Using Tax Footnotes to Qualify COLI Candidates

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Corporate Owned Life Insurance (COLI) brokers can save time by qualifying COLI prospects and contacting only those companies who would benefit from COLI's tax advantages. A review of a company's financial statements, especially the income tax footnote, will help determine whether a COLI prospect pays income taxes that might be avoided through COLI. A meaningful comparison of COLI to taxable investments requires a comparison of COLI's loads to the taxes on a taxable portfolio. Many corporate tax managers will not be persuaded by numeric exhibits that show taxes paid on investment income of 40% annually—it's not always that simple. The industry term for this comparison of COLI to taxable investments is COLI tax wrapper analysis. This article explores what a COLI broker can glean from tax footnotes to help in this process.

CORPORATE TAX RATES ON INVESTMENT INCOME

First, a quick review of corporate income taxes as they apply to this analysis.

- Capital gains are the primary form of investment income, especially on equity portfolios. Corporations pay capital gains at 35% for federal tax purposes, not the 15% that individuals pay on long term capital gains.

- Unlike COLI losses, capital losses generate tax benefits by offsetting capital gains. Such capital losses are carried back three years and forward five years against capital gains.

- Interest is taxed as ordinary income at the federal rate of 35%.

- Dividends enjoy the dividends received deduction of 70%, effectively taxing dividends on only the remaining 30%.

After-tax investment returns are not only affected by tax rates, but by the timing of those taxes.

- Portfolio turnover affects the timing of capital gains and losses.

- Net operating loss (NOL) carryforwards can change the timing of taxes by allowing the refund of taxes paid in the two years prior to the loss year, with the balance offsetting otherwise taxable income in the next twenty years.

- Alternative Minimum Tax (AMT) credits can also change the timing of taxes. AMT credits occur when AMT exceeds the regular tax. Such credits can be applied to future years to the extent that regular tax exceeds AMT. A company that realizes all of its AMT credits pays the same cumulative taxes as a company that never pays AMT, only earlier.

Potential corporate tax legislation can affect the decision to buy COLI—either by changing the taxation of COLI or by changing the taxation of other investments.

Some multinational corporations with U.S. headquarters minimize corporate taxes through creative transfer pricing between the U.S. parent and non-U.S. subsidiaries, particularly those subsidiaries in foreign tax havens such as Singapore and Ireland. The effect of such transfer pricing is to minimize income taxable under U.S. tax law and maximize taxable income in the more favorable foreign jurisdiction. During his election campaign, President Obama hinted at possible legislation that would tax these unremitted foreign earnings and encourage U.S. based multinationals to repatriate foreign earnings. Repatriated earnings will remove the attractiveness of creative transfer pricing, increase U.S. taxable income, and therefore increase U.S. taxes. Higher U.S. taxes on U.S. investments drive the need for COLI.

State taxes also reduce returns on taxable investments. Because state income taxes are deductible for federal tax purposes, the effective state income tax rate is only 65% of the nominal rate (assuming federal tax savings of 35%). Many companies assume a combined tax of 40% to reflect the federal rate and the state rate net of the federal tax benefit.

INCOME TAX ACCOUNTING

A review of a company's income tax footnote to its financial statements helps explain the effect of income taxes on the organization.

Here's a quick review of accounting for income taxes under FASB's Accounting Standards Codification paragraph 740, Income Taxes. Under ASC 740, companies recognize taxes payable for the current year and deferred tax liabilities for the future tax consequences of transactions recognized in financial statements or tax returns. Tax savings and deferred tax assets receive similar treatment, but we'll focus on taxes payable to simplify this explanation. A current tax liability is recognized for the estimated taxes payable on tax returns for the current year. A deferred tax liability is recognized for the future tax effects of temporary differences, which occur when transactions affect taxable income in one year and the pretax financial income in another (earlier or later) year. A deferred tax liability represents the increase in taxes payable in future years as a result of temporary differences at the end of the current year. ASC 740 allows the non-recognition of deferred tax liabilities on unremitted foreign earnings to the extent that a company never intends to repatriate such earnings. Current and deferred tax liabilities are based on current tax law—future changes in tax laws or rates are not anticipated. Deferred tax assets reflect not only temporary differences, but also NOL carryforwards and AMT credits. Deferred tax assets are reduced by any tax benefits not expected to be realized.

