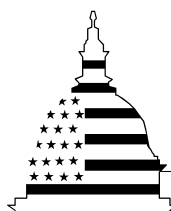


May 2004

# BUSINESS-OWNED LIFE INSURANCE

## More Data Could Be Useful in Making Tax Policy Decisions



G A O

Accountability \* Integrity \* Reliability



Highlights of [GAO-04-303](#), a report to congressional requesters

## Why GAO Did This Study

Business-owned life insurance is permanent insurance held by employers on the lives of their employees, and the employer is the beneficiary of these policies. Its attractive features, common to all permanent life insurance, generally include both tax-deferred accumulation of earnings on the policies' cash value and tax-free receipt of the death benefit. Legislators have expressed concerns about the ability of employers to receive tax-favored treatment from insuring their employees' lives.

GAO was asked to discuss (1) the prevalence and use of business-owned life insurance, (2) federal and state regulation and oversight of these policies, and (3) the potential usefulness of and costs associated with obtaining more comprehensive data on business-owned life insurance.

## What GAO Recommends

If Congress decides that it needs more data on business-owned life insurance, it may wish to consider having SEC, Treasury, or NAIC collect the data from businesses or insurance companies. SEC and Treasury expressed reservations about collecting the data, noting that the data is not needed to fulfill their regulatory missions. GAO recognized that these agencies do not need the data to fulfill their regulatory missions. That is, the data would be used in making tax policy decisions rather than doing regulatory oversight.

[www.gao.gov/cgi-bin/getrpt?GAO-04-303](http://www.gao.gov/cgi-bin/getrpt?GAO-04-303).

To view the full product, including the scope and methodology, click on the link above. For more information, contact Davi M. D'Agostino at (202) 512-8678 or [dagostinod@gao.gov](mailto:dagostinod@gao.gov).

# BUSINESS-OWNED LIFE INSURANCE

## More Data Could Be Useful in Making Tax Policy Decisions

### What GAO Found

Limited data are available on the prevalence and use of business-owned life insurance. Federal bank regulators have financial reporting requirements, but not all institutions holding policies meet reporting thresholds. The Securities and Exchange Commission (SEC), the Internal Revenue Service (IRS), and state insurance regulators told GAO that they generally have not collected comprehensive policy data because they have not had a need for such data in fulfilling their regulatory missions. GAO found, however, that some insurers have disclosed information about policy sales. Also, the Joint Committee on Taxation and the Office of Management and Budget have reported estimates of forgone tax revenues from these policies as \$7.3 billion to \$13 billion for the period 2004–2008, excluding forgone tax revenues on additional income from death benefit payments. Regulators said that they do not generally collect data on the intended use of policies, but that businesses can, for example, use business continuation policies to insure against the loss of a key employee or broad-based policies to fund employee benefits.

The federal bank regulators told GAO that they have reviewed the holdings of institutions with significant amounts of business-owned life insurance against their guidelines and concluded that no major supervisory concerns exist. SEC officials said that the agency has relied on its broadly applicable requirement that public companies disclose information material to investors in their financial statements, which would include any material information related to business-owned life insurance; SEC did not have investor protection concerns about public firms' ownership of the insurance. IRS had some requirements related to the tax treatment of the insurance and is reviewing compliance with these requirements. State laws governing the insurance differed; the four states' regulators that GAO contacted described limited oversight of the policies, and these regulators and the National Association of Insurance Commissioners (NAIC) generally reported no problems with the policies.

More comprehensive data could be useful to Congress in assessing the potential effects of legislative proposals that address the tax-favored treatment of business-owned life insurance. Costs would be incurred in obtaining the data. Such data would be most useful if reported separately for business continuation and broad-based policies because legislative proposals have generally treated these policies differently. Data on the amount of tax-free income that businesses received from death benefits could help explain the potential effect of changes to the tax treatment of policies on tax revenues. Businesses holding the policies or insurance companies that sold them could provide this and other data. SEC, Department of the Treasury (Treasury), and NAIC already collect financial information from businesses and insurers and could be required or asked to collect the data. Should Congress decide that the data would be useful, decisions would be required on, among other things, whether the benefits of collecting the data outweigh the costs of doing so.

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**Abbreviations**

FDIC	Federal Deposit Insurance Corporation
IRS	Internal Revenue Service
NAIC	National Association of Insurance Commissioners
OCC	Office of the Comptroller of the Currency
OMB	Office of Management and Budget
OTS	Office of Thrift Supervision
SEC	Securities and Exchange Commission

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United States General Accounting Office  
Washington, D.C. 20548

May 13, 2004

The Honorable Daniel K. Akaka  
The Honorable Jeff Bingaman  
United States Senate

Congress has debated the appropriate income tax treatment of business-owned life insurance since at least the mid-1980s and is likely to continue doing so. Most recently, some members of Congress have expressed concern that more complete data are not available describing the prevalence and use of the insurance, information that could be used in assessing its income tax treatment and related policy issues. Business-owned life insurance—including corporate-owned, bank-owned, and trust-owned life insurance—is permanent insurance<sup>1</sup> that an employer purchases on the lives of its employees, with the business as the policy beneficiary.<sup>2</sup> Attractive features of business-owned life insurance, which are features common to all permanent life insurance, generally include both tax-deferred earnings on the policies' cash value and, if the policy is held until the death of the insured, tax-free income from the death benefit itself. Some business-owned life insurance protects against the death of owners or key employees (business continuation insurance), while some of it covers larger groups of employees (broad-based insurance). Generally, businesses can retain ownership of these policies after the employment relationship has ended.

Before 1986, businesses could take loans against the cash value of their business-owned life insurance policies and deduct the interest expense from their taxable income without limitation. To address concerns that businesses were abusing their ability to deduct these interest expenses, Congress passed legislation in 1986 and 1996 to limit this practice. The Internal Revenue Service (IRS) and Department of Justice also pursued litigation against some businesses. Nonetheless, public policy issues have remained regarding the extent to which businesses should be allowed to

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<sup>1</sup>Unlike term life insurance, permanent life insurance lasts for the life of the insured and accumulates cash value as it provides coverage. Businesses may purchase term life insurance on their employees; this report does not address such purchases.

<sup>2</sup>This report focuses on businesses that own insurance on the lives of their employees. As such, it does not address charitable organizations that purchase insurance on the lives of their members or donors and businesses that purchase insurance on the lives of their creditors.

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benefit from insuring their employees' lives, with or without their consent, and the extent to which they should be allowed to receive tax advantages from holding these policies. Proponents of continuing the tax advantages of broad-based business-owned life insurance assert that these advantages are important to financing employee benefits because rules relating to other tax-favored financing mechanisms for employee benefits are too restrictive.<sup>3</sup> Some proponents also assert that changing the tax treatment of business-owned life insurance would affect businesses' ability to provide employee benefits. Opponents of continuing the tax advantages of broad-based business-owned life insurance, while not directly addressing the potential effect of a change in tax treatment on the provision of employee benefits, state that Congress has already provided specific tax-favored financing mechanisms for these benefits and has determined the appropriate scope of such financing. Some opponents are also concerned that policy proceeds can be used for any purpose, even when the purchase was justified based on projected employee benefit liabilities, and that the tax-favored treatment of the policies gives them a competitive advantage over other investments.

This report provides information for use in discussing the public policy issues related to permanent business-owned life insurance and expands on the preliminary observations we presented in October 2003 testimony before the Senate Finance Committee.<sup>4</sup> As agreed with your staff, the report discusses (1) the prevalence and use of business-owned life insurance, (2) federal and state regulatory requirements for and oversight of business-owned life insurance, and (3) the potential usefulness of and costs associated with obtaining more comprehensive data on business-owned life insurance.

To obtain information on the prevalence and use of business-owned life insurance, we met with officials from federal agencies that require financial reporting from businesses, including: the federal bank regulators—meaning for this report, the Board of Governors of the Federal Reserve System (the Federal Reserve), Federal Deposit Insurance Corporation

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<sup>3</sup>Various types of plans and accounts exist that provide some tax preferences for funding employee benefits. These plans and accounts are subject to limitations that generally do not apply to business-owned life insurance.

<sup>4</sup>U. S. General Accounting Office, *Business-Owned Life Insurance: Preliminary Observations on Uses, Prevalence, and Regulatory Oversight*, [GAO-04-191T](#) (Washington, D.C.: Oct. 23, 2003).

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(FDIC), Office of the Comptroller of the Currency (OCC), and Office of Thrift Supervision (OTS);<sup>5</sup> the Securities and Exchange Commission (SEC); and IRS. We analyzed quarterly financial reports that banks and thrifts filed with federal bank regulators and annual financial reports (Forms 10-K) that publicly traded companies filed with SEC. In addition, we obtained some information on the prevalence and use of such insurance from the National Association of Insurance Commissioners (NAIC) and two life insurance trade associations.<sup>6</sup> We considered conducting a survey of life insurance companies to gather additional data but did not do so after a survey pretest in which insurance companies' representatives told us that their companies did not routinely maintain the data we sought. We did not verify the accuracy of their statements. To describe federal and state regulatory requirements for and oversight of business-owned life insurance, we obtained information from officials of the federal bank regulators, SEC, IRS, NAIC, and the insurance departments of four states with differing business-owned life insurance provisions. To address the potential usefulness of and costs associated with obtaining more comprehensive data on business-owned life insurance, we reviewed legislative proposals to determine the types of data that could be useful and IRS, SEC, and NAIC's reporting forms and instructions to understand what role these organizations or the Department of the Treasury (Treasury) might play in collecting more comprehensive data. We also discussed the challenges insurers might face in providing data and organizations might face in collecting it with insurance companies, Treasury (including IRS), SEC, and NAIC representatives, as applicable. Appendix I provides detailed information on our scope and methodology. We conducted our work between February 2003 and December 2003, in accordance with generally accepted government auditing standards.

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<sup>5</sup>The Federal Reserve regulates state-chartered banks that are members of the Federal Reserve System, their foreign branches and subsidiaries, and bank holding companies and their nonbank and foreign subsidiaries. FDIC regulates state-chartered banks that are not members of the Federal Reserve System and federally insured, state-chartered state savings banks. OCC regulates nationally chartered banks and federal branches and agencies of foreign banks. OTS regulates state and federally chartered savings associations and savings and loan holding companies. In this report, we refer to savings banks and savings associations as thrifts.

<sup>6</sup>NAIC is a membership organization of chief state insurance regulators that helps promote coordination among the states.

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## Results in Brief

Federal and state regulators, in pursuing their regulatory responsibilities, have collected limited data on the prevalence and use of business-owned life insurance. Federal bank regulators have collected more data than other regulators. Our analysis of the data showed that at least one-third of banks and thrifts held business-owned life insurance with a total cash surrender value of more than \$56 billion as of December 31, 2002, and that banks and thrifts earned at least \$2 billion from such policies in 2002.<sup>7</sup> We also found that, although SEC does not specifically require reporting on business-owned life insurance, nine of the largest life insurance companies reported to SEC in their Forms 10-K total premiums of more than \$3 billion in 2002 from their sales of such insurance. Also, surveys of life insurance companies estimated that premiums from new sales of business-owned life insurance totaled more than \$9 billion in 2001. Further, although IRS has not collected comprehensive tax-related data on business-owned life insurance policies, the Joint Committee on Taxation and the Office of Management and Budget (OMB) have reported estimates of forgone tax revenues from these policies as \$7.3 billion to \$13 billion for the period 2004–2008, excluding forgone tax revenues on additional income from death benefit payments. State insurance regulators have collected extensive financial information from insurance companies, but the data have not addressed the prevalence of business-owned life insurance. Some state insurable interest laws permit businesses to purchase business-owned life insurance to provide for business continuation when a key employee dies or as a strategy to help defray the costs of providing a variety of benefits to current and retired employees. However, unless a business places its policies in a trust that restricts the use of the proceeds to specific purposes, the business may use the proceeds for any purpose. Although federal and state regulators generally have not collected data that distinguish among the uses of business-owned life insurance, we found examples of how businesses stated they intended to use such policies from our analysis of Forms 10-K and a consulting firm’s survey.

Federal bank regulators, SEC, IRS, and four state insurance regulators that we contacted have issued guidelines or requirements that are applicable to business-owned life insurance and generally have not had significant regulatory concerns about such insurance. As part of their responsibility to

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<sup>7</sup>“Banks and thrifts” or “institutions,” as referred to in this report, are the commercial bank and thrift institutions regulated by the Federal Reserve, FDIC, OCC, and OTS. However, the report does not cover bank and thrift holding companies and foreign banks with domestic branches.



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oversee the safety and soundness of banks and thrifts, the federal bank regulators have issued guidelines for institutions that buy business-owned life insurance. These regulators told us that they have applied the guidelines in their risk-based examinations of institutions with significant amounts of business-owned life insurance and generally have concluded that no major supervisory concerns exist. SEC officials said that the agency had not issued specific requirements for holders of business-owned life insurance, relying instead on its broadly applicable requirement that public companies disclose information material to investors in their financial statements. These officials also said that, in the absence of any past problems, SEC did not have investor-protection concerns about public firms' ownership of business-owned life insurance. The Internal Revenue Code includes statutory requirements and IRS has issued regulatory requirements related to the tax treatment of the insurance. IRS officials said that the agency has been studying potential concerns related to the use of the policies. State laws governing business-owned life insurance differed; the four states' regulators that we contacted described limited oversight of the policies, primarily involving the regulators' review of proposed policy forms that insurers must submit for approval before using the forms to sell policies in their states. The state officials said that their departments had not routinely verified that employees covered by the policies had consented to being insured. However, these regulators and NAIC generally reported no problems with the policies.

More comprehensive data on the prevalence and use of business-owned life insurance could be useful to Congress in assessing the potential effects of legislative proposals that address the tax-favored treatment of the insurance. Costs would be incurred in obtaining the data. Such data would be most useful if reported separately for business continuation and broad-based policies because legislative proposals that would further limit the tax-favored treatment of these policies generally have treated these policies differently. Data on both categories could help in understanding the proportion of the total business-owned life insurance market that might be affected by future legislative proposals. Useful data that are not available include the amount of tax-free death benefit income that businesses received from these two types of policies—data that could help Congress better understand the potential effect of changes to their tax treatment on tax revenues. Other data on business continuation and broad-based policies that might be helpful to Congress in evaluating the potential effects of legislative proposals on businesses, their employees, and insurance companies include the annual premiums paid on new policies, the number and types of businesses that hold such policies, and the

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number of covered employees. Businesses that hold the policies or insurance companies that sold them could provide the data, but both types of entities would incur administrative costs in extracting the required information from their records and summarizing it. We did not discuss these costs with businesses, however, we expect that they would maintain records from which the required data could be extracted. Also, some businesses already aggregate this information for use in completing forms filed with IRS and SEC, which suggests that some businesses would not have difficulty providing the data. Nonetheless, businesses might differ in their willingness to voluntarily provide the data, depending at least in part on the cost and their perception of the benefits of doing so. While we did not independently determine the costs that insurers would incur in collecting the data, officials from several insurance companies told us that extensive effort would be required to identify the relevant policies. Although businesses might be able to identify the policies and provide the data more easily, requiring insurance companies to provide the data would substantially limit the number of affected entities. Similar to the data providers, the organization collecting, analyzing, and reporting the data would incur costs. SEC, Treasury, and NAIC are candidates for this role because each already collects financial information from businesses, insurers, or both and could modify existing reporting forms or, alternatively, conduct a survey to obtain the data.

This report includes a matter that Congress may want to consider if it decides that it needs more comprehensive data on the prevalence and use of business-owned life insurance. Specifically, Congress could direct SEC or Treasury or encourage NAIC to obtain the needed data from either the holders of business-owned life insurance or life insurance companies.

