IMPACT OF THE TREASURY DEPARTMENT'S FINAL REGULATIONS ON REPORTABLE POLICY SALES ON COLI/BOLI MARKETPLACE

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Disclaimer
This memorandum is not intended to constitute tax or legal advice.

The Regulation
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Background
The Tax Cuts and Jobs Act of 2017 (the **"TCJA"**) modified the prior-law exceptions of the Transfer for Value rules **("TFV Rules"**) to include a new reportable policy sale requirement that is applicable to all transfers for valuable consideration. In March, Treasury and the IRS proposed regulations detailing how this new provision interacts with existing TFV Rules. *This rulemaking has important implications for the company-owned life insurance (**"COLI"**) and bank-owned life insurance (**"BOLI"**) marketplaces and will affect the taxation of death benefits on some contracts.*

For readers unfamiliar with the TFV Rules, the tax code generally excludes the value of death benefits from taxable income. However, when insurance contracts are transferred or assigned in exchange for valuable consideration, the TFV Rules apply and limit the portion of the death benefit that is excludable for tax purposes. Unless an exception applies, under the TFV Rules the tax-free death benefit of a transferred life insurance policy may not exceed the sum of the consideration paid in exchange for the transferee to obtain the contract and the unpaid premiums which will now be paid by the transferee.

Prior to the TCJA, two critical exemptions to the TFV Rules excluded certain transactions involving life insurance contracts. Critically, these two exemptions generally shielded COLI/BOLI policies acquired during ordinary-course mergers and acquisitions (**"Ordinary Course Transactions"**) from the TFV Rules' tax burden.

The TCJA altered the framework for determining the amount of death benefits generally excluded from gross income, thereby potentially impacting the COLI/BOLI marketplace. The TCJA now requires a determination that the transaction is *not* a reportable policy sale before deciding whether the transaction falls under existing exemptions to avoid TFV Rules' tax liability.

On Thursday, October 31, the Treasury Department finalized these rules (the **"RPS Final Rule"**) and published the regulations in the Federal Register. The RPS Final Rule became effective on October 31, 2019. However, taxpayers may choose to apply all of the rules retroactively to December 31, 2017 when the TCJA changes took effect.

Commentary
The purpose of this memorandum is to review the outcome of the recently adopted RPS Final Rule with respect to reportable policy sales occurring between companies engaged in Ordinary Course Transactions that include COLI/BOLI assets. In addition, the conclusion will offer a retrospective review of the improvements since the TCJA was enacted, including changes to address concerns raised by AALU.

General Rules – Transfers for Value & Reportable Policy Sales
Before diving into the changes brought about by the TCJA and the RPS Final Rule, it is first important to understand the existing TFV Rules. It is critical to understand that neither the TCJA, nor the RPS Final Rule alter the TFV Regulations described below. Rather, the changes to the tax code introduced by the TCJA add an additional layer of analysis.

As stated above, section 101(a) of the Internal Revenue Code generally excludes life insurance death benefits from income. However, where a life insurance policy is transferred in exchange for valuable consideration, the policy then may be subject to the TFV Rules which limit the excludable portion of the death benefits to the consideration paid for the policy plus any subsequent premiums paid with respect to the policy.

The statutory TFV Rules have two important exceptions known as the "Carryover Basis Exception" and the "Transfer-to-Insured Exception." Thereby, the TFV Rules apply for <u>any</u> transfer or assignment of a life insurance policy <u>except</u> where: (a) "such contract or interest therein has a basis for determining gain or loss in the hands of a transferee determined in whole or in part by reference to such basis of such contract or interest therein in the hands of the transferor" (the "**Carryover Basis Exception**") or (b) "such transfer is to the insured, to a partner of the insured, to a partnership in which the insured is a partner, or to a corporation in which the insured is a shareholder or officer" ("**Transfer-to-Insured Exception**").

Neither the statutory reportable policy sale provision nor the RPS Final Rule change the TFV Rule described above. In fact, the RPS Final Rule confirms the statute by specifically providing that in order for the death benefits paid with respect to a transferred life insurance policy to be fully excludable from income (1) the policy must not have been transferred in a reportable policy sale <u>and</u> (2) either the Carryover Basis Exception or the Transfer-to-Insured Exception must apply.[1] Thus, the reportable policy sale exceptions discussed below <u>do not expand the universe</u> of life insurance policy transfers that result in policies whose death benefits are fully excludable.

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[1] Treas. Reg. sec. 1.101-1(b)(1)(ii)(A)-(B).

Under the statutory changes enacted by the TCJA, a life insurance policy has been transferred pursuant to a reportable policy sale if (1) there is a direct or indirect a transfer of life insurance **and** (2) the acquirer of the life insurance does not have a "substantial family, business, or financial relationship with the insured apart from the acquirer's interest in such life insurance contract."[2] **If either of these conditions are not met then the transfer is not treated as a reportable policy sale and the Carryover Basis Exception or Transfer-to-Insured Exception to the TFV Rules still apply as before (if assuming such exceptions are otherwise applicable)**.

