A Layman's Guide to Corporate-Owned Life Insurance

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Section 1. *Background, Purpose, and Scope*

1.1 *Background*—The term *corporate-owned life insurance* (COLI) is generally used to describe a life insurance product funded by a corporation that is also the owner and beneficiary of the policy. COLI is commonly used as a means to (1) protect a corporation from financial costs related to the loss of a key employee, (2) fund transition costs associated with buy/sell agreements, or (3) fund employee benefits.

In recent years COLI has been particularly popular with banks and has also been utilized by manufacturers, insurance companies, and other corporations. Any employer purchasing COLI faces various important decisions with respect to program structure, provider selection, communications, and documentation.

1.2 *Purpose/Scope*—This paper provides guidance to employers who are contemplating the use of COLI as a means for funding employee benefits. Commentary will be provided on critical issues to consider when analyzing the benefits of COLI, including product characteristics, cost considerations, legal considerations, representations and warranties, investments, and accounting. "Best Practices" pricing guarantees, representations, warranties, and indemnities will be provided as examples and are generally indicative of the stronger positions taken to date on each issue. This paper does not provide guidance on group term life or other non-COLI products.

1.3 *Qualifications*—The author has a background in actuarial science and 15 years experience in the COLI marketplace but is not qualified to provide tax, investment, legal, accounting, or regulatory advice. Readers should consult with their professional advisors for guidance in these areas.

Section 2. *Policy Characteristics*

The COLI purchaser will face many decisions relating to the type of insurance policy that will be most suitable. This section is intended to highlight some of the key factors that may be taken into consideration when making various choices regarding policy characteristics.

2.1 *General Account versus Separate Account*

Funding employee benefits with COLI involves the purchase of a cash value life insurance policy on a select group of employees. Cash value life insurance typically takes the form of a general account product or a separate account product,[1] although some hybrid-type products do exist. The distinction between the two product types lies in the investment of the funds underlying the cash value. The following outlines some of the primary differences between general account and separate account products that may be taken into consideration when choosing between the two.

2.1.1 *Background*—Cash value life insurance is generally designed to provide protection for the life of the insured and is available with a variety of premium patterns. Early year premium payments are higher than the cost of one-year term insurance. Unlike multiyear term life, these higher payments typically create a cash value asset for the policyholder, which is available upon surrender.

Historically the funds backing the cash value of whole life insurance have been pooled in the carrier's *general account* and managed in accordance with the carrier's internal investment guidelines. In 1976 the SEC enacted Rule 6E-2, providing a limited exception to the Investment Company Act of 1940 and marking the beginning of variable life insurance. The cash value of a variable life insurance policy varies to reflect the investment performance of a *separate account* chosen by the policyholder.

2.1.2 *Investment Availability*—A separate account transaction allows the policyholder to allocate the cash value across investment options made available by the insurance carrier. Separate account investment options are available in a variety of asset classes, with a variety of risk-reward profiles and investment managers. Many carriers are willing to explore new options if the current selection does not meet policyholder needs. Funds may be directly managed by the insurance carrier (internally managed accounts) or by outside managers appointed by the carrier (externally managed accounts). The investment manger must maintain compliance

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[1] Separate accounts include both segregated asset accounts and portions of the general account that have been segmented for specific classes of policyholders. Throughout this paper the term *separate account* is used to the mean the equivalent of segregated asset account. All segregated asset accounts are separate accounts, but not all separate accounts are segregated asset accounts.

with a set of investment guidelines that are created for each separate account option. Some funds are governed by very restrictive guidelines that put tight bands on, for example, leverage and duration; others allow the manager broader degrees of freedom. Although sometimes limited in the number of reallocations that can be made in a year, the policyholder can move money between the various funds offered by the carrier.

Policyholders owning general account COLI do not have the ability to allocate funds to different investment options. Funds are invested pursuant to insurance company guidelines, which commonly involve a large allocation to fixed-income investments (see Section 6.1). Some variable products offer the general account as an investment option. This may be an attractive alternative for COLI purchasers who like the features of the general account but would like to reserve the ability to reallocate at some point in the future.

As discussed in Section 6.3, investment smoothing features are available with some separate accounts. These smoothed separate accounts are designed to limit investment volatility and offer another alternative to general accounts.

2.1.3 *Minimum Interest Guarantee*—General account products provide a minimum interest rate guarantee for the life of the policy. A common lifetime guarantee is 3–4 percent, and some carriers provide a higher guarantee in the early years if economic conditions permit. Separate account policies generally provide no interest guarantee.

2.1.4 *Variable Returns*—The cash value of a separate account policy varies with the investment performance of the underlying fund(s) selected by the policyholder. General account returns are commonly fixed for a period of one year and reset by the insurance provider on an annual basis.

2.1.5 *Credit Risk*—Assets held in a separate account are generally not chargeable with liabilities arising out of any other lines of business and are not subject to the general creditors of the insurance company. The policyholder takes on the credit risk associated with the securities in the underlying portfolio(s) they have selected.

General account policyholders are subject to the credit risk of the issuing carrier. To manage this risk many COLI purchasers buy several smaller policies with different carriers and pay close attention to credit ratings.

2.1.6 *Securities Regulations*—Separate account insurance is affected by regulation on more fronts than general account insurance. Issuers of separate account transactions must, as with all insurance providers, comply with state insurance laws and regulations. Separate account contracts and their issuers are also subject to federal securities laws and regulations and are regulated by the Securities and Exchange Commission (SEC; Black and Skipper 1994, p. 115). Variable (separate account) policies must generally be registered under the Securities Act of 1933 (see Section 2.3 for exceptions), entities that distribute separate account insurance generally must register as broker-dealers under the Securities Exchange Act of 1934, and agents selling variable insurance must pass a securities examination. Variable life insurance is a security, and the potential purchaser must generally be provided with a prospectus before the sale (see Section 2.3 for exceptions).

2.1.7 *Investor Control*—As outlined in Section 4.7, the concept of "investor control" provides that a policyholder who exerts too much control over the assets in a separate account may be deemed the owner of those assets and be required to pay tax on the policy's inside buildup. Although prudent policy management procedures would seem to minimize this risk, some COLI purchasers may prefer to avoid it all together by pursuing a general account transaction.

2.1.8 *Transparency*—Separate account transactions link the cash value asset directly to the performance of an underlying group of investments. Many insurance carriers make available to separate account policyholders a detailed explanation of the investment returns on a monthly basis.

General account returns are prescribed by the insurance provider, usually in the form of a level crediting rate that is reset on an annual basis. COLI policies offered on a participating basis pay dividends reflecting the favorable (or unfavorable) interest, mortality, and expense experience of the insurance provider. The amount of information commonly provided to the general account policyholder, relating to the methodology used to set the annual crediting rate, determination of the annual dividend, performance of the general account assets, and fees that have been deducted from the gross return may be unacceptably low for some COLI purchasers.

2.2 *Traditional Whole Life versus Universal Life*

Universal life products provide additional flexibility to the policyholder and are available as general account or separate account products. The following discussion outlines some of the primary differences between traditional whole life and universal life products that could be taken into consideration when choosing between the two.

2.2.1 *Background*—Universal life insurance policies were introduced to the U.S. marketplace in the late 1970s. As highlighted by Lynch (1982), universal life policies offer most if not all of the features of traditional whole life including minimum guaranteed cash values, a 60-day grace period for premium payments, incontestability of coverage under the policy after it has been in force for two years except for nonpayment of premium, the right to assign the policy as collateral for a loan, the right to paid-up insurance, and the right to obtain a policy loan and to surrender the policy for its net cash value (pp. 45–46). The features that distinguish universal life from traditional whole life include premium payment flexibility, adjustable death benefits, and improved transparency.

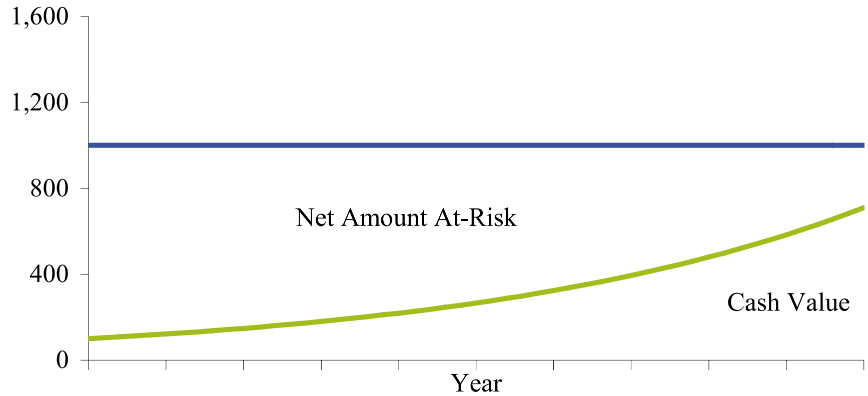
2.2.2 *Premium Flexibility*—Universal life allows the policyholder to prescribe their own premium payment pattern within limits. After an initial minimum payment is made, the policyholder can increase, decrease, or skip payments altogether as long as the funds in the cash value are sufficient to cover policy charges for the upcoming period. This feature may be important to a COLI purchaser who is intending to use the cash value asset as a hedge for a particular liability, such as deferred compensation or postretirement medical liability, because future growth of the liability is uncertain.

2.2.3 *Adjustable Death Benefits*—A universal life policyholder can lower the policy death benefit at any time and, subject to evidence of insurability, can increase the death benefit at any time. This can be an important tool for reducing program costs if it is determined that the initial funding capacity was more than will be required in the future.

The total death benefit of any whole life policy comprises two pieces. The first source of funds used to pay a death claim is the cash value associated with the deceased individual. The amount by which the total death benefit exceeds the cash value is called the *net amount at risk.* In addition to the ability to adjust the death benefit at any time, universal life policyholders can typically choose between two death benefit options.

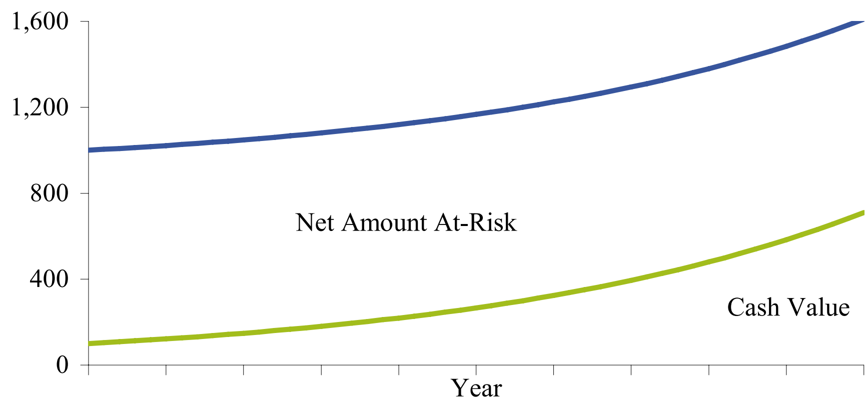
a. *Level Death Benefit Option*—Commonly referred to as Option A, the level death benefit option holds the total death benefit constant (subject to Internal Revenue Code [IRC] requirements), and the net amount at risk shrinks as the cash value asset grows (see Fig. 1).

Figure 1
Level Death Benefit Option



b. *Level Net Amount At-Risk Option*—Commonly referred to as Option B, the level net amount at-risk option holds the net amount at risk constant, and the total death benefit increases as the cash value asset grows (subject to IRC requirements; see Fig. 2).

Figure 2
Level Net Amount At-Risk Option



Variations on the options described above may be available under some policy designs, including the return of premium in the death benefit amount.

When considering the choice of death benefit options, the COLI purchaser should consider the long-term need for death benefit coverage and recognize that some of the components of program costs are directly linked to the net amount at risk. IRC requirements may dictate the minimum total death benefit and net amount at risk based on the size of the cash value asset, making the choice of death benefit option irrelevant (see Section 2.4.3). A program designed to follow the IRC minimum death benefit requirements may be the optimal solution in some circumstances.

2.2.4 *Transparency*—The cash value asset of a universal life policy operates much the same as a bank account. In each period the cash value starts with the ending balance from the previous period, charges are removed, deposits are made, if any, in the form of premium payments or mortality-based dividends (see Section 2.5.2), withdrawals are taken, if any, in the form of partial surrenders and cash value death benefits, and interest is credited to determine the ending balance for the current period. Many carriers make detailed explanations of each item affecting the cash value available to the policyholder. This level of detail is not commonly available with traditional whole life insurance.

2.2.5 *Interaction with General and Separate Accounts*—Universal life is available with the general account or separate account investment options, as is the traditional whole life policy design. Table 1 provides a comparative summary of the characteristics of the four product types created by considering the general account and separate account forms of both universal life and traditional whole life policy designs. Traditional whole life refers to the traditional policy design with the general account investment option, universal life refers to the universal life policy design with the general account investment option, variable life refers to the traditional policy design with the separate account investment option, and variable universal life refers to the universal life policy design with the separate account investment option. The COLI purchaser should note that the product names used are common but not universally standard and that product characteristics vary from carrier to carrier. Table 1 is intended only as a guide to help conceptualize the different products that may be available. The COLI purchaser should refer to the policies when comparing the attributes of each of the available products.

Table 1
Product Comparison Chart

	General Account		Separate Account	
	Traditional Whole Life	Universal Life	Variable Life	Variable Universal Life
Ability to select and switch investment options	No	No	Yes	Yes
Minimum interest guarantee	Yes	Yes	No	No
Policyholder exposed to credit risks	Insurance provider	Insurance provider	Underlying securities of selected funds	Underlying securities of selected funds
Subject to state insurance laws	Yes	Yes	Yes	Yes
Subject to SEC regulations	No	No	Yes	Yes
Investor control regulations	Generally not a concern	Generally not a concern	Need to be understood and managed	Need to be understood and managed
Investment performance transparency	No	No	Yes	Yes
Premium flexibility	No	Yes	No	Yes
Adjustable death benefits	No	Yes	No, although may increase with investment performance	Yes
Detailed information provided on policy elements	No	Yes	Some detail provided in prospectus	Yes
Policy loans	Permitted	Permitted	Permitted	Permitted
Partial surrenders	Permitted with some limitations	Permitted	Not permitted	Permitted subject to restrictions of underlying funds

A number of exceptional pieces of literature discuss the characteristics of the different types of life insurance. Black and Skipper (1994) provides an overview of the various types of life insurance policies in Chapter 4, a detailed review of fixed-premium whole life polices including traditional whole life and variable life in Chapter 5, and a detailed review of flexible-premium whole polices including universal life and variable universal life in chapter 6 (relied on in part for certain comparisons above). Although specifically in the context of individual life insurance, Easton and Harris (1999) provides a strong overview of the different types of life insurance in chapter 1. Lynch (1982) focuses on the historical development of universal life and its similarities and differences to traditional whole life. Cunningham (1995) and Baldwin (1996) provide commentary on the development and mechanics of variable universal life.

2.3 *Private Placement versus Registered*

The term *private placement* has been commonly used to describe a transaction that is not part of a general public offering and is exempt from the registration processes of the Securities Act of 1933 and the Investment Company Act of 1940. The following briefly discusses the Securities Act of 1933, the Investment Company Act of 1940, exemptions from these acts that may be available, and some issues that may be considered when selecting between a private placement and a registered transaction.

