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IRS RELEASES NEW RULING ON BOLI PARTNERSHIP

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In late February, the Internal Revenue Service (IRS) released PLR 201308019,[1] addressing the treatment of a partnership formed to hold and manage bank-owned life insurance (BOLI) policies. The facts and issues involved in the new ruling share certain similarities with those involved in a private letter ruling from 2011, on which we reported in the May 2012 issue of *Taxing Times*.[2] Both rulings address federal income tax issues presented by the transfer of BOLI policies by unrelated banks to a new partnership and the ongoing operation of the partnership. The biggest difference between the transactions is that, in the earlier ruling, the partnership intended to exchange most or all of the policies contributed to it, whereas in the new ruling the partnership would not exchange any of the policies. As a result of this factual difference, the tax and non-tax regulatory implications of the arrangements also differed somewhat.

FACTS INVOLVED IN PLR 201308019

The transaction in PLR 201308019 involves a limited liability company (the "Company") that intends to be treated as a partnership for federal income tax purposes. Two unrelated banks, A and B, propose transferring some of their existing BOLI policies to the Company in return for percentage interests in the Company. The policies are general account (*i.e.*, non-variable) life insurance contracts that insure the lives of individuals who, at the time first covered, were employees, officers or directors of the two banks or their affiliates.

Each of the two banks will irrevocably assign all its ownership rights in the policies to the Company. In return, the banks will receive percentage interests in the Company based on the relative fair value of the policies they contribute. The Company will accept additional contributions of policies from the initial two banks and other unrelated banks for up to two years from the date the first policies are contributed. If such additional contributions occur, the Company will adjust the bank-partners' percentage interests accordingly.

The Company will engage in the business of managing the policies for the benefit of the bank-partners. A non-bank "Managing Member" will enjoy broad discretion in controlling the Company's activities. Those activities could include (1) exercising all rights under the policies, (2) interacting with regulators to facilitate compliance with any applicable banking laws, and (3) collecting the policies' death benefits and distributing them to the bank-partners. As compensation, the Managing Member will receive a fee based on the fair value of the Company's policies. This fee will be funded through the Company's cash flows, which will consist primarily of death benefits it receives from the policies. The Managing Member will treat all amounts it receives as taxable compensation, even if the Company funds a payment to the Managing Member using the policies' otherwise tax-exempt death proceeds.

Although the Managing Member will hold broad discretion in exercising the Company's rights with respect to the policies, the Company does not intend to engage in exchanges of the policies or to acquire additional policies other than through banks transferring them to the Company as partnership contributions. As the Company receives death benefits under the policies, it will allocate the proceeds, net of Company expenses, to the bank-partners based on their percentage interests. According to the ruling, the bank-partners will likely want to retain their interests in the Company because those interests will have significant value and will fund the banks' employee benefit liabilities. The ruling also says, however, that bank-partners may need to dispose of their percentage interests in some cases, such as in a liquidity emergency or at the direction of a bank regulator. To facilitate this, the bank-partners will be allowed to sell their interests in the Company to other banks, with the replacement banks thereby succeeding to all attendant benefits and burdens of those interests. The Company also will retain the right to purchase outstanding interests from the bank-partners at negotiated prices, but generally will not offer a redemption right.

ISSUES ADDRESSED IN PLR 201308019

PLR 201308019 addresses the Company's treatment as a partnership as opposed to an investment company, which

CONTINUED ON **PAGE 14**

The transfer for value rule is a limitation on the income tax exclusion that life insurance death benefits otherwise enjoy.

has implications for how the "transfer for value rule" of section 101(a)(2) applies to the policies the Company holds.[3] In the 2011 ruling noted above, the IRS also addressed this aspect of the partnership tax rules, although the 2011 ruling did not elaborate on the implications of that conclusion for the transfer for value rule. In contrast, PLR 201308019 expressly addresses those implications, concluding that the banks' transfer of policies to the Company will not trigger the transfer for value rule. In addition, unlike the 2011 ruling, PLR 201308019 addresses how the transfer for value rule applies to a bank's sale or exchange of its partnership interest in the Company to another bank, concluding that the transaction will not amount to a transfer of the policies themselves for purposes of that rule.

With respect to the partnership tax issue, the new ruling concludes that no gain or loss will be recognized pursuant to section 721 upon the transfer of a policy by a bank to the Company in exchange for a percentage interest in the Company. 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. In such cases, sections 721(b) and 351 operate to tax property when contributed to a partnership. By concluding that the normal section 721 rules, and not the investment company rules, will apply to the banks' transfers of policies to the Company, the ruling confirms that the policies can be transferred to the Company tax-free.

As is sometimes the case with private letter rulings, PLR 201308019 provides little analysis in stating its conclusion under section 721(b). We note, however, that to be treated as an investment company for purposes of that section, the Company would need to meet several requirements, including having more than 80 percent of its assets comprised of stock and securities.[4] When addressing this issue in the 2011 ruling, the IRS reasoned that because the partnership's assets would consist solely of life insurance policies and some cash, its assets would not be comprised of stock and securities.[5] Presumably, the IRS relied on a similar analysis in PLR 201308019. Indeed, the conclusion may have been easier to reach in the new ruling, considering that the 2011 ruling involved both variable (separate account) and fixed (general account) life insurance policies, whereas the new ruling involved only fixed policies.