We received written comments on a draft of this report from Treasury, IRS, SEC, and NAIC that are reprinted in appendixes III–VI, respectively. Treasury commented that the report is well-researched and informative. In response to the matter for congressional consideration, SEC and Treasury expressed reservations about having a potential role in collecting data on business-owned life insurance, stating that assuming such a role would not be necessary to fulfill their regulatory missions. We recognized in the report that these agencies do not need the data to fulfill their regulatory missions. That is, the data would be used in making tax policy decisions rather than doing regulatory oversight. NAIC did not express reservations about collecting the data, but said that it would like to better understand and evaluate the need for and utility of the data and favored using a survey

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as an initial step in the data gathering process. The comments are discussed in greater detail at the end of this letter.

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## Background

A business is generally allowed to insure an employee's life when the business has an insurable interest in the employee.<sup>8</sup> Insurable interest is defined by state law and, once established at the time of purchase, continues for the life of the insured.<sup>9</sup> Thus, a business generally may maintain life insurance on employees even after their employment has ended. Business-owned life insurance can refer to corporate-owned life insurance (held by all types of corporations or only nonbank corporations), bank-owned life insurance, trust-owned life insurance (held by business-established trusts), or all three.<sup>10</sup>

Business-owned life insurance is permanent life insurance, which has an insurance component and a savings component. The premium for a newly issued permanent life insurance policy pays for the insurance component, but the premium initially exceeds the cost of providing life insurance protection for the insured person. The excess amount is added to the policy's cash value, which earns interest or other investment income—called inside buildup. The inside buildup is accrued income because the policyholder does not receive cash payment as the policy earns income.

The Internal Revenue Code allows for the deferral of income tax on the accumulated inside buildup on life insurance policies and some other investments that appreciate in value, such as stocks, some bonds, and real estate.<sup>11</sup> However, the Internal Revenue Code provides for income tax-free death benefit payments on life insurance, so that unlike other investments, the accrued income is not taxed if the policy is held until the insured party's death. However, if a policy owner surrenders a policy before the death of the insured, the owner may incur a tax liability to the extent that the

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<sup>8</sup>Bank regulators' guidelines impose additional restrictions on allowable life insurance purchases for banks.

<sup>9</sup>In New York, employees insured under broad-based plans may request that coverage on their lives be discontinued at any time.

<sup>10</sup>With a business-established trust, trust-owned life insurance is similar to corporate-owned or bank-owned life insurance. The business generally controls the trust that holds the policies—for example, a trust may maintain assets to fund nonqualified employee benefits.

<sup>11</sup>IRC §72(e)(1).

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policy's cash surrender value exceeds its cost base and may incur a tax penalty. The cost base is equal to the total premiums paid less dividends and withdrawals received from the policy. Also, if a business owns life insurance policies, the annual earnings and death benefit proceeds are among the factors that could make the business subject to the alternative minimum tax.<sup>12</sup>

To qualify as life insurance for tax purposes, a contract must qualify as a life insurance contract under applicable state law and meet one of two tests defined in Internal Revenue Code section 7702 to ensure that the contract is not overly investment oriented.<sup>13</sup> In addition, while policy owners may access the cash value of their policies by borrowing against them, policy owners' ability to deduct the interest on such loans in connection with policies covering employees, officers, and individuals financially interested in the business was limited to loans up to \$50,000 per policy by the Tax Reform Act of 1986.<sup>14</sup> The Health Insurance Portability and Accountability Act of 1996 eliminated the interest deductibility for these individuals,

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<sup>12</sup>In general, the alternative minimum tax is based on a corporation's regular taxable income adjusted for certain tax preference income items, such as exclusions, deductions, and credits. The amount due is the amount by which the tax computed under this system exceeds a corporation's regular tax.

<sup>13</sup>Under the first of the two alternative tests to qualify as life insurance for tax purposes under Internal Revenue Code section 7702, the cash value of a policy cannot at any time exceed the net single premium that would have to be paid to fund the future benefits under the contract. This test is designed to exclude contracts with an investment orientation from the definition of life insurance. Under the second test, the cumulative premiums paid cannot exceed a limitation, computed at the time the policy is issued, and the ratio of the death benefit to the cash value of the policy can never fall below specified percentages. These tests are designed to restrict treatment as a life insurance contract to those contracts where policyholders make traditional levels of investment through premiums and to contracts that do not allow excessive amounts of cash value to build up in regard to the life insurance risk.

<sup>14</sup>The Tax Reform Act of 1986 disallowed interest deductions for interest on a loan in excess of \$50,000 with respect to policies on the life of an officer, employee, or person financially interested in the business. This provision did not apply to policies purchased on or before June 20, 1986. The Health Insurance Portability and Accountability Act of 1996 provided that no deduction is allowed for interest on any indebtedness with respect to policies on any individual who is or has been an officer or employee or financially interested in any business carried on by the employer, regardless of the amount of debt with respect to policies covering the individual. An exception was provided for key persons where the indebtedness does not exceed \$50,000. A key person was defined as an officer or 20-percent owner. The 1996 legislation applied generally to interest paid or accrued after October 13, 1995, with a phase in period. The legislation generally did not apply to policies purchased on or before June 20, 1986.

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except for policies on a limited number of key persons.<sup>15</sup> Before the limitations adopted in 1986 and 1996, some businesses purchased “leveraged business-owned life insurance,” in which they leveraged their life insurance ownership by borrowing against the policies to pay a substantial portion of the insurance premiums and in doing so incurred a tax-deductible interest expense while realizing tax-free investment returns.<sup>16</sup>

State and federal legislatures considered numerous proposals in 2003 and early 2004 that would change the conditions under which businesses may purchase business-owned life insurance, the consent requirements for such purchases, or the tax treatment of the insurance. For example, California considered and passed a law to prohibit businesses from purchasing life insurance policies on employees that are not exempt from the state’s overtime compensation requirements. Texas considered, but did not adopt, a proposal to prohibit business-owned life insurance except in certain cases, such as when an employee is eligible to participate in an employee benefit plan and consents to being insured. Also, several members of Congress introduced legislation in 2003 that would have required employee consent or limited the tax-favored treatment of business-owned life insurance on policies taken out on employees that were not key persons, although none had been enacted by the end of the first session of the 108th Congress. The legislation would have affected the tax-favored treatment of such policies in various ways, such as taxing policy earnings and income from death benefits except on key person policies, taxing the death benefit payments on policies where the employee died more than 1 year after leaving employment, and limiting allowed deductions for a business’s general interest expenses based on its business-owned life insurance

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<sup>15</sup>The 1996 legislation also amended the Internal Revenue Code section 264 to limit the number of policies on key persons for which interest remained deductible to the greater of (1) 5 individuals or (2) the lesser of 5 percent of the total number of officers and employees of the business, or 20 individuals.

<sup>16</sup>In addition to the 1986 and 1996 legislation addressing leveraged business-owned life insurance policies, IRS and the Department of Justice prevailed in three cases involving the deductibility of loan interest related to such policies. These plans covered over 55,000 employees. The courts found that the leveraged plans lacked economic substance, making the interest deduction unallowable. See *In re C.M. Holdings, Inc.*, 301 F.3d 96 (3rd Cir. 2002); *Am. Elec. Power v. United States*, 326 F.3d 737 (6th Cir. 2003), reh. denied, 338 F.3d 534 (6th Cir. 2003), cert. denied, 72 U.S.L.W. 3446 (Jan. 12, 2004); *Winn Dixie Stores v. Commissioner*, 254 F.3d 1313 (11th Cir. 2001), cert. denied, 535 U.S. 986 (2002). The taxpayer prevailed in a fourth case. See *Dow Chemical Co. v. United States*, 250 F Supp. 2d 748 (E.D. Mich. 2003), modified, 278 F. Supp. 2d 844 (E. D. Mich. 2003).

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holdings. In addition, pension legislation that the Senate Finance Committee passed in February 2004 included provisions that would generally limit the tax-favored treatment of business-owned life insurance, except for policies on those individuals the legislation defined as key persons; require employees' written consent for a business to hold insurance on their lives; and require businesses to report policy information to IRS.

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## Available Information on the Prevalence and Use of Business-Owned Life Insurance Is Limited

In pursuing their regulatory missions, federal and state regulators have collected limited information on the prevalence and use of business-owned life insurance. Federal bank regulators have collected more data than other regulators on the prevalence of business-owned life insurance; however, the data are limited because the regulators did not require all banks and thrifts to report it. While SEC has not specifically required reporting on business-owned life insurance, we found that some life insurance companies had reported information on policy sales in their Forms 10-K and in a life insurance industry survey. Federal revenue estimators have estimated the annual forgone tax revenue attributable to earnings on the insurance, although IRS has not required businesses to report on the prevalence of business-owned life insurance. Information at the state level is limited, however, because state insurance regulators have not collected information on the prevalence of the policies through their financial reporting forms. Some state laws permit businesses to purchase business-owned life insurance for business continuation purposes or in connection with employee benefit plans, but businesses generally are not obligated to use the death benefit proceeds for a particular purpose. Although federal and state regulators generally have not collected data on the uses of business-owned life insurance, we found some examples of how businesses said they intended to use such policies.

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## Federal Bank Regulators Have Collected the Most Data on the Prevalence of the Policies, but Not All Banks and Thrifts Provided Information

In monitoring the safety and soundness of individual institutions, federal bank regulators have collected more financial information than other federal and state regulators on business-owned life insurance policies. For supervisory purposes, federal bank regulators have required that regulated institutions disclose in quarterly financial reports earnings from and the cash surrender value of business-owned life insurance if the amounts exceed a certain threshold. As discussed below, the regulators have used the amounts reported to determine the need for further review of institutions' risk exposure. Business-owned life insurance is an asset

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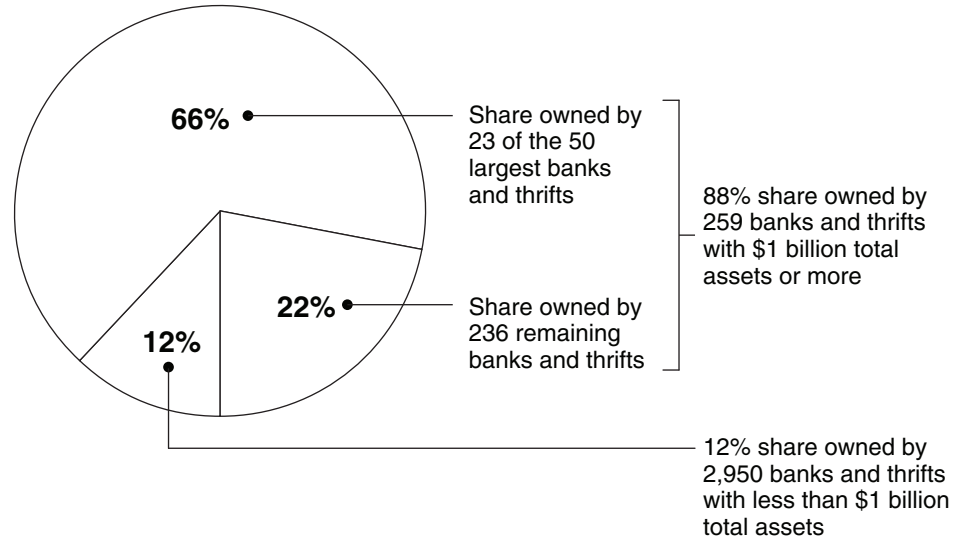
reported at cash surrender value—that is, the sum of accumulated premium payments and inside buildup, less accumulated insurance costs, fees, and charges that the policyholder would be required to pay for surrendering the policy. It does not take into account income tax liabilities that might result from the surrender. The Federal Reserve, FDIC, and OCC require the institutions they regulate to disclose the cash surrender value of policies worth more than \$25,000 in aggregate and exceeding 25 percent of “other assets,” which include such items as repossessed personal property and prepaid expenses. Through the end of 2003, OTS required the thrifts it supervises to report the cash surrender value of policies if the value was one of the three largest components of “other assets;” in 2004, OTS began requiring all the thrifts it supervises to report the cash surrender value of their policies.

We found that about one-third of banks and thrifts—3,209 of 9,439, including many of the largest institutions—had disclosed the cash surrender value of their business-owned life insurance holdings as of December 31, 2002.<sup>17</sup> The remaining two-thirds either did not hold business-owned life insurance or held such insurance but did not meet the reporting threshold. The total cash surrender value of reporting institutions’ policies was \$56.3 billion. A total of 259 banks and thrifts with assets of \$1 billion or more owned 88 percent (\$49.4 billion) of the total reported cash surrender value (fig. 1). These 259 institutions included 23 banks and thrifts that were among the top 50 largest institutions and that owned 66 percent (\$36.9 billion) of the total reported cash surrender value. Because not all institutions that owned policies met the reporting threshold, these data indicate the minimum number of institutions that held business-owned life insurance and the aggregate cash surrender value of their policies; with this data we could not estimate the prevalence of business-owned life insurance or its value among institutions that did not report on their holdings.

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<sup>17</sup>The data do not include bank holding companies or foreign banks with domestic branches. The Federal Reserve started collecting data on business-owned life insurance from bank holding companies in 2003, but the data were not available at the time of our analysis. The reporting form for foreign banks with domestic branches did not have a standardized reporting category for business-owned life insurance.

**Figure 1: Cash Surrender Value of Business-Owned Life Insurance Reported by Some Banks and Thrifts as of December 31, 2002**



**Total reported cash surrender value: \$56.3 billion**

Sources: GAO analysis of FDIC and OTS data.

The federal bank regulators' thresholds for reporting business-owned life insurance earnings differed from the ones for reporting cash surrender value, so not all of the same institutions reported earnings as reported cash surrender value.<sup>18</sup> We found that nearly one-fifth of banks and thrifts reported their 2002 annual earnings on the cash surrender value of business-owned life insurance. As of December 31, 2002, some 1,563 institutions reported \$2.2 billion in such earnings.

<sup>18</sup>The Federal Reserve, FDIC, and OCC require an institution to report the tax-deferred earnings on life insurance if the amount exceeds 1 percent of the sum of the institution's total interest and noninterest income. OTS requires an institution to report adjustments to the cash surrender value of life insurance if the amount is one of the two largest items comprising the "other noninterest income" item, which includes net income from leased property and real estate held for investment, adjustments to prior periods, and other items.



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## SEC Has Not Specifically Required Reporting on the Policies, but Some Insurers Have Reported Sales

SEC officials told us that the agency has not specifically required businesses to report on their purchases or sales of business-owned life insurance because such data generally are not material to public companies. According to SEC officials, agency regulations do not specifically require public companies to disclose the value of their business-owned life insurance in the financial statements submitted to the agency. Similarly, SEC does not specifically require public companies that sell business-owned life insurance to report on those sales. Rather, in administering federal securities laws, SEC requires public companies to prepare their financial statements in accordance with generally accepted accounting principles, which would require them to disclose information about business-owned life insurance policies that is material—that is, according to SEC, information that an investor would consider important in deciding whether to buy or sell a security or in making a voting decision related to a security that the investor owns.<sup>19</sup> According to SEC officials, however, following generally accepted accounting principles would rarely require holdings of and earnings from business-owned life insurance to be shown as separate line items because they are unlikely to be financially material to a company.

Although SEC does not explicitly require insurance companies to report information on the business-owned life insurance policies they have sold, some insurance companies have disclosed such information on their Forms 10-K. By reporting their revenue from business-owned life insurance premiums, life insurance companies show how significant sales of such policies are compared with total sales; they also provide an indication of the level of demand for business-owned life insurance. We reviewed the Forms 10-K of 32 life insurance companies that were among the 50 largest such companies ranked by assets. We found that nine insurers reported receiving, in aggregate, over \$3 billion in total business-owned life insurance premiums in 2002 from new and, in some cases, previous sales. The amount of business-owned life insurance premiums received in 2002

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<sup>19</sup>According to the Financial Accounting Standards Board and other auditing guidance, the determination of what information should be disclosed as material in financial statements is a matter of professional judgment. Materiality involves both quantitative and qualitative considerations. Even though quantitatively immaterial, certain types of misstatements could have a material impact or warrant disclosure in the financial statements for qualitative reasons. The omission or misstatement of an item in a financial report is material if, in the light of surrounding circumstances, the magnitude of the item is such that it is probable that the judgment of a reasonable person relying upon the report would have been changed or influenced by the inclusion or correction of the item.