2.3.1 *Securities Act of 1933*—Designed to protect investors, the Securities Act of 1933 (1933 Act) has two basic objectives: (1) require that investors receive financial and other significant information concerning securities being offered for sale; and (2) prohibit deceit, misrepresentations, and other fraud in the sale of securities. The primary means of accomplishing these goals is the disclosure of important financial information through the registration of securities. Recognizing that not all investors need this level of protection, the 1933 Act outlines securities and transaction that are exempt from certain of the registration requirements (see generally www.sec.gov/about/laws.shtml, the official SEC web site).

An exemption applicable to many COLI purchases is provided in Section 4(2) of the 1933 Act, which provides an exemption for "transactions by an issuer not involving any public offering." Rule 506 of Regulation D (Exemption for Limited Offers and Sales Without Regard to Dollar Amount of Offering) outlines a series of conditions that, if met, qualify a transaction for exemption under Section 4(2) of the 1933 Act. Specific conditions under Rule 506 include a limitation on the number of purchasers and a requirement on the nature of each purchaser. Accredited investors, as defined in Section 2(15) of the 1933 Act, and certain other purchasers meet the nature of purchaser requirement and, subject to the other requirements of Rule 506, may be except from certain of the registration requirements.

The term *accredited investor* generally includes the following groups:

a. Banks as defined in Section 3(a)(2) of the 1933 Act

b. Insurance companies as defined in Section 2(13) of the 1933 Act

c. Investment companies registered under the Investment Company Act of 1940

d. Business development companies defined under Section 2(a)(48) of the Investment Company Act of 1940

e. Small business investment companies licensed by the Small Business Administration

f. Employee benefit plans subject to the provisions of the Employee Retirement Income Security Act of 1974 (with certain restrictions)

g. Any person who, on the basis of such factors as financial sophistication, net worth, knowledge, and experience in financial matters or amount of assets under management, qualifies as an accredited investor under rules and regulations which the Commission shall prescribe.

2.3.2 *Investment Company Act of 1940*—This act focuses on the disclosure of information about an investment company, its objectives, structure, and operations. Because separate accounts are engaged primarily in investing, reinvesting, and trading in securities, they are generally required to register as investment companies under the Investment Company Act of 1940 (1940 Act).

Section 3(c)1 of the 1940 Act provides an exemption from certain of the registration requirements for "any issuer, whose outstanding securities (other than short term paper) are beneficially owned by not more than one hundred persons and which is not making and does not presently propose to make a public offering of its securities."

2.3.3 *Issues to Consider*—Private placement transactions are commonly offered through a private placement memorandum, which is subject to less formal restrictions than a prospectus. As highlighted by Bakos (2000), slow and expensive registration processes are avoided when a transaction can be structured such that it is exempt from the registration processes of the Securities Act of 1933 and the Investment Company Act of 1940 (p. 37). The issuer of a private placement transaction may be able to act more quickly in responding to policyholder needs or gaps in their investment offerings than the issuer of a registered product. In addition to the qualification requirements outlined above, the purchaser and the issuer of a private placement COLI transaction both need to be mindful of investor control issues as outlined in Section 4.7.

2.4 *Modified Endowment Contracts versus Non-Modified Endowment Contracts*

Another important decision facing the COLI purchaser is whether to structure the transaction as a modified endowment contract (MEC) or a non-modified endowment contract (non-MEC). Non-MECs receive additional tax benefits and those benefits are outlined below.

To receive any of the tax-related benefits afforded to life insurance, the transaction must meet the requirements of IRC Section 7702, which defines life insurance for U.S. tax purposes. The definition of life insurance under Section 7702 is discussed below to provide a backdrop for the discussion of MECs and non-MECs.

IRC Section 7702A defines a modified endowment contract as any contract meeting the requirements of Section 7702, which is entered into on or after June 21, 1988, and fails to meet the requirements of the seven-pay test. The seven-pay test and some of the implications of passing it and maintaining non-MEC status are discussed below.

Finally, a summary of considerations relating to the choice between MECs and non-MECs is provided.

2.4.1 *Background*—In November 1988 the Technical and Miscellaneous Revenue Act of 1988 (TAMRA 1988) was signed into law, and qualified life insurance policies were split into two classes for U.S. tax purposes: modified endowment contracts and non-modified endowment contracts. IRC Section 7702 defines life insurance for U.S. tax purposes, and before TAMRA 1988 all income tax advantages afforded to life insurance were available to all contracts that qualified under Section 7702.

2.4.2 *Additional Benefits Afforded to Non-MECs*—Currently both MECs and non-MECs qualify for the tax-deferred treatment of policy gains and the tax-free receipt of death benefits; however, the IRC provides the following additional benefits to contracts that are maintained as non-MECs:

a. *Partial Surrenders*—Distributions from MECs are taxed as gain first and recovery of basis second. Distributions from non-MECs are taxed as recovery of basis first and gain second.

b. *Loans—*The IRC treats loans from a MEC as partial surrenders. They are taxed as income at the time received on a gain first basis. Loans from a non-MEC are not taxable as income.

c. *Penalty Tax*—A 10 percent penalty tax is imposed on the gain associated with partial surrenders and loans under a MEC. Non-MECs are not subject to this penalty tax. (Note that there is an age 59½ exception to the penalty tax rule that is generally not considered to apply to COLI.).

2.4.3 *Definition of Life Insurance*—IRC Section 7702 defines life insurance to mean any contract, which is a life insurance contract under applicable law, that passes either the cash value accumulation test or the guideline premium test (applicable law is generally state law). The cash value accumulation test is the most common test applied to COLI contracts and states that "the cash surrender value of such contract may not at any time exceed the net single premium which would have to be paid at such time to fund future benefits under the contract." The net single premium is calculated using (1) the greater of 4 percent interest or the rate guaranteed in the contract and (2) "reasonable" mortality charges not to exceed the prevailing commissioners standard tables. This means that to qualify as life insurance, the ratio of cash value to total death benefit (and by implication at-risk death benefit) must not exceed a factor, which varies by age and is predefined in the policy. Figure 3 provides a sample series of male net single-premium factors and illustrates the maximum cash value for each $1.00 of total death benefit at various ages. Figure 4 applies these ratios to a sample $500 single-premium policy issued at age 40 and shows the growth in the total death benefit necessitated by the growth in the cash value.

Figure 3
Maximum Cash Value by Age for Each $1.00 of Total Death Benefit

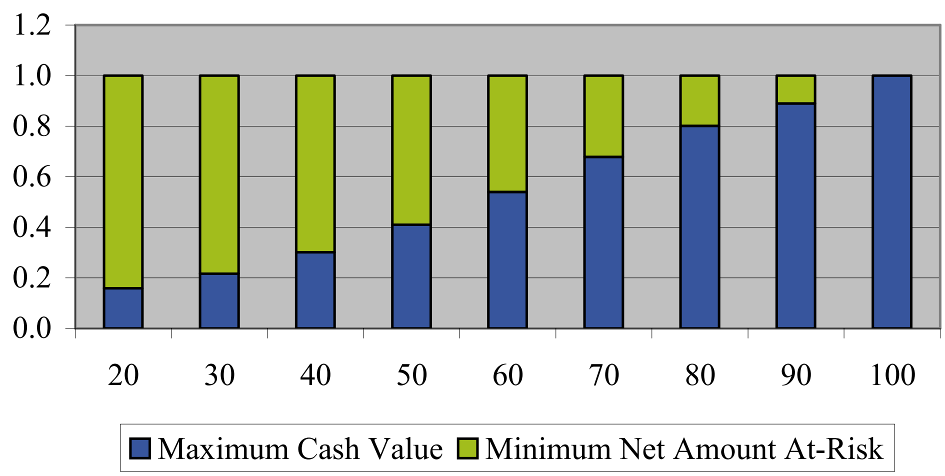
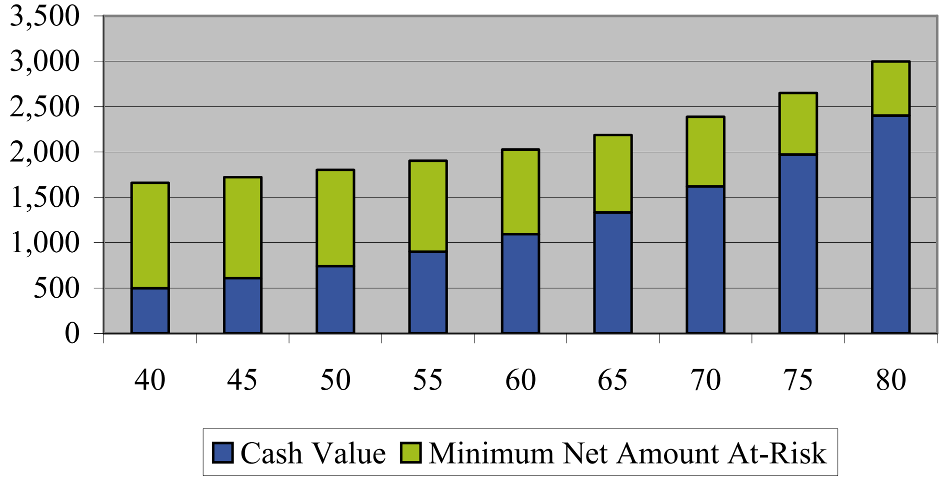


Figure 4
Growth in Death Benefit Necessitated by Growth in Cash Value
(Single $500 Premium, MEC, Male Age 40)

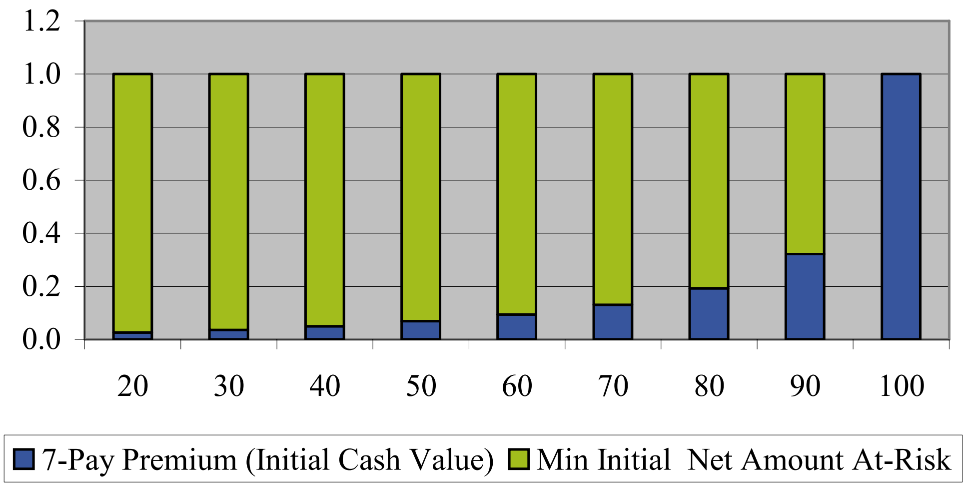


Desrochers (1988) gives a historical look at the development of the definition of life insurance and a detailed review of the application of both the cash value accumulation test and the guideline premium test.

2.4.4 *Qualifying for Non-MEC Status*—IRC Section 7702A defines a modified endowment contract as any contract meeting the requirements of Section 7702, which is entered into on or after June 21, 1988, and fails to meet the requirements of the seven-pay test. By extension, a new life insurance policy must pass the seven-pay test to qualify for non-MEC status.

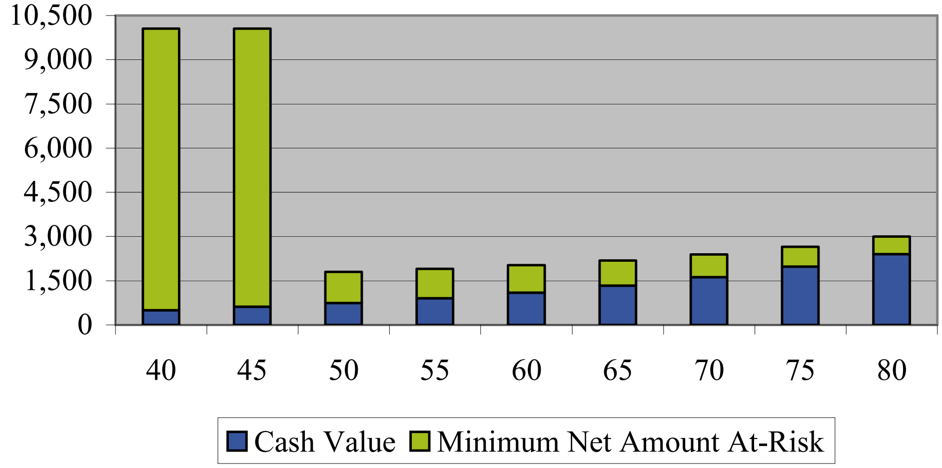
The seven-pay test requires that the accumulated amount paid under the contract at any time during the first seven contract years must not exceed the sum of the net level premiums that would have been paid on or before such time if the contract provided for paid-up future benefits after the payment of seven level annual premiums. The seven-pay net level premium is calculated using assumptions and methodology consistent with that of the net single-premium factors under the cash value accumulation test. Because the premium paid establishes initial cash value, the seven-pay test inadvertently places another constraint on the relationship between the cash value and the total death benefit. Figure 5 provides a sample series of male seven-pay factors and illustrates the maximum seven-pay annual premium for each $1.00 of total death benefit at various ages.

Figure 5
Maximum Seven-Pay Premium by Age
for Each $1.00 of Total Death Benefit



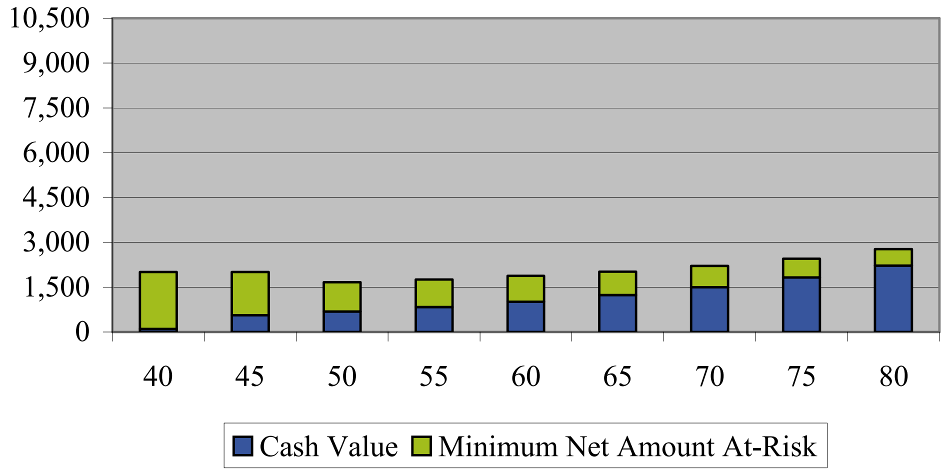
The seven-pay factor for a male age 40 in the sample above is approximately 0.05. To qualify the $500 single-premium policy, issued to a male age 40 and illustrated in Figure 5 for non-MEC treatment, the initial total death benefit would need to be set to $10,000 ($500 ÷ 0.05). This death benefit would need to be held at that level for the first seven years to maintain non-MEC status. After seven years the total death benefit could be reduced to the amount dictated by the cash value accumulation test. Figure 6 shows the minimum total death benefit necessary to maintain non-MEC status, for the sample $500 single-premium policy issued to a male age 40.

