliate), (3) payable to a trust for the benefit of such a person, (4) payable to the insured's estate, or (5) to be used to purchase an equity interest in the employer (or affiliate) from any such person.

The notice and consent requirements under the proposal are met if, prior to the issuance of the contract, the employee (1) is notified in writing that the employer intends to insure his or her life, (2) provides written consent to being insured under the contract and that the coverage

[12] Sec. 105(h)(5). For purposes of determining the top-paid 25 percent of employees, certain employees, such as employees subject to a collective bargaining agreement, are disregarded.

[13] As under present law, certain employees are disregarded in making this determination.

may continue after the insured terminates employment with the employer, and (3) is informed in writing that the employer will be the beneficiary of any proceeds payable upon his or her death.

For purposes of the proposal, an employee includes an officer, director and highly compensated employee; an insured is an individual who is a U.S. citizen or resident, and includes coverage of joint lives.

The proposal requires recordkeeping and reporting with respect to employer-owned life insurance contracts (without regard to the rule excluding contracts covering highly compensated individuals) for taxable years beginning after 2003. The information to be reported is (1) the number of employees of the employer at the end of the year, (2) the number of employees insured under the program at the end of the year, (3) the total amount of insurance in force at the end of the year, and (4) the name, address, and taxpayer identification number of the employer and the type of business in which the employer is engaged.

Effective Date

The proposal generally is effective for life insurance contracts issued after the date of enactment. An exception is provided for a contract issued after the date of enactment pursuant to an exchange described in section 1035 for a contract issued prior to that date. A material increase in the death benefit or other material change causes the contract to be treated as newly issued, but the addition of covered lives under a master contract (within the meaning of section 264(f)(4)(E)) is treated as a new contract only with respect to such additional covered lives.