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IRS RULES ON NEW BOLI ARRANGEMENT

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At year-end 2011 the Internal Revenue Service (IRS) released to the public a somewhat groundbreaking private letter ruling it had issued the prior September on a new kind of arrangement involving bank-owned life insurance (BOLI). Under the facts of PLR 201152014 (the Ruling),[1] a partnership of banks was formed to pool and manage the banks' BOLI contracts and, in the process, exchange some or all of them for new contracts. Technically, the transferee of the contracts was a limited liability company (LLC) that planned to elect to be treated as a partnership for federal income tax purposes. The Ruling addresses both the eligibility of the LLC to be taxed in that manner as well as a number of the tax consequences flowing from the LLC's tax treatment as a partnership.

According to the Ruling, initially the LLC would have three members—a BOLI broker denominated the Managing Member, a national bank called Bank A in the Ruling, and a Federal Reserve Board-regulated financial holding company referred to as Bank B—although it was anticipated that other banks would join as members over time. Both Bank A and Bank B owned BOLI policies (Policies), some covering current employees and some former employees, and some of the Polices were fixed, general account contracts while others were variable contracts based on separate accounts. Significantly for the Ruling's various holdings, after contributing their Policies, Bank A would hold a greater-than-50 percent interest in the LLC, whereas Bank B would hold only a minority interest in it. (The Ruling noted that when other banks joined the LLC, Bank A's interest likely would dip below 50 percent, too.) The Ruling recited that only Policies in force for five years, and under which the insureds had been given notice of the coverage and consented to it, would be accepted into the LLC, and that banks must represent that the LLC's holding of the Policies would not enable them to have BOLI holdings beyond the limits prescribed by bank regulators.[2]

The IRS was told (according to the Ruling) that the banks who became LLC members would benefit in a number of ways. Specifically, they would receive death benefits when paid under the Policies (plus any other profits and less any losses) in proportion to their interests in the LLC, and in the meantime they would enjoy having "a more effective, centralized way to manage Policies and, where appropriate, to negotiate the terms of new Policies (i.e., via exchange) or renegotiate the terms of existing BOLI holdings." In other words, the members expect the LLC to exchange most or all of the Policies for new ones, although, technically, this decision would be left to the Managing Member. What the members could not do, however, is have the LLC redeem their interests. Rather, any bank wishing to withdraw would need to sell its interest to another bank, but it would also need to obtain the Managing Member's consent to this, which the IRS was told would be given only in "rare and extraordinary circumstances."

The Ruling addressed three aspects of the tax treatment of the arrangement: (1) the LLC's taxation as a partnership as opposed to an investment company, (2) the deductibility of interest expenses by the LLC and its members, and (3) the excludability of death benefits under the Policies, which began life as employer-owned life insurance contracts.

PARTNERSHIP TAXATION—SECTIONS 721 AND 351[3]

First, the Ruling addressed a potential barrier to the treatment of the LLC as a partnership for tax purposes, holding that the banks' transfer of Policies to the LLC would not be treated as a transfer to an "investment company" within the meaning of section 351 if the LLC were incorporated. The significance of this holding, which was the sole legal element of the Ruling that was truly groundbreaking, requires some explanation, starting with the reason why it was asked of the IRS.

In general, the character of income earned by a partnership is passed through to the partners. Thus, life insurance death benefits paid to a partnership, assuming that the underlying life insurance contracts meet the requirements of the federal tax definition (section 7702), normally would be income-tax-

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free in the hands of the partners because they would be excludable from the partnership's gross income pursuant to section 101(a)(1). However, under the "transfer-for-value rule" of section 101(a)(2), if a life insurance contract is transferred "for a valuable consideration," the income tax exclusion is limited to the consideration and any subsequent premiums that the transferee paid for the contract. Since, under the facts of the Ruling, banks would transfer their Policies to the LLC in return for interests therein, then, absent an exception, the transfer-for-value rule would apply and the death benefits would lose their tax-free treatment. One exception to this rule is for "carryover basis," *i.e.,* the rule does not apply if the transferee's basis in the contract is determined in whole or in part by reference to the transferor's basis.[4] The good news for the LLC in this case is that such a carryover basis normally applies under section 723 when property is contributed to a partnership, so that, as long as the transfer of the Policies to the LLC is treated as a contribution of property to an entity recognized as a partnership for tax purposes, the transfer-for-value rule would not apply.[5]