As will be demonstrated below, this general rule is essential to understand the effect of the Proposal (defined hereafter) on Ordinary Course Transactions.

NOTE: Satisfying any of the exceptions described below will generally be sufficient to preserve the prior-law tax treatment of the death benefits. The only exception that is specific to C corporations is the first. All the other exceptions apply irrespective of the business form of the entities in question. Practitioners reviewing these exceptions with clients in specific situations should especially consider the application of exceptions 1, 7, 8 and 9(c).

Exceptions from Being Considered a Reportable Policy Sale

1. Certain Ordinary Course Transactions involving C Corporations. This exception provides that there is no "indirect transfer" of life insurance where (a) the acquirer becomes a beneficial owner of a C corporation that owns life insurance contracts and (b) life insurance contracts do not comprise more than 50 percent of the gross value of assets of such C corporation immediately before the acquisition.[3]

   As explained above, without a "direct" or "indirect" transfer of a life insurance contract there can be no reportable policy sale—even if an Ordinary Course Transaction is involved.

   Thus, for example, where shares[4] in a C corporation that owns life insurance are acquired by another person there is no indirect transfer of life insurance (and thereby no reportable policy sale) so long as the gross value of the life insurance owned by the C corporation does not exceed 50 percent of the C corporation's gross assets. The RPS Proposal's use of "gross value" in this test is particularly helpful in the case of Ordinary Course Transactions because it means that otherwise insolvent C corporations (*i.e.*, where the fair market value of the C corporation is below zero) can be sold without automatically giving rise to a reportable policy sale.

[2] Sec. 101(a)(3)(B).
[3] Treas. Reg. sec. 1.101-1(e)(3)(ii).
[4] This "C corporation" exception does not apply to direct asset sales. Such transactions may qualify, however, for one of the other "general" reportable policy sale exceptions.

Additionally, the RPS Final Rule confirmed that tax-free **asset** reorganizations and taxable asset transactions do **not** qualify for the C corporation exemption, thereby creating disparate treatment between life insurance policies transferred through stock transfers and those transferred through asset purchases.[5] Put simply, Treasury acknowledged that the exemption **only** applies to stock-transfers and confirmed that asset acquisitions will not qualify.

In addition to the carveout for most indirect transactions involving C corporations, the RPS Final Rule contains a number of exceptions that apply regardless of the type of entity that owns the life insurance. They are –

2. *De Minimis* Acquisition. This exception is for *de minimis* acquisitions of any entity that owns life insurance. It applies where (a) not more than 50 percent of the **gross value** of the entity's assets are life insurance contracts **and** (b) the acquirer (and any family members, if the acquirer is a natural person) own 5 percent or less of the entity (as measured after the acquisition). In such a case, there is no reportable policy sale.[6]

3. Same Beneficial Owners. Another transactional exception to reportable policy sale status is for transfers of interests in life insurance contracts between entities with the same beneficial owners. This exception applies where the ownership interest of each beneficial owner in the transferor entity does not vary by more 20 percent from that person's ownership interest in the transferee entity.[7] For these purposes, transitory transfers are ignored—only the interest in the first and last entity that holds the insurance are examined.

4. Consolidated entities. A further exception to reportable policy sale status applies to transfers of life insurance contracts between entities that are consolidated for tax purposes.[8]

5. Indirect Acquisitions. The RPS Final Rule includes an exception for indirect acquisitions of any entity that owns an interest in a life insurance contract and which acquired the interest in the life insurance contract before January 1, 2019.[9] This exemption is critically important for Ordinary Course Transactions involving holding companies that own operating companies which hold COLI/BOLI policies. In instances where an acquiror purchases a holding company owning a subsidiary holding an interest in life insurance, the exemption will apply, so long as the subsidiary acquired its interest in the life insurance policy prior to January 1, 2019.

[5] RPS Final Rule, 84 Fed. Reg. 57, 58467 (Oct. 31, 2019).
[6] Treas. Reg. sec. 1.101-1(c)(2)(iii)
[7] Treas. Reg. sec. 1.101-1(c)(2)(i).
[8] Treas. Reg. sec. 1.101-1(c)(2)(ii).
[9] Treas. Reg. sec. 1.101-1(c)(2)(iii)(A).

This exemption could prove useful for Ordinary Course Transactions involving banks structured as S corporations which are owned by bank holding companies.

Exceptions based on the Definition of a Substantial Relationship
Other universally applicable carveouts from reportable policy sale status do not depend on the existence of specific transaction types but are related to the determination of whether a substantial "financial" or "business" relationship exists between the acquirer and the insured.

