

COLI for ESOP Companies

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COLI Defined - and COLI Strategies

COLI stands for “Corporate Owned Life Insurance”, and is any life insurance policy or policies as a group owned by the Corporation where the Corporation is the premium payer and also the beneficiary. Key Man Insurance, for example, is COLI. Insurance purchased for a stock redemption buy sell agreement is COLI as well.

In addition to the uses stated above, COLI has been used by Corporations and Banks as a method of funding corporate liabilities. Here, the company uses COLI as a long-term investment strategy to offset the cost of the liability with interest.

The term “cash value funding” refers to a focus on the return on the cash invested in the COLI product, and the subsequent possible use of that cash to ultimately pay out liabilities.

By keeping the policies after the insured employee retires, the company is taking a 40 or 50 year strategy, and is planning on death proceeds at life expectancy to return the cost of funding the liability, and return of the premiums, plus a factor for interest.

The term “aggregate funding” means insuring a group of employees, not necessarily with the intent of using the planned death proceeds or cash value for the liability of that particular group of employees, but for the good of the company as a whole. Thus, a group of 20 employees may be insured in a company with 200 employees, perhaps with equal premium amounts on each employee, the objective being to achieve a good rate of return on the cash invested and long term cost recovery of benefit liabilities. If benefit liabilities were involved, it would be logical to insure those with the larger liabilities and reasonable expectation they will remain employed. In the event of an early death, the insurance would be in the right place. If good rate of return on cash invested is an objective, employees over a certain age might be eliminated from the mix.

Frequently COLI is used in concert with other investment and cash management strategies, not as the only strategy. Value of the COLI should be compared over the long term – cash on cash returns over a ten or fifteen year period compared to alternative investments; combination of cash on cash and death proceeds at life expectancy return over the 40 or 50 year time horizon with cost recovery in comparison to other investments.

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The repurchase obligation is a benefit liability very similar in nature to a supplemental retirement plan liability. Both are unfunded and are not directly reflected on the balance sheet. RO is an obligation of the company to pay out monies to employees at retirement, termination, or diversification. If current management takes responsibility for the liabilities it is creating, they should carefully plan cash management strategies for meeting those liabilities. In other types of benefit liabilities (i.e. pension plans) the government mandates funding. In ESOP Companies, it's up to management to plan and execute strategies that are successful for the long term.

One such strategy would be to not rely entirely on future cash flows to fund the liability, but in addition to cash flowing to the ESOP, have a cash reserve on the balance sheet for contingencies and hard times, allowing maximum flexibility for recycling and redemption as may be appropriate. If COLI can be shown to have an acceptable rate of return on the cash in comparison to other investment alternatives, it should be considered as part of the overall balance sheet investment strategy, combined with other investments. Insurance on the larger accountholders would be an added advantage not offered by the alternative investments.

COLI wraps the cash reserve inside an insurance policy, separating it from working capital, almost like an "envelope" of cash on the balance sheet. Fortune 1000 companies have been using COLI for many years to fund their Supplemental Retirement Plan Liability. Surveys by Clark Consulting in 2007, to which 18% of the Fortune 1000 companies responded, showed 68% informally financed for these liabilities, of the 68% that informally financed, 72% used Corporate Owned Life Insurance.

COLI in C vs. S Corporations

There are tax advantages to COLI as a cash investment for C Corporations, as the return on cash builds inside the policy without tax, the tax equivalent rate of return would be higher. In an S Corporation 100% owned by the ESOP, the comparison should be made against alternative investments without consideration for any tax advantage. Death proceeds should not be factored into the rate of return in either case until life expectancy, since actuarially it is impossible to project early mortality in a company with less than 5,000 employees. S Corporations with less than 100% ownership by the ESOP also enjoy the tax advantages of a C Corporation so far as the outside shareholders are concerned, because the cash build up in the policies are not taxable to the outside shareholder as long as the policies are not surrendered.

Guaranteed Issue

Usually if 15 or more insured employees are involved in the COLI transaction, a certain amount of insurance will be issued without medical questions or exams. The more participants in the plan, the higher the individual life limits will be. Comparison should be made in the premiums and rates of return projected for the "Guaranteed Issue" insurance with "underwritten" insurance with the same carrier, to be sure the guaranteed issue product does not have excessive loads and expenses.

Change of Insured – What happens if someone leaves?

Most carriers in the COLI market have a provision in the policy that allows the Corporation to substitute a new insured if they choose to not keep the policy on the departing executive. The insurance company will recalculate the policy as if it had originally been issued on the new executive – if the age is the same you would see no difference in the policy – if the new employee was younger the company would get a refund, if he was older there would be a reduced benefit reflecting the difference in the age at issue.

Types of Policies, Rates of Return

There are generally three main types of policies offered in the COLI market, with many variations of each. These are Universal Life, Variable Life, and Traditional Portfolio Driven Whole Life. It is not possible to do a detailed comparison in this article – suffice it to say you need an insurance professional you trust to advise you in this area. Briefly, Universal Life is a usually a segregated account product tied to short to mid term interest rate investments, Variable offers mutual fund sub-accounts, and the Traditional Whole Life is frequently tied to the investment return of the entire portfolio of investments held by the insurance company. How well the insurance company is managed as regards to operating expenses and underwriting may also impact long-term performance in all three types of policies

Rates of return with insurance products fall into two general categories. “Crediting” rate is the interest rate paid on policy values, “Internal Rate of Return” is the rate of return you are actually earning on your dollars invested over a stated time period – obviously the most important.

Accounting for COLI

The accounting treatment for COLI is straight forward, covered by FASB Technical Bulletin 85-4. The increase in cash value each year, to the extent it exceeds the premium outlay, is book income (not taxable until the policy is surrendered – if it is surrendered). To the extent the cash value increase is less than premium outlay in a given year, the difference is an expense (not tax deductible)

On the Balance Sheet the “Cash Value of Life Insurance” is a long-term asset.

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