This led to the LLC's concern with partnership treatment and, in turn, with the question about "investment company" characterization. As a general matter, under section 721(a), no gain or loss is triggered when a person acquires a partnership interest by transferring property to the partnership. Section 721(b) overrides this rule, however, if the partnership would be treated as an investment company within the meaning of section 351 if it were incorporated. Rather, the investment company rules of sections 721(b) and 351 can operate to tax property when contributed to a partnership, and, if so, the transferor's basis in the property would not carry over to the partnership, rendering the carryover basis exception to the transfer-for-value rule unavailable.

The Ruling's holding, confirming that sections 721(b) and 351 would not preclude the normal partnership tax rules from applying to the banks' transfer of Policies to the LLC, is somewhat groundbreaking. The Ruling reasoned that, because the LLC's assets are to consist solely of the Policies and some cash, its assets would not be viewed as comprised of "stock and securities," thereby precluding investment company treatment.[6] The IRS's view that the Policies are not stock and securities within the meaning of section 351(e) is noteworthy, in that the provision broadly defines stock and securities to include money, equity interests in a corporation, evidences of indebtedness, and any equity interest or other arrangement that is readily convertible into cash.[7] The Policies have attributes that make them similar to such investments, *e.g.,* variable Policies are treated as securities under federal securities laws, and both general and separate account Policies can be converted to cash through surrender or withdrawal. Unfortunately, even though the Ruling broke legal ground with its holding, its reasoning on the point was terse at best.

DEDUCTIBILITY OF INTEREST EXPENSE—SECTION 264(f)

Section 264(f)(1) disallows some or all of the deduction for interest expenses by a business that owns or benefits from a life insurance contract with unborrowed cash values, *e.g.,* the typical BOLI contract, even though such expenses are unrelated to the purchase or maintenance of the contract.[8] Pursuant to an exception provided in section 264(f)(4)(A), however, this disallowance does not apply in the case of a contract covering a single insured who, at the time first covered under the contract, was a 20 percent owner of the policyholder or was an officer, director or employee of the policyholder's trade or business (for simplicity, an "employee"). In Rev. Rul. 2011-9,[9] the IRS held that this exception is not available with respect to a new contract received in exchange for an existing contract if, at the time of the exchange, the insured is no longer an employee but is merely a former or "inactive" employee of the policyholder.[10] Hence, a bank that exchanges a BOLI contract covering the life of a former employee at the time of the exchange will lose a portion of its interest deductions unrelated to the contract.

In its ruling request, the LLC asked the IRS to construe the application of the section 264(f) rules to its current two members, Bank A (the majority shareholder) and Bank B, as well as to itself. In response, the Ruling held that a portion of Bank A's interest deductions unrelated to the Policies or to Bank A's interest in the LLC may be disallowed under section 264(f)(1) because of the unborrowed cash values of the Policies held by the LLC, whereas Bank B's interest deductions would not be disallowed under section 264(f)(1) by virtue of the LLC's holding of the Policies. The Ruling also concluded that, to the extent the LLC directly incurs interest expenses unrelated to the Policies, section 264(f)(1) will preclude the bank-members from claiming deductions for their proportionate share of those expenses. In this regard, the Ruling observed that while section 264(f)(5)(B) states that in the case of a partnership section 264(f)(1) applies at the partnership level (rather than the partner level), the denial of interest deductions resulting from the partnership owning life insurance contracts with unborrowed cash values flows through to the bank-partners pursuant to the flow-through nature of the partnership income tax regime. Practically speaking, however, this disallowance likely would not matter, as the IRS was told that any interest expenses unrelated to the Policies that the LLC may incur would be immaterial.