6. Substantial Relationship Rules Generally. The RPS Final Rule includes a helpful rule to establish whether an acquiring entity has a substantial relationship with the insured.[10] The rule specifies that an entity will have a substantial relationship with the insured so long as every "beneficial owner" of the entity has a substantial relationship with the insured; however, these relationships do not need to be all the same type of substantial relationship. Therefore, the entity will be deemed to have a substantial relationship so long as each of the "beneficial owners" have a substantial relationship which they can establish by identifying either some type of substantial familial, business, or financial that the particular owner has with the insured. As an example, a partnership with three partners would itself have a "substantial relationship" with the insured where one partner has a substantial familial relationship with the insured, one partner has a substantial business relationship with the insured, and one partner has a substantial financial relationship with the insured.

7. Special Rule for Indirect Acquisitions of Life Insurance. In applying the substantial relationship tests, an acquirer in an indirect acquisition is deemed to have a substantial business or financial relationship with the insured so long as the acquired entity has a substantial business or financial relationship with the insured both immediately before and immediately after the acquisition.[11] This is a very helpful rule in the case of Ordinary Course Transactions because it "counts" a substantial relationship that exists with respect to either the acquirer or the acquired entity.

8. A Substantial Business Relationship Exists:
    a. where the insured **is** a "key person"[12] of the acquired business or "materially participates"[13] in the acquired business, **and** the acquirer/acquiree directly/indirectly owns at least 80 percent of the acquired business.[14] OR
    b. where (i) the acquirer acquires an **active business**, (ii) the insured (a) **is** an employee of the acquired business immediately before the acquisition **or** (b) **was** a director, highly-compensated employee, or highly-compensated individual of the acquired business **and** immediately after the acquisition the acquirer has ongoing financial obligations to the insured with respect to the

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[10] Treas. Reg. sec. 1.101-1(d)(4)(iii).
[11] Treas. Reg. sec. 1.101-1(d)(4)(i).
[12] As defined in section 264.
[13] As defined in section 469.
[14] Treas. Reg. sec. 1.101-1(d)(2)(i).

insured's employment, **and** (iii) the acquirer carries on the acquired business or uses a significant portion of the acquired business's assets in an active business (not including investing in life insurance contracts).[15]

9. A Substantial Financial Relationship Exists:
    a. where (i) the acquirer (or its beneficial owners) has a common investment with the insured and (ii) it is reasonably foreseeable that in the event of the insured's death his or her interest will be bought out by the co-investors.[16] OR
    b. where the acquirer is (i) either a section 170(c) organization (*i.e.*, certain tax-exempt charitable organizations), an organization described in section 2055(a) (*i.e.*, certain charitable and/or tax exempt organizations), or an organization described in section 2522(a) (*i.e.*, certain charitable and/or tax exempt organizations) and (ii) the particular organization had previously received a substantial amount of financial support or significant volunteer support from the insured.[17] OR
    c. where the acquirer/acquiree has the life insurance contract on the insured to provide funds to purchase assets of or satisfy liabilities of the insured or the insureds estate, heirs, legatees, or successors in interest or to satisfy other liabilities arising upon or by reason of the death of the insured.[18]

       This latter exception detailed in 9(c) was significantly narrowed in the RPS Final Rule. Under the RPS Final Rule, a substantial financial relationship may only arise when at least some portion of the particular liabilities are connected to the insured or their successors in interest. This cuts off the possibility that the funds derived from the life insurance contract could be used **solely** to satisfy liabilities unrelated to the insured, such as funding retiree health benefits, but doesn't describe what quantum of connection must exist. This may prove problematic for certain entities looking to establish the existence of a substantial financial relationship. Further, it is not clear how the IRS will ultimately interpret this exception. Given the lack of clarity on this point (and the possibility that the IRS will take a very narrow view of the exception) practitioners relying on this exception should be particularly cautious.

    d. Another important facet of the rules describing when a substantial business or financial relationship exists is that the rules apply to both indirect and direct transfers of life insurance contracts.[19]

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[15] Treas. Reg. sec. 1.101-1(d)(2)(ii).
[16] Treas. Reg. sec. 1.101-1(d)(3)(i).
[17] Treas. Reg. sec. 1.101-1(d)(3)(iii).
[18] Treas. Reg. sec. 1.101-1(d)(3)(ii).
[19] As noted in greater detail above, direct transfers of life insurance will still have to meet either the Carryover Basis Exception or the Transfer-to-Insured Exception in order to be excepted from the TFV rules (thereby making the death benefits paid with respect to such insurance eligible for full income exclusion under section 101(a)).

