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# Investing in BOLI/COLI When Tight on Liquidity

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## Investing in BOLI/COLI when Liquidity is Tight

Management teams are responsible for ensuring that their company's investments are getting the best returns. One investment option that they may consider is Bank Owned Life Insurance (BOLI) or Corporate Owned Life Insurance (COLI). While BOLI/COLI can provide a variety of benefits, many companies with tight liquidity overlook life insurance as one of their investment options.

In this whitepaper, we will discuss how companies that are tight on liquidity may still have the opportunity to invest in BOLI/COLI.

## Understanding BOLI/COLI

BOLI is typically purchased as a single-premium investment, with one large premium paid at the time the policy is purchased. Due to this payment structure, these policies are typically considered Modified Endowment Contracts (MECs), which we will discuss in more detail in the next section. COLI, on the other hand, can be funded by a single lump sum premium, or more typically, through a series of annual payments.

To better understand why BOLI/COLI can be considered a viable investment alternative for many companies, below are a few of the most common benefits:

- Earnings and insurance proceeds can be used to offset the costs of new and existing employee benefit plan expenses, offset costs of Nonqualified Plans for key employees and provide Keyperson Life Insurance
- Death benefits are received by the corporate beneficiary 100% income tax-free
- Cash Value Earnings are income tax-free if policy is held to maturity.
- Allows for portfolio diversification, without adding additional risk
- Immediately accretive to earnings and improves non-interest income and shareholder value
- Cash values are backed by highly-rated insurance companies with a strong AAA credit rating

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***Earnings and insurance proceeds from BOLI/COLI can be used to offset employee benefit plan expenses.***

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## Modified Endowment Contract (MEC)

A MEC is a heavily funded life insurance policy (typically single-premium) that provides higher cash yields and lower death benefits and is taxed less favorably than other life insurance contracts, unless the policy is held to maturity where all benefits are tax-free.

- For life insurance policies issued June 21, 1988 or later, if the cumulative premium paid exceeds the premium limit established by the Internal Revenue Code (IRC Section 7702), the policy is classified as a **MEC**
- A **10% penalty tax** is imposed on any Cash Value amount received and is includable in gross income unless the distribution is made after the taxpayer becomes disabled, attains age 59 ½, or the distribution is part of a series of substantially equal periodic payments made for the taxpayer’s life or life expectancy

## MEC vs. Non-MEC

|   | MEC                                  | Non-MEC                                 |
|---|--------------------------------------|---|
| Tax-Deferred Cash Value Growth              | Yes                                  | Yes                                     |
| Tax-Free Death Proceeds                     | Yes                                  | Yes                                     |
| Tax-Free Policy Loans                       | No                                   | Yes                                     |
| Tax-Free Withdrawals to Basis               | No / LIFO                            | Yes / FIFO                              |
| Avoids 10% Penalty on Withdrawals and Loans | No / LIFO                            | Yes / FIFO                              |
| Initial Death Benefits                      | Low minimums to qualify as insurance | Higher due to premium payment structure |
| 1035 Exchange Charge/Restrictions           | Typical (15 years)                   | Possibly                                |

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***A MEC provides higher cash yields and lower death benefits.***

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## Non-MEC BOLI Alternative

An alternative to using a Single Premium MEC product for a BOLI/COLI purchase is to use an **annual premium, non-MEC product**. Non-MEC BOLI/COLI requires a substantially lower up-front cash commitment, which allows companies experiencing lower liquidity the opportunity to use this financing tool. The annual premium product still has a tax-free death benefit, which can be used to recover the cost of benefits and premiums paid, but has smaller equal premium payments spread out over several years. Additionally, the company has tax-free and MEC penalty-free, access to the policy cash values at any time. It is a benefit to have the cash values available if needed, however, paying retirement benefits with company earnings is more efficient than using the cash value.