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ranged from 11 to 53 percent of each company's 2002 total life insurance premiums for the four companies that reported this information. In addition, three insurance companies reported the accumulated cash surrender value of business-owned life insurance policies they had previously sold as totaling about \$28 billion as of December 31, 2002.

Separate from reporting to SEC, some insurance companies have also reported business-owned life insurance sales in response to industry surveys. CAST Management Consultants, Inc., conducts research on business-owned life insurance and has reported on premiums paid on new policies. A life insurance industry association and life insurance companies cited CAST's surveys as the only currently available information on aggregate business-owned life insurance premiums. CAST estimated that in 2001, premiums from new sales of business-owned life insurance totaled \$9.3 billion: \$5.2 billion in bank-owned life insurance premiums and \$4.1 billion in corporate-owned (excluding bank-owned) life insurance premiums. CAST also estimated that in 2002, premiums from new sales of corporate-owned (excluding bank-owned) life insurance totaled \$3.2 billion. CAST did not estimate bank-owned life insurance premiums for 2002. CAST's estimates were based on responses to a 2003 survey concerning corporate-owned life insurance premiums and a 2002 survey concerning bank-owned life insurance, increased by CAST adjustments. Each survey received responses from 20 life insurance companies, although not all of the same companies responded to both surveys.<sup>20</sup> In addition, a representative of the A.M. Best insurer rating company said that the company collects information on business-owned life insurance, but does not currently report the data. A.M. Best reported aggregate premiums from business-owned life insurance for 1998 (the last year for which it reported data) as more than \$10 billion for 20 large insurers.<sup>21</sup> Because these surveys did not use statistical samples of insurers, the resulting estimates made from the limited number of respondents do not represent statistically valid estimates of all business-owned life insurance sales and, therefore, our interpretation of the resulting data is limited. The statistics from these surveys are meant to indicate only that some large insurance companies have had active sales in recent years and that the premiums in the aggregate are significant.

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<sup>20</sup>“CAST 2002 COLI Marketplace Review and Assessment,” CAST Management Consultants, Inc. (July 2003). “CAST 2001 Bank-Owned Life Insurance Market Survey – Final,” CAST Management Consultants, Inc. (April 2002).

<sup>21</sup>Cynthia Crosson, “Capturing COLI/BOLI,” *Best's Review*, vol. 100, no. 9 (2000).

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## IRS Has Not Collected Information on the Policies, but Federal Revenue Estimators Have Estimated the Forgone Tax Revenues

IRS officials told us that the agency has not generally required businesses to report on the value of, earnings on, or death benefit income from business-owned life insurance policies. The officials noted that these amounts are not typically included in taxable income and that, therefore, the information is generally not needed. Businesses that are subject to the alternative minimum tax include income from death benefits and earnings from insurance when calculating the tax, but they are not required to list the insurance-related values on the alternative minimum tax form. Also, businesses that are required to complete Schedule M-1, Reconciliation of Income (Loss) per Books with Income per Return, as part of their Form 1120, U.S. Corporation Income Tax Return, would report earnings on business-owned life insurance as part of the income recorded on their books but not on the tax return. However, according to IRS officials, these earnings might not be identified as earnings from business-owned life insurance, as they are often lumped together with other adjustments.<sup>22</sup>

Federal revenue estimators have estimated that the current tax treatment of earnings on the cash value of business-owned life insurance results in over a billion dollars in forgone tax revenues annually. In its “Estimates of Federal Tax Expenditures for Fiscal Years 2004-2008,” prepared for congressional use in analyzing the federal budget, the Joint Committee on Taxation estimated that the forgone tax revenues resulting from the tax treatment of investment income on life insurance for corporations would total \$7.3 billion for 2004 through 2008. Similarly, OMB, in its fiscal year 2005 budget “Analytical Perspectives,” reported Treasury’s estimate of forgone tax revenues resulting from the tax treatment of life insurance as \$13 billion for 2004 through 2008. These estimates assumed policies would be held until the insureds’ deaths, making the current tax-deferred earnings tax-free. The estimates did not reflect the forgone tax revenues on the additional income from death benefit payments in excess of the premiums paid and the accumulated tax-deferred earnings. Officials involved in preparing these estimates said that, lacking comprehensive data on the earnings on business-owned life insurance, they developed their estimates using available data on life insurance companies’ investment income and assumptions about business-owned life insurance’s share of the total life insurance market.

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<sup>22</sup>A proposed IRS form, Schedule M-3, Net Income (Loss) Reconciliation for Corporations with Total Assets of \$10 Million or More, would expand the current Schedule M-1 for certain corporate taxpayers and include specific reporting on life insurance proceeds and corporate-owned life insurance premiums.

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## State Insurance Regulators Have Not Collected Data on the Prevalence of the Policies

State insurance regulators, concerned with state requirements, rates, and solvency issues, have collected extensive financial information from insurers through NAIC's standardized financial reporting forms, but not at the level of detail that would describe the prevalence of business-owned life insurance policies. State insurance regulators use insurers' financial statements to monitor individual companies' solvency. According to the four state regulators we contacted and NAIC, information on business-owned life insurance is not required or necessary for regulating solvency.<sup>23</sup> Insurers' financial statements list the number of policies and premiums collected during the reporting period, but the amounts are broken out only by individual and group policies, not by whether businesses or individuals owned the policies.

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## Businesses May Purchase Business-Owned Life Insurance for Various Purposes but Generally Are Not Required to Use Policy Proceeds for Those Purposes

Under state laws that define insurable interest, businesses may purchase life insurance for various purposes, including for business continuation—that is, to ensure that a business can continue to operate when a key employee or owner dies. Historically, insurable interest reflected a family or business's dependency on an individual and the risk of financial loss in the event of that individual's death. Accordingly, a traditional use of business-owned life insurance is as key-person insurance, which is intended to ensure recovery of losses—such as a loss of earnings or added hiring costs—in the event of the death of key employees. In addition, businesses may use business-owned life insurance as part of “buy-sell arrangements” that allow the surviving owners to use the death benefits to purchase a deceased owner's share of the business from the estate or heirs.

In the 1980s and 1990s, several states expanded their definitions of employers' insurable interest to permit purchases of broad-based business-owned life insurance in connection with employee compensation and benefit programs. Several of these states limit the aggregate amount of insurance coverage on nonmanagement employees to an amount commensurate with the business's employee benefit plan liabilities or require that insured employees be eligible to receive employee benefits.

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<sup>23</sup>New York state insurance regulators said that while they did not collect detailed information on the prevalence or use of business-owned life insurance, information about insurers that have a high volume of business-owned life insurance sales would be useful to them in conducting market conduct examinations in which examiners visit an insurance company to evaluate its practices and procedures, such as for selling and underwriting insurance policies.

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Information we obtained from officials of large banks and from our analysis of a sample of public companies' Forms 10-K indicates that firms have related their purchases of broad-based business-owned life insurance to various types of employee benefit costs, including health care for current or retired employees, life and disability insurance for current or retired employees, workers' compensation, qualified retirement plans—including defined benefit and defined contribution plans, such as 401(k) plans—and nonqualified retirement plans, such as supplemental executive retirement plans.<sup>24</sup> Consistent with this expanded use of business-owned life insurance, NAIC has observed that many products sold by life insurers have evolved to become primarily investment products. Also, consulting firms that specialize in business-owned life insurance transactions, life insurance brokers, and industry experts have emphasized the potential use of broad-based business-owned life insurance as a profitable long-term investment strategy to finance employee benefit costs and not merely as protection against financial losses that a business would incur in the event of the death of key persons.

According to bank regulators and life insurance industry representatives, when purchasing life insurance, businesses generally relate the amount of coverage they purchase on a group of employees to the value of their projected employee benefit costs. For example, a business might insure the lives of a group of employees such that the present value of expected cash flows to be received from the policies over time, net of premiums, would cover some portion or all of the present value of the business's employee benefit expenses over the same period of time.<sup>25</sup> When calculating the

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<sup>24</sup>Qualified retirement plans receive special tax treatment under present law and must meet requirements of the Internal Revenue Code. In order to be tax-qualified, private pension plans must satisfy a number of requirements, including minimum requirements on coverage and benefits, including requirements on who is covered by plans and how plans must provide benefits. A defined benefit plan is a qualified plan that promises a participant monthly payments at retirement, usually based on the participant's salary and years of covered service. A defined contribution plan, such as a 401(k) plan, is a qualified plan in which the employer, the employee, or both contribute to the employee's account under the plan, and the employee ultimately receives the balance of the account, which is based on contributions plus or minus investment gains or losses. Nonqualified retirement plans are not subject to many of the requirements of qualified plans and do not receive the same tax treatment as qualified plans. Further, in contrast to qualified retirement plans, assets intended to finance nonqualified plans are not typically beyond the reach of a business's creditors in bankruptcy proceedings.

<sup>25</sup>Present value is the value today of amounts to be paid or received at a later date, taking into account the time value of money—that is, a dollar today is worth more than a dollar in the future, because the dollar today can be invested and earn interest.

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expected future cash flows from the insurance, businesses would not generally assume policies will be surrendered if employees leave or retire because surrendering the policies would result in taxation and possibly surrender charges; rather, businesses would assume that they will hold the policies until the insured employees die.

Because businesses may hold business-owned life insurance policies for many years before receiving death benefit payments, businesses do not necessarily receive the cash flows from business-owned life insurance at the same time that they must pay their employee benefit expenses. According to insurance industry representatives, when businesses use the insurance in connection with health care benefits for retired employees, the death benefit proceeds are well timed for reimbursing the benefit costs, because retirees tend to incur their largest medical expenses in the last months of their lives. However, we found examples of businesses that said they used the insurance in connection with current employee benefit costs, such as active employee health care. In such cases, the timing of the death benefit payments would not necessarily correspond to the timing of employee benefit expenses because businesses must pay those expenses years before receiving death benefits on most insured employees.

Regardless of a business's reported purpose for purchasing business-owned life insurance, the business generally does not have an obligation to restrict its use of the life insurance proceeds to these purposes. Although the expected income from broad-based business-owned life insurance policies over time might be commensurate with a business's expected employee benefit costs at the time of the insurance purchase, businesses are generally not required to use the proceeds from the policies to pay for employee benefits. Unless the policies were placed in a trust that restricted their use to employee benefit payments, the life insurance policies would be part of the unrestricted general assets of the business and, as such, could be used to pay any obligations of the business.<sup>26</sup>

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### Limited Data Show That Some Businesses Use Life Insurance in a Variety of Ways

Of the federal and state regulators we contacted, only OTS has required the institutions it regulates to provide information that distinguishes among the uses of business-owned life insurance. Through the end of 2003, OTS required the thrifts it supervises to report the value of their key-person

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<sup>26</sup>Life insurance held in certain trusts may be subject to creditors' claims in bankruptcy.

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policies and the value of business-owned life insurance policies purchased for other purposes as separate items, if the amounts met the reporting threshold. Of the \$3.3 billion cash surrender value that 249 OTS-supervised thrifts reported owning as of December 31, 2002, about \$400 million was for key-person insurance and \$2.9 billion was for other business-owned life insurance. However, these amounts may not be representative of the proportions of key-person and other business-owned life insurance that these thrifts held. OTS's disclosure threshold applied separately to each category, so that OTS-supervised thrifts could have been required to report on only one type of policy rather than the total value of their business-owned life insurance holdings. Beginning in 2004, OTS eliminated its reporting threshold so that all the thrifts it supervises are required to report the value of both their key-person and other business-owned life insurance policies. The new requirement will allow OTS to determine the cash surrender value of all key-person and other business-owned life insurance held by the institutions it supervises.

Although SEC did not specifically require them to do so, we found that some businesses included information on how they intended to use business-owned life insurance in the Forms 10-K they filed with SEC. We reviewed the Forms 10-K of 100 randomly selected Fortune 1000 public companies. Of these, 11 provided information on the intended use of their business-owned life insurance policies. All 11 businesses reported using these policies to provide deferred compensation or benefits for executives; 1 also reported using them to provide postretirement health care.<sup>27</sup> For example, 1 of the 11 businesses reported having a supplemental executive retirement plan financed by life insurance that had a cash surrender value of about \$66 million as of December 31, 2002. The amount of insurance coverage was designed to cover the full cost of the plan, which at that time was estimated to have a present value of about \$69 million. Another 1 of the 11 businesses reported that it had purchased policies with a cash surrender value of about \$161 million as of February 28, 2003, with the intention of using the policies' proceeds as a future financing source for postretirement medical benefits, deferred compensation, and supplemental retirement plan obligations aggregating \$241.3 million. However, the business noted that the life insurance assets did not represent a committed financing

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<sup>27</sup>SEC requires companies to disclose information related to the compensation of top officers. Therefore, the fact that companies most frequently disclosed the use of business-owned life insurance in connection with executive compensation does not mean that this is necessarily the most common use of such policies.

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source and that the business could redesignate them for another purpose at any time.

Some large businesses have also provided survey responses suggesting that some business-owned life insurance is used to finance executive benefit plans. Clark Consulting has conducted annual executive benefits surveys of Fortune 1000 corporations and reported on respondents' use of business-owned life insurance to informally fund nonqualified deferred compensation and supplemental executive retirement plans. Businesses informally fund such plans by planning to have assets available to pay for them, although the assets would not generally be protected in bankruptcy.<sup>28</sup> From its 2003 survey, which had a 22 percent response rate, Clark Consulting reported that 93 percent of the respondents offered nonqualified deferred compensation plans, 69 percent of those with nonqualified deferred compensation plans informally funded them, and 55 percent of those that informally funded the plans used business-owned life insurance to do so.<sup>29</sup> Similarly, 71 percent of the respondents offered supplemental executive retirement plans, 53 percent of those respondents informally funded the plans, and 61 percent of those that informally funded the plans used business-owned life insurance to do so. Because the survey did not use a statistical sample of businesses and may be subject to other sources of error such as nonresponse bias, respondents' answers cannot be projected to all Fortune 1000 companies or to all businesses in the United States.<sup>30</sup> The statistics reported here are meant to indicate only that some large businesses are using life insurance in a variety of ways.

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<sup>28</sup>Businesses could informally fund nonqualified deferred compensation and supplemental executive retirement plans by placing assets in a trust that would restrict their use.

<sup>29</sup>"Executive Benefits: A Survey of Current Trends, 2003 Results," Clark Consulting (2003). Clark Consulting changed its name from Clark/Bardes Consulting in 2003. Clark/Bardes published the results of similar surveys from prior years, but comparisons among the surveys cannot be used to infer trends, because the design of the survey may have changed from year to year. We did not assess the quality of this survey's methodology or the accuracy of its findings.

<sup>30</sup>Nonresponse bias results when potential providers of data do not respond; it can be introduced when respondents as a group differ from nonrespondents on some measured characteristic and consequently are likely to differ in their responses.



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## Regulators Have Applied Their Guidelines or Requirements and Have Generally Not Had Significant Regulatory Concerns about Business-Owned Life Insurance

Banks and thrifts are required to follow federal regulatory guidelines in purchasing business-owned life insurance. Officials from federal bank regulators that had examined some institutions' purchases told us that these purchases had not raised major supervisory concerns. SEC's general disclosure requirements apply to business-owned life insurance; the agency has not had specific investor-protection concerns about such policies. The Internal Revenue Code includes statutory requirements, and IRS has issued regulatory requirements related to the tax treatment of the insurance. IRS officials told us that the agency was studying potential concerns. States had differing laws concerning insurable interest and consent requirements for business-owned life insurance. The insurance regulators of the four states we contacted described limited oversight of business-owned life insurance sales, and the four state regulators and NAIC generally did not have concerns about the policies.

