

AUGUST 4, 2006

CONGRESS APPROVES COLI/BOLI “BEST PRACTICES” LEGISLATION***NEW IRC §101(J) CODIFIES TAX-FREE TREATMENT OF EMPLOYER-OWNED LIFE INSURANCE***

On August 3, 2006, the Senate approved a pension bill (H.R. 4 - The Pension Protection Act of 2006), which among other things, adds a new section to the Internal Revenue Code - §101(j) - that codifies life insurance industry “best practices” relating to the use of employer-owned life insurance to fund employee benefits (sometimes referred to as “COLI” or “BOLI” policies). New IRC §101(j) also codifies the tax-free treatment of death benefits from COLI/BOLI policies if certain requirements are satisfied. The legislation generally applies to COLI/BOLI policies issued after the date on which the legislation is enacted (i.e., the date the President signs the bill).

The bill, which had been approved by the House of Representatives at the end of last week, will now be sent to President Bush for signature. It is expected that the President will sign the measure into law, although the exact timetable for signature is uncertain. A summary of the provisions applicable to COLI/BOLI policies is included below. In addition, Clark Consulting will soon be hosting a client webcast to discuss these provisions—details on this webcast will be provided to you shortly.

I. “BEST PRACTICES” PROVISIONS OF NEW IRC §101(J)

Pursuant to new IRC §101(j) (“§101(j)”), death benefits from COLI/BOLI policies are excludable from an employer’s taxable income if the requirements of the statute are satisfied. The requirements of §101(j) generally are consistent with current life insurance industry “best practices.” In particular, §101(j) contains notice and consent requirements that must be satisfied before a COLI/BOLI policy is issued, and generally limits potential insureds to directors and “highly compensated” employees. If an employer does not comply with §101(j), all policy proceeds in excess of total premiums paid by the employer would be included in the employer’s taxable income. The requirements of §101(j) are summarized below.

Issue	Requirements of §101(j)	Comments
Notice and Consent	<p>§101(j) provides that the following notice and consent requirements must be satisfied <u>prior to issuance</u> of a COLI/BOLI policy:</p> <ul style="list-style-type: none"> • The insured must receive <u>written notice</u>, which (i) indicates that the employer intends to insure the employee’s life; (ii) specifies the maximum face amount for which the employee could be insured at the time the policy is issued; and (iii) informs the insured that the employer will be the beneficiary of the policy. • The employee must provide <u>written consent</u> to being insured and that such coverage may continue after the employment relationship terminates. 	<p>Tax practitioners interpret the notice and consent requirements of the statute, taken together, as requiring the “informed” written consent of the proposed insured prior to issuance of the policy. As a result, employers should disclose the maximum face amount of coverage to a proposed insured at the time the employer solicits the individual’s written consent to the insurance coverage.</p>

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Issue	Requirements of §101(j)	Comments
<p>Status of the Insured</p>	<p>General Rule. §101(j) generally restricts the group of potential insureds under a COLI/BOLI program to the employer’s directors and “highly compensated” employees.</p> <p>Definition of “Highly Compensated.” An employee is treated as “highly compensated” under §101(j) if, at the time the policy is issued, it is determined that for the relevant time period the employee:</p> <ul style="list-style-type: none"> • Had “compensation” <u>in excess of the IRC §414(q) limitation</u>, as adjusted annually for inflation (for 2006, an individual is “highly compensated” if he or she had 2005 “compensation” in excess of \$95,000); or • Is <u>among the highest paid 35%</u> of all employees, determined in accordance with the rules of IRC §105(h); or • Is <u>an owner of 5% or more</u> of the employer at any time during the year (or was in the preceding year); or • Is <u>among the top-5 highest paid officers</u> of the company. <p>Additional Circumstances that Comply with §101(j). Notwithstanding the general rule described above, assuming the notice and consent requirements were satisfied, §101(j) also provides that policy death proceeds are excludable from income under the following circumstances:</p> <ul style="list-style-type: none"> • If the insured was employed by the policyholder at any time during the 12-month period preceding death; or • To the extent of any policy proceeds payable to the insured’s heirs. 	<ul style="list-style-type: none"> ◆ Employers generally are required to make a determination of who is a “highly compensated” employee under IRC §414(q) for purposes of their qualified retirement plan testing (e.g., 401(k) plan). Experience with this analysis will be helpful to an employer in determining whether a proposed insured is “highly compensated” for purposes of §101(j). ◆ If an employer chooses to insure an employee whose compensation is below the threshold provided in IRC §414(q), the employer should confirm that the employee is among the highest paid 35% of all employees in order to ensure compliance with §101(j).

Clark Consulting comment: It should be noted that §101(j) does not replace state law requirements that may apply to a COLI/BOLI program (e.g., rules to determine whether an employer has an insurable interest in the life of an employee or director). Compliance with applicable state law will continue to be a requirement for an employer to receive tax-free treatment with respect to death benefits from a COLI/BOLI policy. Consequently, employers should perform due diligence prior to issuance of a COLI/BOLI policy to ensure compliance with applicable state law in addition to compliance with the rules of §101(j).