Figure 6
Minimum Death Benefit Required to Maintain Non-MEC Status
(Single $500 Premium, Non-MEC, Male Age 40)



Because certain policy fees are directly related to the net amount at risk, policy charges in the first seven years of a single-pay non-MEC could be unacceptably large. In addition the total death benefit may be limited by the COLI purchaser's insurable interest (see Section 4.2). As an alternative, the $500 premium could be spread over up to seven years, thus reducing the minimum total non-MEC death benefit. For example, if the $500 were paid in five level premiums over the first five policy years, the initial death benefit would need only to be $2,000 ($100 premium ÷ 0.05 seven-pay factor). The minimum total death benefit necessary to maintain non-MEC status for the five level premium payment example is shown in Figure 7.

Figure 7
Minimum Death Benefit Required to Maintain Non-MEC Status
(Five $100 Premiums, Non-MEC, Male Age 40)



2.4.5 *Summary of Considerations*

a. *Cost*—As discussed in Section 3, certain policy charges are directly linked to the net amount at risk. Because a MEC requires less net amount at risk in the early contract years, it can be designed with less costs than a comparable non-MEC. The magnitude of the cost differential is dependent on the premium payment pattern, is greatest for single-premium policies, and decreases with the number of years over which premium payments are spread.

b. *Liquidity*—Non-MECs have distinct liquidity advantages. Partial surrenders are taxed as recovery of basis first, loans are not considered partial surrenders for tax purposes, and the 10 percent penalty tax does not apply.

c. *Funding Requirement*—Spreading the premium payment may be an ideal compromise in some funding situations; however, it may be less than optimal in others because a delayed policy investment may be inconsistent with funding goals. Another compromise would be to split the transaction in two policies, one MEC and one non-MEC. Under this model, liquidity needs would first be met with funds from the non-MEC policy, and overall transaction cost would be less than a 100 percent non-MEC transaction.

d. *Flexibility*—The COLI purchaser should note that it is possible to switch from a non-MEC to a MEC after policy inception, but it is generally not possible to switch from a MEC to a non-MEC.

2.5 *Experience Rating versus Community Rating*

The COLI purchaser may be presented with various decisions relating to experience rating. The following defines experience rating and outlines issues that may be considered when (1) choosing between experience rating and community rating, (2) choosing among experience-rated programs, and (3) choosing among community-rated programs.

2.5.1 *General Definitions*—Experience rating is the process under which an insurance provider agrees to reduce its expected profit margin in exchange for a limited right to recover losses in the event of adverse claims. A familiar example of experience rating is the process under which a group term life or medical premium for the upcoming policy year is determined in part by the claims experience in the previous policy year. In a nonexperience-rated policy, charges are based on the claims experience of the carrier's block of business or on the results of experience studies of similar risks. Nonexperience-rated policies are sometimes referred to as community-rated or pooled policies.

2.5.2 *Experience Rating within COLI*—Many different approaches are used to experience rating among cash value life insurance providers, and these differences can have a material effect on program performance. Experience rating is more commonly available through group insurance policies but may also be available with respect to a collection of individual policies. Experience rating can be applied to either general account or separate account policies and typically involves the creation of a second policyholder asset (in addition to the cash value asset) called the *mortality reserve* or *claims reserve.* The mortality reserve is funded with cost of insurance (COI) charges that are removed from the cash value on a monthly basis (see Section 3.5 for additional commentary on COI charges). This process effectively earmarks a portion of COI charges for use in paying only the claims of the particular policy and not the claims of the carrier's larger pool of policies. The remaining portion, commonly call the *retention charge,* is held by the carrier to provide margins against claims from their larger pool of policies.

The size of the mortality reserve can be managed in several different ways. Many carriers review the reserve on an annual basis and if it is larger than necessary provide a mortality-based dividend (also known as a retrospective rate credit) to the policyholder. Some carriers will remove an additional charge from the cash value if the annual review of the mortality reserve determines that the size of the reserve is too low. Another approach to managing the size of the mortality reserve, which can be used on its own or in conjunction with the methods outlined above, is to adjust future COI charges based on the size of the reserve. COI charges can be adjusted once a year as part of the annual review of the mortality reserve or adjusted dynamically as the size of the reserve hits upper and lower thresholds.

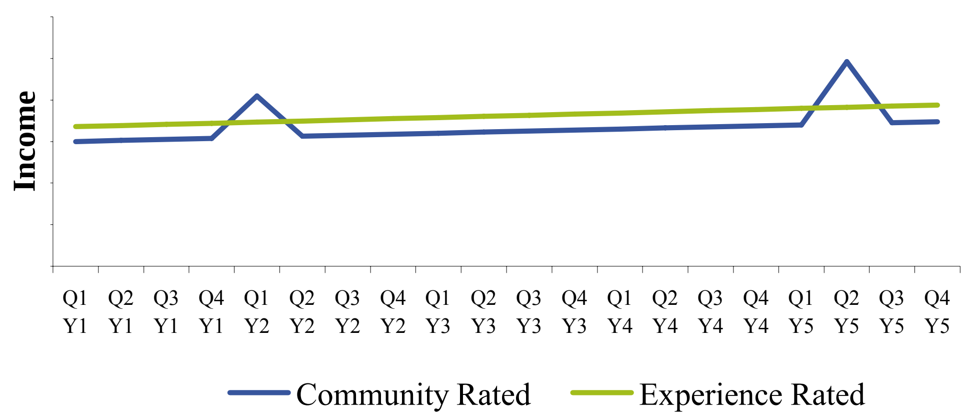
2.5.3 *Effect on Financial Statements*—In both community- and experience-rated policies, the payment of the cash value death benefit reflects the monetization of an asset already on the books of the policyholder and does not affect the income statement.

In a community-rated policy the monthly COI charges are expense items, which have an impact on the income statement, and the at-risk death benefits are income items, which also have an impact on the income statement.

In an experience-rated policy the monthly COI charges are transferred from one policyholder asset to another and do not impact the income statement. Similarly the payments of at-risk death benefits generally represent the monetization of the mortality reserve asset, which is already on the policyholder's balance sheet (exception exist under certain circumstances).

Figure 8 illustrates the effect a community-rated policy and an experience-rated policy may have on the income statement. If all other factors are set equal, the community-rated policy will generate less income during the periods of zero mortality and generate positive spikes in income as claim payments are received.

Figure 8
Relative Value Depiction of Experience Rating on Income Statement



2.5.4 *Issues to Consider*

a. *When Choosing between Experience Rating and Community Rating*

i. *Income Statement Volatility*—A well-designed experience-rating methodology will have a smoothing effect on the income statement volatility associated with program mortality. This volatility can be material, particularly if a relatively small group of employees are insured with high face amounts. COLI purchasers should consider their tolerance for income statement volatility when choosing between experience rating and community rating.

ii. *Transfer of Risk*—As highlighted in Section 4.1, risk shifting (transfer of risk) and risk distribution are essential elements of any life insurance contract. Although experience rating commonly imposes additional restrictions, beyond those mandated by regulation, on the level of COI charges that can be collected, the risk-shifting characteristic of experience-rated COLI policies have been more heavily scrutinized, in recent years, than their community-rated counterparts. The COLI purchaser should work with their legal advisors to gain comfort that the methodology selected will not subject the transaction to criticism due to lack of risk shifting.

iii. *Availability*—Experience rating is widely available for large groups of 500 insured lives or more. As the number of lives decreases so does the carriers ability to predict mortality and effectively build and maintain a mortality reserve (assuming other variables are fixed). As such, the availability of experience rating decreases as the number of insured lives decreases. For example, a single event such as a car accident could produce claims far in excess of the mortality reserve for a 50-life group. The probability of a single event producing claims in excess of the reserve is less, and the ability of the carrier to quickly rebuild the reserve is greater, with a larger case.

iv. *Complexity*—Community-rated polices do not have as many moving parts as experience-rated polices. Although some purchasers may value the transparency and level of detail available with many experience-rated policies, others may appreciate the simplicity of a community-rated policy.

b. *When Comparing Experience-Rated Policies*

i. *Mortality Reserve Interest*—The mortality reserve is an asset of the policyholder's and should be credited with interest. Any positive spread between the cash value crediting rate and the mortality reserve crediting rate will create a drag on earnings (see Section 3.10 for an example). The crediting rate as well as the methodology for applying the rate should be considered when comparing experience-rated polices.

ii. *Size of the Mortality Reserve*—Managing the size of the mortality reserve is important to minimize any drag on earnings associated with a crediting rate spread. In a separate account policy, because the mortality reserve may be subject to the claims of the insurance company's general creditors, managing the size of the mortality reserve may also be important in managing credit risk (in a general account policy both the cash value and the mortality reserve are subject to the insurance company's general creditors). As outlined above, various different ways are used to manage the size of the mortality reserve. The COLI purchaser should understand how the target reserve is calculated and the means by which the product attempts to bring the actual reserve in line with the target.

iii. *Transparency*—The COLI purchaser should consider whether the components of the experience-rating algorithm are clearly defined in the closing documents and understand the carrier's ability to change parameters.

iv. *Loss Carry Forwards*—The phrase "loss carry forwards" in the context of experience-rating cash value life insurance relates to the situation that occurs when current at-risk death benefits exceed the size of the mortality reserve. Some products will allow a negative reserve balance to be carried by the policyholder in hopes that future COI charges will make up the shortfall. Other policies do not allow negative mortality reserve balances to be carried forward from one period to the next (no loss carry forwards). In this situation the shortfall becomes income to the policyholder. A no-loss carry forward provision has value to a policyholder and should be considered when comparing experience-rated policies.

v. *Mortality Reserve on Surrender*—The COLI purchaser should consider whether or not the closing documents clearly state if and how the mortality reserve will be returned to the policyholder on surrender. Does the reserve get returned in its entirety? Are there any circumstances under which the entire reserve will not be returned?

vi. *Ability to Book the Asset*—When comparing experience-rated products, the COLI purchaser should consult with their accountant regarding their ability to book the mortality reserve, as an asset. Many accountants have become comfortable with the notion of booking the mortality reserve asset if it can be shown that the funds in the reserve will be returned to the policyholder under any circumstance (i.e., in the form of at-risk death benefits, mortality-based dividends, or a terminal dividend on surrender).

vii. *Policy Illustrations*—When comparing experience-rated policies, the purchaser should consider if the terms of the experience-rating methodology are correctly reflected in policy illustrations. Projected returns, from an illustration that does not properly reflect the policy's experience-rating mechanism, can be misstated, and when comparing products in this competitive marketplace the misstatement can be material.

c. *When Comparing Community-Rated Policies*

i. *Initial COI Charge*—The COLI purchaser should consider the initial COI rates and how long they are guaranteed to remain unchanged. If a new COLI policy is covering only active employees, it may be reasonable to expect that initial COI charges would be lower than those being applied to the carrier's in-force block of business. A group of active employees will typically be healthier on average than the carrier's in-force block of business, which may include sick and disabled lives.

ii. *Changes to the COI Charge*—The COLI purchaser should understand the circumstances under which COI charges can be changed and what information will be presented to them when a change is made. It may be reasonable to request a letter from an actuary justifying the change on the basis of mortality experience alone if that is the basis under which changes are permitted. Comfort may be gained by requesting a history of changes to existing policies and samples of the documentation made available to existing policyholders at the time of historical changes.

iii. *Guaranteed Maximum COI Charge*—Currently most COLI providers guarantee that COI charges will not exceed those derived from the application of the Commissions 1980 Standard Ordinary Table of Mortality (1980 CSO). This is the mortality table utilized in IRS Section 7702 in the computational tests for life insurance and is commonly required under state law.

In June 2002 the American Academy of Actuaries' Commissioners Standard Ordinary Task Force released its final report on a new mortality table, the Commissions 2001 Standard Ordinary Table of Mortality (2001 CSO). Mortality rates from the 2001 CSO table are lower than the rates from the 1980 CSO Table. Most states have provided life insurance companies with the option of electing to have their maximum cost of insurance charges limited by 2001 CSO instead of 1980 CSO as of January 1, 2004, but are mandating the use of 2001 CSO by January 1, 2009. Policies purchased before the insurance company's adoption of 2001 CSO will not generally be required to impose the lower maximum COI charges after January 1, 2009.

iv. *Policy Illustrations*—The COLI purchaser should have a clear understanding of the effect of different mortality patterns on program performance, particularly with a community-rated program. As such, multiple policy illustrations should be examined for each product under consideration.

Section 3. *Cost Considerations*

The COLI pricing component policies vary from one product to the next. The following discussion attempts to provide commentary on the most common components of cost in a COLI transaction. The terminology presented is common but not universally used in the industry. The COLI purchaser should note that although a complete detailing of cost is provided with some products, others bundle policy charges and provide little detail on the components of cost. "Best Practices" pricing guarantees are generally indicative of the stronger pricing assurances provided to date on each component of cost. The COLI purchaser should not limit themselves by these guidelines, nor should they expect to receive this level of assurance on each component of cost. The COLI purchaser is encouraged to take a balanced look at pricing guarantees along with other selection criteria and the purchaser's specific COLI use (general employee benefit funding, specific hedging of asset-linked benefit, etc.). "Shopping for the company with the best guarantee, the highest guaranteed cash values, and the highest guaranteed interest rate may result in dealing with the company doomed to disappear first" (Baldwin 1996, p. 89).

3.1 *Premium Tax*

3.1.1 *Nature of the Tax*—Insurance carriers are required to pay premium tax on every dollar paid into a life insurance policy. Depending on the circumstances and the carrier involved, the tax may be paid to the state in which the contract was issued, the state of residence of the insured population, or another state(s) connected to the transaction. Premium tax typically ranges from 1 to 3 percent, with a few outliers.

3.1.2 *Payment Methods*—The carrier recoups the premium tax cost by charging the policyholder either a single fee each time a premium is paid or a series of fees under a financing arrangement. A common option offered by many insurance carriers is a 10-year level dollar premium tax financing arrangement. Under this type of arrangement, instead of the full amount of premium tax being removed from the premium payment up front, 10 level payments are removed from the cash value asset on each policy anniversary. The calculation of the level payment includes interest at a rate specified by the carrier.

3.1.3 *Selection of Payment Method*—Although a 10-year level dollar financing option is quite common, many carriers are willing to consider policyholder requests for extended financing periods and nonlevel payment patterns. The two primary considerations in selecting a payment schedule are typically the economic impact and the impact on the purchaser's financial statements.

A pure economic analysis would involve comparing the interest rate used by the carrier to calculate the payment schedule (financing rate) and the expected rate of return (net of policy charges) on the cash value asset. A financing rate that is less than the expected rate of return would suggest delaying the removal of the premium tax charge from the cash value as long as possible by choosing a long financing schedule because the funds in the cash value are expected to earn more than the cost of financing. A financing rate that is greater than the expected rate of return would suggest choosing a single up-front payment or a short financing period because financing is expected to cost more than what is earned on the cash value asset.

Many COLI purchasers are very focused on the impact of policy decisions on their financial statements. The income statement impact of an up-front expense of 2 percent or more of invested premium is too onerous for many COLI purchasers. Such purchasers should consult with their accountants before selecting any payment method. Some financing arrangements that allow the carrier to recoup unpaid premium tax in the event of surrender may also require the immediate recognition of expense.

If a mechanism is utilized to smooth investment returns (see Section 6.3), features may be available within the contract to smooth the impact of an up-front premium tax charge.

