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Final Regulations on “Reportable Policy Sales”— Impact on COLI/BOLI

The Tax Cuts and Jobs Act of 2017 included an Amendment to the Transfer for Value (TFV) rules under Internal Revenue Code (IRC) Section 101. The Amendment subjected certain transfers of life insurance policies to new reporting requirements and made detrimental changes to the taxation of policy death benefits after such transfers.

While it seems the result was unintended, the Amendment also appeared to affect the treatment of corporate-owned life insurance (COLI) and bank-owned life insurance (BOLI) in the ordinary course of mergers and acquisitions (Ordinary M&A Transactions). The IRS has now issued final regulations, Treasury Regs. § 1.101-1, 1.101-6, and 1.6050Y-1 (Final Regulations), providing how the Amendment will affect Ordinary M&A Transactions.

Many acquisitions of policies in Ordinary M&A Transactions will escape these detrimental changes, but not all. Notable exceptions to the new TFV new rules include:

- Indirect acquisitions of policies involving C corporations. See A.1., below.

- Indirect acquisitions of policies originally acquired by an acquired entity prior to January 1, 2019. See A.2., below.
- Policies acquired on (i) current employees, or (ii) prior directors, highly compensated employees, or individuals to whom the acquirer has ongoing financial obligations related to the insured’s employment by the business. See B.2., below.

In any merger or acquisition in which the acquired entity owns life insurance policies, it is imperative that acquisition counsel consider the effect of these rules on the taxation of acquired life insurance policies and the associated reporting requirements.

The Generally Applicable TFV Rules

IRC Section 101(a) provides for the general exclusion of life insurance death benefits from income taxation. However, if a life insurance policy is transferred in a TFV (see below), tax-free death benefits are limited to the amount paid for the policy, plus any subsequent premiums paid into the policy (the “tax basis”).

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The remainder of the death benefit is subject to income tax.

A TFV is any transfer of a life insurance policy except when:

- A transferee's tax basis in the property is determined, in whole or in part, by reference to the tax basis in the hands of the transferor. This will occur in many tax-free mergers and acquisitions.
- The 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.

The Amendment leaves these rules in place but imposes an additional restriction. If a TFV of policies is considered a Reportable Policy Sale, then the above exceptions will not apply, and the tax-free treatment of policy death benefits will be limited to the acquirer's investment in the contract.



Reportable Policy Sales

The Amendment provides that for a TFV to qualify as a Reportable Policy Sale:

- There must be a **direct or indirect transfer** of life insurance (Transfer Requirement); and
- The acquirer of the life insurance must **not** have a **substantial family, business, or financial relationship with the insured (Substantial Relationship)** apart from the acquirer's interest in the life insurance policy.

Acquirers of policies in Ordinary M&A Transactions, therefore, will need to either qualify for an exception to the Transfer Requirement or have a Substantial Relationship with the policy insureds.

The Final Regulations offer acquirers several exceptions to the Transfer Requirement.

A. Transfer Exceptions

1. Indirect Acquisitions Involving C Corporations

Under the Final Regulations, there is neither a **direct** nor **indirect** transfer of life insurance, and therefore no Reportable Policy Sale, if an acquirer becomes an owner of a C corporation that owns life insurance contracts, provided the life insurance contracts do not comprise more than 50 percent of the gross value of assets of such C corporation immediately before the acquisition.

This is a key exception that will help many Ordinary M&A Transactions avoid the Reportable Policy Sale rules. However, it is essential to note that the Preamble to the Final Regulations specifically states that the acquired C Corporation must **survive the acquisition**. Otherwise, there would be a **direct** acquisition of the life insurance policies, and therefore (absent a Substantial Relationship with the insureds or other applicable exception), there would be a Reportable Policy Sale.

2. Indirect Acquisitions of Policies Originally Acquired Prior to January 1, 2019

The indirect acquisition of an interest in a life insurance contract by a person will not be a Reportable Policy Sale if the entity being acquired survives and directly or indirectly holds the interest in the life insurance contract and acquired that interest before January 1, 2019. This will be a significant exception in acquisitions in which an acquired corporation continues in existence after the acquisition. This exception is not limited to C corporation acquisitions.

3. Other Transfer Exceptions

- a. An indirect acquisition of a life insurance policy will not be a Reportable Policy Sale if, after the acquisition, the acquirer (and family members if the acquirer is a natural

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person) owns less than 5 percent of the entity acquired and not more than 50 percent of the gross value of the entity's assets are life insurance assets.

- b. Transfers between entities with the same beneficial owners are not Reportable Policy Sales. Note that the ownership interest of each beneficial owner in the transferor entity must not vary by more than a 20 percent ownership interest from that beneficial owner's interest in the transferee entity.
- c. Transfers between entities that are consolidated for tax purposes are not Reportable Policy Sales.

B. Relationship Exceptions

If one of the transfer exceptions above does not apply, then it will be necessary for the acquirer to have a substantial relationship with the insureds after the acquisition, as set forth below.

