

A Report to the Legislature:
Regulating the Interests of
Employer-Owned Life Insurance
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Executive summary

Starting in 2002, employer-owned life insurance or corporate-owned life insurance (COLI) received substantial national attention. National media reports focused on employers purchasing life insurance on large numbers of employees naming the corporation as the beneficiary—often without the employee’s knowledge. While employer-owned life insurance has legitimate and well-established business uses, the reports prompted policymakers to question whether or not companies had a legitimate “insurable interest” in these insurance contracts. They also started to question whether companies were using the product inappropriately in order to take advantage of its potential tax benefits.

In 2005, at the request of the Office of the Insurance Commissioner (OIC), the Washington State Legislature passed Senate Bill 5196. The new law protects Washington consumers by requiring written consent of an employee and disclosures of certain information before an employer may insure an employee’s life. It also requires the OIC to promulgate rules regarding the act and report to the Legislature on implementation and whether or not it is adequately protecting consumers.

Since passage of the new law, the OIC has performed market conduct surveys and rates and forms reviews and found that current products meet both the insurable interest and disclosure provisions of the law.

However, the issue of insurable interest warrants further clarity. Following the intent of the legislation, the OIC has proposed rules relating to and defining “key person.” This new definition, along with the changes made by SB 5196, are intended to limit the purchase of employer-owned life insurance to officers and the highest compensated employees of a company.

Introduction

In 2005, the Washington State Legislature enacted SB 5196 Regulating Insurable Interests and Employer-Owned Life Insurance. The OIC requested this legislation. The bill made several changes to the insurance code including:

- Establishing disclosure and consent requirements for purchasing employer-owned life insurance.
- Providing protection for employees who do not wish to participate.
- Giving specific rule-making authority to the OIC to further clarify “insurable interest.”

The legislation also required the OIC to report to the Legislature by December 31, 2006 on steps taken to implement the act.

Background and history

Employer-owned life insurance, also known as corporate-owned life insurance (COLI), has been used as a business tool for over 50 years. It was originally known as “Key Man” insurance and was used by small and medium-sized businesses for succession planning. The business (usually partnerships or closely held corporations) would purchase term or whole life insurance on the partners or shareholders, with the business entity as the policy owner and beneficiary. In the event of a premature death of a partner or shareholder, the business would use funds from the life insurance benefit to help ensure that it had the financial resources to continue operating without the key employee.

During the early 1980s, the use of employer-owned life insurance changed as did the life insurance industry. Whole life and variable life insurance products that had an investment value with tax benefits and a death benefit became more popular. Many employers saw an advantage to using employer-owned life insurance and bought very large “Key Person” policies on their executives.

As the practice grew, the Internal Revenue Service and Congress became concerned about the issues surrounding employer-owned life insurance. In addition to the tax-free investment accrual of the whole life policies, the whole life insurance and variable insurance policies had another advantage—tax deductible loans. Since the business owned the policy, it could take out a policy loan against the investment value of the policy and take a tax deduction on the interest. In response to this activity, Congress passed a law in 1986 that only allowed the interest deduction on the first \$50,000 borrowed.

Despite the change in law regarding policy loans, employer-owned life insurance was still attractive. If a “key person” died (regardless of whether they were still employed with the company), the company would receive the death benefit, tax-free. In addition, consultants urged companies to purchase these products as a means to fund employee retirement benefits. The product could provide a predictable and consistent method of funding the future costs of employee benefits, particularly for retired employees. However, there was no requirement that money from the policies be used for this purpose. Using this strategy, companies bought an even greater number of policies on a broader spectrum of employees, but with smaller policy face values. After *The Wall Street Journal* published an article in 2002 regarding the practice, Congress decided to revisit the issue, and so did state insurance regulators.

Primary issues

Two primary issues surfaced surrounding the use of employer-owned life insurance: Who is eligible to be covered by the policy and what degree of disclosure is required?