3.1.4 *Best Practices Pricing Guarantee*—"Carrier guarantees to charge no more than the actual amount due to each state and local taxing authority."

The COLI purchaser should note this guarantee may be challenging for the carrier to meet and for the policyholder to monitor, given the way in which premium tax marginal rates are calculated and the fact that the marginal rate can change during the year because of changes in the sales results of various businesses of the carrier.

3.2 *Deferred Acquisition Cost*

3.2.1 *IRC Requirement*—Section 848 of the Internal Revenue Code (IRC) requires that "In the case of an insurance company—(1) specified policy acquisition expenses for any taxable year shall be capitalized, and (2) such expenses shall be allowed as a deduction ratably over the 120-month period beginning with the first month in the second half of such taxable year." Specified policy acquisition expenses are defined as 7.7 percent of net premiums for COLI policies. This means that, for the purposes of calculating taxable income, the issuing carrier is required to reduce expenses (and increase taxable income) by 7.7 percent of COLI premiums. The issuing carrier is then permitted to increase expenses (and decrease taxable income) at a rate of 0.77 percent per year over the next 10 years (starting with the first month in the second half of the initial taxable year).

3.2.2 *Opportunity Cost*—The effect of IRC Section 848 on the issuing carrier is similar to that of an interest-free loan to the IRS that is paid back over a 10-year period and is commonly referred to as the deferred acquisition cost (DAC). For example, the effect on a carrier with a 35 percent tax rate receiving a single COLI premium payment of $10,000,000 in the first policy year is illustrated in Table 2.

Table 2
Effect of IRC§848 on Carrier Receiving $10,000,000 COLI Premium

Year	Carrier Tax Rate		Amortization Schedule		Capitalization Rate		Cash Flow Per $1	Cash Flow Per $10M	Notional Loan Bal.
1	35%	×	0.95	×	7.70%	=	-0.0256	-256,025	256,025
2	35%	×	-0.10	×	7.70%	=	0.0027	26,950	229,075
3	35%	×	-0.10	×	7.70%	=	0.0027	26,950	202,125
4	35%	×	-0.10	×	7.70%	=	0.0027	26,950	175,175
5	35%	×	-0.10	×	7.70%	=	0.0027	26,950	148,225
6	35%	×	-0.10	×	7.70%	=	0.0027	26,950	121,275
7	35%	×	-0.10	×	7.70%	=	0.0027	26,950	94,325
8	35%	×	-0.10	×	7.70%	=	0.0027	26,950	67,375
9	35%	×	-0.10	×	7.70%	=	0.0027	26,950	40,425
10	35%	×	-0.10	×	7.70%	=	0.0027	26,950	13,475
11	35%	×	-0.05	×	7.70%	=	0.0013	13,475	0

Table Notes: Amortization schedule reflects 5 percent (6 months/120 months) of the specified acquisition expenses deductible in year 1 (100% − 5% = 95%).

Each premium of a multiple-pay policy would have its own schedule similar to Table 2.

3.2.3 *Payment Methods*—The issuing carrier looks to the policy for remuneration of the opportunity cost, and it is common for carriers to offer policyholders more than one DAC payment method.

a. *DAC Pass-Through*—Under the pass-through methodology, funds are exchanged between the carrier and the policyholder's cash value in a manner necessary to put the carrier in the same cash flow position at as it would have been in had the policy not been issued. Although the funds received by the carrier may establish a DAC liability on the carrier's books for GAAP reporting purposes, the carrier is required to book these payments as income for tax purposes. Therefore the funds are commonly exchanged with the cash value to be grossed up for taxes. Table 3 is an extension of the $10,000,000 example above reflecting how the pass-through methodology might work at a carrier with a 35 percent tax rate.

Table 3
DAC Pass-Through Methodology

Year	Cash Flow Requirement (Per Table 3.1)		1 - Carrier Tax Rate		Exchange with Cash Value
1	-256,025	÷	0.65	=	-393,885
2	26,950	÷	0.65	=	41,462
3	26,950	÷	0.65	=	41,462
4	26,950	÷	0.65	=	41,462
5	26,950	÷	0.65	=	41,462
6	26,950	÷	0.65	=	41,462
7	26,950	÷	0.65	=	41,462
8	26,950	÷	0.65	=	41,462
9	26,950	÷	0.65	=	41,462
10	26,950	÷	0.65	=	41,462
11	13,475	÷	0.65	=	20,731

Note: The negative exchange with the cash value in year 1 represents a removal of funds from the cash value, and the positive exchange with the cash value in years 2–11 represents a return of funds to the cash value.

b. *Up-Front Payment*—Many carriers are willing to accept an up-front payment as remuneration of the opportunity costs. This payment is expressed as a percentage of premiums and removed from the cash value each time a premium is paid. In this situation the carrier will calculate the present value of the DAC cash flow stream resulting from each premium payment and remove it from the cash value concurrent with the premium payment. The interest rate used in the present value calculation varies significantly from carrier to carrier and is a key factor in the determination of the up-front payment. Because the up-front payment itself is taxable to the insurance carrier, it is typically grossed-up for taxes. Table 4 shows a sample calculation of the up-front DAC payment on a $10,000,000 COLI premium, using an 8 percent interest rate to calculate the present value and a carrier with a 35 percent tax rate.

Table 4
DAC Up-Front Payment Methodology

Year	Carrier Cash Flow (Per Table 3.1)		Discount Factor (at 8.0%)		Present Value
1	-256,025	×	1.000	=	-256,025
2	26,950	×	0.926	=	24,954
3	26,950	×	0.857	=	23,105
4	26,950	×	0.794	=	21,394
5	26,950	×	0.735	=	19,809
6	26,950	×	0.681	=	18,342
7	26,950	×	0.630	=	16,983
8	26,950	×	0.583	=	15,725
9	26,950	×	0.540	=	14,560
10	26,950	×	0.500	=	13,482
11	13,475	×	0.463	=	6,242
Present Value of carrier DAC Cash Flow stream:					-81,430
Charge to Policyholder Cash Value: ÷ (1 - Tax Rate)					125,277
Expressed as a percentage of premium:					1.25%

c. *Other Payment Methods*—As an alternative to a single up-front payment many policyholders are afforded the opportunity to elect a multiple payment schedule as a means of reimbursing the carrier for the opportunity cost. This process typically involves first expressing the DAC charge as an up-front payment amount and then financing that amount over a fixed or variable time period. DAC financing options are typically similar to those available with the premium tax (see Section 3.1).

   If a mechanism is utilized to smooth investment returns (see Section 6.3), features may be available within the contract to smooth the impact of an up-front payment of DAC.

3.2.4 *Choosing a Payment Method*—Because the pass-through methodology involves removing funds from the cash value and placing them in a non-interest-earning DAC asset, a pure economic analysis of payment methods would involve comparing the rate of interest used to calculate the up-front DAC payment and the rate of return expected on the cash value (net of policy charges). If the rate of return on the cash value were expected to exceed the 8.0 percent in the above example, a pure economic analysis of payment methods might suggest electing to pay the up-front charge of 1.25 percent of premium over the DAC pass-through.

The impact of the DAC payment method on the income statement is an important consideration for many COLI purchasers. The treatment of DAC-related items is not uniform, and purchasers are encouraged to consult with their accountants before electing a DAC payment method. The pass-through methodology will require the policyholder to make a determination as to whether to hold the DAC asset at face value or to discount the asset to reflect the present value of future cash flows (which are not typically accelerated on surrender). If a multiple payment methodology were elected that provided the carrier the opportunity to recoup unpaid amounts at surrender, the policyholder would need to decide whether or not to offset the cash value asset with the outstanding payments.

3.2.5 *Best Practices Pricing Guarantee*

a. *DAC Pass-Through Method*—"Carrier guarantees that the economic benefit it realizes from the amortization of the capitalized specified policy acquisition expenses will be credited in full to the policy cash value. In the event the policy matures prior to the completion of any DAC amortization schedule, Carrier agrees to make the remaining payments, in full, and directly to the policyholder."

b. *Up-Front Payment Method*—"Carrier guarantees that any change in the up-front payment rate will be the direct result of a change to an external factor outside of its control. For example a change to the capitalization rate under IRC Section 848(c)(1)(C). Carrier agrees that any change in the Up-Front Payment rate will be limited to the actual increase in cost to the Carrier and to provide a detailed explanation of such increase, signed by a member of the American Academy of Actuaries, if requested. Sixty days notice will be provided to the policyholder prior to the effective date of any change."

3.3 *Mortality and Expense Risk Charge*

3.3.1 *General Discussion*—The carrier assumes the risk that mortality experience will exceed the rates guaranteed in the policy. They also assume the risk that the lifetime servicing cost will exceed the charges guaranteed in the policy. One of the means by which the carrier is compensated for shouldering these risks (and a potential source of carrier profit) is through the mortality and expense (M&E) risk charge. M&E is typically an asset-based fee charged monthly and often tiered based on policyholder assets. For example, the charge may start out at 15 basis points on the first $25 million in cash value, reduce to 10 basis points on the next $25 million in cash value, and further reduce for cash value in excess of $50 million. M&E is one of the largest and most easily compared policy charges. The COLI purchaser should be comfortable with not only the current M&E scale but also the carrier's ability to increase rates and the guaranteed maximum scale.

3.3.2 *Best Practices Pricing Guarantee*—"Charge will not exceed an amount calculated in accordance with the following schedule that is guaranteed for the duration of the contract."

3.4 *Administrative Fee*

3.4.1 *General Discussion*—Many carriers charge a per-insured administrative fee to cover the cost of servicing the policy. This fee is typically charged monthly and varies significantly from carrier to carrier. Current and maximum administrative fees should be understood by the COLI purchaser.

3.4.2 *Best Practices Pricing Guarantee*—"Carrier guarantees the charge will not exceed $x per covered life."

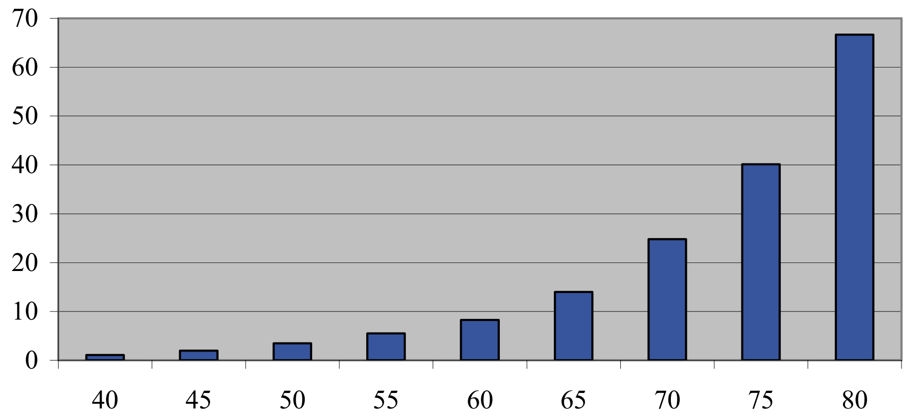
3.5 *Cost of Insurance Charge*

3.5.1 *General Discussion*—Both current and guaranteed maximum COI rates are outlined in each policy. Rates typically vary by age and sex; however, some COI charges are based on unisex rates. A portion of 1983 GAM is frequently used as a basis for current charges, and most carriers guarantee that COI rates do not exceed 100 percent of 1980 CSO.

COI charges are calculated at the individual insured level and removed from the cash value on a monthly basis. The basic calculation of the COI charge for an individual insured is the product of the net amount at risk (depicted in Figs. 1 and 2) and the applicable COI rate. Adjustments to the basic formula vary significantly from one carrier to the next making the COI charge a challenging pricing component for cost comparisons.

The COI charge is akin to the cost of pure term insurance. As depicted in Figure 9, COI rates per thousand dollars of net amount at risk increase dramatically with age.

Figure 9
Sample COI Rates per $1,000 Net Amount at Risk



3.5.2 *Best Practices Pricing Guarantee*—"Carrier guarantees the mortality charge in any one contract year will not exceed 100% of 1980 CSO."

3.6 *Retention*

3.6.1 *General Discussion*—Another means by which the carrier is compensated for assuming the risk that mortality will exceed the rates guaranteed in the policy is the retention charge. The retention charge varies significantly from one carrier to the next both in magnitude and in method of calculation. Methods of calculation include a fixed or variable percentage of (1) the COI charge, (2) the actual at-risk death benefits paid, (3) the total net amount at risk, (4) an alternative COI calculation, or a combination of two or more of the above. Some community-rated policies make adjustments to the basic COI calculation in lieu of an explicit retention charge.

Comparing the retention charge from one policy to the next can be difficult. The COLI purchaser should consider a series of illustrations run at varying mortality patterns, carefully examine the carrier's ability to change the retention rates on an ongoing basis, and carefully examine the carrier's ability to change the item on which the retention is based. For example, if retention is defined as a percentage of the COI charge, the COLI purchaser should seek to understand not only the carrier's ability to change retention rates, but also the carrier's ability to change COI rates under varying mortality patterns.

3.6.2 *Best Practices Pricing Guarantee*—"Carrier guarantees that the charge will be no greater than an amount calculated in accordance with the following schedule."

3.7 *Commissions*

3.7.1 *General Discussion*—Significant variance exists in the level and type of commission paid with respect to corporate insurance. Types of commissions presented may include front-end loads paid as a percentage of premium invested, contingent sales charges that are paid if the policy is surrendered within a fixed period of time, and asset-based fees that are paid throughout the life of the policy. Often the option is offered of fees for service instead of commissions.

The COLI purchaser should consider whether the knowledge and resources necessary to select, implement, and administer a transaction are available in house. If the decision is made to utilize outside resources, consideration should be given to whether the method of payment is consistent with the tasks to be performed. For example, a front-end commission may not be conducive to ongoing policy servicing.

Whatever the method of payment, the COLI purchaser should seek assurance that all means of compensation have been fully disclosed and are not subject to change.

3.7.2 *Best Practices Pricing Guarantee*—"Carrier guarantees that the charge will be no greater than an amount calculated in accordance with the following schedule."

3.8 *Reallocation Fees*

3.8.1 *General Discussion*—To discourage short-term trading, some carriers limit the number of reallocations that can be made in a separate account from one investment option to another or charge a fee for each reallocation in excess of a fixed number per period. The COLI purchaser should consider these limits and fee schedules and be comfortable that the chosen policy will efficiently permit the anticipated number of reallocations.

3.8.2 *Best Practices Pricing Guarantee*—"Carrier guarantees fee for each reallocation will not increase by more than the Consumer Price Index."

3.9 *Loan Spread*

3.9.1 *General Discussion*—Typically the policyholder will be able to borrow up to 90 percent of the cash value, from the insurance carrier, using the cash value as collateral. The policyholder will continue to earn interest on the borrowed cash value at a rate defined in the policy. The policyholder will pay loan interest at a rate greater than what is earned on borrowed cash value. The difference between the two rates is called the *loan spread.* A COLI purchaser who may need to consider a policy loan as a source of cash should be comfortable with the policy loan spread.

The COLI purchaser should note that under IRC Section 264(a)(4) and with certain exceptions, no deduction shall be allowed for "any interest paid or accrued on any indebtedness with respect to 1 or more life insurance policies owned by the taxpayer covering the life of any individual." As noted in Section 2.4.2, loans from MECs are taxed as gain first, and a 10 percent penalty tax is applied.

3.9.2 *Best Practices Pricing Guarantee*—"Carrier guarantees that the crediting rate on borrowed cash value will be x basis points less than the policy loan rate."

