TAX CUTS AND JOBS ACT OF 2017:
TRANSFER FOR VALUE RULE IMPACT ON EMPLOYER OWNED LIFE INSURANCE

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Introduction
This article summarizes the current state of the Transfer for Value (TFV) rules under current tax law as they pertain to Employer Owned Life Insurance (e.g., COLI, BOLI, CUOLI). The Tax Cuts and Jobs Act of 2017 (TCJA) modified the TFV rules, such that policy death proceeds are only partially excludable from gross income for any commercial transfer of a life insurance contract considered a "reportable policy sale." This could apply to any policy where the insured is a former employee of a company acquired on or after 01/01/2018, and result in some portion of future death proceeds from that policy being subject to tax.

At the time of writing, Treasury Regulations have not been released, and there is a lack of consensus regarding interpretation and application. The purpose of this article is to make you aware of the possible implications of the modified TFV rules and provide you with background for further discussion with your accountants and/or auditors.

Note that final (and generally favorable) rules were published on October 31, 2019, addressing many if not all of the questions raised in this article. A link to the final rules is provided on page 4.

Background[i]
As written, the Tax Cuts and Jobs Act of 2017 (Pub.L. 115-97) modifies the Transfer for Value (TFV) exception for life insurance contracts for transactions (e.g., business acquisitions) after 12/31/2017. Under 101(a)(1), death proceeds paid under an insurance contract are generally excluded from gross income. Under 101(a)(2), limitations and exceptions to those limitations are outlined for cases when a policy has been transferred for "valuable consideration." Under 101(a)(3), death proceeds are only *partially* excludable from gross income for any commercial transfer of a life insurance contract considered a "reportable policy sale."

Under 101(a)(3)(B), "the term 'reportable policy sale' means the acquisition of an interest in a life insurance contract, directly or indirectly, if the acquirer has no substantial family, business, or financial relationship with the insured apart from the acquirer's interest in such life insurance contract. For purposes of the preceding sentence, the term 'indirectly' applies to the acquisition of an interest in a partnership, trust, or other entity that holds an interest in the life insurance contract."

Application to Employer Owned Life Insurance
For business acquisitions taking place after 12/31/2017, it can be argued that 101(a)(3)(B) should broadly apply to Employer Owned Life Insurance where the insured is a former employee of the business being acquired.

If 101(a)(3)(B) applies, then any affected policies (limited to *former* employees of the *acquired* entity) could have the following negative outcomes:

1. Some portion of future death proceeds will be included in the gross income of the acquiring company
2. The acquiring company may need to reflect a Deferred Tax Liability (DTL) on its books
3. The reportable policy sale must be reported under Section 6050Y[ii]

At this time, the phrase "no substantial family, business, or financial relationship with the insured" is undefined from a regulatory standpoint, so it can also be argued that there are a wide variety of business and financial relationships that could preserve the full exclusion of gross death benefit from gross income. For example, the insured could continue to be part of a benefit plan (e.g., NQDC, Split Dollar); the insured/policy could be part of a larger benefit offset funding strategy affecting a combination of current and former employees; the insured could continue to serve the acquiring entity as an independent contractor.

Inclusion in Gross Income

The amount to include in gross income for a policy impacted by the new transfer for value rules will depend on the acquiring entity's cost basis at the time of the transaction and any future premiums paid by that entity into the policy. Under Section 1016(a)(1)(B), no adjustment should be made to cost basis for mortality or expense.[iii]

If the acquisition is a stock sale then the cost basis will generally be the sum of the net premiums paid. If the acquisition is an asset sale then the acquiring entity receives a step-up in basis equal to the asset value (Fair Market Value) at the time of the sale. In the most straightforward asset sale, the asset value (i.e., initial cost basis) will equal the cash surrender value of the policy.

Once the initial cost basis is established, it can be increased periodically at the time of any future premium payments.

At the time of the insured's death, the amount to include in gross income will be the gross death proceeds *minus* the then-current cost basis.