An important interpretation provided by the Final Regulations in applying the substantial relationship rules deals with how the rules are applied to indirect acquirers of policy interests. Under the Final Regulations, the acquirer of an interest in a life insurance contract in an indirect acquisition is deemed to have a substantial business or financial relationship with the insured if the direct holder of the interest in the life insurance contract has a substantial business or financial relationship with the insured immediately before and after the date the acquirer acquires its interest. Thus, for example, an acquirer of a corporation's stock (either an S or C corporation's) will be deemed to have a substantial business or financial relationship with an insured if the acquired corporation has such a relationship.

Substantial Business Relationships

A substantial business relationship between the insured and the acquirer exists in each of the following situations:

1. Insured is a Key Person or Materially Participates in an Active Business

The insured is a key person (as defined in IRC § 264) of, or materially participates (within the meaning of section 469) in, an active business,

and at least 80 percent of that trade or business is owned (directly or indirectly, through one or more partnerships, trusts, or other entities) by the acquirer or the beneficial owners of the acquirer.

2. Insured is Employee at Acquisition or was Director, Highly Compensated Employee, or Highly Compensated Individual and Acquirer Carries on Acquired Business

The acquirer acquires an active business and acquires the interest in the life insurance contract as part of that acquisition if—

- a. The insured—
 - (i) **Is an employee** of acquired business immediately preceding the acquisition; or
 - (ii) **Was a director, highly compensated employee, or highly compensated individual within the meaning of section 101(j)(2)(A)(ii) of the acquired business,** and the acquirer, immediately after the acquisition, has **ongoing financial obligations to the insured with respect to the insured's employment** by the business. For example, the life insurance contract is maintained by the acquirer to fund current or future retirement, pension, or survivorship obligations based on the insured's relationship with the entity or to fund a buyout of the insured's interest in the acquired trade or business; **and**
- b. The acquirer either carries on the acquired business or uses a significant portion of the acquired business assets in an active business that does not include investing in interests in life insurance contracts.

This relationship described above in 2.a.(ii), helps cover policies on insureds who are no longer employed by the acquired corporation. It is necessary, however, that the acquirer immediately after the acquisition has ongoing financial obligations to the insured with respect to the insured's employment. This would include, for example, former highly compensated employees who are still being paid out their deferred compensation or SERP benefits.

Substantial Financial Relationships

The substantial financial relationship rules are not likely to play a large role in helping Ordinary M&A Transactions avoid the Reportable Policy Sales rules.

A substantial financial relationship between the insured and the acquirer exists in each of the following situations:

1. Acquirer has a Common Investment with Insured a Buyout of Insured's Interest in Investment on Death is Reasonably Foreseeable

The acquirer (directly or indirectly) has, or the beneficial owners of the acquirer have, a common investment (other than the interest in the life insurance contract) with the insured and a buyout of the insured's interest in the common investment by the co-investor(s) after the insured's death is reasonably foreseeable.

2. Acquirer Maintains Life Insurance on Insured to Provide Funds to Purchase Assets of or to Satisfy Liabilities of the Insured or Insured's Estate

The acquirer maintains the life insurance contract on the life of the insured to provide funds to purchase assets of or to satisfy liabilities of the insured or the insured's estate, heirs, legatees, or other successors in interest, or to satisfy other liabilities arising upon or by reason of the death of the insured.

3. Acquirer is Charity That Received Substantial Financial or Volunteer Support from the Insured

The acquirer is an organization described in IRC §§ 170(c), 2055(a), and 2522(a) that previously received from the insured either financial support in a substantial amount or significant volunteer support or that meets other requirements prescribed in guidance published in the Internal Revenue Bulletin (see § 601.601(d)(2) of this chapter) for establishing that a substantial financial relationship exists between the insured and the organization.

Reporting Requirements

In general, every person that is an acquirer in a Reportable Policy Sale during any calendar year must file a separate information return with the Internal

Revenue Service (IRS) for each Reportable Policy Sale during payment. Acquirers should consult with their counsel to insure reporting requirements are met.

In addition, every issuer that is a payor of reportable death benefits during any calendar year must file a separate information return for such calendar year for each reportable death benefits payment recipient in the form and manner prescribed by the IRS including, among other things, the gross amount of reportable death benefits paid to the reportable death benefit payment recipient during the taxable year and the issuer's estimate of investment in the contract with respect to the buyer.



Final Regulation—Effective Dates

Reportable Policy Sales made after December 31, 2018, and reportable death benefits paid after December 31, 2018 are subject to the reporting requirements.

For any purpose other than for reporting, including for purposes of determining the amount of the proceeds of life insurance contracts payable by reason of death excluded from gross income under IRC § 101, Final Regulations §1.101-1(b) through (g) apply to amounts paid by reason of the death of the insured under a life insurance contract, or interest therein, transferred after October 31, 2019.