The basis for the distinction made in the Ruling between the treatment of Bank A and that of Bank B arises from section 264(f)(8), which imposes an aggregation rule under which Bank A and the LLC are treated as a single taxpayer for purposes of section 264(f)(1) because Bank A's ownership interest in the LLC exceeds 50 percent. Thus, for purposes of section 264(f)(1), the ownership of the Policies is attributed to Bank A despite its transfer of their legal ownership to the LLC. In contrast, because Bank B possesses only a minority interest in the LLC, the aggregation rule would not apply to treat Bank B and the LLC as a single taxpayer under section 264(f)(1), thereby allowing Bank B to escape the disallowance rule. By implication, Bank B's favorable treatment would apply to Bank A if and when a sufficient number of additional banks joined the LLC to dilute Bank A's interest below 50 percent.

The Ruling's section 264(f) holdings mean that the bank-members of the LLC, assuming that they confine themselves to minority interests therein, can avoid the disallowance of interest deductions otherwise imposed under Rev. Rul. 2011-9 with respect to new coverage on their former employees—by transferring the Policies to the LLC and having the LLC conduct the exchanges. This follows from the Ruling's treatment of Bank B, which is not viewed as owning any interest in the Policies held by the LLC, and from section 264(f)(5)(B), which states section 264(f)(1) applies at the partnership level. Thus, whether the Policies cover the lives of current or former employees of Bank B at the time of the exchange is immaterial for purposes of section 264(f)(1).

Of course, the ability of the LLC (or of Bank A or Bank B, for that matter) to engage in an exchange that results in the issuance of a Policy covering the life of a former employee presupposes that the Policy received in the exchange will be treated as a life insurance contract under sections 7702 and 1035, which is necessary for the exchange to be tax-free and for the new Policy to provide tax-deferred inside buildup and a tax-free death benefit. Section 7702 defines the term "life insurance contract" for all purposes of the Code as a contract that is a life insurance contract under "the applicable law" and that meets certain other requirements; and for contracts issued in the United States, the reference to "applicable law" means state law, which incorporates such laws' requirements with respect to "insurable interest."[11]

Based on concepts inherited from English law (the Life Assurance Act of 1774), all states require the initial owner of a life insurance contract to possess an insurable interest in the life of the insured under the contract at the time of its issuance. Many states also have statutes expressly recognizing the insurable interest of an employer in the lives of its employees, *e.g.,* to the extent that they are covered under an employee benefit plan. Because insurable interest typically must be established only at the time a contract is issued, the fact that an insured's employment is subsequently terminated generally does not affect the continued validity of the contract under state law in the hands of the employer. In this connection, the transfer of the Policies to the LLC and the subsequent exchanges by the LLC raise two questions. First, does the transfer of the Policies require re-establishing insurable interest at the time of the transfer? If so, then presumably it would need to be shown that the LLC (not the employer) possesses insurable interest in the insureds under the Policies at the time of the transfer. Second, would insurable interest need to be established at the time of an exchange? If so, then again, the LLC's insurable interest in the new contract acquired in the exchange would need to be demonstrated.

In seeking the Ruling, the LLC represented to the IRS that the Policies, at issuance and upon transfer to the LLC, would meet all applicable state insurable interest laws, and that the LLC's exchanges of the Policies would comply with those laws. Since the insureds under the Policies would not be employees of the LLC, and a fair number of them would likely be merely former employees of the LLC's members, it would seem vital to obtain clarity on these points.[12] The consequences of failing to comply with state insurable interest laws would be the loss of the favorable income tax treatment of the Policies and of the exchanges, not to mention that the Policies could be deemed to be void or else the death benefits could be re-directed to the insureds' own heirs.[13]

EXCLUDABILITY OF DEATH BENEFITS—SECTION 101(j)

To address abuses perceived in the corporate-owned life insurance market, in 2006 Congress enacted section 101(j) to

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impose special requirements on "employer-owned life insurance contracts" (EOLI). Under this provision, in order for the employer-policyholder to obtain a tax-free death benefit when an insured employee dies, the employer must satisfy certain notice and consent requirements prior to the time the contract is issued.[14] An exchange of an existing EOLI contract will re-trigger these notice and consent requirements unless (1) the exchange occurs within a year of the issue date of the contract being exchanged, or (2) the exchange does not result in a material change in the death benefit or other material change in the contract.[15] In addition, the insured at issuance of an EOLI contract must be a director, a highly compensated employee, or a highly compensated individual with respect to the policyholder.[16] If these requirements are not met, the contract's death benefit is taxable to the extent that it exceeds the policyholder's investment therein.[17] For purposes of these rules, an EOLI contract is defined as one (a) owned by a trade or business, (b) directly or indirectly benefitting that trade or business (or a related party), and (c) covering the life of an insured who is an employee with respect to the trade or business of the "applicable policyholder" on the date the contract is issued.[18]