Insurable interest

In order to obtain a life insurance policy, a person or entity must have an interest in that person remaining alive, or expect emotional or financial loss from that person's death. This is called insurable interest.¹ The existence of an "insurable interest" is clear in many employer-owned life insurance transactions. For instance, some business partnerships purchase life insurance on all partners involved in the business in case one of the partners dies prematurely. The business is the policy owner as well as the beneficiary and the proceeds are used to replace the talents and capital of the partner who has died.

In other employer-owned insurance transactions, the existence of an insurable interest has not been as clear. Some companies purchase large numbers of policies on a broad spectrum of employees from executives to hourly customer service personnel. For instance, according to *the Wall Street Journal*, Wal-Mart stores purchased life insurance on 350,000 employees between 1993 and 1995. While Wal-Mart certainly has an insurable interest in some executives and senior management of the company, they also purchased policies on many front-line employees who would not be considered "Key Persons."

Consent and disclosure

As more information surfaced regarding the uses and abuses of employer-owned life insurance, it became evident that some companies purchased policies making them the beneficiary without ever notifying the employee. Furthermore, thousands of employees never gave consent for the companies to purchase a life insurance policy on their lives.

2005 legislative session

Considering these primary issues, the OIC requested legislation to address this practice. The intent statement of the bill clearly defined what the OIC and the Legislature expected to accomplish with SB 5196:

"The legislature finds that there is a long-standing principle that corporations have an insurable interest in the lives of key personnel. Nationally, some corporations have begun to insure the lives of personnel that have not met the insurable interest standard of Washington. Entry-level workers have been insured by their corporate employer for the benefit of the corporate employer. The legislature intends to clarify this subject and preclude

¹ "Insurable Interest" is defined at RCW 48.18.030. RCW 48.18.060 requires that the person who is the subject of life or disability insurance must consent to the application for such insurance, with limited exceptions.

corporations from insuring the lives of employees when the employees are not key personnel and the corporations have no insurable interest.”

With nearly unanimous consent, the Washington State House and Senate passed the bill and the Governor signed it into law on May 9, 2005.

The legislation amended State law RCW 48.18.030 as follows:

- An insured must consent in writing to the issuance of an employer-owned group life insurance policy.
- Within 30 days of purchasing a life policy on an employee, an employer must disclose to the employee the identification of the insurer, the benefit amount, and the identity of the beneficiary.
- Employers are prohibited from retaliating against an employee who does not consent to inclusion in an employer-owned life insurance policy.
- With respect to employer-owned life insurance policies, the bill applies only to those policies issued and delivered after the effective date of the act, July 24, 2005.
- An insured is not required to consent to the issuance of a group disability insurance policy.

In addition to these changes in the law, the bill also required the Office of the Insurance Commissioner to examine the issue further. The Legislature provided the OIC with rule-making authority and required the agency to report back before December 31, 2006 on steps taken to implement the law.

The Pension Protection Act of 2006

As discussed earlier, Congress also became concerned with the proliferation and practices surrounding employer-owned life insurance. In particular, it was concerned with insurable interest and tax treatment of employer-owned life insurance. With this in mind, Congress passed the Pension Protection Act (PPA) of 2006.

Under the PPA, employer-owned life insurance must meet new requirements in order for the death proceeds to be excluded from the employer's income. If the requirements are not met, the death proceeds will be included in income to the extent that they exceed the amount paid for the policy.

The PPA had an effective date of August 17, 2006, with major provisions addressing:

- **Notice and Consent Requirements**

The insured/employee must be notified in writing that the employer intends to insure the employee's life and the maximum amount of the insurance. The notice must state that the employer/policyowner will be the beneficiary. The employee/insured must consent to coverage continuing after the insured terminates employment.

- **Insured's Employment Status**

The insured must have been an employee during the 12-month period before his or her death, or was a director or highly compensated employee at the time the contract was issued. A "highly compensated employee" is defined under Sec. 414(q) of the Code and at 26 USC 105(h).