3.10 *Drag on Earnings*—When comparing the cost of available policies, the COLI purchaser should include an analysis of the drag on earnings related to features such as a DAC pass-through, low crediting rate on mortality reserve, and the timing of policy charges.

Under many DAC pass-through options, 4 percent or more of the initial investment is set aside in a non-interest-earning asset. If the expected rate of return on the cash value were 6 percent, the drag on earnings in year 1 associated with having 4 percent of the investment in the non-interest-earning DAC asset would be 24 basis points (4 percent of asset × 6 percent rate of return on cash value).

With most general account experience-rated products and some separate account experience-rated products, the mortality reserve crediting rate is set equal to the rate of return on the cash value. In other instances the expected rate of return on the cash value is greater than the expected return on the mortality reserve. The drag on earnings associated with a low crediting rate on the mortality reserve should be considered when comparing products. For example, if the claims reserve was expected to average 2 percent of the total asset, and the spread between the rate of return on the cash value and the rate of return on the mortality reserve were expected to be 3 percent, the drag on earnings would be 6 basis points (2 percent of asset × 3 percent spread on crediting rates).

Even the timing of policy charges could make a difference in the competitively priced COLI marketplace. A 15 bps fee removed from the cash value quarterly in arrears is much preferable to a 15 bps fee removed from the cash value monthly in advance.

When comparing policy costs, the COLI purchaser should include a comparison of the expected IRR for each policy under a variety of specific interest and mortality assumptions. The IRR of a well-modeled product will reflect the drag on earnings associated with each of its policy features. In addition, the COLI purchaser may want to seek assurances that the product illustrations being presented are true representations of the way the policy will be administered. In some instances material differences exist between illustration systems and administration systems.

3.11 *Investment Management Fees*

3.11.1 *General Discussion*—Investment management fees are typically expressed as a percentage of assets under management. Performance-based or other fees may be included in addition to, or in replacement of, the asset-based fee. Many carriers make available a variety of both low-cost, passively managed options and higher-cost, actively managed options. The COLI purchaser should understand the investment management fee structure and be comfortable that the level of fees is consistent with the value being added by the manager.

3.11.2 *Best Practices Pricing Guarantee*—"Charges for investment management services are on a pass-through basis. Carrier will not share in the fees paid to the investment manager."

3.12 *Custody and Accounting Fees*

3.12.1 *General Discussion*—These fees are related to the custody and accounting of the securities underlying the cash value. They can be material and vary significantly from one carrier to the next, and sometimes from one investment option to the next. The COLI purchaser should be comfortable with the current and guaranteed level of all charges including the custody and accounting fees.

3.12.2 *Best Practice Pricing Guarantee*—"Carrier guarantees that annual custody and accounting fees will not exceed actual costs."

3.13 *Charge for Smoothing Portfolio Returns*

3.13.1 *General Discussion*—Mechanisms to smooth investment returns are discussed in Section 6.3. The pricing of these items is dependent on product features and underlying investment choices.

3.13.2 *Best Practice Pricing Guarantee*—"Charge will be no greater than an amount calculated in accordance with the following schedule."

Section 4. *Legal Considerations, Representations, and Warranties*

The following discussion attempts to provide an overview of various legal issues that may be considered when purchasing COLI. Many COLI providers are willing to provide the policyholder with an extensive set of representations and warranties relating to these issues. They each have different views and tolerance levels, and the representation and warranties provided vary significantly from one carrier to the next and sometimes from one transaction to the next. The COLI purchaser should understand the allocation of risk assumptions and opportunities as between the purchaser and the provider. In some instances the representations and warranties may not be worth the financial cost (in terms of increased policy charges). "Best Practices" representations, warranties, and indemnities are generally indicative of the stronger positions taken to date on each issue. The COLI purchaser should not limit themselves by these guidelines, nor should they expect to receive this level of backing on each issue.

4.1 *Transfer of Risk*

4.1.1 *Background Information*—In *Helvering v. Le Gierse* (1941), the U.S. Supreme Court explained that a valid life insurance contract, for federal tax purposes, must involve risk shifting (transfer of risk) and risk distribution. The case involved the simultaneous purchase of a single-premium life insurance contract and an annuity contract by Le Gierse at the age of 80. The life insurance policy paid $25,000 on Le Gierse's death and was purchased for $23,000. The annuity entitled Le Gierse to $600 per year as long as she lived and was purchased for $4,000. The Court required that the two contracts be viewed together and focused on the fact that "annuity and insurance are opposites; in this combination the one neutralizes the risk customarily inherent in the other." The combination of the insurance and annuity did not sufficiently shift risk to the insurance company (consider the interest alone on the $27,000 payment in relation to the $600 annual annuity benefit). The Court ruled that this was not a valid life insurance contract and that the proceeds paid on Le Gierse's death (less than a month after entering into the contracts) were not exempt from federal estate taxation. The accepted definition of insurance for federal tax purposes, although since supplemented, became a contact involving the shifting and distribution of an insurance risk.

The Supreme Court in *Helvering v. Le Gierse* made it clear that insurance requires both risk shifting and risk distribution; however, the Court did not provide definitions for those terms. Subsequently lower courts have provided interpretations of risk shifting and risk distribution.

In *Commissioner v. Treganowan* (1950), the Second Circuit stated that "Risk shifting emphasizes the individual aspect of insurance: the effecting of a contract between the insurer and insured each of whom gamble on the time the latter will die. Risk distribution, on the other hand, emphasizes the broader, social aspect of insurance as a method of dispelling the danger of a potential loss by spreading its costs throughout a group."

In *Beech Aircraft v. United States* (1986), the Tenth Circuit stated that "'risk-shifting' means one party shifts his risk of loss to another, and 'risk-distributing' means that the party assuming the risk distributes his potential liability, in part, among others."

In *Clougherty Packing Co. v. Commissioner* (1987), the Ninth Circuit stated, "Shifting risk entails the transfer of the impact of a potential loss from the insured to the insurer. If the insured has shifted its risk to the insurer, then a loss by or a claim against the insured does not affect it because the loss is offset by the proceeds of an insurance payment … Distributing risk allows the insurer to reduce the possibility that a single costly claim will exceed the amount taken in as a premium and set aside for the payment of such a claim. Insuring many independent risks in return for numerous premiums serves to distribute risk."

In *Humana Inc. v. Commissioner* (1989), the Sixth Circuit stated, "Risk shifting involves the shifting of an identifiable risk of the insured to the insurer … Risk distribution involves shifting to a group of individuals the identified risk of the insured."

Note that in 1941 when hearing *Helvering v. Le Gierse* the Supreme Court had little regulatory guidance on which to base their decision: "None of the acts has ever defined 'insurance.' Treasury Regulations, interpreting the original provisions, stated simply: 'The term 'insurance' refers to life insurance of every description, including death benefits paid by fraternal beneficial societies, operating under the lodge system.'" The Deficit Reduction Act of 1984 provides a definition and numerical tests for a life insurance contract (IRC Section 7702). The Tax Reform Act of 1986 distinguishes a life insurance contract from a fund (IRC Section 419(e)). Some observers would suggest that, per *Milwaukee v. Illinois* (1981), these definitions preempt the requirements put forth by the Supreme Court in 1941.

4.1.2 *Traditional Group Life Insurance*—In general, the risk that mortality experience will fall outside of the expected range (measured for example by standard deviation) is greatest with a single life policy and decreases with group policies as the number of lives increases. In a group policy (or a collection of individual policies), particularly those insuring a large number of lives, the risk that claims experience will exceed the premiums collected may be minimal. Group insurance, however, is often purchased for protection against the severe but unlikely events that would cause claims to exceed premium. If claims experience falls within the expected range, the policyholder is likely to be able to withstand the expense without insurance. It is the unlikely but costly events, such as a car or plane accident involving several employees or a catastrophe at the corporate offices, for which the prospective group policyholder is often most concerned. One of the goals of group life insurance is to shift the risk associated with such an event to an insurance provider. Group life insurance has been offered since 1911 (Thompson and Cassandra 2003, p. 59), and, to the author's knowledge, the mere fact that a product was issued as a group contract has not been a reason for the courts to assert a lack of risk shifting or risk distribution. A collection of individual policies owned by the same entity may be just prone to a risk-shifting challenge as group insurance.

4.1.3 *Universal Life Insurance*—As with traditional group life insurance, one of the goals of group universal life insurance is to shift the financial cost associated with an unlikely but significant event to an insurance provider. Although many of the policy elements are unbundled, "universal life policies provide for a meaningful 'insurance risk' since from the payment of the first premium until their maturity, the insurer is at risk for at least the total face amount less the reserve just as any other life insurance policy" (Lynch 1982, p. 49). Universal life has been sold in the United States since the late 1970s, and, to the author's knowledge, lack of risk shifting or risk distribution has not been asserted by the courts solely based on the nature of the product.

4.1.4 *Experience-Rated Life Insurance*—As discussed in Section 2.5, experience rating is the process under which an insurance provider agrees to reduce its expected profit margin in exchange for a limited right to recover losses in the event of adverse claims. Many different experience-rating methodologies are used in the COLI marketplace, and although the amount of risk shifting may vary from one experience-rating methodology to the next, they do not inherently shift less risk than community-rated policies. They have, however, been subject to more scrutiny in recent years relating to risk shifting.

Experience rating is discussed at length in four recent cases involving COLI and the deductibility of policy loan interest. Although these cases do not involve direct challenges to the validity of life insurance solely on the existence of experience rating, and some observers suggest have failed to discuss key aspects of applicable law, they do provide insight into how such an argument may be framed. In each case the experience-rated nature of the transaction was used as support for the argument that the programs lacked economic substance and should therefore be considered shams.

In *Winn-Dixie v. Commissioner* (1999), *CM Holdings v. Internal Revenue Service* (2000), and *AEP v. United States* (2001), arguments were unsuccessfully made that the potential to receive death benefits under the life insurance contracts was significant enough evidence to show that the transactions had economic substance. The transactions each involved some form of experience rating, and in each case the nature of the experience rating contributed to the downfall of the economic substance argument.

In *Dow Chemical Company v. United States of America* (2003) the government contended that Dow's COLI programs were designed to be "mortality neutral," and as such these aspects of the programs should be viewed as shams. The court for the eastern district of Michigan found the government's position "somewhat curious and quite provocative, since it potentially could invalidate all forms of group life insurance." The court differentiated the Dow policies from prior cases, highlighting the fact that the COI charges and death benefits were not "trued up" retrospectively as was the practice in the three prior cases. The Court of Appeals for the Sixth Circuit later cited other policy features, such as "the right to increase COI charges to recoup losses if claims for death benefits exceeded COI charges," as evidence that the Dow polices were not distinguishable from those in the prior cases on this issue (*Dow Chemical Company v. United States of America* [2006]).

Numerous methods of experience rating are available in the marketplace, and the COLI purchaser should work with their legal advisors to gain comfort that the methodology selected will not subject the transaction to criticism due to potential interpretation of lack of risk shifting.

4.1.5 *Best Practices Representations, Warranties, and Indemnities*

a. *Representations and Warranties*—"Carrier represents and warrants that the Policy is an insurance policy that provides sufficient transfer of risk to the Carrier under applicable state and federal laws."

b. *Indemnities*—"Carrier shall indemnify policyholder and hold harmless in any challenge under state or federal law against status of the Policy as insurance based on lack of adequate transfer of risk."

4.2 *Insurable Interest*

4.2.1 *Background Information*—"The purpose of insurance is to indemnify or compensate the insured or a beneficiary or assignee for a loss that the insured suffered. The correlative of this basic principle is that the insured should have an interest in the subject of insurance, otherwise the insured will not suffer a financial loss upon the loss of the thing insured. From this arises the need, in principle, for an insurable interest" (Meyer 1990, p. 168).

A life insurance contract may be purchased only by a policyholder who can reasonably expect some benefit or advantage from the continuance of the life of the insured and, conversely, would suffer a loss on the death of the insured. The absence of such "insurable interest" would render the contract a mere wager and against public policy.

4.2.2 *Common Law*—Insurable interest requirements and policies against wagering date back centuries to laws passed in England and include the Life Assurance Act of 1774, which states no insurance shall be made on lives by persons having no interest. The Supreme Court of the United States has heard various cases involving insurable interest that serve as a foundation for this issue. Three influential cases heard by the Supreme Court in the late nineteenth century are summarized below:

In *Connecticut Mutual v. Schaefer* (1876) the Court heard a case involving a policy issued in 1868 on the lives of a husband and wife, payable to the survivor on the death of either. In 1870 the couple divorced, and alimony was paid to the wife. Both individuals subsequently remarried, and in 1871 the ex-husband died. The ex-wife sought the death proceeds. The Court was charged with analyzing whether the cessation of insurable interest invalidates a life insurance contract. In an attempt to first ascertain what an insurable interest is, the Court stated "generally that any reasonable expectation of pecuniary benefit or advantage from the continued life of another creates an insurable interest in such life." The Court ultimately ruled that "a policy taken out in good faith, and valid at its inception, is not avoided by the cessation of the insurable interest, unless such be the necessary effect of the provisions of the policy itself."

Warnock v. Davis (1881) is a frequently referenced case that involved the assignment of a life insurance policy. In 1872 the insured applied for a life insurance policy on his own life and on the same day entered into an agreement with an association, assigning nine-tenths of the amount due and payable on his death to the association. The insured died in 1873, and the association collected the amount of the policy and paid one-tenth to the widow of the deceased. The Court found that "the policy executed on the life of the deceased was a valid contract, and as such assignable by the assured to the association as security for any sums lent to him, or advanced for the premiums and assessments upon it." But because of a lack of insurable interest, it was not assignable to the association for any other purpose. The Court stated that although it is difficult to define insurable interest, "in all cases there must be a reasonable ground, founded upon the relations of parties to each other, either pecuniary or of blood or affinity, to expect some benefit or advantage from the continuance of the life of the assured. Otherwise the contract is a mere wager, by which the party taking the policy is directly interested in the early death of the assured. Such polices have a tendency to create a desire for the event.

They are, therefore, independently of any statute on the subject, condemned, as being against public policy."

In *Connecticut Mutual v. Luchs* (1883) the Court heard a case involving a beneficiary's right to the proceeds of a life insurance policy he had purchased on the life of his business partner. The partnership called for each partner to contribute $5,000 in capital. The beneficiary contributed the entire $10,000 and, upon his partner's failure to make his contribution, applied for a $5,000 life policy on the partner's life. The insurance company claimed that the beneficiary lacked insurable interest in the partner's life. The Court disagreed, stating that "besides what was due, [the beneficiary] was interested in having [his partner] continue in the partnership. He had such an interest, therefore, as took from the policy anything of a wagering character."

4.2.3 *State Law*—Most states have passed insurable interest laws, and many address the interest an employer has in the lives of its employees. Although common elements run through many of the state laws, significant variance exists relating to the content and extent to which these laws address issues such as the acceptable amount of coverage.

Many states have enacted laws that define insurable interest in a manner similar to the Supreme Court in *Warnock v. Davis* (1881). Washington state, for example, defines insurable interest as follows: "(i) In the case of individuals related closely by blood or by law, a substantial interest engendered by love and affection; and (ii) In the case of other persons, a lawful and substantial economic interest in having the life, health or bodily safety of the individual insured continue, as distinguished from an interest that would arise only by, or would be enhanced in value by, the death, disability or injury or the individual insured" (ARCW Section 48.18.030).