The Ruling reached two divergent conclusions regarding the section 101(j) treatment of the Policies in the hands of the LLC, including those it receives in exchange for Policies contributed to it. First, according to the Ruling, each Policy would constitute an EOLI contract as defined in section 101(j)(3)(A) if it covers the life of an insured who, on the date the Policy is issued, is either an employee of the LLC or an employee of Bank A. As regards Bank A, this conclusion stems from aggregation rules under section 101(j) that identify the "applicable policyholder" with respect to an EOLI contract. Like the section 264(f) aggregation rule, the section 101(j) rule treats Bank A and the LLC as the same taxpayer by virtue of Bank A's majority interest in the LLC. (Although the Ruling referred to insureds who are LLC employees, it said nothing about the LLC actually having employees; if the only Policies held by the LLC are those transferred to it by banks, it would seem that an insured would be an LLC employee only by happenstance, assuming the LLC had any employees at all.)

Second, in contrast, the IRS said that a former Bank B Policy transferred to the LLC would not constitute an EOLI contract if it covers the life of an insured who, on the date the Policy is issued, is an employee of Bank B but not of the LLC. In other words, the aggregation rule would not apply to Bank B, since it holds less than a 50 percent interest in the LLC. Rather, after Bank B transfers its Policies to the LLC, the LLC would be the only "applicable policyholder" with respect to those Policies, and because those Policies would not cover the lives of any employees of the LLC, they would not be EOLI contracts. This means, in turn, that the section 101(j) rules—including the notice and consent requirements and the limits on the insured population—would no longer apply to the former Bank B Policies or to any that replaced them through an exchange.[19]

Importantly, albeit by implication, the favorable Bank B treatment ultimately would apply to Bank A, once a sufficient number of additional banks joined the LLC to dilute Bank A's interest below 50 percent (just as in the case of section 264(f)). Thus, Bank A would be in the same posture as Bank B (and presumably all the other bank-members), so that none of the Policies that the LLC holds would be EOLI contracts. This is significant for the success of the exchanges proposed under the arrangement, in that the notice and consent requirements of section 101(j) would not apply upon any such exchange. That said, it is worth noting that many states impose notice and consent requirements on employers who purchase life insurance coverage on their employees. In such states, the employer must provide notice to the employees before purchasing the coverage and/or obtain the employees' consent to the coverage. Like the insurable interest requirements discussed above, states that impose notice and consent requirements may view them as re-applying upon the exchange of an existing contract for a new one. In this connection, in seeking the Ruling the LLC told the IRS that it would accept transfers of Policies only if the insureds thereunder were provided notice of the coverage and had consented to it. The Ruling, however, did not indicate that the LLC would provide new notice and obtain new consents upon the exchange of Policies for new ones, and the Ruling's conclusions on the application of section 101(j) suggest that the LLC has no plan to do so.

The Ruling's conclusions also would seem to provide a taxpayer-friendly outcome on the effective date of the section 101(j) rules. Section 101(j) generally applies to contracts issued after Aug. 17, 2006, subject to certain transition rules. Under those transition rules, section 101(j) does not apply to:

> a contract issued after [Aug. 17, 2006] pursuant to an exchange described in section 1035 … for a contract issued on or prior to that date. For purposes of the preceding sentence, any material increase in the death benefit or other material change shall cause the contract to be treated as a new contract …. [20]

The apparent generosity of this "grandfather" rule for EOLI contracts received in a section 1035 exchange is deceptive, at least in the IRS's eyes. The IRS has narrowly construed the rule by stating in published guidance that any material change to a contract involved in such an exchange—other than changing the issuer—will result in a loss of the grandfather.[21]

In light of this, yet another significant consequence of the Ruling's holding that the Policies are not EOLI contracts in the LLC's hands is that its members would no longer need to worry about material changes to the Policies triggering a loss of any grandfather. In this sense, the structure would appear to liberalize the transition rules that apply to section 101(j), at least in circumstances where the contracts would be viewed as undergoing material changes when exchanged.

