Understanding Basic BOLI (Bank Owned Life Insurance)

Institutions often purchase life insurance as a way to increase their yield on General Assets. The non-taxable yield on the cash value assets provides the institution with a vehicle that allows them to use a pre-tax earnings rate on the cash value increase within the policy. Also, since the yield is not currently taxable, they are able to increase their asset base annual at a favorable tax-sheltered basis.

This type of BOLI is usually purchased with a single premium as the institution is seeking to gain a first year profit and continuing. Unfortunately, this type of life insurance does not meet the Internal Revenue Code Section 7702 A test for life insurance. It is a Modified Endowment Contract (or MEC). A MEC involves the payment of a single premium at the inception of the contract. As a result, it fails the seven-pay test as provided in the statue.

MEC policies are denied some of the most favorable tax treatment accorded to life insurance. Most distributions, including loans, are treated as taxable income. Also, a penalty tax of 10 percent is imposed on distributions too.

It is primarily for this reason that single premium MEC policies are kept until death of the executive or executives insured. Even if the policy is 1035 exchanged for another due to under performance, it is still a MEC.

Basically, once a life insurance policy is a MEC, all exchanged policies are MECs.

If non-qualified deferred compensation plans are established using these policies, cost recovery is delayed until the insured employee dies. The employees who receive benefits have no ownership interest in the insurance and might not be the insured under the policy. Cost recovery would then be delayed until the insured executive dies.

The basic method of deferred compensation is usually the cost recovery method, involving present value analysis. The institution projects the amount of expected benefits owed to the executive and discounts this amount to determine its present value of the benefit. The gains from the (MEC) proceeds of the life insurance proceeds reimburses the institution for the benefit payments.

This method subjects the institution to 409 A deferred compensation rules, FASB accounting liabilities, cash outlays, benefit costs and the cost of purchasing the life insurance, which was intended for earnings enrichment.

The Economic Benefit Program And Split-Dollar Plans

Revenue Ruling 2003–105 establish the final regulation of split-dollar life insurance plans. It created two separate regimes, the Economic Benefit Regime (formally endorsed split-dollar) and the Loan Regime (formally the collateral assignment split-dollar).

In the banking arena, a major difference was created. Prior to Rev Ruling 2003-105, both techniques were taxed under the same method; FASB 85-4, a cash value method.

However, the new Loan Regime is considered an insider loan for purposes of Reg O, under the federal reserve banking rules. Therefore we will concentrate our efforts on the Economic Benefit Regime.

In the Economic Benefit Regime, the institution is the owner of the life insurance policy. The life insurance policy is not a MEC, as it conforms to and meets the Internal Revenue Code section 7702A, test for life insurance.

As a result, the most favorable tax treatment is accorded to these policies. Distributions up to basis and loans beyond basis, are not treated as taxable income. There is no 10% penalty tax either. The insured executive, when he or she gains ownership of the policy, can make non-taxable loans well beyond basis from the policy for various living and retirement needs. Upon his or her death, any policy loans are paid by the life insurance death benefit, and the balance paid to his or her beneficiary. The Economic Benefit design allows the institution to recover its premium asset at retirement and not at death.

THE RIBA ECONOMIC BENEFIT PROGRAM

PLAN HIGHLIGHTS

INSTITUTION

1) NO 409A DEFERRED COMP INVOLVEMENT

2) NO FASB LIABILITY

3) NO LOSS OF CASH OUTLAY

4) NO REG O INVOLVEMENT

5) NO FDIC VIOLATIONS

6) NO SEC VIOLATIONS

7) NO SARBANES-OXLEY INVOLVEMENT

8) SIMPLICITY OF ADMINISTRATION

EXECUTIVE

1) LIFETIME EXECUTIVE DEATH BENEFIT

2) PROVIDES NON-TAXABLE POLICY INCOME TO EXECUTIVE

3) HIGH YIELD (20+%) LOW RISK EXECUTIVE PLAN

4) TOP HAT PLAN EXCLUSION APPLIES

PLAN STRUCTURE:

1. BANK IS OWNER OF THE POLICY

2. POLICY IS SPLIT DOLLAR WITH THE EXECUTIVE

3. COMPLIES WITH REGULATORY RULES PER OCC BULLETIN 2004-56

4. FULL COST RECOVERY

5. PLAN IS CARRIED AS AN ASSET ON THE BALANCE SHEET