Some states provide further clarification relating to corporations that provide benefits to employees. Indiana insurance law, for example, states that "an employer that provides life insurance, health insurance, disability insurance, retirement benefits, or similar benefits to an employee of the employer has an insurable interest in the life of the employee" (Indiana Insurance Code Section 27-1-12-17.1). Other states, such as New York and Illinois, apply similar insurable interest provisions with respect to benefit plans governed by the Federal Employee Retirement Income Security Act of 1974 and limit the acceptable amount of insurance coverage accordingly.

Many state laws expressly state that insurable interest is only a matter of concern at inception. For example, Section 10110.1(d) of the California Insurance Code states, "An insurable interest shall be required to exist at the time the contract of life or disability insurance become effective, but need not exist at the time the loss occurs." California also limits insurable interest to exempt employees under state labor law (Cal. Ins. Code Section 10110.4)

4.2.4 *Conflicts of Law*—Life insurance is generally regulated by state law as opposed to federal law. Given the variance between states in insurance and insurable interest laws, it is important to consider which state's law governs the transaction. A COLI transaction involves many components that may impact this issue. The location of the insurance provider, the location of the policyholder, the location of the insured, the location where the contract is executed, and various other contacts and public policy issues are among the issues to consider when examining which law governs the transaction.

Some states have issued statutes specifically applying state laws to life insurance transactions insuring their residents. Minnesota statute 60A.08–Subdivision 4, for example, states, "[a]ll contracts of insurance on property, lives, or interests in this state, shall be deemed to be made in this state. It shall be unlawful for any person, firm, or corporation to solicit or make, or aid in soliciting or making, any contract of insurance not authorized by the laws of this state." Most states have adopted some form of the tests suggested by the American Law Institute relating to conflicts of law. The "most significant relationship" test is outlined in Section 188 of the Restatement of the Law, Second, Conflict of Laws (1971, American Law Institute) and relates to the law governing in absence of an effective choice by the parties. Section 187 of the Restatement of the Law, Second, Conflict of Laws (1989, American Law Institute) relates to the law governing in situations in which the parties have chosen a state.

The COLI purchaser should work with their legal advisors to examine which state's law governs the transaction. Many COLI purchasers conservatively take a lowest common denominator approach when examining insurable interest and adopt the methodology permitted by the most restrictive law of the various states involved.

4.2.5 *Best Practices Representations, Warranties, and Indemnities*

a. *Representations and Warranties*—"Carrier represents and warrants that it will not assert lack of insurable interest as a defense for nonpayment of a policy claim. Carrier represents and warrants that it will defend any claim against the policy based on lack of insurable interest with the policyholder. Carrier represents and warrants that it will pay all prevailing third party claims and not seek to recover payment made to the policyholder."

b. *Indemnities—*“Carrier shall indemnify policyholder and hold harmless for challenges alleging violation of state insurable interest laws.”

4.3 *State Insurance Law*

4.3.1 *Background Information*—In addition to insurable interest laws, state laws concerning, among other things, policy design and administration must be followed for the formation and continuance of a valid life insurance contract. As such, many COLI purchasers look to the carrier for assurance regarding state insurance law.

4.3.2 *Best Practices Representations, Warranties, and Indemnities*

a. *Representations and Warranties*—“Carrier represents and warrants that the policy has been approved for use by the [list of states relative to transaction] and that the policy complies with the laws of those states. [If a separate account transaction] Carrier represents and warrants that the separate account will be administered in accordance with applicable law. [If a separate account transaction] Carrier represents and warrants that the separate account will not be charged with liabilities arising out of any other business of the Carrier.”

b. *Indemnities*—Carriers typically do not provide indemnification language with respect to general regulatory compliance with state insurance laws.

4.4 *“Life Insurance Contract” Status under IRC Section 7702*

4.4.1 *Background Information*—For the death benefit of a life insurance policy to be excluded from taxable income, IRC Section 7702(a) requires the contract to be a life insurance contract under applicable law *and* meet the requirements of either the cash value accumulation test or the guideline premium test.

4.4.2 *Applicable Law*—Because transfer of risk, insurable interest, and other state insurance concerns are among the laws applicable to life insurance, a representation relating to compliance with IRC Section 7702 could be viewed as a blanket representation on all of these issues and more. The COLI purchaser should seek a clear understanding of the carrier’s position regarding the issues covered by their 7702 representation before entering into a contract. It is in everyone’s best interest to avoid a misunderstanding by clarifying these issues up front. This is particularly important if separate consideration is not given to each issue in the closing documents.

4.4.3 *Computational Tests*—For a contract to qualify as life insurance and remain qualified, the relationship between the cash value and the total death benefit must meet certain standards. Compliance can be demonstrated by meeting the requirements of either the cash value accumulation test or the guideline premium test. The cash value accumulation test is more prevalently used in COLI and is described in Section 2.4.3.

IRC Section 7702(f)(8) provides that, if the taxpayer establishes to the satisfaction of the Secretary that failure to meet the computational requirements for any contract year was due to a reasonable error and reasonable steps are being taken to remedy the error, the Secretary may waive the failure to satisfy such requirements. Several taxpayers have sought and received private letter rulings relating to Section 7702(f)(8). Although these rulings are specific to the circumstances of the particular taxpayer involved and cannot be cited as precedent (IRC Section 6110(k)(3)), they do provide some insight into the application of Section 7702(f)(8). As cited in the 2007 edition of *Tax Facts:*

> Where six life insurance policies were temporarily out of compliance with the guideline premium test requirements due to the inadvertence of the insurer's employees during a change in computer systems, the IRS granted such a waiver after the insurer increased the policy death benefit. Let. Rul. 9042039. See also Let. Ruls. 9801042, 9727025, 9621016. Where clerical errors involving lost records, missed testing dates, and the failure to make scheduled premium adjustments combined with the conversion of the insurance company's policy administration system from a manual procedure to a fully computerized one to cause policies to be out of compliance, the Service granted a waiver provided the policies were brought back into compliance within 90 days. Let. Rul. 9416017. See also Let. Ruls. 200006030, 199924028, 9834020, 9838014. Where a clerk failed to realize that a certificate holder had paid additional premiums that put the group universal life certificate out of compliance, the Service granted a waiver provided that the company refund the excess premiums, with interest, or increase the policy death benefit from the time of noncompliance. Let. Rul. 9623068. See also Let. Ruls. 200027030, 9805010, 9601039, 9517042, 9322023, 9146016, 9146011. However, the Service refused to waive an insurer's failure to satisfy these requirements where several policies were discovered to be out of complicate due to the company's use of a software program which contained an 'inherent structural flaw.' Let. Rul. 9202008." (p. 316)

4.4.4 *Best Practices Representations, Warranties, and Indemnities*

a. *Representations and Warranties*—"Carrier represents and warrants that the policy and its coverage on each insured will qualify as life insurance under IRC Section 7702."

b. *Indemnities*—"Carrier shall indemnify policyholder and hold harmless if the policy design or administration is not in compliance. Carrier shall seek any cure at own expense. Carrier shall hold policyholder harmless for any damages arising out of pursuit of a cure."

4.5 *Modified Endowment Contract Status under IRC Section 7702A*

4.5.1 *Background Information*—Life insurance contracts are divided into two groups: modified endowment contracts (MECs) and non-modified endowment contracts (non-MECs). In addition to the benefits of tax-deferred inside buildup and tax-free death benefits, distributions from non-MECs are taxed as recovery of basis first, and loans are not taxable as income. To qualify for the extra benefits afforded a non-MEC, the contract must meet the requirements of the seven-pay test as defined in IRC Section 7702A.

4.5.2 *Seven-Pay Test and Procedures to Remedy Failure*—A contract fails to meet the seven-pay test if the accumulated amount paid under the contract at any time during the first seven contract years exceeds the sum of the net level premiums that would have been paid on or before such time if the contract provided for paid-up future benefits after the payment of seven level annual premiums. The test can become complicated in situations in which funding requirements necessitate material changes to the benefits under the contract.

Revenue Procedure 2001-42 "provides the procedures by which an issuer may remedy an inadvertent non-egregious failure to comply with the modified endowment contract rules under § 7702A of the Internal Revenue Code." The procedure provides relief on eligible policies, outlines an amount to be paid with respect to each policy, and generally requires the policies to be brought back into compliance by either increasing the contract's death benefits or returning excess premiums and earnings.

4.5.3 *Best Practices Representations, Warranties, and Indemnities*

a. *Representations and Warranties*—"[If non-MEC transaction] Carrier represents and warrants that the policy will not be deemed a modified endowment contract ('MEC') at issue or thereafter. Carrier represents and warrants that it will ensure that the policy complies with tax requirements for non-MEC status."

b. *Indemnities*—"[If non-MEC transaction] Carrier shall indemnify policyholder and hold harmless if the Carrier fails to maintain the non-MEC status of the policy. Carrier shall seek any cure at own expense. Carrier shall hold policyholder harmless for any damages arising out of pursuit of a cure."

4.6 *Diversification Status under IRC Section 817(h)*

4.6.1 *Background Information*—IRC Section 817(h) was enacted as part of the Deficit Reduction Act of 1984 and provides that a variable contract shall not be treated as a life insurance contract for purposes of receiving preferential tax treatment unless the contract is adequately diversified in accordance with regulations prescribed by the Secretary of the Treasury. On March 2, 1989, final regulations (1.817-5) addressing diversification requirements were issued.

4.6.2 *Diversification Requirements*—Section 1.817-5(b)(1) of the Income Tax Regulations provides that the investments of a segregated asset account will be considered adequately diversified if:

a. No more than 55 percent of the value of the total assets of the account is represented by any one investment

b. No more than 70 percent of the value of the total assets of the account is represented by any two investments

c. No more than 80 percent of the value of the total assets of the account is represented by any three investments

d. No more than 90 percent of the value of the total assets of the account is represented by any four investments.

For segregated accounts that contain Treasury securities, an adjustment to the general rule, outlined above, is provided in 1.817-5(b)(3). An alternative means of satisfying the diversification requirements, which relates to the definition of a regulated investment company (Section 851), is provided in 1.817-5(b)(2).

In general a segregated asset account will be considered adequately diversified for a calendar quarter if it passes the diversification requirements on the last day of the quarter or within 30 days after the last day of the quarter. Grace periods relating to the start-up and liquidation of a segregated asset account are provided in 1.817-5(c).

4.6.3 *Look-through Rules*—As provided in 1.817-5(f), "a beneficial interest in a regulated investment company … shall not be treated as a single investment of a segregated asset account." Instead, a pro rata portion of each asset of the investment company will be treated as the asset of the segregated asset account.

The look-through rules are available only to interests in investment companies that are owned exclusively by one or more segregated asset accounts of one or more insurance companies. Public access to investment companies must be available only through the purchase of a variable contract (with some exceptions provided in 1.817-5(f)(3)).

4.6.4 *Inadvertent Nondiversification*—The final regulation on diversification requirements contains commentary relating to public comments. In response to concerns expressed by various commentators, the text of the final regulation states: "The Internal Revenue Service agrees that variable contracts based upon a segregated asset account that inadvertently becomes nondiversified should be treated as remaining qualified, provided that the issuer or holder of the contract agrees to pay such amounts as may be required by the Commissioner. The amount required by the Commissioner to be paid will be based on the amount of tax the policyholders would have been required to pay if they were treated as receiving the income on the contract during the period of nondiversification."

4.6.5 *Best Practices Representations, Warranties, and Indemnities*

a. *Representations and Warranties*—"Carrier represents and warrants that the policy and the separate account will satisfy the diversification requirements at issue and thereafter. Carrier represents and warrants that it will ensure continued compliance."

b. *Indemnities*—"Carrier shall indemnify policyholder and hold harmless against any violation of diversification requirements. Carrier shall seek any cure at own expense. Carrier shall hold policyholder harmless for damages arising out of pursuit of cure."

4.7 *Investor Control*

4.7.1 *Background Information*—The concept of investor control provides that a policyholder who exerts too much control over the assets in a separate account may be deemed the owner of those assets and be required to pay tax on the policy's inside buildup. This issue was first raised in a series of Revenue Rulings published by the Internal Revenue Service relating to variable annuities and was referenced in temporary separate account diversification regulations.

In January 1977 the Service issued Revenue Ruling 77-85 providing that, if a variable annuity policyholder has the power to direct the custodian to sell, purchase, or exchange securities or other assets held in the separate account, the policyholder, rather than the insurance company, will be viewed as the owner of the assets in the separate account. Thus, any interest, dividends, or other income derived from the investment assets is includible in the gross income of the policyholder.

In July 1981 the Service issued Revenue Ruling 81-225, which states:

> Life insurance companies will not be considered the owners of mutual fund shares that are held by the companies in connection with 'wraparound annuity' contracts sold to policyholders. The policyholder is the owner and any earnings and gains from the shares are included in the gross income of the policyholder. However, the insurance company is considered to be the owner of mutual fund sales in a situation in which the investments in the mutual fund shares are controlled by the insurance company and the mutual fund shares are only available through the purchase of an annuity from the insurance company.

The final regulation, discussed in Section 4.6, regarding diversification requirements (1.817-5) was predated by a temporary regulation that was issued September 15, 1986 (T.D. 8101; 51 FR 32633). The Explanation of Provisions section of the temporary legislation contained the following paragraph, which left the marketplace anticipating further guidance which is yet to be released:

> The temporary regulations in this document do not address issues other than the diversification standards applicable to variable annuity, endowment, and life insurance contracts. In particular, they do not provide guidance concerning the circumstances in which investor control of the investments of a segregated asset account may cause the investor, rather than the insurance company, to be treated as the owner of the assets in the account. For example, the temporary regulations provide that in appropriate cases a segregated asset account may include multiple sub-accounts, but do not specify the extent to which policyholders may direct their investments to particular sub-accounts without being treated as owners of the underlying assets. Guidance on this and other issues will be provided in regulations or revenue rulings under 817(d), relating to the definition of variable contract.

