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UPDATE: COLI/BOLI
REPORTABLE POLICY SALE / TRANSFER FOR VALUE
TREASURY REGULATIONS

March 10, 2020

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

Reminder
Asset based mergers that include life insurance have always been treated as Transfers for Value affecting the taxation of the death benefits. Nothing in the Tax Cuts and Jobs Act nor the regulations on Reportable Policy Sale/Transfer for Value has changed those facts.

This update and our explanation of the final rule apply to stock based mergers, where there could be an implication for the taxation of death benefits on the lives of former employees of an acquired institution.

The Situation
There is a concern affecting the application of the exception to the Transfer for Value rule related to 'Certain Ordinary Course Transactions involving C Corporations' ("C Corporation Exception"). The issue has been slow to emerge (and many have still not focused on it) because the change from the proposed rule and the final rule was made in the preamble to the regulation, not in the regulation itself. The regulatory text itself related to this exception did not change between the proposed rule and the final rule.

This preamble language indicates that where the stock merger is a tax-free reorganization, **and** the target bank or company's separate existence is terminated as of the merger date, then you have a Reportable Policy Sale, unless another exception covers the transaction (for a full discussion of those exceptions, please review our explanation of the final rule). Such a result could make the death benefits on some of the policies of the acquired entity taxable.

This development could have significant implications for the marketplace, and we are actively pursuing avenues for resolution.

Background

As noted above, the regulatory text of the C Corporation Exception did not change between the proposed reportable policy sale regulations and the final reportable policy sale regulations ("Final RPS Regulations"). This exception is found in the definition of an "indirect acquisition." The general definition of an "indirect acquisition" that can give rise to a reportable policy sale (assuming no other exception of substantial relationship exists) provides that:

> For purposes of this section and section 6050Y, an indirect acquisition of an interest in a life insurance contract occurs when a person (acquirer) becomes a beneficial owner of a partnership, trust, or other entity that holds (whether directly or indirectly) the interest (whether legal or beneficial) in the life insurance contract.

The C Corporation Exception modifies this definition of "indirect acquisition" and provides that:

> For purposes of this paragraph (e)(3)(ii), the term other entity does not include a C corporation, unless more than 50 percent of the gross value of the assets of the C corporation consists of life insurance contracts (as determined under paragraph (f)(4) of this section) immediately before the indirect acquisition.

Based solely upon the text of the proposed reportable policy sale regulation, many practitioners had concluded that any time a person became a "beneficial owner" of a C corporation whose gross assets were not more than 50 percent comprised of life insurance contracts, there was no reportable policy sale—regardless of the form of the transaction whereby the person became such a beneficial owner. **As described further below, this interpretation may no longer be correct in light of the Preamble to the Final RPS Regulations**. In any event, certain accounting practitioners have questioned this interpretation.

More Detail on the Preamble Modification to the C Corporation Exception

The genesis of the current confusion surrounding the scope of the C Corporation Exception stems from the explanatory language contained in the preamble to the Final RPS Regulations ("**Preamble**") that clarifies the Treasury Department's view as to the meaning of the C Corporation Exception.

The Preamble states that in relevant part:

> § 1.101-1(e)(3)(ii) of the proposed regulations applies only in the case of indirect acquisitions of life insurance contracts (which include a tax-free reorganization in which the corporate existence of the target that holds an interest in a life insurance contract survives the acquisition), and not direct acquisitions of life insurance contracts (which include a tax-free reorganization in which the separate corporate existence of a target that holds an interest in a life insurance contract is terminated).

In short, this (and other similar) Preamble language indicates that the C Corporation Exception may not apply to at least some scenarios where the separate corporate existence of a C corporation target in an acquisition is terminated. Thus, rather than being a clear, broad-based rule for all types of stock-based mergers involving C corporations, the full meaning of the C Corporation Exception is no longer clear in certain contexts – though it remains clear in others.

Legal Authority of Preamble Language
Various courts have come to a number of differing conclusions regarding what level of legal deference to accord Preamble language from a final regulation, both in the Treasury Regulation and non-tax contexts. A court could, at a minimum, utilize the Preamble to determine what Treasury and the IRS understand the meaning of the Final RPS Regulations to be (even if the court did not feel bound to accept such understanding).

Original AALU Analysis of the Final Rule
https://www.aalu.org/impact-of-the-treasury-departments-final-regulations-on-reportable-policy-sales-on-coli-boli-marketplace/

The Regulation
https://www.govinfo.gov/content/pkg/FR-2019-10-31/pdf/2019-23559.pdf
Publication Date: October 31, 2019

We are working on potential solutions. We will keep you informed of progress in clarifying these questions. In the meantime, if you have any questions or would like to discuss this issue futher, please reach out to Armstrong Robinson (robinson@aalu.org).