Accounting for taxes on investment income illustrates these points. Investment portfolios outside the context of pensions and post retirement medical funding are generally available to creditors, and recorded at fair value (except for certain debt securities recorded as held-to-maturity). ASC 320, Investments—Debt and Equity Securities, specifies the accounting for such investments and categorizes them as either trading or available-for-sale. Unrealized gains and losses represent temporary differences under ASC 740, creating deferred tax liabilities in the case of gains and deferred tax assets in the case of losses. Changes in the fair value of trading securities flow through the income statement, whereas changes in the fair value of available-for-sale securities flow through other comprehensive income (OCI) until realized. When changes in fair value flow through the income statement (as in trading securities), the related tax expense (or savings) also flows through the income statement. When changes in fair value flow through OCI (as in unrealized gains and losses on available-for-sale securities), the related deferred tax expense (or savings) also flows through OCI. In other words, changes in deferred taxes follow the changes in fair value.

Effective Tax Rate

The footnote to the financial statements includes a reconciliation of the 35% federal statutory rate to the effective tax rate. According to

ASC 740-10-50-12, public entities must disclose a reconciliation (using percentages or dollar amounts) of the federal statutory rate (currently 35%) to the effective tax rate (income tax expense divided by pretax income from continuing operations). Nonpublic companies must disclose only the nature of significant reconciling items but may omit the numerical reconciliation.

COLI brokers may be tempted to use this effective tax rate in COLI tax wrapper analysis, but doing so is a misapplication of this rate. COLI brokers need to know the tax rate applicable to U.S. investment income, the timing of any taxes paid, and the related accounting for these taxes. The effective tax rate in the income tax footnote does not provide this information. The effective tax rate is only the GAAP income tax expense as a percentage of pretax income from continuing operations. Examples show how unrelated transactions affect the effective tax rate without being relevant to taxation of investment portfolios.

- Foreign taxes are rarely exactly 35%. Rates in excess of 35% increase the effective tax rate and vice versa, but foreign taxes are irrelevant to the taxation of U.S. investment income.

- Changes in the deferred tax asset valuation allowance affect the effective tax rate. A valuation allowance is an estimate of the portion of the deferred tax asset that will not be realized. The effect of these changes in the valuation allowance on the effective tax rate is completely misleading in the context of COLI tax wrapper analysis. An increase in the valuation allowance increases the effective tax rate, and vice versa. An increase in the valuation allowance indicates that a company has less need for COLI, not more need as the higher effective tax rate might suggest. This is often because NOL carryforwards have grown so large that at least some portion will expire. Companies that can offset loss carryforwards against otherwise taxable income may not need COLI to avoid taxes. Conversely, a decrease in the valuation allowance indicates that a company has more need for COLI, not less need as the lower effective tax rate might suggest.

- NOL carryforwards affect tax expense only to the extent that they create valuation allowances. Otherwise, such carryforwards only delay the tax effects of transactions. The lack of any change in the effective tax rate is deceptive because NOL carryforwards may cause a company not to buy, or at least postpone buying, COLI.

- Likewise, AMT credits affect tax expense when they create valuation allowances. Ordinarily, such credits only accelerate income tax cash outlays. COLI gains create AMT credits because COLI gains are included in Adjusted Current Earnings (ACE). 75% of the excess of ACE over alternative minimum taxable income (AMTI) calculated without ACE is added to AMTI. AMT credits created by COLI gains and not expected to be fully realized create a tax expense. Even when AMT does not change the effective tax rate, a company may decide not to buy, or at least postpone buying, COLI.

How can COLI brokers decipher the effect of all these tax issues? The best way is to learn the fundamentals of corporate taxation, read the income tax footnote to the prospect's annual report, and then discuss tax assumptions with the prospect. The client's tax manager will have strong opinions on what assumptions to use, but a little homework done ahead of time will minimize wasted time.