If there is a "post-retirement" endorsement split dollar plan in effect for the former employee, it is unclear if the participant's share of death benefit under the plan can be excluded from the gross income calculation.

Deferred Tax Liability

There seems to be consensus among practitioners that where some portion of death proceeds will be included in gross income, an accrual-basis entity should book a Deferred Tax Liability (DTL). However, there is not yet consensus on how that amount should be calculated.

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One approach books an initial DTL based on the total policy cash value *minus* the initial cost basis as of the date of the transaction/acquisition. In the case of an asset sale, this could be zero due to the step-up in basis. Periodically, the DTL could be updated based on the current cash value *minus* the current cost basis, where the current cost basis equals the initial cost basis *plus* any additional premiums paid.

The other approach books a DTL based on the policy death benefit *minus* the initial cost basis as of the date of the transaction/acquisition. This amount may also be adjusted periodically if (a) additional premiums are paid (decreasing the DTL) or (b) the policy death benefit changes due to policy design or market conditions.

Note that there does not seem to be any justification to record a DTL based solely on the full death benefit of the policy.

Possible Relief
The Joint Committee on Taxation released their "Bluebook" (JCS-1-18) on 12/20/2018[iv]. Footnote 1160 on page 243 directs the Treasury Department to provide guidance on the definition of "A substantial family, business or financial relationship with the insured apart from the interest in the life insurance contract." The Bluebook also indicates that policies not subject to 101(a)(3)(B) may be subject to reporting under a new section 6050Y.

This leaves readers to wait on applicable Treasury guidance. At the time of writing, the Treasury was significantly impacted by an ongoing partial government shutdown, further delaying guidance.

On 01/02/2019, Congressman Kevin Brady released a discussion draft technical corrections bill[v] for the TCJA; however, it did not contain any provisions related to the TFV rules. There will likely be efforts to urge Congress to add a technical correction related to the TFV rules. Even if included, passage of any technical corrections bill is questionable with the Split Congress.

Open Questions
There are still many unanswered questions, and our research has found divisive opinions and interpretations abound. Some examples of the open questions are listed below:

1. If an insured is employed at the date of an acquisition, but subsequently separates from service, are they subject to the terms of 101(a)(3)?
2. Is there a preferred way to calculate Deferred Tax Liability?
3. What sort of benefit and/or business relationships will exclude a policy from 101(a)(3)?
4. Can "post-retirement" split dollar benefits be excluded from death proceeds included in gross income?

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Next Steps

If your organization or your client's organization was involved in an acquisition on or after 01/01/2018 you should work with your professional advisors to determine if any Employer Owned Life Insurance policies may be subject to 101(a)(3), and if so, what action(s) should be taken.

The following is a non-inclusive list of diagnostic questions that may be helpful in identifying Transfer for Value issues:

- Was there a merger/acquisition on or after 01/01/2018 that could invoke the new Transfer for Value rules under TCJA?
- What was the type of merger (e.g., stock sale, asset sale)?
- Was there Employer Owned Life Insurance on any former employees of the entity being acquired?
- Was there Employer Owned Life Insurance on any employees that separated from service as a result of the acquisition?
- Have there been any death proceeds paid on impacted policies?
- What was the cost basis at the date of acquisition for any impacted policies?
- Is the acquiring entity an accrual-basis taxpayer?
- What, if any, Deferred Tax Liability should be recorded and when should it be reviewed?
- **Has there been any regulatory guidance since the date of this article?**
- **Note: Final Rules were published on October 31, 2019: https://www.federalregister.gov/d/2019-23559**

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[i] See https://www.law.cornell.edu/uscode/text/26/101

[ii] See https://www.law.cornell.edu/uscode/text/26/6050Y

[iii] See https://www.law.cornell.edu/uscode/text/26/1016

[iv] See https://www.jct.gov/publications.html?func=startdown&id=5152

[v] See https://kevinbrady.house.gov/components/redirect/r.aspx?ID=2525-72274534