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## Federal Bank Regulators Examined Some Institutions' Purchases of Business-Owned Life Insurance and Have Not Had Major Supervisory Concerns

Federal bank regulators have issued guidelines for purchases of business-owned life insurance that they have used in overseeing banks and thrifts' holdings of such policies. The regulators' oversight, consistent with their missions, includes assessing the safety and soundness of supervised institutions, and regulatory officials said that the agencies generally have not had major supervisory concerns about banks and thrifts' business-owned life insurance holdings. They said that while business-owned life insurance carries some risk, policies that were purchased in accordance with their guidelines are generally not a major threat to an institution's safety and soundness. The regulators cited other types of activities—such as commercial real estate, specialized, and subprime lending—as generally raising more supervisory concerns than business-owned life insurance because of increased risk or volatility.

OCC and OTS guidelines describe the permissible uses of business-owned life insurance.<sup>31</sup> According to Federal Reserve and FDIC officials, their agencies generally follow OCC's guidelines. The OCC and OTS guidelines state that banks and thrifts may purchase life insurance only for reasons incidental to banking, including insuring key persons and borrowers and

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<sup>31</sup>Department of the Treasury, OCC, "Bulletin 2000-23" (July 20, 2000). Department of the Treasury, OTS, "Regulatory Bulletin RB 32-26" (July 31, 2002). These bulletins rescinded previous guidelines. OCC officials said that the agency drafted revised guidance and circulated it to the other regulators for review in January 2004; the officials did not know when the revised guidance would be issued.

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purchasing insurance in connection with employee compensation and benefit plans. The guidelines require that, before purchasing policies, a bank or thrift's management conduct a prepurchase analysis that, among other things, determines the need for insurance and ensures that the amount of insurance purchased is not excessive in relation to the estimated obligation or risk. For example, the guidelines state that when purchasing life insurance on a group of employees, the institution may compare the aggregate obligation to the group (such as employee benefit costs) with the aggregate amount of insurance purchased.

The guidelines require that the prepurchase analysis determine the amount of insurance needed using "reasonable" financial and actuarial assumptions, such as those for the time period or the discount rate used to calculate the present value of expected employee benefit costs.<sup>32</sup> However, the guidelines do not specify parameters for the assumptions, such as the discount rate or time period, to be used in the prepurchase analysis—parameters that affect the amount of insurance that can be purchased.<sup>33</sup> OCC officials stated that specifying such parameters would have little or no effect because banks tend to purchase less insurance than they could justify based upon their expected employee benefit expenses, regardless of the assumptions used in prepurchase analyses. In addition to the requirements for determining the need for insurance, the guidelines state that banks and thrifts using business-owned life insurance for executive compensation should ensure that total compensation is not excessive—that is, unreasonable or disproportionate to the services performed, taking into account factors such as the financial condition of the institution and compensation practices at comparable institutions.

The OCC and OTS guidelines also require the bank or thrift's prepurchase analysis to consider the risks associated with business-owned life insurance and to maintain effective senior management and board oversight of the purchases. In addition, the guidelines state that a bank or thrift should consider the size of its purchase of business-owned life insurance relative to the institution's capital and diversify risks associated with the policies. The OCC and OTS guidelines require banks and thrifts to

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<sup>32</sup>The discount rate is the assumed interest rate used in a present value calculation, reflecting how much could be earned from investing today's dollars.

<sup>33</sup>In general, assuming a lower discount rate or including additional years when calculating expected employee benefit costs would increase the present value of the costs, which could in turn increase the amount of insurance that could be purchased.

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document their decisions and continue to monitor, on an ongoing basis, the financial condition of the insurance companies that carry their policies. For example, the guidelines state that institutions should review an insurance company's ratings and conduct further independent financial analysis, with the depth and frequency of such analysis determined by the relative size and complexity of the transaction.

OCC officials explained that the agency's guidelines do not require institutions to continue to compare their projected employee benefit costs with the projected cash flows from the insurance after purchasing the policies. However, purchases of additional insurance would require a prepurchase analysis, so that institutions would be required to update their comparisons at such times. Officials at three large banks said that their banks had not compared the projected employee benefit costs and projected insurance cash flows after purchasing the insurance. Officials at a fourth large bank said their bank had updated the comparison annually in conjunction with additional insurance purchases in recent years.

Federal bank regulators told us that their risk-based examination programs are designed to target aspects of banks and thrifts' purchases of business-owned life insurance that would raise supervisory concerns about institutions' safety and soundness. They specifically identified the credit and liquidity risks associated with business-owned life insurance as concerns that could warrant attention during an examination. Credit risk arises from the potential failure of an insurance carrier that might then be unable to pay death benefits or return the cash surrender value of policies upon request. OCC and Federal Reserve officials said they were less concerned about credit risk when it was diversified—for example, when institutions held policies with several highly rated insurers. Liquidity risk arises from the long-term nature of life insurance and the cost to the bank or thrift of surrendering policies.

OCC officials emphasized that other risks associated with business-owned life insurance could also raise supervisory concerns, particularly among institutions with relatively large holdings. Specifically, OCC officials said that the potential risk to institutions' reputations could be of concern as a result of negative perceptions of their holding the policies. For example, the officials noted that under California's new law, businesses must disclose to insured employees the existence and face amount of insurance policies purchased on their lives by the end of March 2004, which could negatively affect the businesses' reputations if employees were unaware that the policies existed. The officials also cited potential concerns about

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transaction risk, which arises from an institution not fully understanding or properly implementing a transaction. For example, if an institution did not comply with applicable insurable interest laws in purchasing a policy, it may not be able to collect the death benefits on the policy.<sup>34</sup> Finally, OCC and Federal Reserve officials cited potential concerns about tax risk—the risk that Congress could change the tax treatment of business-owned life insurance. If any such changes were applied to previously purchased policies, banks might not receive the returns on the policies that they had expected, which could, in turn, raise supervisory concerns with respect to certain institutions.<sup>35</sup>

The federal bank regulators explained that they determined whether to include business-owned life insurance in the scope of an examination based not only on their preliminary assessment of the level of risk associated with business-owned life insurance but also on the size of an institution's holdings relative to capital. The regulators' examination procedures, in general, direct examiners to identify concentrations of credit—instances where the institution's exposure to a creditor or, in some cases, a group of creditors (such as an insurance company or companies from which the institution has purchased policies) exceeds 25 percent of the regulator's measure of the institution's capital. All of the regulators said that, if the cash surrender value of a bank or thrift's policies exceeded this threshold, they would consider whether further supervisory review of these holdings was warranted. Such a review would help to ensure that the institution was not unduly exposed to credit or liquidity risk and that it was

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<sup>34</sup>OCC officials cited a court decision concerning Wal-Mart Stores, Inc. as an illustration of transaction risk, see *Mayo v. Hartford Life Ins. Co.*, 220 F. Supp. 2d 714 and 794 (S.D. Tex. 2002), *aff'd*, 354 F. 3d 400 (5th Cir. 2004). In 2002, a federal district court in Texas found that Wal-Mart did not have an insurable interest in employees' lives under Texas law, given the nature of the policies taken out on each of 350,000 Wal-Mart employees, and that under Texas law, Wal-Mart could not collect on the death benefits paid under policies covering deceased employees. Although the policies had been held by a trust in Georgia, the court found that Texas insurable interest law applied.

<sup>35</sup>In addition to the risks identified above, the OCC and OTS guidelines identify other types of risk, such as interest rate risk, price risk, and compliance risk, that institutions should consider when purchasing business-owned life insurance.

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complying with the guidelines on business-owned life insurance.<sup>36</sup> OCC officials also said that the difficulty of quantifying the reputation, transaction, and tax risks associated with the policies underscored the importance of examiners considering whether institutions had overly concentrated holdings of business-owned life insurance.

As of December 31, 2002, 467 banks and thrifts reported business-owned life insurance holdings in excess of 25 percent of their tier 1 capital.<sup>37</sup> We asked the bank regulators to explain their oversight of 58 institutions with the largest concentrations, all in excess of 40 percent of tier 1 capital. Bank regulatory officials said that their agencies were monitoring these institutions' levels of holdings through reviews of quarterly financial reports and had conducted reviews of the holdings as part of their examinations at many of the institutions. Officials from each regulator told us their agencies had concluded that major supervisory concerns did not exist about the amount of insurance the institutions owned, although the Federal Reserve and OCC had cited the need for some institutions to improve their oversight or internal controls related to the policies.

Specifically, Federal Reserve officials said that the agency had reviewed business-owned life insurance holdings as part of its examinations of the nine Federal Reserve-supervised banks that we identified (table 1). Federal Reserve officials said that the agency's examinations did not raise concerns about the nine banks' total holdings of business-owned life insurance. However, the officials said that the Federal Reserve had made recommendations to four of the banks, including that they conduct more diligent prepurchase analyses, communicate more information to board members, enhance internal controls, and conduct quarterly reviews of insurance carriers' financial condition. Based on a review of examination summary reports, FDIC officials said that FDIC had criticized the level of business-owned life insurance at only 1 of the 32 FDIC-supervised

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<sup>36</sup>Since July 2002, OTS has required thrifts to request its permission before investing more than 25 percent of total capital in business-owned life insurance policies. OTS officials said that the agency had declined the three requests it had received as of September 2003 because it was not convinced the thrifts needed the additional insurance. The other bank regulators did not have such a requirement.

<sup>37</sup>Tier 1 capital is a measure of the equity cushion that banks have available to absorb loss, including credit losses from their holdings of business-owned life insurance. The ratio of cash surrender value to tier 1 capital is used as a proxy to measure potential risk concentrations including credit risk (the risk of counterparty default) arising from a bank's business-owned life insurance holdings.

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institutions we identified; the officials said that the summaries might only note the results of a review of business-owned life insurance if examiners identified problems, so it was unclear how many of the other institutions' holdings had been reviewed. OCC officials told us that OCC did not have safety and soundness concerns about the amount of holdings at any of the 15 OCC-supervised banks we identified. The officials distinguished between community banks (4 of the 15 we identified) and large banks (11 of the 15 we identified), noting that OCC's primary supervisory concern has been with the effectiveness of community banks' ongoing oversight of their business-owned life insurance.<sup>38</sup> They said that OCC had reviewed the holdings of at least three of the community banks we identified and had cited the need for one of these banks to improve ongoing risk management of the policies. In contrast, the OCC officials said that large banks generally have sophisticated risk management systems and manage their insurance investments well. Although the officials did not report how many of the large banks' business-owned life insurance holdings had been reviewed during examinations, they said that these banks sometimes approach OCC examiners before making new insurance purchases and that, in this respect, OCC monitors some banks' business-owned life insurance programs on an ongoing basis. OTS officials told us that OTS had examined both of the thrifts we identified and did not have supervisory concerns about their current holdings or policy oversight.

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<sup>38</sup>OCC generally defines community banks as banks with less than \$1 billion in total assets. OCC characterizes banks in its Large Bank Supervision program as the largest and most complex national (federally chartered) banks.

**Table 1: Banks and Thrifts with the Largest Concentrations of Business-Owned Life Insurance as of December 31, 2002, and Issues Cited in Regulators' Most Recent Examinations**

Regulator	Institutions with business-owned life insurance holdings greater than 40 percent of tier 1 capital	Institutions whose most recent examination cited concerns or made recommendations related to business-owned life insurance <sup>a</sup>
The Federal Reserve	9	4
FDIC <sup>b</sup>	32	1
OCC <sup>b, c</sup>	15	1
OTS	2	0
<b>Total</b>	<b>58</b>	<b>6</b>

Sources: GAO analysis of FDIC and OTS data for the number of institutions with largest concentrations and all four federal bank regulators for the number of examinations that cited concerns.

<sup>a</sup>Examinations were conducted through September 2003, except that the Federal Reserve examinations were conducted through November 2003.

<sup>b</sup>FDIC and OCC officials did not report whether all examinations had included a review of business-owned life insurance holdings.

<sup>c</sup>Of the 15 OCC-supervised banks, 4 were community banks and 11 were large banks. OCC generally defines community banks as banks with less than \$1 billion in total assets. OCC characterizes banks in its Large Bank Supervision program as the largest and most complex national (federally chartered) banks. One examination of a community bank cited a concern related to business-owned life insurance. The number of large bank examinations that cited concerns was not available.

## SEC Has Applied Its Disclosure Requirements and Has Not Had Investor-Protection Concerns about Business-Owned Life Insurance

SEC officials said that the agency's regulations for public companies do not specifically address business-owned life insurance; rather, SEC has relied on its broadly applicable disclosure requirements to identify any investor protection concerns. As discussed, SEC, whose mission is to protect investors and maintain the integrity of the securities markets, requires public companies to disclose material financial and other information so that investors can make informed decisions. SEC officials said that business-owned life insurance is unlikely to be a material item. However, they added that the agency would have an oversight concern if it became aware of a public company's failure to disclose material purchases of or earnings from business-owned life insurance or if problems developed in accounting for these policies. For example, a senior SEC official said that SEC might become aware of a failure to disclose material information if it was examining a poorly performing business and found that its management had not disclosed that the business was using business-owned life insurance to sustain itself. SEC officials said that, to date, no such problems have arisen, and the agency has not had investor-protection concerns about public companies holding business-owned life insurance.

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## IRS Has Issued Requirements for the Tax Treatment of Policies and Is Studying Potential Concerns

IRS, whose mission includes administering the tax law, had some requirements related to the tax treatment of business-owned life insurance. The Internal Revenue Code defines life insurance for tax purposes, establishes its tax treatment, and limits the deductibility of interest on loans taken against policies. In addition, in September 2003, IRS and Treasury issued final regulations on the tax treatment of split-dollar life insurance policies—policies in which the employer and employee generally share costs and benefits as part of an executive compensation arrangement.<sup>39</sup> Because none of IRS’s prior rulings regarding the taxation of split-dollar arrangements had directly addressed the types of arrangements that have been widely used in recent years, IRS and Treasury issued interim guidance in 2001 and 2002 that culminated in the final regulations. Under the final regulations, corporations cannot provide tax-free compensation to executives using split-dollar policies, and a business’s premium payments are treated as loans to an executive who owns the policy. If the employer owns the policy, the regulations treat the executive’s interest in the policy’s cash value and current life insurance protection as taxable economic benefits to the executive.

IRS officials said that the agency was studying some possible remaining issues related to business-owned life insurance that is held by highly leveraged financial institutions such as banks and thrifts. Various sources have reported that the limitation on the deductibility of policy loan interest adopted in 1996 curtailed new sales of leveraged business-owned life insurance policies. However, IRS officials expressed concern that this limitation had not eliminated the tax arbitrage opportunities available through business-owned life insurance and that, for this reason, highly leveraged financial institutions such as banks and thrifts might be borrowing to indirectly finance their policies. Borrowing to indirectly finance policies can occur when businesses pay the premiums on life insurance policies by increasing debt that is not directly linked to the policies and then deducting the interest they pay on that debt from their taxable income.<sup>40</sup> Although the Internal Revenue Code limits the amount of

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<sup>39</sup>“Split-Dollar Life Insurance Arrangements,” IRS, Department of the Treasury, 68 Fed. Reg. 54336 (Sept. 17, 2003).

<sup>40</sup>Congressional Budget Office, *Budget Options* (Washington, D.C.: March 2003). Congressional Research Service, The Library of Congress, *Corporate-Owned Life Insurance: Tax Issues* (Washington, D.C.: updated June 26, 2003). Congressional Research Service, The Library of Congress, *Taxation of Life Insurance Products: Background and Issues* (Washington, D.C.: July 18, 2003).



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deductible interest that is linked directly to business-owned life insurance, establishing such a link is difficult because businesses may incur debt for many purposes. Borrowing to indirectly finance policies presents a tax advantage to businesses because they receive tax-deferred inside buildup from life insurance policies indirectly financed with debt on which the interest expense is tax-deductible.