### Advantages to Annual Premium, Non-MEC

- Lower annual payments to help free up liquidity
- Higher initial death benefit than with a single premium product
- Able to pay retirement benefits from policy cash value (tax-free)
  - Withdrawals of cash up to basis without income tax or MEC penalty
  - Loans against policy gain without penalty
- Ability to change the insured on an inforce policy
  - For banks with a young workforce this is ideal where some turnover is likely

### Disadvantages to Annual Premium, Non-MEC

- Commitment to paying an annual premium
- Slightly lower initial yields than a single premium product
- Potential need for insured to go through medical underwriting (versus Guaranteed Issue underwriting) due to higher initial death benefit levels

## Conclusion

The annual premium non-MEC product gives the business more flexibility in times of lower liquidity and allows for an easy change of insured option. The initial investment is much smaller than a single premium product and provides the business the same options. The business must be prepared to make all annual premium installment payments to realize benefits and yields. BOLI/COLI is a great option to consider when thinking of key employees, liquidity and the return of investments for the company. The following pages provide examples of annual premium BOLI purchases, with SERP benefits being paid from company earnings and policy cash value.

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***Non-MEC BOLI/COLI requires a lower up-front cash commitment, which allows companies experiencing lower liquidity the opportunity to use this financing tool.***

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## SAMPLE ANNUAL PREMIUM BOLI/COLI PURCHASE

### SERP Assumptions:

Company Pays SERP Benefit from Company Earnings

Retirement Age: 65 | Annual Benefit: \$100,000 | Benefit Duration: 10 Years

| Age       | Annual Premium     | Illustrated Net Cash Value | Illustrated Cash Value Yield | Tax Equivalent Yield* | Illustrated Death Benefit | Annual Retirement Benefit |
|-----------|--------------------|----------------------------|------------------------------|-----------------------|---------------------------|---------------------------|
| 50        | (\$50,000)         | \$51,102                   | 2.20%                        | 3.39%                 | \$654,894                 | \$0                       |
| 51        | (50,000)           | 102,435                    | 1.32%                        | 2.03%                 | 654,894                   | 0                         |
| 52        | (50,000)           | 153,373                    | 0.62%                        | 0.95%                 | 654,894                   | 0                         |
| 53        | (50,000)           | 203,163                    | -0.10%                       | -0.16%                | 654,894                   | 0                         |
| 54        | (50,000)           | 254,913                    | 0.69%                        | 1.06%                 | 654,894                   | 0                         |
| 55        | (50,000)           | 307,695                    | 0.91%                        | 1.40%                 | 654,894                   | 0                         |
| 56        | (50,000)           | 361,640                    | 1.10%                        | 1.70%                 | 654,894                   | 0                         |
| 57        | 0                  | 371,145                    | 2.63%                        | 4.04%                 | 654,894                   | 0                         |
| 58        | 0                  | 379,799                    | 2.33%                        | 3.59%                 | 654,894                   | 0                         |
| 59        | 0                  | 390,396                    | 2.79%                        | 4.29%                 | 654,894                   | 0                         |
| 60        | 0                  | 399,873                    | 2.43%                        | 3.73%                 | 654,894                   | 0                         |
| 61        | 0                  | 417,028                    | 4.29%                        | 6.60%                 | 654,894                   | 0                         |
| 62        | 0                  | 434,919                    | 4.29%                        | 6.60%                 | 654,894                   | 0                         |
| 63        | 0                  | 453,567                    | 4.29%                        | 6.60%                 | 667,825                   | 0                         |
| 64        | 0                  | 472,970                    | 4.28%                        | 6.58%                 | 685,742                   | 0                         |
| 65        | 0                  | 493,150                    | 4.27%                        | 6.56%                 | 704,229                   | 100,000                   |
| 66        | 0                  | 514,134                    | 4.26%                        | 6.55%                 | 723,287                   | 100,000                   |
| 67        | 0                  | 535,946                    | 4.24%                        | 6.53%                 | 742,936                   | 100,000                   |
| 68        | 0                  | 558,614                    | 4.23%                        | 6.51%                 | 763,176                   | 100,000                   |
| 69        | 0                  | 582,174                    | 4.22%                        | 6.49%                 | 784,041                   | 100,000                   |
| 70        | 0                  | 606,639                    | 4.20%                        | 6.47%                 | 805,566                   | 100,000                   |
| 71        | 0                  | 632,017                    | 4.18%                        | 6.44%                 | 827,767                   | 100,000                   |
| 72        | 0                  | 658,294                    | 4.16%                        | 6.40%                 | 850,652                   | 100,000                   |
| 73        | 0                  | 685,466                    | 4.13%                        | 6.35%                 | 874,230                   | 100,000                   |
| 74        | 0                  | 713,550                    | 4.10%                        | 6.30%                 | 898,542                   | 100,000                   |
| 75        | 0                  | 742,587                    | 4.07%                        | 6.26%                 | 923,628                   | 0                         |
| 80        | 0                  | 903,613                    | 3.95%                        | 6.07%                 | 1,061,888                 | 0                         |
| 85        | 0                  | 1,090,656                  | 3.75%                        | 5.77%                 | 1,222,037                 | 0                         |
| 90        | 1,370,613          | 0                          | 0.00%                        | 0.00%                 | 0                         | 0                         |
| <b>PV</b> | <b>(\$103,900)</b> |                            |                              |                       |                           |                           |