CONCLUDING THOUGHTS

The Ruling reached favorable determinations on the treatment of the BOLI arrangement under sections 721 and 351 (partnership taxation), section 264(f) (deductibility of interest expenses) and section 101(j) (EOLI contracts). Those determinations would appear to facilitate the ability of the LLC's bank-members to have their existing Policies exchanged for new ones in circumstances where sections 264(f) and 101(j) would otherwise impose adverse federal income tax consequences or at least requirements that would be difficult to meet.[22] For example, from a tax standpoint, the LLC would be able to exchange Policies that cover the lives of its members' former employees without the need to provide notice to, or seek consent from, those individuals. While this would eliminate the practical barrier of locating and convincing former employees to consent to coverage that their former employers wish to maintain (indirectly) on their lives, similar notice and consent requirements may apply under state law when the Policies covering them are exchanged, assuming that state insurable interest laws allow such exchanges to occur.

While those of us who write for *Taxing Times* often take a purely tax-centric view of the universe, we are forced to acknowledge that there are in fact some other laws of importance, however fleeting they may seem to us. The Ruling, of course, being an IRS product, did not endeavor to address the application of these other laws to the BOLI arrangement. Among the issues not addressed in the Ruling, but that would appear critical to the arrangement's viability, would be not only the application of the state law requirements mentioned above (insurable interest laws and notice and consent laws) but also the manner in which the non-tax regulatory requirements governing banks would apply to the arrangement. Banking institutions are subject to regulation by a variety of federal and state agencies, which monitor the activities and investments of banks—including BOLI purchases—to ensure that they are consistent with safe and sound banking practices. Likewise, the accounting for banks' interests in the LLC would be of concern to the SEC as well as the banking regulators. Thus, while the Ruling broke some important ground in the tax law, a bank planning to participate in an arrangement like the one described in the Ruling presumably would need to obtain comfort on these additional issues.[23]

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END NOTES

1 Dated Sept. 22, 2011, and released to the public on Dec. 30, 2011. A private letter ruling cannot be cited as precedent, and only the taxpayer who received it can rely on it. See section 6110(k)(3) of the Internal Revenue Code of 1986, as amended (the "Code").

2 *See, e.g.*, Interagency Statement on the Purchase and Risk Management of Life Insurance, OCC Bull. 2004-56, at 5 (Dec. 7, 2004) (stating that "it is generally not prudent for an institution to hold BOLI with an aggregate [cash surrender value] that exceeds 25 percent of the institution's capital as measured in accordance with the relevant agency's concentration guidelines").

3 Unless otherwise indicated, the term "section" refers to a section of the Code.

4 Section 101(a)(2)(A).

5 Rev. Rul. 72, 1953-1 C.B. 23 (concluding that the carryover basis exception to the predecessor provision of section 101(a)(2) applied to the contribution of a life insurance contract to a partnership because the partnership tax rules provide for a carryover basis with respect to property contributed to a partnership).

6 Technically, the Ruling reasoned that more than 80 percent of the LLC's assets would not be comprised of stock and securities. Under section 351(e) and Treas. Reg. section 1.351-1(c)(1)(ii), if more than 80 percent of a company's assets are comprised of stock and securities, and certain other requirements are met, the company is treated as an investment company. The IRS's conclusion that the Policies are not stock and securities obviated the need for it to consider the other factors that apply in determining whether a company is an investment company.

7 Section 351(e)(1)(B)(i), (ii) and (iv).

8 These restrictions apply only to contracts issued after June 8, 1997, but they also can apply to contracts issued before that date if the contracts are "materially changed." Pub. L. No. 105 34 § 1084(d)[(f)] (1997).

9 2011-12 I.R.B. 554. For a discussion of Rev. Rul. 2011-9, see John T. Adney and Bryan W. Keene, "IRS Ruling Confirms Exchange of COLI on Former Employees Triggers Loss of Interest Deductions," *Taxing Times*, September 2011, Vol. 7, Issue 3.

10 *See also* PLR 200627021 (July 7, 2006) (reaching the same conclusion as Rev. Rul. 2011-9).