In addition, IRS officials said that the agency is concerned that banks may be using separate account policies to maintain excessive control over investments, which is inconsistent with the Internal Revenue Code treatment of life insurance. Internal Revenue Code provisions were intended to ensure that the primary motivation in purchasing life insurance would be the traditional economic protection provided by such policies, while discouraging the use of tax-preferred life insurance as primarily an investment vehicle. In separate account life insurance, an asset account is maintained independently from the insurer's general account. Compared with a general account policy, which offers either a guaranteed rate of return or a rate that varies at the insurer's discretion, a separate account policy permits the policy owner latitude in the choice of investments, particularly equities.<sup>41</sup> Businesses may also purchase private placement policies, or separate account policies that allow policyholders to negotiate key terms of the policies—such as who will act as investment adviser—with the insurance company. These policies also offer investment alternatives that traditional separate account policies do not, including privately traded investments in start-up businesses and private venture capital funds. Based on IRS revenue rulings, the agency decides on a case-by-case basis whether the purchaser of a policy has excessive control over separate account assets. These revenue rulings have identified factors to consider, such as whether the purchaser directs the account to make a particular investment, sells or purchases assets in the account, or communicates with the investment adviser about the selection or quality of specific investments, and whether the account's investment strategies are broad enough to prevent the purchaser from making particular investment decisions by investing in a subaccount. IRS officials said that the agency was studying its concerns about indirectly financing policies through borrowing and about using separate account policies at five banks that IRS had identified through routine examinations. The officials said that IRS had not taken action against any of these banks.

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<sup>41</sup>OCC and OTS guidelines on business-owned life insurance limit banks and thrifts' equity holdings in separate accounts.

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## State Laws Differ, and Four States with Limited Oversight of Business-Owned Life Insurance Have Not Had Significant Concerns

Although NAIC has developed model legislative guidelines for business-owned life insurance, the states are not required to follow them. NAIC initially developed model guidelines for business-owned life insurance in 1992 and revised them in 2002 (fig. 2). The 1992 guidelines suggested that states consider including in their laws provisions that recognize employers' insurable interest in employees, including nonmanagement employees who could expect to receive benefits. The 2002 revision added a recommendation for states to consider requiring employee consent to be insured and prohibiting employers from retaliating against employees who refused to grant their consent. However, states have passed a variety of laws regulating insurable interest and consent requirements for business-owned life insurance (see app. II).

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**Figure 2: NAIC Model Guidelines on Business-Owned Life Insurance, December 2002 Revision**

NAIC suggests that states considering a legislative response to insurable interest concerns regarding employers and their employees consider including the following elements in their law:

- The law should recognize that employers have a lawful and substantial economic interest in the lives of key employees and in other employees who have a reasonable expectation of benefiting from an employee welfare benefit plan.
- Employers should be required to notify eligible employees of their proposed participation in the plan, and the employees should be given an opportunity to refuse to participate. On a prospective basis, employers should obtain the written consent of each individual being insured. Consent would include an acknowledgement that the employer may maintain the life insurance coverage even after the insured individual's employment has terminated.
- An employer shall not retaliate in any manner against a current or a retired employee for refusing consent to be insured.
- For non-key or nonmanagerial employees, the amount of coverage should be reasonably related to the benefits provided to the employees.
- With respect to employer provided pension and welfare benefit plans, the life insurance coverage purchased to finance the plans should only be allowed on the lives of those employees and retirees who, at the time their lives are first insured under the plan, would be eligible to participate in the plan.

Source: NAIC.

While some states have followed NAIC's guidelines, state consent requirements still differ. Since NAIC revised its guidelines in 2002, several states have passed legislation requiring employers to obtain employees' written consent before taking insurance on their lives (others already had such requirements). Also, while some states have consent provisions that specifically address business-owned life insurance, in some states consent provisions apply to life insurance policies in general. Compendiums of state laws prepared by NAIC and the American Council of Life Insurers and our review of selected state statutes indicated that, as of December 31,

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2003, 35 states had laws requiring written consent (either for life insurance in general or specifically for business-owned life insurance), and another 4 states had consent requirements that were satisfied if an employee did not object to a notice of the employer's intent to purchase a policy. However, at least 18 of these states exempted group life insurance policies from consent requirements. Additionally, 1 state required employers to notify employees when purchasing business-owned life insurance, but did not require employee consent.

We spoke with insurance department officials from California, Illinois, New York, and Texas. The insurable interest and consent provisions of the four states differed, but all allowed some purchases of business-owned life insurance and three required some form of consent; two required the amount of coverage to be related to employee benefit costs (table 2). The insurance department officials told us that they conduct limited oversight to test compliance with their states' insurable interest and consent laws. They said that their primary method of addressing this issue was through policy form reviews, or assessments of the proposed forms that insurers would provide to policyholders when selling policies in their states. For example, New York insurance department officials said that department officials review policy forms for compliance with the state's requirements and that, for policies on non-key employees, the form must describe insured employees' right to discontinue the coverage on their lives and must note the statutory limitations on the coverage amounts. Also, a submittal letter that insurers must provide to the department along with the policy form must explain how the insurer will verify that New York's insurable interest requirements are satisfied and, for non-key employees, whether the employer or the insurer will prepare the required employee consent notices. In Illinois, insurance department officials said that they review policy forms to ensure that the forms include the state's statutory requirements related to business-owned life insurance, but the forms need not detail procedures for obtaining consent or determining appropriate amounts of coverage.

**Table 2: State Insurable Interest and Consent Laws Applicable to Business-Owned Life Insurance in Selected States as of December 31, 2003**

State	Employer and employer-sponsored trusts' insurable interest in current and former employees	Requirements for notifying or obtaining consent of insured employees
California	<ul style="list-style-type: none"> <li>An employer may insure the lives of directors and officers or administrative, executive, or professional employees exempt from California overtime compensation requirements.</li> <li>An employer-sponsored trust providing employee or retiree benefits may insure the lives of those for whom benefits are to be provided.</li> </ul>	<ul style="list-style-type: none"> <li>Employee written consent is required.</li> <li>Policies purchased on nonexempt employees prior to January 1, 2004, will be void no later than January 1, 2010, unless the employer meets certain exceptions, including disclosing in writing information about such policies to insured employees.</li> </ul>
Illinois	<ul style="list-style-type: none"> <li>An employer or employer-sponsored trust may insure the lives of directors and officers and management, nonmanagement, and retired employees.</li> <li>Coverage of nonmanagement and retired employees is limited to an amount commensurate with the employer's projected unfunded employee benefit plan liabilities for nonmanagement and retired employees.</li> </ul>	<ul style="list-style-type: none"> <li>The consent requirement is satisfied if an employee does not reject coverage within 30 days of receiving written notice of the coverage.</li> </ul>
New York	<ul style="list-style-type: none"> <li>Employers may insure the lives of employees in whom the employer has a lawful and substantial economic interest in having the life of the insured person continue.</li> <li>Employers may insure the lives of employees or retirees who participate in or are eligible to participate in an employee benefit plan upon satisfaction of eligibility criteria. In such cases, the total amount of coverage cannot exceed employee benefit costs incurred since date of coverage plus projected future employee benefit costs.</li> </ul>	<p>For all employees:</p> <ul style="list-style-type: none"> <li>Employee notification and written consent are required.</li> </ul> <p>For employees insured under the insurable interest provision related to participation in an employee benefit plan:</p> <ul style="list-style-type: none"> <li>The notification must state that the insured can have coverage discontinued at any time.</li> <li>When employment terminates, employees must receive notice that they can have coverage discontinued. Notification is not required if the employee has a right to receive benefits being financed by the insurance coverage.</li> </ul>
Texas	<ul style="list-style-type: none"> <li>Employers may purchase a group life policy to insure the lives of officers, directors, employees, and retired employees in an amount necessary to provide funds to offset liabilities related to fringe benefits.</li> <li>An individual may consent in writing to the purchase of or application for an individual or group life insurance policy and designation of any entity as beneficiary of the policy or owner of the policy.</li> </ul>	<ul style="list-style-type: none"> <li>Employee consent is not required for policies purchased to offset liabilities related to fringe benefits.<sup>a</sup></li> <li>Any individual may consent to a business's purchase of and designation as beneficiary of a policy on the individual's life.</li> </ul>

Source: GAO analysis of state statutes.

<sup>a</sup>The Texas Department of Insurance noted that, notwithstanding the statute's language, based on its legislative history, the department has consistently maintained that employee consent is required.

NAIC staff said that state insurance regulators generally have the authority to review policies currently in force for compliance with any state requirements. But the officials from the four states we contacted said that their departments had not routinely verified that employees covered by the policies had consented to being insured or, where applicable, tested

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whether coverage amounts were appropriate.<sup>42</sup> An official from California's insurance department said that the department did not routinely review business-owned life insurance sales, but added that the department had recently received complaints about at least one insurer and multiple employers. The official noted that the department was investigating these complaints, including reviewing documentation for the policies in question, and that any policies that were found to violate state provisions could be voided. Officials in Illinois, New York, and Texas said that a pattern of consumer complaints about business-owned life insurance would cause their departments to investigate the insurance sales during market conduct examinations of insurers or refer the matter to their legal division for an enforcement action.<sup>43</sup> However, the officials said that generally they had not received complaints about business-owned life insurance. In addition, NAIC staff told us that the organization maintains a national database of consumer complaints made to state insurance regulators and that business-owned life insurance had not been a significant source of complaints. As a result, NAIC had not developed a separate category for tracking such complaints. However, relying on complaints may not be an effective means of identifying violations of state law related to business-owned life insurance, because employees who are not aware of their state's notification and consent requirements and whose employers have not provided the required notification or obtained the required consent, would not know that they have a basis for complaining to their state insurance regulators.

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<sup>42</sup>The Texas Department of Insurance suggested that no readily available, cost-effective alternatives exist to test for compliance with business-owned life insurance consent requirements.

<sup>43</sup>New York insurance department officials said that other factors might also cause the department to investigate an insurer. For example, they said that the department would investigate, as part of its market conduct examinations, insurers that sell a significant amount of business-owned life insurance. Officials said that, although the insurance department has not systematically collected data on the amount of business-owned life insurance companies have sold, they might ask a company about the extent of such sales during a pre-examination meeting to help the department target its market conduct examination.

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## More Comprehensive Data Could Be Useful to Congress; Costs Would Be Incurred in Obtaining the Data

More comprehensive data on the prevalence and use of business-owned life insurance could be useful to Congress in assessing the potential effects of legislative proposals that address the tax-favored treatment of this insurance. Data would be most useful if reported separately for business continuation and broad-based policies because legislative proposals that would further limit the tax-favored treatment of business-owned life insurance generally have treated the policies differently—they have applied primarily to broad-based policies. Data on business continuation versus broad-based insurance would be useful in understanding the proportion of the total business-owned life insurance market that might be affected by future legislative proposals. Useful data that are not available include the amount of tax-free income received from the death benefit payments on business continuation and broad-based policies—data that could help Congress better understand the potential effect of changes to the tax treatment of these policies on tax revenues.<sup>44</sup>

Other data on the prevalence and use of business-owned life insurance, further broken down or identified by business continuation and broad-based policies, might also be helpful to Congress in evaluating the potential effects of legislative proposals on businesses, their employees, and insurance companies. The cash surrender value of business-owned life insurance policies could help assess whether the value of assets invested in such policies is consistent with the behavior that Congress wishes to encourage through tax preferences. The annual premiums paid on new policies could be used to determine the demand for business-owned life insurance and the potential effect of proposed legislative changes on the market for business-owned life insurance. The number of businesses that hold business-owned life insurance policies could provide information on how many businesses might be affected by proposed legislative changes. Additional information on the size, type, and geographic location of businesses holding the insurance could be used to characterize the businesses that might be affected. Finally, although obtaining an unduplicated count of the total number of people covered by business-owned life insurance might be impractical, data on the number of each business's employees insured under such policies could be used, for

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<sup>44</sup>The total amount of tax-free income that a business receives from a policy is the death benefit payment less premiums paid. A business would have recognized some of this payment as tax-deferred earnings throughout the life of the policy. However, as discussed, these earnings do not become tax-free unless the policy is held until the death of the insured.

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example, to determine the average number or percentage of employees covered by businesses that reported owning policies.<sup>45</sup> Although more costly to obtain, data collected over multiple periods could help identify trends that might provide additional insights into the effects of legislative proposals.

Businesses that hold business-owned life insurance or insurance companies that sold the policies could provide the data for Congress's use, but both types of entities would incur administrative costs in extracting the required information from their records and summarizing it. We did not discuss these costs with businesses, however, we expect that they would maintain financial records and insurance policy statements from which the required data could be extracted. Also, some businesses already aggregate this information for use in completing their income taxes or Forms 10-K filed with IRS and SEC, respectively, suggesting that some businesses would not have difficulty providing the data. Nonetheless, businesses might differ in their willingness to voluntarily provide the data, depending at least in part on the cost and their perception of the benefits of doing so. While we did not independently determine the costs that insurers would incur in collecting the data, officials from several insurance companies told us that extensive effort would be required to identify policies as business-owned life insurance, as opposed to policies in which a business is the owner but not the beneficiary, and extract the data that we identified as being useful for decision making. These officials also told us that it would be difficult for them to distinguish between business continuation and broad-based policies. Consistent with these concerns, three life insurance industry trade associations recently supported proposed legislation that would require businesses that hold business-owned life insurance to report some information on their policies to IRS. While businesses might be able to provide data on the policies they own more easily than insurance companies could provide information on the policies they have sold, requiring insurance companies to report would substantially limit the number of reporting entities. About 1,200 companies sell life insurance, according to NAIC, while many more businesses purchase it.

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<sup>45</sup>Obtaining an unduplicated count of the total number of employees covered by business-owned life insurance could be impractical because businesses can continue to hold policies on employees who have left their employment and, therefore, more than one business can have policies on the same person.

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The organization collecting, analyzing, and reporting the data would also incur costs. SEC, Treasury, and NAIC are candidates for this role, because each already collects financial information from businesses that purchase business-owned life insurance, insurers, or both. One of the agencies or NAIC could collect the data by modifying existing reporting instruments, such as the SEC Form 10-K, applicable IRS tax forms, or insurance company annual reporting forms. Alternatively, the agencies or NAIC could collect the data through a survey. We did not determine the resources that would be required for the agencies or NAIC to modify their existing reporting instruments or conduct a survey. Beyond the costs, other factors could be considered in selecting one of these or another organization to lead the effort. Either SEC or Treasury might be able to combine data on business-owned life insurance with other data that businesses already report to them, such as business size, type, or location. SEC currently collects information only from publicly traded companies, whereas Treasury, through IRS, requires all businesses, including life insurance companies, to file tax returns. While taxpayer information is confidential and would not be publicly available except in the aggregate, Congress would likely need only aggregate information. Collecting business-owned life insurance data through NAIC, a membership organization of chief state insurance regulators, assumes the data would be collected from insurance companies and would involve the organization's voluntary cooperation.

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## Conclusions

The use of life insurance, which receives tax-favored treatment, has expanded from its traditional coverage of a family's principal wage earners and a business's key employees to broad-based coverage of a business's other employees. Although recent legislative proposals have sought to limit the tax-favored treatment of business-owned life insurance, comprehensive data on the prevalence and use of such insurance have not been available for use in assessing the impact of these proposed changes. Should Congress conclude that such data would facilitate its ongoing deliberations on the appropriate tax treatment of business-owned life insurance, decisions would be required on what data are needed, who should provide the data (insurance buyers or sellers), who should collect the data (SEC, Treasury, NAIC, or another organization), how to collect the data (additional reporting or a survey), what it would cost to collect the data, and whether the benefits of collecting additional data warrant the cost of doing so. Important data for understanding the tax and other implications of changes in the tax-favored treatment of business-owned life insurance would be the amount of tax-free income received from death benefit payments, reported separately for business continuation and broad-based



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policies. Additional data of value could include the cash surrender value of policies, the annual dollar amount of premiums paid on new policies, the number of businesses that hold business-owned life insurance, the characteristics of businesses that own the policies, and the number of employees insured under such policies.