4.7.2 *Variable Life Service Rulings*—Clarification on investor control has not been provided through regulation; however, two rulings issued by the

Internal Revenue Service help clarify the Service's position on this matter. Although it is possible that a court could rule that these pronouncements are erroneous or unnecessarily narrow, staying within their fact patterns has been widely viewed as a safe harbor relating to investor control.

a. *Private Ruling 9433030*—On May 25, 1994, Mass Mutual received a ruling from the Service that concluded "that the Insurer rather than the Policy Owner is the owner of the assets held in Special Division underlying the Policy. Thus, income, gain, or loss with regard to those assets is includible in the computation of Insurer's life insurance company taxable income and is not includible in the determination of Policy Owner's taxable income." The facts on which this ruling was based include the following:

   i. The Policy Owner's Special Division is not open to the general public and only available through the ownership of the Policy.

   ii. The Policy Owner is permitted to allocate premiums and contract values across four Segments within the Policy Owner's Special Division.

   iii. The Policy Owner is allowed to reallocate contract values among various Segments no more frequently than four times per year.

   iv. Before purchase the Insurer and Policy Owner agreed to broad investment guidelines relating to each of the four Segments.

   v. Other than the Policy Owner's right to allocate premiums and contract values among the four Segments and the broad investment guidelines described above, all investment decisions are made by the Insurer in its sole and absolute discretion.

   vi. Insurer represents that the Policy Owner, including any officer, director, employee, or agent thereof, will not communicate directly or indirectly with any "investment officer" of the Insurer or its affiliates relating to the quality or rate of return of any specific investment or group of investments held in a Segment.

   vii. The Policy Owner cannot select or identify particular investments to be made by any Segment of the Policy Owner's Special Division.

   viii. The Policy Owner has no right to have any of the terms of the investment guidelines changed.

ix. The Policy Owner has no legal, equitable, direct, or indirect interest in any of the assets held by the four Segments within the Policy Owner's Special Division.

b. *Revenue Ruling 2003-91*—On August 18, 2003, the Service released a ruling that stated that "Based on all the facts and circumstances, holder does not have direct or indirect control over the Separate Account or any Sub-account asset. Therefore, Holder does not posses sufficient incidents of ownership … to be deemed the owner of the assets for federal income tax purposes." The facts and circumstances presented in this ruling include the following:

i. The Separate Account is divided into various Sub-accounts, which are available solely through the purchase of a contract.

ii. Twelve Sub-accounts are currently available under the contracts, but insurance company may increase or decrease this number at any time. However, there will never be more than 20 Sub-accounts available under the contracts.

iii. The purchaser ("Holder") specifies the allocation of premium paid among the Sub-accounts available at the time of purchase.

iv. Holder is permitted one transfer between Sub-accounts without charge per 30-day period. Any additional transfers during this period are subject to a fee.

v. There is no arrangement, plan, contract, or agreement between Holder and insurance company or between Holder and investment advisor.

vi. Other than the Holder's right to allocate premiums and transfer among the available Sub-accounts as described above, all investment decisions concerning the Sub-account are made by the insurance company or the investment advisor in their sole and absolute discretion.

vii. Holder cannot select or recommend particular investments or investment strategies.

viii. Holder cannot communicate directly or indirectly with any investment officer of the insurance company or its affiliates or with the investment advisor regarding the selection, quality, or rate or return of any specific investment or group of investments held in a Sub-account.

ix. Holder has no legal, equitable, direct, or indirect interest in any of the assets of the assets held by a Sub-account.

x. All decisions concerning the choice of investment advisor or the choice of the insurance company's investment officers that are involved in the investment activities of the Separate Account or any of the Sub-accounts, and any subsequent changes thereof, are made by the insurance company in its sole and absolute discretion. Holder may not communicate directly or indirectly with the insurance company concerning the selection or substitution of an investment advisor or the choice of any of the insurance company's investment officers that are involved in the investment activates of the Separate Account or any of the Sub-accounts.

4.7.3 *Best Practices Representations, Warranties, and Indemnities*

a. *Representations and Warranties*—"Carrier represents and warrants that the policy conforms to the tax requirements regarding investor control. Carrier represents and warrants that the policyholder will not be treated as owner of the assets of segregated account provided policyholder conducts itself in accordance with Private Letter Ruling 9433030 and Revenue Ruling 2003-91."

b. *Indemnities*—"Carrier will indemnify policyholder and hold harmless if Carrier's product design or administration is not in compliance provided policyholder conducts itself in accordance with Private Letter Ruling 9433030 and Revenue Ruling 2003-91."

4.8 *COLI Best Practices Act*

4.8.1 *Background Information*—IRC Section 101(a)(1) states that, with certain exceptions, "gross income does not include amounts received (whether in a single sum or otherwise) under a life insurance contract, if such amounts are paid by reason of the death of the insured." The exceptions to this statement are outlined in Section 101(a)(2), Transfer for Valuable Consideration, Section 101(d), Payment of Life Insurance Proceeds at a Date Later Than Death, Section 101(f), Proceeds of Flexible Premium Contacts Issues before January 1, 1985 Payable by Reason of Death, and, as enacted by the COLI Best Practices Act in 2006, Section 101(j), Treatment of Certain Employer-Owned Life Insurance Contracts. Section 101(j) contains guidelines that if followed will prevent otherwise excludable death benefits, from being included in gross income. These guidelines include notice and consent requirements, exceptions based on insured's status, and exceptions for amounts paid to insured's heirs.

In addition, the COLI Best Practices Act (Section 863 of the Pension Protection Act of 2006) includes a requirement that employers that own COLI policies shall file an annual return outlining certain pertinent pieces of information with respect to their COLI policies.

4.8.2 *Notice and Consent Requirements*—The notice and consent requirements are met if before the issuance of the contract, the employee:

a. 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

b. Provides written consent to being insured under the contract and that such coverage may continue after the insured terminates employment and

c. Is informed in writing that an applicable policyholder will be a beneficiary of any proceeds payable upon the death of the employee.

4.8.3 *Exceptions Based on Insured's Status*—IRC Section 101(j)(2)(A) lists as acceptable any amount received by reason of the death of an insured who, with respect to the applicable policyholder:

a. Was an employee at any time during the 12-month period before the insured's death or

b. Is, at the time the contract is issued, a director or highly compensated employee (further defined under the code section).

4.8.4 *Exceptions for Amounts Paid to Insured's Heirs*– IRC Section 101(j)(2)(B) lists as acceptable any amount received by reason of the death of an insured to the extent that

a. The amount is paid to a member of the family of the insured, any individual who is the designated beneficiary of the insured under the contract (other than the applicable policyholder), a trust established for the benefit of any such member of the family or designated beneficiary, or the estate of the insured or

b. The amount is used to purchase an equity (or capital or profits) interest in the applicable policyholder from any person described above.

4.8.5 *Employer Reporting Requirements*—The COLI Best Practices Act generally requires that every applicable policyholder owning one or more employer-owned life insurance contracts issued after August 17, 2006, file a return (at such time and in such manner as the Secretary shall by regulations prescribe) showing for each year such contracts are owned:

a. The number of employees of the applicable policyholder at the end of the year

b. The number of such employees insured under such contracts at the end of the year

c. The total amount of insurance in force at the end of the year under such contracts

d. The name, address, and taxpayer identification number of the applicable policyholder and the type of business in which the policyholder is engaged and

e. That the applicable policyholder has a valid consent for each insured employee (or, if all such consents are not obtained, the number of insured employees for whom such consent was not obtained).

Temporary and proposed regulations concerning the reporting requirements were released by the IRS in November 2007. These temporary regulations included a provision that the Commissioner may prescribe the form and manner of satisfying the reporting requirements (T.D. 9364; 2007 IRB LEXIS 1040).

4.8.6 *Employer Recordkeeping Requirements*—The COLI Best Practices Act requires that each applicable policyholder owning one or more employer-owned life insurance contracts during any year shall keep such records as may be necessary for purposes of determining whether the reporting requirement and the requirements of Section 101(j) have been met.

4.8.7 *Best Practices Representations, Warranties, and Indemnities*

As the guidelines of the COLI Best Practices Act are generally applicable to actions taken by the policyholder, it is not common for a carrier to extend representations, warranties, or indemnities with respect to this issue.

Section 5. *Accounting*

The Financial Accounting Standards Board (FASB) Technical Bulletin 85-4 (FASBT 85-4) provides the following authoritative statement regarding the accounting for an investment in life insurance:[2] "The amount that could be realized under the insurance contract as of the date of the statement of financial position should be reported as an asset. The change in cash surrender or contract value during the period is an adjustment of premiums paid in determining the expense or income to be recognized under the contract for the period" (FASBT 85-4.02).

In addition, on June 15, 2006, and on September 7, 2006, FASB's Emerging Issues Task Force (EITF) met and discussed Accounting for Purchases of Life Insurance—Determining the Amount That Could Be Realized in Accordance with FASB Technical Bulletin 85-4. EITF Abstracts, Issue No. 06-5, contains a summary of the issues discussed, a summary of the consensus reached on each issue, and an example of the application of the consensus reached.

The following is an attempt to provide an overview of certain COLI reporting issues and their interaction with FASBT 85-4 as clarified by EITF in 2006:

5.1 *Premium*—The premium paid in a cash value life insurance program establish the cash value asset, which is commonly booked under other assets on the company's financial statements.

5.2 *Policy Expense Charges*—Charges for policy expenses including up-front or financed premium tax and DAC, mortality and expense risk charges, administrative fees, retention and commissions, reduce the cash value asset, and are commonly booked as other expenses.

5.3 *Cost of Insurance Charges*—Cost of insurance charges in a community-rated policy are commonly booked under other expenses. In an experience-rated program, cost of insurance charges establish the mortality reserve asset. If the COLI purchaser through consultation with their accounting advisors becomes comfortable with booking the mortality reserve asset, it is commonly booked under other assets. In making this determination, the mortality reserve language in the policy and other closing documents should be carefully examined to be sure that any funds in the reserve will be returned to the policyholder, without any holdbacks, and under all circumstances.

5.4 *Surrender Charges and FASB's EITF Consensus*—Because FASBT 85-4 states that "the amount that could be realized under the insurance contract as of the date

[2] OCC 2004-56, an interagency statement from the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, and the Office of Thrift Supervision, provides additional guidance to banks with respect to the accounting for COLI. In addition, OCC 2005-56 provides commentary on legal authority, supervisory requirements, risk management, and risk-based capital requirements.

of the statement of financial position should be reported as an asset," the cash value and claims reserve assets may need to be reduced by any surrender charges. Surrender charges can take many forms, including explicit fees due in the event of surrender, the carrier's ability to recoup unpaid premium tax or DAC charges under a financing arrangement, or the loss of a portion of the mortality reserve asset upon surrender. Surrender charges, if any, may be booked under other expenses.

FASB's EITF specifically considered three issues relating to the amount that could be realized under the insurance contract and by implication three issues relating to surrender charges:

5.4.1 *Additional Amounts Included in Contract*—The EITF reached a consensus "that a policyholder should consider any additional amounts included in the contractual terms of the policy in determining the amount that could be realized under the insurance contract" (EITF Abstracts, p. 4). With respect to this issue, the EITF further noted the following:

a. When it is probable that contractual terms would limit the amount that could be realized under the insurance contact, these limitations should be considered when determining realizable amounts.

b. Those amounts that are recoverable from the amount that could be realized at the discretion of the insurance company should be excluded from the amount that could be realized under the insurance contract.

c. Amounts that are recoverable by the policyholder in periods beyond one year from the surrender of the policy should be discounted in accordance with Accounting Principles Board (APB) Opinion 21 (Interest on Receivables and Payables).

5.4.2 *Ability to Surrender All Policies*—The EITF reached a consensus "that a policyholder should determine the amount that could be realized under the insurance contact by assuming the surrender of an individual-life by individual-life policy (or certificate by certificate in a group policy)" (EITF Abstracts, p. 4). With respect to this issue, the EITF further noted that:

a. Any amount that ultimately would be realized by the policyholder upon the assumed surrender of the final policy should be included in the amount that could be realized under the insurance contract.

5.4.3 *Discounted Basis*—The EITF reached a consensus "that a policyholder should not discount the cash surrender value component of the amount that could be realized under the insurance contact when contractual restrictions on the ability to surrender a policy exist, as long as the holder of the policy continues to participate in the changes in the cash surrender value as it had done prior to the surrender request” (EITF Abstracts, p. 5). With respect to this issue, the EITF further noted that:

a. If the contractual restrictions prevent the policyholder from participating in changes to the cash surrender value component, then the amount that could be realized under the insurance contact at a future date should be discounted in accordance with Opinion 21.

b. IRC Section 1035 exchanges do not constitute a “cash” surrender as contemplated by FASBT 85-4.

5.5 *DAC Asset*—If the policyholder elects a DAC pass-through (see Section 3.2.3), funds will be removed from the policyholder’s cash value asset each time a premium is paid. These funds are commonly booked under other assets. The return of funds to the cash value reduces the DAC asset to zero, which typically occurs 10 years after the last premium payment.

As noted above, the EITF observed “that amounts that are recoverable by the policyholder in periods beyond one year from the surrender of the policy should be discounted in accordance with Opinion 21” (EITF Abstracts, p. 4). As such, the policyholder should consider booking the DAC asset on a discounted basis.

5.6 *Investment Gains*—Both realized and unrealized investment gains are commonly booked to other income.

5.7 *Death Benefits*—One of the means by which the cash value asset is reduced is through the payment of death benefits. When an individual dies in a COLI transaction, the cash value associated with that individual is paid to the policyholder. The amount by which the total death benefit exceeds the cash value is paid in the form of an at-risk death benefit. At-risk death benefits in experience-rated programs are commonly booked as a reduction in the mortality reserve asset. At-risk death benefits in a community-rated program are often booked as other income.

5.8 *Mortality-Based Dividends*—One of the means by which many carriers manage the size of the mortality reserve and return favorable mortality experience to the policyholder is through a mortality-based dividend that is paid in cash or as an increase in the cash value asset. Mortality-based dividends are commonly booked as a reduction in the mortality reserve asset in an experience-rated program and as other income in community-rated programs.

Section 6. *Investments*

The decisions regarding where to place an investment in COLI are critical to the success of the program. This section provides information on issues that may be relevant to the investment decisions. The COLI marketplace today provides many options and as such is capable of serving the needs of investors with a wide variety of investment objectives and preferences.

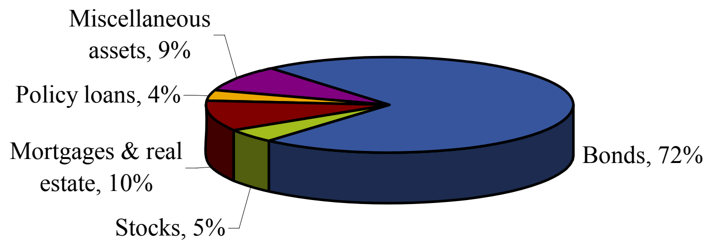
6.1 *General Account Crediting Rates*—The methodologies used by carriers to determine general account interest crediting rates can generally be grouped into two categories: (1) new money methodologies that are initially related to yields available at plan inception and (2) portfolio methodologies that provide the same rate to all policies in which the rate is related to the return on assets backing a broad group of policies. Differences in renewal crediting rates between the two methodologies tend to diminish over time.

The COLI purchaser may want to request and examine historical crediting rates relating to the general account products being considered and consider the rate environment present at the time of purchase. This examination should include a review of historical dividends in which the COLI policy under consideration is participating.

Figure 10 provides information on how life insurance carrier general account assets are commonly invested. It is a snapshot as of December 31, 2006, and combines both new money and portfolio accounts (*Life Insurers Fact Book* 2007, p. 11).

Figure 10

General Account Asset Distribution
Life Insurance Companies - 12/31/06



• **Bonds**		• **Stocks**		• **Policy loans**	
Government		Common	2.6%	Total	3.6%
Short-term	0.2%	Preferred	2.1%		
Long-term					
U.S.	14.2%	Total	4.7%		
Foreign	1.5%				
Total long-term	15.7%				
Total government	15.9%	• **Mort & real estate**		• **Miscellaneous assets**	
Corporate		Mortgages		Cash	1.2%
Short-term	1.3%	Farm	0.5%		
Long-term		Residential	0.2%	Other	
U.S.	46.1%	Commercial	9.1%	invested assets	3.2%
Foreign	9.2%	Total	9.8%		
Total long-term	55.3%			Non-invested	
Total corporate	56.6%	Real estate	0.6%	assets	4.4%
Total	72.4%	Total	10.4%	Total	8.8%

6.2 *Separate Account Asset Allocation*—Asset allocation within a separate account COLI program refers to the process of distributing the cash value investment across available investment options. Most carriers provide their separate account clients with various existing investment options, and many are willing to consider adding new options if delivered within the confines of investor control regulations.