11 *See, e.g.*, H.R. Rep. No. 98-861, at 1075 (1984) (Conf. Rep.) (referring to "state or foreign law" in describing the "applicable law" requirement of section 7702); Dow Chem. Co. v. United States, 250 F. Supp. 2d 748, 796 (E.D. Mich. 2003), *rev'd on other grounds*, 435 F.3d 594 (6th Cir. 2006), *cert. denied* 127 S.Ct. 1251 (2007) (recognizing that for purposes of section 7702 "applicable law" means state law, and that such law subsumes the insurable interest requirement).

12 In March 2011, the NAIC's Director of Regulatory Services sent a memorandum to the NAIC's Life Insurance and Annuities (A) Committee recommending that state insurable interest laws be amended to permit exchanges of corporate-owned life insurance contracts that insure the lives of former employees and that state notice and consent requirements be amended to eliminate any requirement to provide new notices to insured employees or obtain new consents from them in connection with such exchanges.

The A Committee ultimately tabled the recommendation. Thus, in the authors' understanding, only the laws of Delaware, Georgia and Utah expressly provide an employer with an insurable interest in a former employee across an exchange. If exchanges were to occur that were subject to the laws of those states, it would seem necessary to determine that an entity like the LLC in the Ruling could derive its insurable interest in the insureds from the interests of the employers.

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END NOTES CONT.

[13] The insured employees, or their estates or legal heirs, may bring lawsuits in state courts (or federal courts under diversity of citizenship) if the Policies were acquired in violation of state law. *See, e.g.,* Mayo v. Hartford Life Ins. Co., 354 F.3d 400 (5th Cir. 2004).

[14] Section 101(j)(4). For an in-depth discussion of section 101(j), *see* John T. Adney, Kirk Van Brunt and Bryan W. Keene, "COLI in Congress: New Tax Rules Address Concerns and the Product's Future," Journal of Financial Service Professionals, March 2007, Vol. 61, No. 2 (Society of Financial Service Professionals 2007).

[15] Q&A-16 and Q&A-9, respectively, of Notice 2009-48, 2009-24 I.R.B. 1085. A "material change" for this purpose does not include a change from general account to separate account or vice versa, or a change in the identity of the issuing life insurance company. *See* Q&A-15 of Notice 2009-48. For a discussion of Notice 2009-48, see John T. Adney, Bryan W. Keene and Joel W. Mann, "Guidance Released on COLI Best Practices Rules," *Taxing Times*, September 2009, Vol. 5, Issue 3. A broader discussion of "material change" concepts appears in the article published as a supplement to the current issue of *Taxing Times*. *See* John T. Adney and Craig R. Springfield, "They Go Bump in the Night: Life Insurance Policies and the Law of Material Change."

[16] Section 101(j)(2)(A)(ii). Other exceptions to the limitations on the insured population are available, but generally do not apply to the typical broad-based BOLI plan.

[17] Section 101(j)(1).

[18] Section 101(j)(3)(A).

[19] This also would relieve both Bank B and the LLC from the reporting requirements that section 6039I imposes with respect to EOLI contracts.

[20] Pub. L. No. 109-280 § 863(d).

[21] *See* Q&A-15 of Notice 2009-48, 2009-24 I.R.B. 1085.

[22] As summarized by the law firm of Locke Lord Bissell & Liddell LLP, which represented the parties in obtaining the Ruling, "[t]he basic lesson to be drawn from PLR 201152014 is that by utilizing a LLC, a bank may be able to manage its BOLI holdings in ways that it could not do on its own as a practical matter, given the constraints of sections 264(f) and 101(j)." Kirk Van Brunt, *Important IRS Private Letter Ruling on Bank-Owned Life Insurance Policies,* Locke Lord Quickstudy, Corporate Insurance Practice (Jan. 11, 2012) (available at http://www.lockelord.com/qs_2011corpins_irsletter/).

[23] *See* Matthew Schoen, *New IRS PLR Portends Trickle of 1035 Exchanges, Not a Flood,* Insurance Broadcasting (Jan. 1, 2012) (available at *http://www.insurancebroadcasting.com/news/IRS-2720923-1.html*) (subscription required) (identifying the resolution of banking law and state insurable interest law as two items on the "long list of steps to check off before proceeding" with the transaction).