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## Matter for Congressional Consideration

If Congress decides that it needs more comprehensive data on the prevalence and use of business-owned life insurance, such as the tax-free income from death benefit payments and/or other select data reported separately for business continuation and broad-based policies, Congress could, among other alternatives, obtain the data by

- assigning responsibility to SEC or Treasury to (1) require purchasers of business-owned life insurance or insurers to report the data in their financial statements or federal tax returns, respectively, or (2) conduct a survey of the purchasers or insurers to obtain the data; or
- encouraging NAIC to (1) require insurers to report the data in the annual reports they file with NAIC or (2) conduct a survey of insurers to obtain the data.

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## Agency Comments and Our Evaluation

We received written comments on a draft of this report from Treasury, IRS, SEC, and NAIC that are reprinted in appendixes III–VI, respectively. Treasury commented that the report is well-researched and informative, but together with SEC expressed reservations about the matter for congressional consideration. Both agencies were reluctant to have a potential role in collecting data on business-owned life insurance, stating that having such a role would not be necessary to fulfill their regulatory missions. NAIC did not express such reservations, but said that it would like to evaluate the need for and utility of the data and favored using a survey as an initial step in the data gathering process. In addition, we received technical comments from Treasury, the federal bank regulators, SEC, and NAIC that we incorporated into the report where appropriate.

In addressing their concern about collecting the data described in our matter for congressional consideration, SEC and Treasury commented that because they do not need the data to fulfill their regulatory missions, they do not believe it would be appropriate for them to collect the data. Specifically, SEC expressed concern about collecting data for purposes

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other than protecting investors. Similarly, Treasury expressed concern about collecting information not directly needed to calculate tax liabilities or enhance IRS's ability to audit tax returns. However, as discussed in our report, Treasury provides OMB the estimate of forgone tax revenues resulting from the tax treatment of life insurance, and OMB reports this estimate in its budget documents. As we also report, this estimate is not complete because it does not reflect the forgone tax revenues on the additional income from death benefit payments in excess of the premiums paid and the accumulated tax-deferred earnings. Accordingly, Treasury might find that gathering additional data would allow the agency to provide OMB with a more complete and accurate estimate. NAIC reiterated that collecting the data described in our matter for congressional consideration would go beyond what is needed to support states' regulation of insurers' solvency. But NAIC did not explicitly express reservations about being charged with collecting the data should Congress request that it do so. We recognized in the report that none of the potential candidates that we identified for collecting additional data on business-owned life insurance needs the data to fulfill its missions and that the data would be used primarily for making tax policy decisions rather than for providing regulatory oversight. As discussed in the report, if Congress decides that it needs more comprehensive data on business-owned life insurance, among its alternatives would be to turn to SEC, Treasury, NAIC, or another entity to collect the data.

Addressing the issue of how to collect the data, Treasury commented that it would be costly to design and distribute a survey, that response rates might be low without a penalty for noncompliance, and that Treasury would not be the best candidate to conduct a survey because it is not a "statistical gathering agency." Regarding the latter, Treasury said that a survey of insurance products could be better performed by other organizations or agencies. As discussed in the report, we agree that collecting the required data would involve an investment of resources, whether it is done through a survey or via existing reporting mechanisms. We also agree that obtaining an adequate survey response rate presents a challenge. However, according to professional literature, congressional action making the survey

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mandatory should significantly improve the response rate.<sup>46</sup> Also, according to this literature, government surveys that have employed response improvement methods continue to achieve acceptable response rates. Additionally, the surveyed entities may be more likely to respond if they believed that doing so would be in their interest. For example, they might conclude that congressional action would be more favorable to them if it was based on more complete data. Further, although Treasury is not a statistical gathering agency, it has chosen to conduct surveys to provide required information to Congress, as well as for other purposes, such as to study the growth of investment in foreign securities. Treasury has also contracted out surveys, as have other federal agencies. NAIC also commented that collecting the data could entail significant costs. NAIC said that it would like to evaluate the need for and utility of collecting the data and suggested that an initial study sampling the data described in our matter for congressional consideration might be a cost-effective way to assess the need for broader data collection. We agree that such a strategy could be one way of approaching the data collection effort.

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We are sending copies of this report to the Chairmen of the Senate Committee on Finance, House Committee on Financial Services, Joint Committee on Taxation, and other interested congressional committees. We will send copies to the Chairman of the Board of Governors of the Federal Reserve, Secretary of the Treasury, Chairman of FDIC, Commissioner of Internal Revenue, Comptroller of the Currency, Director of OMB, Director of OTS, Chairman of SEC, Executive Vice President of NAIC, and other interested parties. We also will make copies available to

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<sup>46</sup>Several studies have found that mandatory reporting has a positive effect on survey response rates. S. Cole, G. Kusch, C.E. Hoy, and J. Berry, "Studies of Nonresponse in Industrial Surveys" (paper presented at the International Conference on Establishment Surveys, Buffalo, NY, June 1993). D. Dillman, E. Singer, J. Clark, and J. Treat, "Effects of Benefits Appeals, Mandatory Appeals, and Variations in Statements of Confidentiality on Completion Rates for Census Questionnaires," *Public Opinion Quarterly*, vol. 60, no. 3 (1996). C. Paxson, D. Dillman, and J. Tarnai, "Improving Response to Business Mail Surveys," in *Business Survey Methods*, eds. B. G. Cox et al. (New York, NY: Wiley, 1995), 303-316. E. O'Brien, "Respondent Role As A Factor In Establishment Survey Response," in *Proceedings of the Second International Conference on Establishment Surveys*, ed. American Statistical Association (Alexandria, VA: 2000), 1462-1467.

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others upon request. In addition, the report will be available at no charge on the GAO Web site at <http://www.gao.gov>.

If you have any further questions, please call me at (202) 512-8678, [dagostinod@gao.gov](mailto:dagostinod@gao.gov), or Cecile Trop at (312) 220-7600, [tropc@gao.gov](mailto:tropc@gao.gov). Additional GAO contacts and staff acknowledgments are listed in appendix VII.

A handwritten signature in black ink, reading "Davi M. D'Agostino". The signature is fluid and cursive, with the first name "Davi" being the most prominent.

Davi M. D'Agostino  
Director, Financial Markets and  
Community Investment

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# Scope and Methodology

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To obtain information on the prevalence and use of business-owned life insurance, we analyzed the quarterly financial reports—the Call Report and Thrift Financial Report—that banks and thrifts filed with their respective regulators. We obtained the data from the Federal Deposit Insurance Corporation (FDIC), which compiles Call Report and Thrift Financial Report data collected by the Board of Governors of the Federal Reserve System (the Federal Reserve), FDIC, the Office of the Comptroller of the Currency (OCC), and the Office of Thrift Supervision (OTS). We also obtained additional Thrift Financial Report data from OTS. Because regulators only began collecting the information in a consistent format at the beginning of calendar year 2001, our analysis covered the eight quarters ending March 31, 2001, through December 31, 2002. Although we did not independently verify the accuracy of the data, we assessed its reliability by discussing the data system with bank regulatory officials and examining the data for missing or unreasonable values. We concluded that the data were reliable for purposes of this report.

To obtain further information on the prevalence and use of business-owned life insurance, we reviewed the most recent annual Form 10-K financial reports that publicly traded companies had filed with the Securities and Exchange Commission (SEC) between January 2002 and September 2003. To identify information about insurance companies' sales of such policies, we reviewed the Forms 10-K of 32 life insurance companies that were among the 50 largest such companies ranked by assets. We also searched for references on how businesses used such policies in the Forms 10-K that a random sample of 100 Fortune 1000 public companies filed with SEC. Although the examples that we identified were not necessarily representative of all businesses that own these policies, they illustrated some uses of business-owned life insurance. We also reviewed industry literature, including studies by life insurance industry consultants and brokers, and interviewed experts to identify other surveys related to business-owned life insurance sales and use. We reviewed surveys conducted by CAST Management Consultants, Inc. that estimated 2001 and 2002 business-owned life insurance premiums and by Clark Consulting that reported on businesses' use of business-owned life insurance in 2003. We did not fully assess the quality of these surveys, but we determined that despite some limitations, the surveys illustrated the amount of some recent sales and some businesses' uses of business-owned life insurance.

We also obtained information concerning the prevalence and use of business-owned life insurance from officials of relevant federal regulatory agencies: four federal bank regulators (the Federal Reserve, FDIC, OCC,

and OTS), SEC, and the Internal Revenue Service (IRS). In addition, we reviewed the Joint Committee on Taxation's and the Office of Management and Budget's reported estimates of forgone tax revenues attributable to business-owned life insurance and obtained information from officials of both entities about the development of these estimates. We also obtained information about the prevalence and use of business-owned life insurance from the National Association of Insurance Commissioners (NAIC), two life insurance trade associations (the American Council of Life Insurers and the Association for Advanced Life Underwriting), and four large banks that held business-owned life insurance.

In an effort to better describe the prevalence and use of business-owned life insurance, we also considered the possibility of conducting a survey of life insurance companies, but did not do so. Although representatives of six life insurance companies cooperated in a survey pretest, and American Council of Life Insurers representatives said that they would encourage their members to participate in the survey itself, the results of the pretest led us to conclude that we would not be able to obtain sufficiently reliable data to warrant conducting the survey. The insurance company representatives told us that their companies do not have a business need to maintain the comprehensive data on business-owned life insurance that we needed for the survey. We did not verify the accuracy of these statements. Still, for the reasons the insurance company representatives cited, we were uncertain whether we would receive an acceptable response rate to a survey. Also, insurance companies' requests for anonymity would have precluded us from determining the percentage of total life insurance sales the survey respondents represented.

To describe federal and state regulatory requirements for and oversight of business-owned life insurance, we met with officials of federal and state agencies that have regulatory authority related to business-owned life insurance to discuss their requirements and oversight activities and reviewed agency documentation and applicable federal and state laws. Specifically, we discussed requirements and oversight with officials at each of the four federal bank regulators and reviewed their guidelines, regulations, and reporting forms and instructions. We also discussed these topics with officials at SEC and IRS and reviewed their regulations, reporting requirements, and applicable sections of the Internal Revenue Code. We also interviewed NAIC staff to gain a perspective on state approaches to regulating business-owned life insurance and to discuss the organization's model guidelines for state laws concerning such policies. To understand more about how states oversee compliance with their statutes,

we obtained information from officials of insurance departments in California, Illinois, New York, and Texas. We selected these states because they represented different geographical regions of the United States and had differing insurable interest and consent provisions for business-owned life insurance; we did not select states whose provisions did not specifically address business-owned life insurance because we concluded that their insurance departments would not have specific oversight activities or requirements for business-owned life insurance. We did not conduct a comprehensive evaluation of the quality of federal and state regulators' oversight activities. For example, we did not review records from federal examinations of banks and thrifts or state examinations of insurers. In addition, although we did not review every state statute that could affect business-owned life insurance, we reviewed each state's statutes that related specifically to business-owned life insurance. Further, to better understand differences in state laws concerning insurable interest and consent requirements for business-owned life insurance, we analyzed compendiums of state statutes from NAIC and the American Council of Life Insurers.

To address the potential usefulness of and costs associated with obtaining more comprehensive data on business-owned life insurance, we reviewed state and federal legislative proposals for changing the tax treatment of business-owned life insurance or addressing other public policy issues related to this insurance and determined the types of data that could be useful in considering these kinds of proposals. We also assessed the extent to which the information we obtained on the prevalence and use of business-owned life insurance provided a comprehensive basis for decision making. In addition, we reviewed IRS, SEC, and NAIC's reporting forms and instructions to understand what role these organizations or Treasury might play if Congress wanted them to collect, analyze, and report more comprehensive information on business-owned life insurance. We also discussed with representatives of six insurance companies the challenges insurers might face in providing data, including what data they would be able to readily provide and what data would be difficult to provide. Finally, we discussed challenges that might be faced in collecting the data with Treasury (including IRS), SEC, and NAIC representatives.

We conducted our work between February 2003 and December 2003, primarily in Washington, D.C., in accordance with generally accepted government auditing standards.

# State Insurable Interest and Consent Provisions

Table 3 provides information on state insurable interest and notification and consent provisions applicable to purchases of business-owned life insurance by employers or employer-sponsored trusts.

**Table 3: State Insurable Interest and Consent Laws Applicable to Business-Owned Life Insurance as of December 31, 2003**

State	Employer and employer-sponsored trusts' insurable interest in current and former employees	Requirements for notifying or obtaining consent of insured employees
Alabama	<ul style="list-style-type: none"> <li>• A corporation or employer-sponsored trust established for the sole benefit of the corporation may insure the lives of directors, officers, employees, or any other person whose death might cause financial loss to the corporation.</li> <li>• An employer-sponsored trust established to provide employee benefits may insure the lives of employees, retirees, or their dependents or beneficiaries for whom the benefits are to be provided.</li> </ul>	<ul style="list-style-type: none"> <li>• Consent of insured is required, but the requirement is not specific to business-owned policies and excludes group life insurance.</li> </ul>
Alaska	<ul style="list-style-type: none"> <li>• For people not closely related, an insurable interest includes a lawful and substantial economic interest in having the life of the insured person continue.</li> </ul>	<ul style="list-style-type: none"> <li>• Written consent of insured is required, but the requirement is not specific to business-owned policies and excludes group life insurance.</li> </ul>
Arizona	<ul style="list-style-type: none"> <li>• For people not closely related, an insurable interest includes a lawful and substantial economic interest in having the life of the insured person continue.</li> </ul>	<ul style="list-style-type: none"> <li>• Consent of insured is required, but the requirement is not specific to business-owned policies and excludes group life insurance.</li> </ul>
Arkansas	<ul style="list-style-type: none"> <li>• An employer or trust providing employee benefits may insure the lives of key employees and employees for whom employee benefits are to be provided.</li> <li>• Coverage of non-key and nonmanagement employees must be reasonably related to the benefits provided to the employee.</li> <li>• Insurance purchased to finance pension and welfare benefit plans is only allowed on the lives of employees who have a reasonable expectation of receiving such benefits at the time their lives are first insured.</li> </ul>	<ul style="list-style-type: none"> <li>• Employee written consent is required.</li> </ul>
California	<ul style="list-style-type: none"> <li>• An employer may insure the lives of directors and officers or administrative, executive, or professional employees exempt from California overtime compensation requirements.</li> <li>• An employer-sponsored trust providing employee or retiree benefits may insure the lives of those for whom benefits are to be provided.</li> </ul>	<ul style="list-style-type: none"> <li>• Employee written consent is required.</li> <li>• Policies purchased on nonexempt employees prior to January 1, 2004, will be void no later than January 1, 2010, unless the employer meets certain exceptions, including disclosing in writing information about such policies to insured employees.</li> </ul>
Colorado	<ul style="list-style-type: none"> <li>• No statutory definition of employer or employer-sponsored-trust insurable interest exists.</li> </ul>	<ul style="list-style-type: none"> <li>• No statutory consent requirement exists.</li> </ul>