- **Payment of Proceeds – Tax Treatment**

The death proceeds of employer-owned life insurance will not be included in the employer's income if the proceeds are paid to a member of the insured's family or a beneficiary designated by the employee/insured.

- **Attribution Rules**

The PPA includes attribution rules that may make life insurance contracts owned by individuals who are not themselves business owners, be treated as employer-owned. If shareholders of a closely-held corporation are all family members and enter into a cross-purchase buy-out, all the policies owned by the various family members will be considered employer-owned.

Implementation of SB 5196

Since the July 24, 2005 effective date of the legislation, the OIC has been monitoring compliance with the provisions of SB 5196 in three ways:

- **Rates and Forms Review**

Life insurance application forms submitted for approval are reviewed for compliance with the new law – in particular, section three regarding insurable interest and section four regarding consent of the insured. The OIC is satisfied with compliance under the present law.

- **Market Conduct Review**

When examined, an insurance company's life operation (if applicable) is reviewed for compliance with the new law. The OIC is satisfied with compliance for carriers reviewed to date.

- **Consumer Complaints/Inquiries**

We have received no complaints or inquiries regarding employer-owned life insurance since the law took effect.

Rule-making activity

The new law also provides the OIC with rule-making authority to take additional steps to protect Washington consumers from the abuses of employer-owned life insurance. The Legislature and the OIC will clearly define insurable interest with regard to employer-owned life insurance. This is an important element to ensure that this product is only purchased on appropriate “key persons” and not abused in the manner described earlier.

At the time this legislation was considered, federal rules regarding insurable interest and its tax treatment were being considered that would supersede any definition of this subject at the state level. Prudence required monitoring the progress of this federal effort before deciding what further rules were necessary in order to adequately protect consumers.

As discussed earlier, The Pension Protection Act of 2006 became effective in August of this year. This act contains new federal rules regarding insurable interest and sets a standard that must be met to obtain favorable tax treatment. After reviewing the federal rules, and input from stakeholders, the OIC proposes the following rules:

WAC 284-23-580 Insurer must obtain and keep evidence that insured is a key person – definition of “key person.”

- (1) If a business entity seeks to be the owner or beneficiary of a contract of life insurance on an employee, the insurer must obtain and keep evidence that

the business entity had an “insurable interest” in the life of the insured as required by RCW 48.18.030(3) and was a “key person” at the time the contract was made.

(2) The term “key person” means a “highly compensated individual” where, during the year the contract was made, the employee:

- (a) was one of the five highest paid officers of the employer;
- (b) was a shareholder who owned more than ten percent in value of the stock of the employer; or
- (c) was among the highest paid ten percent of all employees.

A CR-101 was filed on June 23, 2004 and the CR-102 was filed on December 20, 2006.

The OIC rules differ from the federal rules in that we restrict “key person” to the top highest paid 10 percent of all employees. The federal rules allow the top 25 percent. Twenty five percent is too broad and would allow this type of policy to be taken out on middle managers and below which is not the intent of the legislation.

Conclusion

Employer-owned life insurance can be an important business tool for many businesses. When used appropriately, it serves small and medium businesses in succession planning and provides financial security for large corporations from the premature loss of a key executive or manager.

While the above purposes serve a legitimate business need, the use of employer-owned life insurance had become too broad. Life insurance was being purchased and issued on employees who were not “key persons” and often without the insured’s knowledge or consent. This situation required further regulatory activity to prevent this from happening in Washington.

Senate Bill 5196 provided important disclosure and consent requirements regarding the use of employer-owned life insurance. It also granted the OIC rule-making authority to provide further protections and clarity of the law. A clearer definition of “key person” will help maintain the integrity of the insurable interest requirement in life insurance transactions. With these important protections, Washington consumers should not experience the same abuses seen in other states.