The factors deemed critical by a COLI purchaser in the analysis and selection of traditional (non-COLI) investments should not be lost in the analysis and selection of investment options within the COLI program. Many organizations consider factors such as length of track record and consistency of meeting stated objectives; however, countless theories and preferences exist, and the presence of COLI should not cloud the importance of careful investment analysis.

In cases for which COLI is being used to fund employee benefits liabilities that have their growth linked to publicly available investments funds or indices, the availability of investment options that closely track those funds or indices may be an important consideration.

If a portion of employee benefit liabilities are being funded with COLI and a portion are being funded with traditional investments, it may be optimal to consider asset allocation decisions in unison. Two primary differences between funding liabilities with COLI assets and utilizing traditional investments are the added insurance costs associated with COLI and the tax-preferred treatment of an investment in life insurance, which is not available for most traditional investments, although other tax efficiencies may be available. The tax efficiency of the investment outside of the COLI program may be critical to asset allocation decisions. For example, a buy and hold equity-type investment is inherently very tax efficient, and the benefits of holding it in a COLI policy may be minimal or nonexistent. Investments in fixed-income securities, hedge funds, and high-turnover strategies can be very tax inefficient, and as such the benefits of COLI are often substantial when applied to these asset classes.

6.3 *Smoothing of Returns*

6.3.1 *General*—Many separate account investment options, particularly fixed-income options, are available with features designed to smooth investment returns and reduce income statement volatility. The amount that could be realized under a life insurance contract, relating to assets allocated to a smoothed separate account, is generally the book value of the separate account investment.

6.3.2 *Book Value Crediting Rate*—The book value of a smoothed separate account investment grows at a synthetic crediting rate that is reset periodically and determined based on the terms of the smoothing contract.

A popular crediting rate formula used in several smoothing contracts is as follows:[3]

$$CR = (1 + Y) \times (MV / BV)^{1/D} - 1,$$

where

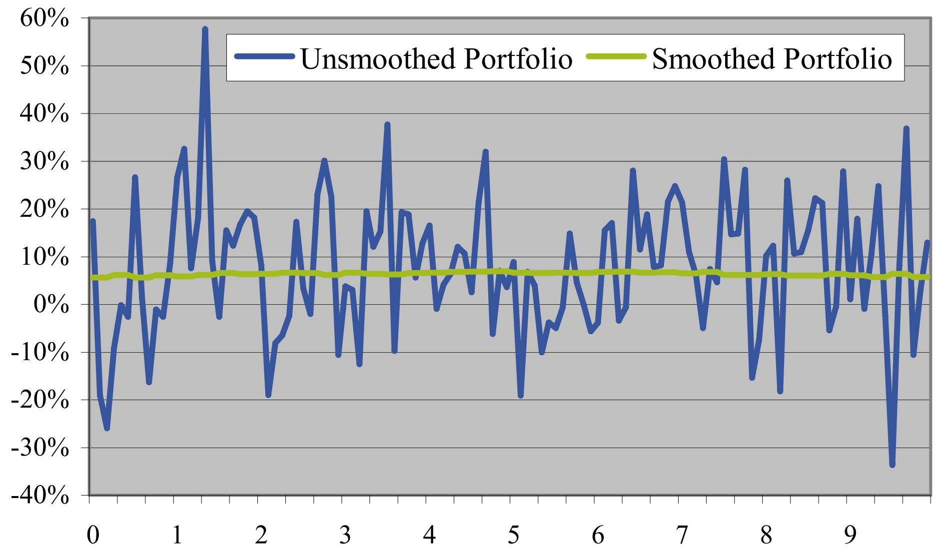
CR = Renewal crediting rate

[3] The COLI purchaser should note that the formula referenced above is contained in United States Patent Number 5,926,792 (with some variation in terms and possibly in application) and may want to consider rights to its use in discussions with carriers.

Y	=	Average yield of the underlying investments
MV	=	Market value of the underlying investments
BV	=	Book value of the investment
D	=	Portfolio duration of the assets.

The effect of the formula is to amortize gains and losses over a period linked to the duration of portfolio Figure 11 illustrates the potential effect by applying the crediting rate formula outlined above to a sample bond portfolio for the period ending December 31, 2003.

Figure 11
Impact of Smoothing Portfolio Returns



6.3.3 *Issues to Consider When Comparing Smoothing Product Features*

a. *Provider Credit Rating*—Because the smoothing provider is responsible for the difference between book value and market value in the event of surrender, the COLI purchaser should be comfortable with the credit of the provider, who is often different from the insurance carrier.

b. *Exceptions*—Most smoothing contracts contain exceptions under which book value may not be available in the event of surrender. These exceptions may include conditions relating to the tax and financial position of the purchaser at the time of surrender or to other recent or planned COLI purchases. The COLI purchaser should understand and be comfortable with these exceptions before allocating to a smoothed investment option.

c. *Portability*—Many smoothing contracts allow the policyholder to reallocate among various investment options and even execute an IRC Section 1035 exchange from one carrier to another without breaking the contract. The COLI purchaser should seek to ensure the terms of the smoothing contract will not impair their ability to effectively manage their investment allocations.

d. *Mandatory Reallocation*—A common means by which providers seek to manage their risk is by requiring a reallocation to a shorter-duration portfolio if certain events occur (as can be seen by examining the sample crediting rate formula, a reallocation of this nature will shorten the time over which gains and losses are amortized into the book value). The events that trigger a reallocation may include book value falling below a certain threshold in relation to market value or the average age of the insured population reaching a certain milestone. The COLI purchaser should be comfortable with these restrictions and the speed at which they will be lifted once applied.

e. *Timing of Surrender Payment*—The COLI purchaser should be comfortable with the speed at which the book value will be paid upon surrender and the interest earned between surrender and payment.

f. *Initial Crediting Rate*—The crediting rate formula outlined above defines the renewal crediting rate for the second and subsequent periods. The initial crediting rate is somewhat arbitrary but often linked to a benchmark index that the underlying manager may seek to outperform.

g. *Cost*—The cost of a smoothing is typically expressed in basis points. The fee scale may decrease over time, reflecting the policyholders' growing disincentive to surrender caused by the accumulation of policy gains (which would be taxable on surrender).

h. *Financial Reporting*—The COLI purchaser should consult with their accounting professional before allocating to a smoothed separate account to ensure that the terms of the smoothing contract will allow them to reflect the book value on their financial statements.

6.3.4 *Amortization of Up-Front Charges*—Some providers afford the policyholder the ability to amortize up-front charges such as premium tax and DAC through the smoothing contract. This is achieved by setting the initial book value of the portfolio at a level greater than the market value of the underlying securities. An adjustment in made to the crediting rate formula defined above to reflect the amortization of up-front charges, including a notional finance charge, through the agreed-upon amortization period.

At-Risk Death Benefit—The amount by which the total death benefit exceeds the individual's cash value.

Beneficiary—The person or entity named in the policy to receive the life insurance proceeds (the corporate employer in the case of COLI).

Borrowed Cash Value—The portion of the cash value equal to any loan taken from the policy plus any outstanding accrued interest.

Cash Surrender Value—The amount available in cash upon the surrender of a policy.

Cash Value Accumulation Test—One of two alternative tests (the other being the guideline premium test) that must be passed, in conjunction with other requirements, to meet the definition of life insurance under IRC Section 7702.

Cash Value Death Benefit—The portion of the total death benefit equal to the individual's cash value at the time of death.

Claims Reserve—A second policyholder asset, in additional to the cash value, in an experience-rated program. It is funded with monthly cost of insurance charges and is used to pay at-risk death benefits. Also commonly referred to as the mortality reserve.

COI Charge—See Cost of Insurance Charge.

Commission—A fee paid to an insurance agent.

Community Rating—The process under which the experience of a carrier's block of business or studies of like risks is used to determine policy charges. Also commonly referred to as pooled rating or non-experience rated.

Cost of Insurance Charge—An amount removed from the cash value on a monthly basis representing expected at-risk death benefits. Commonly abbreviated to COI charge.

DAC—See Deferred Acquisition Cost.

DAC Asset—The non-interest-earning asset of the policyholder arising from the election of a DAC pass-through.

DAC Capitalization Rate—The portion of premiums received by a carrier that are required to be capitalized when received and allowed as a deduction ratably over 120-months. Currently 7.7 percent of COLI premiums.

DAC Pass-Through—A means of compensating the carrier for DAC-related costs whereby funds are exchanged with the policyholder's cash value in a manner designed to make the carrier cash flow neutral.

Deferred Acquisition Cost—Term commonly used to refer to the cost associated with capitalizing specified policy acquisition expenses under IRC Section 848. Commonly abbreviated DAC.

Diversification Requirements—A series of conditions defined by the Secretary of the Treasury and outlined in IRC Section 817(h) that a variable contract must meet to be treated as a life insurance contract.

Experience Rating—The process under which an insurance provider agrees to reduce its expected profit margin in exchange for a limited right to recover losses in the event of adverse claims.

Face Amount—The amount stated in the policy (or on its face) that will be paid in case of death or at maturity. Universal life–type plans have two death benefit options. Under an Option A plan the total death benefit is designed to stay level and equal the initial face amount throughout the life of the policy. Under Option B the total death benefit is designed to equal the cash value plus the initial face amount and will typically rise over time.

General Account—One of two primary categories of assets making up a life insurance company's investment portfolio (segregated asset account assets being the second). General account assets are typically used to support obligations with guaranteed minimum investment performance or guaranteed benefits.

General Account Life Insurance—A life insurance policy supported by the assets in the carrier's general account. Policy types commonly include traditional whole life and universal life.

Group Insurance—A means by which a group of individuals, joined by a common relationship, such as employment, credit union membership, or trade association membership, are insured under the terms of a single policy.

Guideline Premium Test—One of two alternative tests (the other being the cash value accumulation test) that must be passed, in conjunction with other requirements, to meet the definition of life insurance under IRC Section 7702.

Indemnity—A guarantee against a loss which another might suffer.

Individual Insurance—A means by which an individual, rather than a group, is insured under the terms of a single policy.

Investor Control—Term used in reference to the concept that a policyholder who exerts too much control over the assets in a separate account may be deemed the owner of those assets and be required to pay tax on the policy's inside buildup.

Leveraged COLI—A type of transaction popular before 1997 in which a number of the premium payments would be immediately loaned back to the policyholder. The cash value generally grew tax free at a rate tied to the policy loan rate.

Loan Spread—The difference between the interest rate paid by the policyholder on loans taken out against the policy and the rate credited to the policyholder on borrowed cash value.

Loss Carry Forward—A feature of some experience rating methodologies that allows the mortality reserve balance to roll forward from one period to the next with a negative balance. Contracts that do not allow loss carry forwards reset negative mortality reserve balances to zero at the end of each measurement period, causing the policyholder to recognize income and the carrier to realize a loss.

M&E—See Mortality and Expense Risk Charge.

MEC—See Modified Endowment Contract.

Modified Endowment Contract—A type of life insurance policy defined by IRC Section 7702A. Modified endowment contracts are contracts that meet the definition of life insurance under Section 7702 but fail the seven-pay test under Section 7702A. Commonly abbreviated MEC.

Mortality and Expense Risk Charge—A fee paid to the carrier for accepting the risk that mortality experience will exceed the cost of insurance rates guaranteed in the policy and the risk that servicing costs will exceed the charges guaranteed in the policy. Commonly abbreviated M&E charge.

Mortality-Based Dividend—Remuneration paid to the policyholder as a result of favorable mortality experience. It could take the form of a cash payment, a return of funds to the cash value, an increase in face amounts, or other means of payment.

Mortality Reserve—See Claims Reserve.

Mortality Reserve Interest—Interest earned by the policyholder on the mortality reserve asset.

NAR—See Net Amount At-Risk

Net Amount At-Risk—The amount by which the current policy death benefit exceeds the cash value. Commonly abbreviated NAR.

Net Single-Premium Factor—The single premium that would have to be paid to fund $1 of death benefit under the policy under certain interest and mortality assumptions.

Non-Borrowed Cash Value—The amount by which the cash value asset exceeds policy loans and accrued interest.

Non-MEC—See Non-Modified Endowment Contract.

Non-Modified Endowment Contract—A life insurance policy that meets the definition of life insurance under Section 7702 and passes the seven-pay test under Section 7702A. Commonly abbreviated non-MEC.

Partial Surrender—The withdrawal of a portion of the funds in the cash value asset.

Policyholder—The person or entity who owns the life insurance policy.

Pooled Rating—See Community Rating.

Premium Tax—A tax paid by the carrier to the state in which the contract was issued, the state of residence of the insured population, or another state(s) connected to the transaction. The tax is expressed as a percentage of premiums and typically ranges from 1 to 3 percent.

Reallocation Fee—A fee charged by the carrier for each reallocation of funds from one separate account investment option to another.

Representation—An express statement of fact.

Retrospective Rate Credit—See Mortality-Based Dividend.

Retention—One of the fees charged by the carrier for assuming the risk that mortality experience will exceed the cost of insurance rates guaranteed in the policy.

Segregated Asset Account—One of two primary categories of assets making up a life insurance company's investment portfolio (general account assets being the second). Segregated asset accounts are typically used to support obligations without guaranteed minimum investment performance and in cases that the values of assets vary according to investment experience.

Separate Account—Either a segregated asset account or a portion of the general account that has been segmented for a specific class of policyholders. Throughout this paper the term *separate account* is used to mean the equivalent of segregated asset account as defined above. All segregated asset accounts are separate accounts, but not all separate accounts are segregated asset accounts.

Separate Account Life Insurance—A life insurance policy supported by the assets held in a separate account. Policy types commonly include variable life and variable universal life.

Seven-Pay Factor—The level premium that, if paid annually for seven years, would provide for $1 of future death benefit under certain interest and mortality assumptions. Used in the seven-pay test under IRC Section 7702A.

Seven-Pay Test—Test that must be passed to establish and maintain Non-MEC status under IRC Section 7702A. The test compares premium paid under the contract to the premiums that would have been paid on or before such time if the contract provided for paid-up future benefits after the payment of seven level annual premiums.

Smoothing Contract—A contact under which the investment returns of an underlying portfolio of securities are smoothed to limit, and in some cases eliminate, market volatility by providing a "book value" guarantee.

Terminal Dividend—Mechanism by which some carriers return the mortality reserve asset to the policyholder in the event of surrender.

Term Life Insurance—An insurance policy that covers the insured for a fixed time period, typically one to 25 years. The policy pays death benefits only if the insured dies during the term.

Universal Life Insurance—A type of flexible-premium whole life insurance with minimum guaranteed investment performance. Premium payment schedules are flexible, death benefits are adjustable, and partial surrenders are permitted.

Variable Life Insurance—A type of fixed-premium whole life insurance whose policy values fluctuate according to the investment performance of the assets in the underlying separate account. Typically there are no minimum interest guarantees, death benefits vary to reflect investment performance, and partial surrenders are not permitted.

Variable Universal Life Insurance—A type of flexible-premium whole life insurance whose policy values fluctuate according to the investment performance of the assets in the underlying separate account. Premium payment schedules are flexible, death benefits are adjustable, and partial surrenders are permitted to the extent allowable by the underlying funds.

Warranties—A legal promise that certain facts are true.

80CSO—The Commissions 1980 Standard Ordinary Table of Mortality.

83GAM—The 1983 Group Annuity Mortality Table.

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