**Appendix II  
State Insurable Interest and Consent  
Provisions**

*(Continued From Previous Page)*

<b>State</b>	<b>Employer and employer-sponsored trusts' insurable interest in current and former employees</b>	<b>Requirements for notifying or obtaining consent of insured employees</b>
Connecticut	<ul style="list-style-type: none"> <li>• No statutory definition of employer or employer-sponsored-trust insurable interest exists.</li> <li>• The trustee of any voluntary employee benefits association may insure the lives of employees or retired employees to provide benefits to those employees.</li> </ul>	<ul style="list-style-type: none"> <li>• No statutory consent requirement exists.</li> </ul>
Delaware	<ul style="list-style-type: none"> <li>• An employer providing benefits to some or all employees or their dependents or beneficiaries may insure the life of any employee.</li> <li>• An employer-sponsored trust established substantially for the employer or for the benefit of employees or their dependents or beneficiaries may insure the lives of such employees.</li> </ul>	<ul style="list-style-type: none"> <li>• Employee notification or consent is not required if the employer is located in Delaware and has at least 50 employees.</li> </ul>
Florida	<ul style="list-style-type: none"> <li>• No statutory definition of employer or employer-sponsored-trust insurable interest exists.</li> </ul>	<ul style="list-style-type: none"> <li>• No statutory consent requirement exists.</li> </ul>
Georgia	<ul style="list-style-type: none"> <li>• A corporation may insure the lives of directors, officers, employees, or any other person whose death might cause financial loss to the corporation.</li> <li>• An employer-sponsored trust providing benefits to employees, retirees, or their dependents or beneficiaries may insure the lives of employees for whom such benefits are to be provided.</li> </ul>	<ul style="list-style-type: none"> <li>• Employee written consent is required.</li> </ul>
Hawaii	<ul style="list-style-type: none"> <li>• For people not closely related, an insurable interest includes a lawful and substantial economic interest in having the life of the insured person continue.</li> </ul>	<ul style="list-style-type: none"> <li>• Written consent of insured is required, but the requirement is not specific to business-owned policies and excludes group life insurance.</li> </ul>
Idaho	<ul style="list-style-type: none"> <li>• For people not closely related, an insurable interest includes a lawful and substantial economic interest in having the life of the insured person continue.</li> </ul>	<ul style="list-style-type: none"> <li>• Written consent of insured is required, but the requirement is not specific to business-owned policies and excludes group life insurance.</li> </ul>
Illinois	<ul style="list-style-type: none"> <li>• An employer or employer-sponsored trust may insure the lives of directors and officers and management, nonmanagement, and retired employees.</li> <li>• Coverage of nonmanagement and retired employees is limited to an amount commensurate with the employer's projected unfunded employee benefit plan liabilities for nonmanagement and retired employees.</li> </ul>	<ul style="list-style-type: none"> <li>• The consent requirement is satisfied if an employee does not reject coverage within 30 days of receiving written notice of the coverage.</li> </ul>
Indiana	<ul style="list-style-type: none"> <li>• An employer or employer-sponsored trust may insure the lives of employees for whom they provide employee benefits.</li> </ul>	<ul style="list-style-type: none"> <li>• The consent requirement is satisfied if an employee does not reject coverage within 30 days of receiving notice of the coverage.</li> </ul>
Iowa	<ul style="list-style-type: none"> <li>• An employee or employer-sponsored trust may insure the lives of employees, retirees, officers, managers, directors, owners, shareholders, and members.</li> <li>• Coverage of nonmanagement and non-key employees must be reasonably related to the benefits provided to the employees.</li> </ul>	<ul style="list-style-type: none"> <li>• Employee written consent is required.</li> </ul>

**Appendix II**  
**State Insurable Interest and Consent**  
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*(Continued From Previous Page)*

<b>State</b>	<b>Employer and employer-sponsored trusts' insurable interest in current and former employees</b>	<b>Requirements for notifying or obtaining consent of insured employees</b>
Kansas	<ul style="list-style-type: none"> <li>• An employer or employer-sponsored trust for the benefit of employees may insure the lives of directors, employees, or retirees.</li> <li>• Coverage of nonmanagement and retired employees is limited to an amount commensurate with the aggregate projected liabilities under all employee welfare benefit plans.</li> </ul>	<ul style="list-style-type: none"> <li>• The consent requirement is satisfied if an employee does not reject coverage within 30 days of receiving notice of the coverage.</li> </ul>
Kentucky	<ul style="list-style-type: none"> <li>• A corporation that provides active or retired employees with retirement or other benefits, or a trust established by the corporation for its sole benefit, may insure the lives of active or retired employees who are covered by the retirement or other benefit plan.</li> </ul>	<ul style="list-style-type: none"> <li>• Written consent of insured is required, but the requirement is not specific to business-owned policies and excludes group life insurance.</li> </ul>
Louisiana	<ul style="list-style-type: none"> <li>• For people not closely related, an insurable interest includes a lawful and substantial economic interest in having the life of the insured person continue.</li> </ul>	<ul style="list-style-type: none"> <li>• Written consent of insured is required, but the requirement is not specific to business-owned policies and excludes group life insurance.</li> </ul>
Maine	<ul style="list-style-type: none"> <li>• A corporation or trust may insure the lives of employees, former employees, and retirees for the purpose of funding pre- and postretirement benefits, provided that the insured employees are selected by objective standards and that the proceeds are used for the sole purpose of funding the benefit programs covering at least a broad class of employees.</li> </ul>	<ul style="list-style-type: none"> <li>• Employee written consent is required.</li> </ul>
Maryland	<ul style="list-style-type: none"> <li>• A private or public corporation or a trust established by such a corporation for the benefit of employees may insure the lives of key employees.</li> <li>• A public corporation or a trust established by such a corporation may insure the lives of non-key employees who have been employed at least 12 consecutive months, provided the amount of coverage on non-key employees is commensurate with employer-provided benefits.</li> </ul>	<ul style="list-style-type: none"> <li>• In general, consent of insured is required, but the requirement is not specific to business-owned policies and excludes group life insurance.</li> <li>• Non-key employees of public corporations must consent in writing to be insured.</li> </ul>
Massachusetts	<ul style="list-style-type: none"> <li>• A corporation or employer-sponsored trust established for the sole benefit of the corporation may insure the lives of directors, officers, employees, or any other person whose death might cause financial loss to the corporation.</li> <li>• An employer-sponsored trust established to provide employee benefits may insure the lives of employees or retirees for whom the benefits are to be provided.</li> </ul>	<ul style="list-style-type: none"> <li>• Written consent of insured is required, but the requirement is not specific to business-owned policies and excludes group life insurance.</li> </ul>

**Appendix II  
State Insurable Interest and Consent  
Provisions**

(Continued From Previous Page)

State	Employer and employer-sponsored trusts' insurable interest in current and former employees	Requirements for notifying or obtaining consent of insured employees
Michigan	<ul style="list-style-type: none"> <li>An employer or a trust maintained for the purpose of providing for the cost of benefits under an employee benefit plan may insure the lives of directors, officers, and managers and nonmanagement and retired employees.</li> <li>Coverage of nonmanagement and retired employees is limited to an amount commensurate with the employer's projected unfunded employee benefit plan liabilities for nonmanagement and retired employees.</li> </ul>	<ul style="list-style-type: none"> <li>For business-owned life insurance purchased by an employer, employee written consent is required.</li> <li>For business-owned life insurance purchased by a trust maintained for the purpose of providing for the cost of benefits, written notice is required, and the trust may purchase insurance only if the employee does not object in writing to the coverage.</li> </ul>
Minnesota	<ul style="list-style-type: none"> <li>A corporation or employer-sponsored trust providing benefits to employees may insure the lives of employees for whom the benefits are to be provided.</li> </ul>	<ul style="list-style-type: none"> <li>Employee written consent is required.</li> </ul>
Mississippi	<ul style="list-style-type: none"> <li>A corporation or trust may insure someone's life if the corporation or trust has a lawful and substantial economic interest in having the life of the insured person continue.</li> </ul>	<ul style="list-style-type: none"> <li>Written consent of insured is required, but the requirement is not specific to business-owned policies and excludes group life insurance.</li> </ul>
Missouri	<ul style="list-style-type: none"> <li>An employer or employer-sponsored trust for the benefit of employees may insure the lives of directors, employees, or retirees.</li> <li>Coverage of nonmanagement and retired employees is limited to an amount of aggregate projected death benefits commensurate with the aggregate projected liabilities to employees under all employee welfare benefit plans.</li> </ul>	<ul style="list-style-type: none"> <li>Written notice is required, and the insurance may be purchased only if the employee does not object in writing within 30 days of the notice of coverage.</li> </ul>
Montana	<ul style="list-style-type: none"> <li>For people not closely related, an insurable interest includes a lawful and substantial economic interest in having the life of the insured person continue.</li> </ul>	<ul style="list-style-type: none"> <li>Written consent of insured is required, but the requirement is not specific to business-owned policies and excludes group life insurance.</li> </ul>
Nebraska	<ul style="list-style-type: none"> <li>For people not closely related, an insurable interest exists when, because of a pecuniary relationship, the beneficiary expects some benefit in having the life of the insured person continue.</li> </ul>	<ul style="list-style-type: none"> <li>Written consent of insured is required, but the requirement is not specific to business-owned policies and excludes group life insurance.</li> </ul>
Nevada	<ul style="list-style-type: none"> <li>For people not closely related, an insurable interest includes a lawful and substantial economic interest in having the life of the insured person continue.</li> </ul>	<ul style="list-style-type: none"> <li>Written consent of insured is required, but the requirement is not specific to business-owned policies and excludes group life insurance.</li> </ul>
New Hampshire	<ul style="list-style-type: none"> <li>A business may insure a person's life if the business expects pecuniary benefit or advantage in having the life of the insured person continue.</li> </ul>	<ul style="list-style-type: none"> <li>Written consent of insured is required, but the requirement is not specific to business-owned policies.</li> </ul>
New Jersey	<ul style="list-style-type: none"> <li>A corporation may insure the lives of directors, officers, or employees whose death might cause financial loss to the corporation.</li> <li>A trust established and fully funded by a corporation to provide benefits to employees may insure the lives of employees for whom such benefits are to be provided.</li> </ul>	<ul style="list-style-type: none"> <li>No statutory consent requirement exists.</li> </ul>
New Mexico	<ul style="list-style-type: none"> <li>For people not closely related, an insurable interest includes a lawful and substantial economic interest in having the life of the insured person continue.</li> </ul>	<ul style="list-style-type: none"> <li>Written consent of insured is required, but the requirement is not specific to business-owned policies and excludes group life insurance.</li> </ul>

**Appendix II  
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(Continued From Previous Page)

State	Employer and employer-sponsored trusts' insurable interest in current and former employees	Requirements for notifying or obtaining consent of insured employees
New York	<ul style="list-style-type: none"> <li>• Employers may insure the lives of employees in which the employer has a lawful and substantial economic interest in having the life of the insured person continue.</li> <li>• Employers may insure the lives of employees or retirees who participate in or are eligible to participate in an employee benefit plan upon satisfaction of eligibility criteria. In such cases, the total amount of coverage cannot exceed employee benefit costs incurred since date of coverage plus projected future employee benefit costs.</li> </ul>	<p>For all employees:</p> <ul style="list-style-type: none"> <li>• Employee notification and written consent are required.</li> </ul> <p>For employees insured under the insurable interest provision related to participation in an employee benefit plan:</p> <ul style="list-style-type: none"> <li>• The notification must state that the insured can have coverage discontinued at any time.</li> <li>• When employment terminates, employees must receive notice that they can have coverage discontinued. Notification is not required if the employee has a right to receive benefits being financed by the insurance coverage.</li> </ul>
North Carolina	<ul style="list-style-type: none"> <li>• An employer or business trust may insure the life of any employee.</li> <li>• A trust to provide pension benefits may insure the life of any person covered by the pension plan.</li> </ul>	<ul style="list-style-type: none"> <li>• No statutory consent requirement exists.</li> </ul>
North Dakota	<ul style="list-style-type: none"> <li>• A corporation or employer-sponsored trust providing employee benefits may insure the lives of employees for whom the benefits are to be provided.</li> </ul>	<ul style="list-style-type: none"> <li>• Employee written consent is required.</li> </ul>
Ohio	<ul style="list-style-type: none"> <li>• An employer or employer-sponsored trust for the benefit of employees may insure the lives of directors, employees, or retirees.</li> <li>• Coverage of nonmanagement and retired employees is limited to an amount of aggregate projected death benefits commensurate with the aggregate projected liabilities to employees under all employee benefit plans.</li> </ul>	<ul style="list-style-type: none"> <li>• Written notice and employee written consent are required.</li> </ul>
Oklahoma	<ul style="list-style-type: none"> <li>• An employer or employer-sponsored trust for the benefit of employees may insure the lives of directors, employees, or retirees.</li> <li>• Coverage of nonmanagement and retired employees is limited to an amount agreed to by the employee or, in the absence of an agreement, an amount of aggregate projected death benefits commensurate with the aggregate projected liabilities to employees under all employee welfare benefit plans.</li> </ul>	<ul style="list-style-type: none"> <li>• Written notice and employee written consent are required.</li> <li>• Unless otherwise agreed, the employer must offer to sell the policy to the employee upon termination of employment.</li> </ul>
Oregon	<ul style="list-style-type: none"> <li>• No statutory definition of employer or employer-sponsored-trust insurable interest exists.</li> </ul>	<ul style="list-style-type: none"> <li>• Written consent of insured is required, but the requirement is not specific to business-owned policies and excludes group life insurance.</li> </ul>
Pennsylvania	<ul style="list-style-type: none"> <li>• A corporation or a trust established to provide benefits to a corporation's officers, directors, principals, partners, and employees may insure the lives of such people.</li> </ul>	<ul style="list-style-type: none"> <li>• Written notification and written consent of insured are required.</li> </ul>

**Appendix II  
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(Continued From Previous Page)

State	Employer and employer-sponsored trusts' insurable interest in current and former employees	Requirements for notifying or obtaining consent of insured employees
Rhode Island	<ul style="list-style-type: none"> <li>• An employer or employer-sponsored trust may insure the lives of key employees.</li> <li>• An employer or employer-sponsored trust may insure the lives of other employees, former employees, and retirees for the sole purpose of funding the cost of preretirement and postretirement benefits.</li> <li>• The amount of coverage on non-key employees is limited to an amount commensurate with employer-provided benefits to those employees.</li> </ul>	<ul style="list-style-type: none"> <li>• Consent of insured is required for policies benefiting tax-exempt charitable organizations, but the requirement does not address business-owned policies.</li> </ul>
South Carolina	<ul style="list-style-type: none"> <li>• No statutory definition of employer or employer-sponsored-trust insurable interest exists.</li> </ul>	<ul style="list-style-type: none"> <li>• No statutory consent requirement exists.</li> </ul>
South Dakota	<ul style="list-style-type: none"> <li>• For people not closely related, an insurable interest includes a lawful and substantial economic interest in having the life of the insured person continue.</li> </ul>	<ul style="list-style-type: none"> <li>• Written consent of insured is required, but the requirement is not specific to business-owned policies and excludes group life insurance.</li> </ul>
Tennessee	<ul style="list-style-type: none"> <li>• No statutory definition of employer or employer-sponsored-trust insurable interest exists.</li> </ul>	<ul style="list-style-type: none"> <li>• No statutory consent requirement exists.</li> </ul>
Texas	<ul style="list-style-type: none"> <li>• Employers may purchase a group life insurance policy to insure the lives of officers, directors, employees, and retired employees in an amount necessary to provide funds to offset liabilities related to fringe benefits.</li> <li>• An individual may consent in writing to the purchase of or application for an individual or group life insurance policy and designation of any entity as the beneficiary of the policy or owner of the policy.</li> </ul>	<ul style="list-style-type: none"> <li>• Employee consent is not required for policies purchased to offset liabilities related to fringe benefits.<sup>a</sup></li> <li>• Any individual may consent to a business's purchase of and designation as beneficiary of a policy on the individual's life.</li> </ul>
Utah	<ul style="list-style-type: none"> <li>• An employer or employer-sponsored-trust may insure the lives of directors, officers, managers, nonmanagement employees, and retirees.</li> <li>• Coverage for nonmanagement and retired employees is limited to an amount commensurate with the employer's unfunded employee benefit liabilities.</li> </ul>	<ul style="list-style-type: none"> <li>• Employee written consent is required.</li> </ul>
Vermont	<ul style="list-style-type: none"> <li>• No statutory definition of employer or employer-sponsored-trust insurable interest exists.</li> </ul>	<ul style="list-style-type: none"> <li>• No statutory consent requirement exists.</li> </ul>
Virginia	<ul style="list-style-type: none"> <li>• A corporate employer or employee benefit trust may insure the lives of key employees and other employees who have been employed for 12 consecutive months.</li> <li>• Coverage on non-key employees is limited to an amount commensurate with employer-provided benefits to these employees.</li> </ul>	<ul style="list-style-type: none"> <li>• Written notice is required.</li> </ul>
Washington	<ul style="list-style-type: none"> <li>• For people not closely related, an insurable interest includes a lawful and substantial economic interest in having the life of the insured person continue.</li> </ul>	<ul style="list-style-type: none"> <li>• Written consent of insured is required, but the requirement is not specific to business-owned policies and excludes group life insurance.</li> </ul>
West Virginia	<ul style="list-style-type: none"> <li>• For people not closely related, an insurable interest includes a lawful and substantial economic interest in having the life of the insured person continue.</li> </ul>	<ul style="list-style-type: none"> <li>• Written consent of insured is required, but the requirement is not specific to business-owned policies and excludes group life insurance.</li> </ul>

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<b>State</b>	<b>Employer and employer-sponsored trusts' insurable interest in current and former employees</b>	<b>Requirements for notifying or obtaining consent of insured employees</b>
Wisconsin	<ul style="list-style-type: none"> <li>• No statutory definition of employer or employer-sponsored-trust insurable interest exists.</li> </ul>	<ul style="list-style-type: none"> <li>• Written consent of insured is required, but the requirement is not specific to business-owned policies.</li> </ul>
Wyoming	<ul style="list-style-type: none"> <li>• For people not closely related, an insurable interest includes a lawful and substantial economic interest in having the life of the insured person continue.</li> </ul>	<ul style="list-style-type: none"> <li>• Written consent of insured is required, but the requirement is not specific to business-owned policies and excludes group life insurance.</li> </ul>

Source: GAO analysis of state statutes.