II. REPORTING AND RECORDKEEPING REQUIREMENTS

A COLI/BOLI policy subject to §101(j) will also be subject to the reporting and recordkeeping requirements provided under new IRC §6039I (“§6039I”). These requirements are summarized in the table below.

Issue	Effective Date of Legislation	Comments
Reporting Requirement	<p>Under §6039I, employers must file an annual information return with the IRS that includes the following:</p> <ul style="list-style-type: none"> • the total number of employees at the end of the year; • the number of employees insured under COLI/BOLI policies at the end of the year; • the total amount of insurance in force under the COLI/BOLI program at the end of the year; • the name, address, and taxpayer identification number of the employer and the type of business in which it is engaged; • a statement that the employer has a valid consent for each insured employee in accordance with the requirements of §101(j) (or if not, the total number of insured employees for whom such consent was not obtained). 	<p>Clark Consulting is in the process of reviewing the reporting requirements of §6039I to determine how those requirements compare to policy information clients may already be receiving as part of our recordkeeping services for their COLI/BOLI policies. Clients will receive additional communication on this topic in the near future.</p>
Recordkeeping Requirement	<p>§6039I also requires that employers maintain the records necessary to determine whether the requirements of §101(j) have been satisfied.</p>	

III. STATUTORY EFFECTIVE DATE AND LIMITED “GRANDFATHERING” PROVISION

The effective date of the legislation is described in the table below.

Issue	Effective Date of Legislation	Comments
Effective Date	<p>General Rule. The requirements of §101(j) generally apply to policies issued after the date on which the pension bill is enacted into law.</p> <p>Limited “Grandfathering” Provision. Subject to the limitations described below, the following policies are eligible for “grandfathering”:</p> <ul style="list-style-type: none"> • Existing policies (i.e., policies issued <u>on or before</u> the date of enactment), and • A new policy issued after date of enactment, as part of a tax-free exchange pursuant to IRC §1035, to replace a policy issued prior to date of enactment. <p>Caution: The legislation provides that “grandfathering” is not available if there is a “<u>material increase in the death benefit or other material change</u>” after the date of enactment to a policy not otherwise subject to §101(j). Such a “material increase” or “material change” could occur either (i) directly to an existing policy or (ii) as part of, or the result of, a §1035 exchange transaction. <i>(Please see below for information on certain changes to a policy that will not trigger application of this rule.)</i> As a result of this limitation, the “grandfathering” provided by the legislation for policies issued in a §1035 exchange may be more narrow than the statutory language suggests.</p>	<p>Even where a new policy issued as part of a §1035 exchange qualifies for the “grandfathering” exclusion from §101(j), notice and consent of the insured may be required under applicable state law.</p>

Issue	Effective Date of Legislation	Comments
<p>Effective Date (Cont.)</p>	<p>“Material Increase in Death Benefit or Other Material Change.” As noted above, a policy that would otherwise be eligible for “grandfathering” will become subject to the new rules of §101(j) if a “material increase in the death benefit or other material change” is made to the policy after the date of enactment. This phrase is not defined in the legislation. However, the Joint Committee on Taxation’s “Technical Explanation of H.R. 4” released on August 3, 2006, does provide limited examples of changes to a policy that will <u>NOT</u> be considered “material,” as outlined below.</p> <ul style="list-style-type: none"> • Increases in Death Benefit. Examples of death benefit increases for an existing policy that will <u>not</u> be considered “material” include: <ul style="list-style-type: none"> ⇒ <u>An increase made in order to comply with IRC §7702</u> that does not require consent of the insurance carrier (e.g., such as an automatic increase in the death benefit under the terms of the contract that is based on the cash surrender value of the policy); ⇒ <u>An increase due to normal operation of the policy</u> that does not require consent of the insurance carrier (e.g., such as an increase due to a policyholder’s application of dividends to purchase paid-up additions in accordance with the terms of the contract); ⇒ <u>An increase as a result of market performance or contract design</u> that does not require consent of the insurance carrier (e.g., a variable or universal life contract designed such that the death benefit fluctuates depending on changes in the cash value of the contract); • Other Changes. Examples of other changes to an existing policy that will <u>not</u> be considered “material” include. <ul style="list-style-type: none"> ⇒ A change from <u>general to separate account</u>; ⇒ Changes as a result of the <u>exercise of an option or right granted under the contract as originally issued</u>. 	<p>Absent further guidance, employers uncertain about whether a particular change to an existing COLI/BOLI policy (including any change which may occur as part of or as a result of a §1035 exchange) would be considered “material” should treat the policy as potentially being subject to §101(j) as a result of such change (i.e., should assume the change is “material” and should comply with the new requirements of §101(j)) in order to avoid jeopardizing the favorable tax treatment of the policy.</p>

Clark Consulting comment: Employers considering a §1035 exchange should continue to exercise caution to ensure that the exchange does not trigger other adverse tax consequences (e.g., a potential disallowance of interest expense deductions under IRC §264(f)).

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