Cost Recovery of premiums, interest, and benefits paid

Paid from Company Earnings

\*Assumes 28% Tax Rate; 5.0% cost of money.

Insurance values based on non-guaranteed 5.0% Tier 1 Interest crediting rate. Assumes Age 50, Premier, Non-Tobacco UW status. Retirement benefits paid from company earnings; Premiums and SERP benefits recovered from death benefit proceeds.

## SAMPLE ANNUAL PREMIUM BOLI/COLI PURCHASE

### SERP Assumptions:

Company Pays SERP Benefit from Policy Cash Values

Retirement Age: 65 | Annual Benefit: \$100,000 | Benefit Duration: 10 Years

| Age       | Annual Premium     | Illustrated Net Cash Value | Illustrated Cash Value Yield | Tax Equivalent Yield* | Illustrated Death Benefit | Annual Retirement Benefit |
|-----------|--------------------|----------------------------|------------------------------|-----------------------|---------------------------|---------------------------|
| 50        | (\$85,000)         | \$86,937                   | 2.28%                        | 3.51%                 | \$1,113,320               | \$0                       |
| 51        | (85,000)           | 174,269                    | 1.36%                        | 2.09%                 | 1,113,320                 | 0                         |
| 52        | (85,000)           | 260,933                    | 0.64%                        | 0.99%                 | 1,113,320                 | 0                         |
| 53        | (85,000)           | 345,649                    | -0.08%                       | -0.13%                | 1,113,320                 | 0                         |
| 54        | (85,000)           | 433,700                    | 0.71%                        | 1.09%                 | 1,113,320                 | 0                         |
| 55        | (85,000)           | 523,508                    | 0.93%                        | 1.43%                 | 1,113,320                 | 0                         |
| 56        | (85,000)           | 615,299                    | 1.12%                        | 1.72%                 | 1,113,320                 | 0                         |
| 57        | 0                  | 631,544                    | 2.64%                        | 4.06%                 | 1,113,320                 | 0                         |
| 58        | 0                  | 646,345                    | 2.34%                        | 3.61%                 | 1,113,320                 | 0                         |
| 59        | 0                  | 664,456                    | 2.80%                        | 4.31%                 | 1,113,320                 | 0                         |
| 60        | 0                  | 680,667                    | 2.44%                        | 3.75%                 | 1,113,320                 | 0                         |
| 61        | 0                  | 709,935                    | 4.30%                        | 6.62%                 | 1,113,320                 | 0                         |
| 62        | 0                  | 740,460                    | 4.30%                        | 6.61%                 | 1,113,320                 | 0                         |
| 63        | 0                  | 772,273                    | 4.30%                        | 6.61%                 | 1,137,084                 | 0                         |
| 64        | 0                  | 805,374                    | 4.29%                        | 6.59%                 | 1,167,683                 | 0                         |
| 65        | 72,000             | 764,611                    | 4.26%                        | 6.55%                 | 1,094,178                 | 100,000                   |
| 66        | 72,000             | 721,994                    | 4.24%                        | 6.53%                 | 1,022,178                 | 100,000                   |
| 67        | 72,000             | 677,440                    | 4.22%                        | 6.50%                 | 950,178                   | 100,000                   |
| 68        | 72,000             | 630,869                    | 4.20%                        | 6.46%                 | 878,178                   | 100,000                   |
| 69        | 72,000             | 582,204                    | 4.18%                        | 6.42%                 | 806,178                   | 100,000                   |
| 70        | 72,000             | 531,336                    | 4.14%                        | 6.37%                 | 734,178                   | 100,000                   |
| 71        | 72,000             | 478,145                    | 4.09%                        | 6.30%                 | 662,178                   | 100,000                   |
| 72        | 72,000             | 422,493                    | 4.03%                        | 6.19%                 | 590,178                   | 100,000                   |
| 73        | 72,000             | 363,965                    | 3.84%                        | 5.91%                 | 515,141                   | 100,000                   |
| 74        | 72,000             | 302,318                    | 3.55%                        | 5.46%                 | 435,805                   | 100,000                   |
| 75        | 0                  | 313,073                    | 3.56%                        | 5.47%                 | 428,048                   | 0                         |
| 80        | 0                  | 371,737                    | 3.39%                        | 5.22%                 | 469,974                   | 0                         |
| 85        | 0                  | 434,687                    | 3.02%                        | 4.65%                 | 517,149                   | 0                         |
| 90        | 556,401            | 0                          | 0.00%                        | 0.00%                 | 0                         | 0                         |
| <b>PV</b> | <b>(\$149,142)</b> |                            |                              |                       |                           |                           |

