

# Spooky New Life Insurance Regulations



Generally, life insurance death benefits pay out income tax-free, but when a life insurance contract is transferred or assigned in exchange for valuable consideration (transfer for value, or TFV) the death benefit in excess of what was paid for the contract is subject to income taxes. It is possible for the death benefit to retain tax-free status if the TFV meets one of the exceptions set out in the tax code. The TCJA altered the TFV rules and available exceptions by creating the idea of a reportable policy sale (RPS), which potentially has a significant impact on the COLI and BOLI marketplaces. Under the TCJA rules, one must now determine that the transaction is not a RPS before deciding whether it falls into an existing TFV exemption.

## BACKGROUND

On October 31, 2019, the Treasury Department finalized rules detailing the requirements for RPS, which were created under the 2017 Tax Cuts and Jobs Act (TCJA) and apply to TFV of life insurance contracts. Those final regulations help to provide guidance for which transfers are RPS and clarify the implications for the COLI/BOLI market. We created the “Reportable Policy Sale Analysis Chart” that you can view on our Marketing Bridge for more insight into the RPS rule and its potential impact on COLI/BOLI insurance policies.

It is crucial to understand that neither the TCJA nor the RPS final regulations alter the TFV regulations, they just add another layer of analysis to the existing TFV rules. The TFV exceptions fall into one of two categories: transfer to a certain person or a transfer with carry-over basis. However, the RPS rule confirmed that in order for the death benefits, with respect to a transferred life insurance policy, to be excluded from income **1)** the policy must not have been transferred in an RPS and **2)** either the transfer to a certain person or carry-over basis exceptions apply.

## RPS RULES AND EXCEPTIONS

A policy is transferred in an RPS if: 1) there is a direct or indirect 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.” If either of the RPS conditions is not met, then the transfer is not treated as an RPS and the TFV exceptions still apply as before.

The RPS final rules provided several exceptions wherein the transfer of the policy (directly or indirectly) will not be considered an RPS.

- 1. Transactions Involving C Corporations:** There is no indirect transfer of life insurance where **1)** the acquirer becomes the beneficial owner of a C corporation that owns the life insurance contract and **2)** life insurance contracts do not comprise more than 50% of the gross value of the assets of such C corporation. As a result, acquisition of shares in a C corporation owning COLI products is not likely to result in a RPS.
- 2. De Minimis Acquisition:** Where **1)** not more than 50% of the gross value of the entity’s assets are life insurance contract and **2)** the acquirer (and any family members if the acquirer is a natural person) owns 5% or less of the entity.

- 3. Same Beneficial Owners:** Transfers of interest in life insurance contracts between entities with the same beneficial owners. This applies where the ownership interest of each beneficial owner in the transferor entity does not vary by more than 20% from that person's ownership interest in the transferee entity. For purposes of this exception, only ownership in the first and last entity that holds the insurance is examined.
- 4. Consolidated Entities:** Transfers between entities that are consolidated for tax purposes are not RPS.
- 5. Indirect Acquisitions:** The RPS Final Rule includes an exception for indirect acquisitions of life insurance contracts. This exemption is critically important for Ordinary Course Transactions involving S corporations holding COLI/BOLI policies, but it is also applicable to partnerships and trusts. In instances where an acquiror purchases a S corporation through a stock transaction, any COLI/BOLI policies transferred to the acquiror through that purchase are exempt from the reportable policy sale rules, *so long as the S corporation held an interest in the life insurance policies prior to January 1, 2019*. It is important to note that S corporations purchased through asset sales will not qualify for this exemption. C corporations will also not qualify, regardless of whether the transaction is executed as a stock transaction or an asset sale (however, see the C corporation exception to determine whether it applies).
- 6. Substantial Relationship:** 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. These relationships do not need to be all the same type of substantial relationship; therefore, an entity will be deemed to have a substantial relationship so long as each of the "beneficial owners" can establish some type of substantial familial, business, or financial relationship that the particular owner has with the insured.
  - a. Indirect Acquisitions:** 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 after the acquisition.
  - b. Substantial Business Relationship:** Exists for both direct and indirect transfers where the insured is a "key person" of the acquired business or "materially participates" in the acquired business and the acquirer/acquiree directly/indirectly owns at least 80% of the acquired business. Additionally, it exists where the acquirer **1)** acquires an "active business," **2)** the insured is an employee of the acquired business immediately before the acquisition or 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 insured's employment, and **3)** the acquirer carries on an active business.
  - c. Substantial Financial Relationship:** Exists for both direct and indirect transfers where one of the following is true:
    - i. The acquirer has a common investment with the insured and it was reasonably foreseen that in the event of the insured's death, the insured's interest would be bought out by the co-investors.
    - ii. The acquirer is either a Section 170(c) organization, an organization described in 2055(a), or an organization described in 2522(a) and the particular organization has previously received a substantial amount of financial or volunteer support from the insured.
    - iii. 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 insured's estate, heirs, legatees, or successors in interest or to satisfy other liabilities arising upon or by reason of the death of the insured.

The RPS Final Rule also clarifies that with respect to 1035 exchanges of life insurance, for the insurance company acquiring the old policy in exchange for the new policy, the acquisition of the old policy is not a RPS. However, for the exchanging policy holder, the acquisition of the new policy is a RPS unless the policy holder qualifies for one of the Substantial Relationship exemptions. This 1035 rule would apply to exchanges on policies on the life of a former employee and the employer might lack sufficient substantial relationship with the insured to avoid RPS status, making the death benefit partially taxable. Remember, even though the carry-over basis exception would have applied to the 1035 exchange, under the RPS rules, you first have to not have a RPS and then you have to have a valid TFV exception.

The RPS rules are generally effective on October 31, 2019; however, taxpayers may choose to apply the RPS rules to any amounts paid by reason of the death of the insured on a contract transferred after December 31, 2017. This gives tax payers the option to apply the RPS rules retroactively back to the TCJA's enactment. The Treasury Department's clarification of the RPS rules is generally helpful to taxpayers, particularly in the COLI/BOLI space. For more insight as you navigate the RPS rules, read the detailed summary from AALU.