The new ruling's conclusion under section 721(b) also helps clear the path for its second important conclusion: that the transfer for value rule will not apply when banks contribute their policies to the Company. The transfer for value rule is a limitation on the income tax exclusion that life insurance death benefits otherwise enjoy. Pursuant to section 101(a)(1), such benefits normally are tax-free when received by the beneficiary, and, if the beneficiary is a partnership, the death benefits remain tax-free when passed through to the partners. Under the transfer for value rule of section 101(a)(2), however, if a life insurance policy 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 policy.

Since, under the facts of the new ruling, the banks will receive valuable consideration (namely, interests in the Company) in return for transferring their policies to the Company, the transfer for value rule would apply in the absence of any exception. One exception is for "carryover basis," *i.e.*, where the transferee's basis in the contract is determined in whole or in part by reference to the transferor's basis.[6] PLR 201308019 concludes that this exception will apply to the banks' transfers of policies to the Company, making the transfer for value rule inapplicable and ensuring that the policies' death benefits will be tax-free when the Company, and ultimately each bank-partner, receives them. This conclusion was facilitated, in part, by the conclusion above that the partnership tax rules would not operate to tax the gain in the policies at the time of the transfer, thereby allowing the normal carryover basis rules under the partnership tax regime to govern the transaction.[7]

The new ruling also addresses the application of the transfer for value rule to another aspect of the transaction, namely, a bank's potential future sale or exchange of its partnership interest in the Company. The concern apparently was that such a transaction might be viewed as a sale or exchange of the life insurance policies that the Company holds, thereby triggering the transfer for value rule with respect to the policies. The ruling confirms that this will not be the case, as long as the sale or transfer of the partnership interest in the Company does not result in a termination of the Company within the meaning of section 708(b)(1)(B), which would result in a deemed distribution of the Company's assets to its partners.[8]

The ruling provides little analysis in connection with the foregoing conclusion. We note, however, that as a general matter subchapter K represents a blending of "aggregate" and "entity" theories in prescribing the rules that govern the federal income taxation of partnerships. Under the "aggregate" theory, a partnership is merely a conduit for its individual partners, each of whom is deemed to own a direct undivided interest in partnership assets and operations. Under the "entity" theory, a partnership is an entity separate from its partners, such that the partners are not deemed to have a direct interest in partnership assets or operations, but only an interest in the partnership entity separate and apart from its assets and operations. Section 741 generally adopts an entity approach for transfers of partnership interests, in that it provides that the sale or exchange of a partnership interest will result in recognition of gain or loss to the transferor partner, with the character of the gain or loss being capital in nature unless otherwise prescribed by section 751. Thus, the general rule is that the partnership interest itself is the property that is sold or exchanged in a transfer of a partnership interest to a third party, *i.e.*, the entity theory generally controls. The IRS has followed this approach in at least one other private letter ruling in which it concluded that a sale of a partnership interest would not trigger the transfer for value rule with respect to life insurance policies the partnership owned.[9]

CONCLUDING THOUGHTS

PLR 201308019 reaches favorable conclusions on the treatment of the BOLI arrangement under the partnership tax rules of section 721 and the transfer for value rule of section 101(a)(2). While the arrangement is similar to one the IRS addressed in a 2011 private letter ruling, the new arrangement would seem to present fewer issues from a tax and non-tax regulatory perspective. In particular, the new arrangement does not contemplate the Company engaging in any exchanges of the life insurance policies it holds, whereas such policy exchanges were a key component of the arrangement described in the 2011 ruling. The intent to engage in such policy exchanges in the 2011 ruling led the parties to seek guidance from the IRS on the implications under 264(f), which denies interest expense deductions for BOLI owners in certain cases, and section 101(j), which denies the otherwise applicable income tax exclusion for BOLI death benefits in certain cases. Although the IRS reached favorable determinations on those additional issues in the 2011 ruling, there was no need to address them in PLR 201308019. Likewise, for the parties to the new transaction, there would appear to be no need to address some of the non-tax regulatory issues we mentioned in our May 2012 article, such as whether and how state insurable interest and notice and consent laws apply in the context of a policy exchange. ◀

END NOTES

1 The IRS issued PLR 201308019 on Aug. 23, 2012, and released it to the public on Feb. 22, 2013.

2 *See* John T. Adney and Bryan W. Keene, "IRS Rules on New BOLI Arrangement," *Taxing Times*, May 2012, Vol. 8, Issue 2 (discussing PLR 201152014 (Sept. 22, 2011)).

3 Unless otherwise indicated, each of our references to a "section" means a section of the Internal Revenue Code of 1986, as amended.

4 *See* section 351(e) and Treas. Reg. section 1.351-1(c)(1)(ii).

5 PLR 201152014.

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

7 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).

8 Section 708(b)(1)(B) provides that a partnership will be considered terminated if, within a 12-month period, there is a sale or exchange of 50 percent or more of the total interest in partnership capital and profits. If a partnership is terminated, its assets generally are deemed distributed. *See, e.g.*, Rev. Rul. 99-6, 1999-1 C.B. 432.

9 PLR 200826009 (Dec. 20, 2007).

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