Tax-free policy withdrawals to make after-tax benefit payments

\*Assumes 28% Tax Rate; 5.0% cost of money.

Insurance values based on non-guaranteed 5.0% Tier 1 Interest crediting rate. Assumes Age 50, Premier, Non-Tobacco UW status. Retirement benefits paid from company earnings; Premiums and SERP benefits recovered from death benefit proceeds.

## About the Authors



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David Fritz is the Co-Founder and Managing Partner of Executive Benefits Network and a 37-year veteran of the financial services industry. David began his career in the insurance industry in 1986 after graduating from Williams College with a B.A. degree. David specializes his career in the design, funding and securing and administration of nonqualified deferred compensation plans and Bank Owned and Corporate Owned Life Insurance programs. Mr. Fritz is a Past Director of Finseca, an organization which is recognized as the financial services most important organization focused on legislative lobbying on Capitol Hill as well as providing educational opportunities for the industry's most sophisticated planners. He is the Past Chair of Finseca's COLI/BOLI/Nonqualified Plan Committee. In addition, Mr. Fritz is a Past Trustee of The American College of Financial Services. He also serves on several local Boards including the Milwaukee Country Club and a Trustee of the Village of River Hills.



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Pat is a Co-Owner and Managing Director of Executive Benefits Network and a 23-year veteran of the financial services industry. Prior to entering the financial services industry, Pat worked as a senior accountant in audit for KPMG in the bank service area and as an attorney for Michael Best & Friedrich LLP where he concentrated on general corporate and securities law. Pat's career focus is in the BOLI/COLI marketplace, as well designing creative strategies for executive compensation planning, business succession planning and estate planning. Pat is a shareholder and Director of a bank in Iowa and is an active member in the State Bar of Wisconsin. He is a frequent speaker in industry meetings and seminars.

## About Executive Benefits Network (EBN):

As the leading industry advisor, EBN specializes in the customized design, administration, and informal financing of Nonqualified Executive Compensation and Benefit Plans (Deferred Compensation Plans), as well as the procurement of Bank Owned Life Insurance (BOLI) and Corporate Owned Life Insurance (COLI) programs to attract, retain, and reward key executive talent. We emphasize the importance of education and build long-lasting relationships with clients in all 50 states, and we have access to the highest rated insurance companies in the nation. Lastly, we believe that no two companies are alike in their needs; therefore, customization of executive benefit and compensation plans is paramount to a successful program.