

EXPAND PRO RATA INTEREST EXPENSE DISALLOWANCE FOR CORPORATE-OWNED LIFE INSURANCE (COLI)

Current Law

In general, no Federal income tax is imposed on a policyholder with respect to the earnings credited under a life insurance or endowment contract, and Federal income tax generally is deferred with respect to earnings under an annuity contract (unless the annuity contract is owned by a person other than a natural person). In addition, amounts received under a life insurance contract by reason of the death of the insured generally are excluded from gross income of the recipient.

Interest on policy loans or other indebtedness with respect to life insurance, endowment or annuity contracts generally is not deductible, unless the insurance contract insures the life of a key person of the business. A key person includes a 20-percent owner of the business, as well as a limited number of the business' officers or employees. However, this interest disallowance rule applies to businesses only to the extent that the indebtedness can be traced to a life insurance, endowment or annuity contract.

In addition, the interest deductions of a business other than an insurance company are reduced to the extent the interest is allocable to unborrowed policy cash values based on a statutory formula. An exception to the pro rata interest disallowance applies with respect to contracts that cover individuals who are officers, directors, employees, or 20-percent owners of the taxpayer. In the case of both life and non-life insurance companies, special proration rules similarly require adjustments to prevent or limit the funding of tax-deductible reserve increases with tax preferred income, including earnings credited under life insurance, endowment and annuity contracts that would be subject to the pro rata interest disallowance rule if owned by a non-insurance company.

Reasons for Change

Leveraged business can fund deductible interest expenses with tax-exempt or tax-deferred income credited under life insurance, endowment or annuity contracts insuring certain types of individuals. For example, these businesses frequently invest in investment-oriented insurance policies covering the lives of their employees, officers, directors or owners. These entities generally do not take out policy loans or other indebtedness that is secured or otherwise traceable to the insurance contracts. Instead, they borrow from depositors or other lenders, or issue bonds. Similar tax arbitrage benefits result when insurance companies invest in certain insurance contracts that cover the lives of their employees, officers, directors or 20-percent shareholders and fund deductible reserves with tax-exempt or tax-deferred income.

Proposal

The proposal would repeal the exception from the pro rata interest expense disallowance rule for contracts covering employees, officers or directors, other than 20-percent owners of a business that is the owner or beneficiary of the contracts.

The proposal would apply to contracts entered into after the date of enactment.