However, a taxpayer may apply the rules set forth in §1.101-1(b) through (g) of the Final Regulations, in their entirety, 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, and on or before October 31, 2019. ■

M Benefit Solutions Security Part 3: Internal Systems and Policies



In our third and final article about data security at M Benefit Solutions, we will discuss internal security protocols. In the first article, we discussed the human element of data security. *Matters of Interest* Volume 37. The second article covered the security measures we take for our externally facing systems. *Matters of Interest* Volume 38. Now we turn to some of the systems we have put in place that clients will never see. Users logging into our systems will not notice these systems in action, but they are protecting our clients every day.

Encryption at Rest

In Part 2, we talked about the encryption that protects all M Benefit data in transit. The vast majority of the time, client data is not in transit. It is sitting on a hard drive, waiting to be requested. When it is not in transit, is considered “at rest.” M Benefit practices encryption at rest, a simple concept that results in a significant increase in data security: We encrypt our sensitive data when it is at rest. M Benefit takes measures to prevent an intrusion, but in the event those measures fail, a malicious attacker will find the data they access encrypted and unusable.

Email Security

As noted in Part 1, M Benefit staff trains regularly to spot phishing and other email threats. We also have systems that reduce the number of threatening emails that reach inboxes. Most people are familiar with spam filters, but spam filters are in a continuing arms race with spammers. Spam filters have false positives or may not recognize a new form of spam. A key backstop to our spam filtering is the use of DMARC domain rejection.

DMARC is an outgrowth of several prominent email senders banding together to improve email. Two technologies, Sender Policy Framework (SPF) and DomainKeys Identified Mail (DKIM), existed to allow receiving servers to authenticate email. However, while

uptake of these new technologies was good, servers still sent unauthenticated emails. Mail administrators were unwilling to automatically reject this unauthenticated email for fear that they would be rejecting email sent in good faith. In 2007 PayPal, Yahoo!, and Gmail began to collaborate on a method of dealing with the unauthenticated email problem. Their solution grew into DMARC.

DMARC is a form of information sharing that allows mail administrators to increase trust between their systems. It is an additional layer of filtering based on the publication of instructions that tell other servers how to handle unauthenticated email claiming to be from the sender’s servers. These instructions allow the receiving servers to compare what they see to what they should expect. DMARC provides a method for mail administrators to tell other mail administrators that they



can safely reject any unauthenticated email claiming to come from a participating organization. DMARC operates in tandem with measures like IP blocklists, rate limits, reputation monitoring, and spam filters to prevent phishing attempts and other email intrusions from reaching employee inboxes.

By participating in DMARC, DKIM, and SPF, M Benefit practices email security and corporate responsibility at the same time. We reduce the number of email threats we face and aid others in their security efforts.

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Business Continuation Plan

M Benefit Solutions has a Business Continuation Plan (BCP) in case a natural disaster or other disruption prevents service from continuing from our Portland, Oregon office. If an event occurs that prevents our Portland location from conducting business or providing data, a second data center in Arizona will activate. This data center will be used by employees with remote access to ensure our clients continue to receive data uninterrupted in the event of a major disruption in Portland. After accessing the data center, the plan document will guide our staff through a full

resumption of services with minimal impact to our client base.

Of course, it is one thing to have a plan, and another to be sure you can execute on it. To ensure that our BCP functions as intended in the event of a disaster, on an annual basis we conduct a three-part test of the BCP, culminating in a simulated disaster causing the activation of the failover systems in Phoenix. ■



Meet a Managing Associate



M Benefit Solutions has been an innovator in the nonqualified plan space for over four decades. Over these decades, we have been privileged to employ extraordinary people, including our Managing Associates. Managing Associates oversee and partner with our staff of client associates to deliver the exceptional level of service and support our clients and Member Firms deserve. Our Managing Associates are industry experts and client-service leaders, but each brings something unique to our office. We want to introduce them to you here, and allow our clients and Member Firms the opportunity to learn more about the people that are differentiators in our office and industry.

Linda Dixon

When Linda joined M Benefit Solutions over fifteen years ago, she already had more than a decade of industry experience. Her career has touched on almost every facet of the business, from plan design and consulting to client service and plan administration. Linda was a journalism major at the University of Oregon and has a keen editorial eye, which she puts to good use keeping client communications clear, concise, and informative. While working at M Benefit, Linda earned an M.B.A. from Willamette University, where she formed lasting friendships. She later ran the Hood to Coast Relay with one of those classmates, who has since joined her at M.

When not at work, Linda spends time with her son and their two cats. Her cats have always had names starting with 'G.' Griffin and Ginger are no exceptions. Linda is a doting parent and proud soccer mom, taking her son to all the games and making sure he doesn't play too much Fortnite. When all of that is not keeping her too busy, she is a voracious reader and an excellent cook.



Linda elevates her coworkers and is a cornerstone of M Benefit Solutions' commitment to client service. ■

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