1035 Exchanges of Life Insurance Policies

The Final RPS Rule clarifies the **requirements** with respect to section 1035 exchanges of life insurance policies. The rule is twofold. First, for a life insurance company that is party to a section 1035 exchange, the rule provides that its acquisition of the old policy is not treated as a reportable policy sale.[20] More importantly, however, for the exchanging policyholder the RPS Final Rule provides that the acquisition of the new policy is treated as a reportable policy sale **unless** the policyholder qualifies for one of the "Substantial Relationship" exemptions described in points 6, 7, 8, and 9.[21] **Thus, for section 1035 exchanges on policies on the life of a former employee, for example, the exchanging policyholder may lack a sufficient substantial relationship with the insured in order to avoid reportable policy sale status, making the death benefit partially taxable.**

These clarifications clearly apply to section 1035 exchanges that occur after October 31, 2019. It is less clear at this junction how the guidance applies to section 1035 exchanges that occurred between the TCJA's enactment and the final rule's adoption. If you have any questions about this nuance, please contact us.

Effective Dates and Information Reporting

The RPS Final Rules will generally be effective on October 31, 2019. However, they also allow taxpayers to choose to apply the rules included in Treasury Regulation section 1.101-1(b)-(g) (including those described above) "with respect to all amounts paid by reason of the death of the insured under a life insurance contract, or interest therein, transferred after December 31, 2017" as long as those rules are applied in their entirety.[22] In effect, the effective date allows (but does not require) taxpayers to apply these rules retroactively to enactment date of the TCJA. This was a key ask of AALU's comment letter to the Treasury Department.

For purposes of the information reporting required under Section 6050Y, Treasury has provided effective dates as well. In response to comments, Treasury decided to push back the effective date of the rules applying to reportable policy sales made and reportable death benefits paid. Under the RPS Proposal, those rules would apply to reportable policy sales made and reportable death benefits paid after December 31, 2017. The RPS Final Rule pushes that date back to give acquirers and issuers ample time to develop and implement reporting systems. The RPS Final Rule provide that rules contained in §§ 1.6050Y-1 through 1.6050Y-4 to apply to reportable policy sales made and reportable death benefits paid after December 31, 2018.[23]
In addition, the sections defining "reportable death benefits" only applies to transfers of interest in life insurance contracts made after December 31, 2018.

[20] Treas. Reg. sec. 1.101-1(c)(2)(iv).
[21] Treas. Reg. sec. 1.101-1(c)(2)(v).
[22] Treas. Reg. sec. 1.101-6(b)
[23] *See* Treas. Reg. sec. 1.6050Y-1(b)

In terms of information reporting, generally section 6050Y(a) requires acquirers of life insurance to report[24] to the IRS certain information (e.g., name, date, address, taxpayer ID, issuer of insurance policy, payment amount, etc.). Issuers also have to report[25] to the IRS under section 6050Y(b), including with respect to the "investment in the contract" (*i.e.*, tax basis) with respect to the policy. Issuers further have to report[26] to the IRS under section 6050Y(c) where a payment of death benefits is made with respect to a policy transferred in a reportable policy sale. Each of IRS Form 1099-LS, IRS Form 1099-SB, and IRS Form 1099-R must be provided to other parties to the transaction (e.g., the seller) or who are otherwise relevant (e.g., the insurance issuer) depending on the context and specific IRS Form. The RPS Proposal specify a number of other rules that relate to this reporting that are beyond the scope of this memorandum.

Conclusion

In total, the RPS Final Rule is a substantial improvement to the statutory text included in the TCJA. The COLI/BOLI marketplace now has several exemptions to exclude death benefits from taxable income when conducting Ordinary Course Transactions. In effect, these regulations make great strides to correct the TCJA's unintended consequences in the COLI/BOLI market.

In addition, the Treasury Department made several helpful corrections based on AALU feedback. Satisfying any of the exceptions described above will generally be sufficient to preserve the prior-law tax treatment of death benefits. As noted above, the only exception that is specific to C corporation is the first. All other exceptions apply irrespective of business. Practioners reviewing these exceptions with clients should especially consider the applications of exceptions 1, 7, 8, and 9(c).

Fixing the effective date of the regulations was a major win and one of the key "asks" AALU advanced our comment letter. Furthermore, the industry realized an expanded rule for substantial relationships, which allows an entity to have a substantial relationship with the insured so long as every "beneficial owner" of the entity has a substantial relationship, regardless of the type. Finally, the industry received more clarity on the 1035 exchange issue.

This product was developed for AALU Members through the work of AALU staff, the Federal Policy Group, and the volunteer members of AALU's COLI/BOLI Working Group. If you have any questions, please contact Armstrong Robinson at 202-772-2493 or Joseph Conrad at 202-742-4636.

[24] Utilizing IRS Form 1099-LS, which is currently in draft form.
[25] Utilizing IRS Form 1099-SB, which is currently in draft form.
[26] Utilizing IRS Form 1099-R, which is currently in draft form.