<sup>a</sup>The Texas Department of Insurance noted that, notwithstanding the statute's language, based on its legislative history, the department has consistently maintained that employee consent is required.

# Comments from the Department of the Treasury

Note: GAO comments supplementing those in the report text appear at the end of this appendix.



DEPARTMENT OF THE TREASURY  
WASHINGTON, D.C. 20220

APR 23 2004

Ms. Davi M. D'Agostino  
Director, Financial Markets and Community Investment  
U.S. General Accounting Office  
441 G Street, NW, Room 2440B  
Washington, DC 20548

Dear Ms. D'Agostino:

Because the policy issues concerned with business-owned life insurance are tax-related issues, Secretary Snow has asked that I provide Treasury's comments with regard to the GAO draft report, "Business-Owned Life Insurance: More Data Could Be Useful in Making Decisions About Its Tax Treatment."

The draft report is well-researched and informative. It provides useful descriptions concerning the prevalence and use of business-owned life insurance, current regulatory requirements regarding such insurance, and the potential usefulness of more comprehensive data on the ownership and scope of these products. Our comments are limited to a clarification of the current tax treatment of interest as it relates to business-owned life insurance and to a few remarks relevant to the possible collection of additional data by the Internal Revenue Service.

On the whole, the report accurately describes the tax treatment of business-owned life insurance and of interest on loans used to finance such insurance. However, the report leaves the impression that interest that is not linked directly to business-owned life insurance is almost always deductible.

"Borrowing to indirectly finance policies presents a tax advantage to businesses because they receive tax-deferred inside buildup from life insurance policies indirectly financed with debt on which the interest expense is tax-deductible." (p. 30).

This is not entirely correct. Subsection (f) of section 264 of the Internal Revenue Code generally allocates a portion of the interest expense of a business to its unborrowed policy cash values. Thus, in general, if unborrowed policy cash values comprise x percent of the assets of a business, then x percent of interest is held to be nondeductible. However, this provision does not apply to policies that cover the life of any person that owns at least 20 percent of the stock or voting power of a corporation or 20 percent of the capital or profits of a noncorporate business. It also does not apply to contracts that cover the life of a person who is an officer, director, or employee of the business at the time he or she is first covered by the contract. Thus, this rule does not apply with respect to most contracts considered in your report, but does apply to contracts covering insureds who are not employees, such as customers, borrowers, or lenders of the business. The provision also is limited to corporations and partnerships; it does not apply to sole proprietorships.

See comment 1.

Now on p. 29.

**Appendix III**  
**Comments from the Department of the**  
**Treasury**

Now on p. 36.

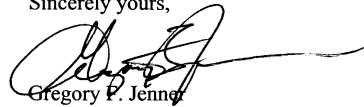
The report suggests that additional data on business-owned life insurance could be collected on applicable IRS forms (p. 38). We are somewhat apprehensive with regard to this suggestion, and are concerned with imposing additional reporting burdens on taxpayers when the information collected does not have direct usefulness in the calculation of tax liability or in enhancing the ability of the IRS to audit tax returns. The types of information being discussed (e.g., the purpose underlying the purchase of policies, the amounts of income not subject to tax, policy cash surrender values, annual premiums paid) do not appear to support these reasons for reporting information on tax returns. Therefore, we do not believe the collection of such information, whether administratively or as the result of a Congressional requirement, to be useful or advisable.

Now on p. 36.

We also have doubts as to the efficacy of the report's suggestion that a survey, or surveys, could be employed by Treasury to gather the desired information (p. 38). Well-constructed surveys can be costly to design and distribute, and can be a burden on respondents. Past experience indicates that, without a penalty for noncompliance, there would be a low response rate to such a survey, and that such a response rate would cast suspicions on the results as being non-representative of the totality of business-owned life insurance. Furthermore, except as a derivative of its function as tax collector, Treasury is not a statistical gathering agency. We believe a survey of insurance products could be better performed by other organizations or agencies.

Please do not hesitate to contact us if you have further questions.

Sincerely yours,



Gregory F. Jenner  
Acting Assistant Secretary (Tax Policy)



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The Department of the Treasury (Treasury) commented on our matter for congressional consideration, which suggested that, among other alternatives, Congress could assign responsibility to Treasury for collecting data on business-owned life insurance. We discuss these comments in the Agency Comments and Our Evaluation section of this report. We also modified the report based on the technical comments that Treasury provided, as appropriate. In addition, discussed below is GAO's detailed response to another comment from Treasury's April 23, 2004, letter.

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## GAO Comments

1. Treasury commented that the report leaves the impression that interest not linked directly to business-owned life insurance is almost always deductible, noting that the Internal Revenue Code generally allocates a portion of the interest expense of a business to its unborrowed policy cash values. However, Treasury also noted that this provision does not apply to contracts that cover the life of a person who is an officer, director, or employee of the business. Our report addresses business-owned life insurance as permanent insurance that an employer purchases on the lives of employees, with the business as the beneficiary. Because the provision cited by Treasury does not apply to this type of insurance, we do not discuss it in the report.

# Comments from the Internal Revenue Service



COMMISSIONER

DEPARTMENT OF THE TREASURY  
INTERNAL REVENUE SERVICE  
WASHINGTON, D.C. 20224

April 22, 2004

Ms. Davi M. D'Agostino  
Director, Financial Markets and Community Investment  
United States General Accounting Office  
Washington, DC 20548

Dear Ms. D'Agostino,

Thank you for allowing us to review and comment on your draft report titled "Business-Owned Life Insurance: More Data Could Be Useful in Making Decisions About Its Tax Treatment." Although your comprehensive report does not contain audit recommendations, it does accurately account for the factors that influence the IRS' audits of businesses that own life insurance.

The IRS' efforts regarding business-owned life insurance have centered on broad-based Corporate-Owned Life Insurance (COLI) and have culminated in the favorable resolution, by litigation or settlement, of the vast majority of cases. The government successfully leveraged its litigation victories in major cases through Announcement 2002-96, which offered taxpayers a final opportunity to settle their cases on terms highly favorable to the government. Most taxpayers accepted the settlement and, as a result, just a small number of broad-based post-1985 COLI cases remain unresolved.

The IRS has also conducted in-depth audits of taxpayers with certain pre-1986 abusive COLI plans. One such case is currently in Appeals jurisdiction and another one was recently docketed for trial in the U.S. District Court for the District of Minnesota. The government expects to vigorously defend its position in that case.

Audit activity regarding Bank-Owned Life Insurance (BOLI) is currently confined to a small number of cases judged to represent a typical cross-section of BOLI products and taxpayers. The results of our review will determine the need for any additional action.

During our exit conference with GAO, the Large and Mid-Size Business (LMSB) Division and the LMSB Division Counsel provided detailed comments on your Statement of Facts for the Business-Owned Life Insurance review. If you have any questions, please contact John Petrella, Director, Heavy Manufacturing and Transportation Industry at (732) 452-8102.

Sincerely,

*For Mark W. Everson*

Mark W. Everson

# Comments from the Securities and Exchange Commission

Note: GAO comments supplementing those in the report text appear at the end of this appendix.



DIVISION OF  
CORPORATION FINANCE

UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549

April 13, 2004

Davi M. D'Agostino  
Director, Financial Markets and Community Investment  
441 G Street, NW  
Washington, DC 20548

Dear Ms. D'Agostino:

Thank you for the opportunity to review and comment on the General Accounting Office's draft report regarding Business-Owned Life Insurance. While the GAO does not recommend executive action, it does suggest how to proceed should Congress decide that it needs more comprehensive data on business-owned life insurance. We appreciate the opportunity to comment on these suggestions.

The GAO concludes that should Congress decide it needs more data on business-owned life insurance, it could have the SEC, the Department of Treasury or the National Association of Insurance commissioners collect the data from businesses or insurance companies. I would like to make two very important points in response to this conclusion. First, the SEC's mission in requiring filings by public companies is to provide investors with information that is material to investment and voting decisions. With this in mind, we are concerned that the collection of data by the SEC for purposes other than the protection of investors may not be appropriate and may establish an unfortunate precedent for other information collections that could clutter the material information that investors seek and expect from the filings companies make with the SEC. Second, please note that the efficacy of such an information collection program through SEC filings would be constrained by the federal securities law's limitations on those companies that are required to file information with the SEC.

Thank you again for this opportunity to provide comments to the GAO as it prepares its final draft of the report.

Sincerely,

A handwritten signature in black ink, appearing to read "ALB", written over a horizontal line.

Alan L. Beller  
Director

See comment 1.

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The Securities and Exchange Commission (SEC) commented on our matter for congressional consideration, which suggested that, among other alternatives, Congress could assign responsibility to SEC for collecting data on business-owned life insurance. We discuss these comments in the Agency Comments and Our Evaluation section of this report. We also modified the report based on the technical comments that SEC provided, as appropriate. In addition, discussed below is GAO's detailed response to another comment from SEC's April 13, 2004, letter.

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## GAO Comments

1. SEC commented that the efficacy of an information collection program through SEC filings would be constrained by the federal securities law's limitations on those companies that are required to file information with SEC. Our report recognizes on page 36 that SEC only collects data from public companies. As Congress evaluates the need for additional data, it might determine that data from a subset of all companies would provide adequate information.

# Comments from the National Association of Insurance Commissioners

Note: GAO comments supplementing those in the report text appear at the end of this appendix.



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April 19, 2004

Ms. Davi M. D'Agostino  
Director, Financial Markets and Community Investment  
U.S. General Accounting Office  
441 G Street, NW  
Washington, DC 20548

Dear Ms. D'Agostino:

Thank you for the opportunity to provide you with feedback on the GAO's draft report entitled, *Business-Owned Life Insurance: More Data Could Be Useful in Making Decisions About Its Tax Treatment*. The NAIC appreciates the opportunity to respond to your findings in this report. We also appreciate the opportunity to have assisted during the development of the report by meeting with the GAO to provide background information.

The NAIC has been interested in this issue for some time and has also reviewed the subject. During 2002, the NAIC appointed a working group, chaired by Commissioner Jim Poolman of North Dakota, to review the NAIC's earlier guidance and to recommend an appropriate state response. The NAIC's COLI Working Group reviewed the model guidelines mentioned in your report and recommended an additional provision that requires written affirmative consent prior to purchase of coverage on an employee. The changes to the model guidelines also acknowledged that coverage might continue after the person was no longer employed by that company and prohibited the employer from retaliating in any way against an employee who chose not to give that consent. The working group also considered requiring notification of the employee's spouse and including a provision that would require employers to make notification to all existing employees where coverage was already in place. These provisions were not ultimately included because of the negative effect they would have on employers in relation to the benefit that would be provided.

As mentioned in the report, the majority of states do define insurable interest in such a way as to allow employers to purchase life insurance coverage on some, if not all, employees. Many states also require getting consent prior to that purchase. The report also notes that in many cases the coverage is purchased specifically to

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**Appendix VI**  
**Comments from the National Association of**  
**Insurance Commissioners**

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Ms. Davi M. D'Agostino  
Director, Financial Markets and Community Investment  
April 19, 2004  
Page 2 of 2

See comment 1.  
Now on p. 4.

fund employee benefits and some state laws require that the policies be segregated into a trust for that purpose. Page 5 of your report may mislead readers by specifying that four insurance regulators have issued guidelines applicable to business-owned life insurance. Readers may assume that the report is referring to the four states interviewed, or may be confused by the wording to believe that only four states have such requirements. A reading of the chart contained in Appendix II will clarify that, in fact, most states have guidelines.

The report correctly states that insurance regulators have collected little data on business-owned life insurance because concerns about abuse or misuse of the policies have not been previously forthcoming. The GAO suggests that the NAIC might be a source of information about the extent of business-owned life insurance by adding the reporting of that information to the annual statement that insurers are required to file with the NAIC. As you are aware, the NAIC collects a large amount of data from the insurance industry, a large portion of which is included in the annual and quarterly financial filings submitted to the states to support solvency regulation. The current statutory filing requirements do not require the level of detail for business-owned life insurance, or any other specialty line of business, contemplated by the GAO in this report. We believe that what the GAO is suggesting by the collection of more detailed information on business-owned life insurance goes beyond that needed to support solvency regulation. We agree there may be a significant cost associated with the collection of this data, both from the reporting entity and collecting organization standpoint; however, the NAIC would like to better understand the type of information to be collected to further evaluate the need for and utility of this information. Perhaps instead of an ongoing data collection effort, a study sampling this data may be more cost effective in assessing the larger need for ongoing data collection.

Thank you again for the opportunity to respond to the findings in your report. We hope these comment are helpful and that you will contact us if we can be of further assistance.

Sincerely,



Ernst N. Csiszar  
NAIC President  
Director, South Carolina Department of Insurance

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The National Association of Insurance Commissioners (NAIC) commented on our matter for congressional consideration, which suggested that, among other alternatives, Congress could encourage NAIC to collect data on business-owned life insurance. We discuss these comments in the Agency Comments and Our Evaluation section of this report. We also modified the report based on the technical comments that NAIC provided, as appropriate. In addition, discussed below is GAO's detailed response to another comment from NAIC's April 19, 2004, letter.

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## **GAO Comments**

1. NAIC commented that a statement on page 5 of our draft report may lead readers to believe that only four states have issued guidelines applicable to business-owned life insurance. We modified that statement to clarify that we are referring only to the four states we contacted. Although many other states have issued guidelines and requirements that are applicable to business-owned life insurance, we only discussed regulatory oversight of such policies with officials from the four states that we contacted.

# GAO Contacts and Staff Acknowledgments

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## GAO Contacts

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Cecile Trop, (312) 220-7600

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## Staff Acknowledgments

In addition to those individuals named above, Joseph Applebaum, Emily Chalmers, Rachel DeMarcus, Daniel Meyer, Marc Molino, Carl Ramirez, and Julianne Stephens made key contributions to this report.



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