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ADVANCED PLANNING
BULLETIN
March 2012
BUSINESS | RETIREMENT | FINANCIAL | ESTATE

Favorable Ruling for BOLI (and Probably for Most COLI too): Private Letter Ruling 2011-52-014 (Dec. 30, 2011)

Summary
The IRS provides a favorable ruling regarding bank-owned insurance transferred to an LLC.

Related Information
New Guidance on Bank-Owned Life Insurance: OCC Bulletin 2004-56; 264(f) Interest Deduction Denial for Unborrowed Cash Values.

Background

Bank owned life insurance (BOLI) is permitted within guidelines set by bank regulators.[1] Among the issues for banks to consider are the following:

1. Under § 264(f), a bank loses a tax deduction for interest expense when it holds life insurance policies with unborrowed cash values, unless the insured is an at least 20% owner, or officer, director, or employee at the time of policy issue; and

2. Employer owned insurance policies are subject to § 101(j), which imposes income taxation on death benefit in certain situations, unless "notice and consent" requirements are met.

Facts

A managing company (Manager) forms a limited liability company (LLC), taxed as a partnership. The purpose of the LLC is to provide banks with a more effective, centralized way to manage life insurance policies. A national bank (Bank A) and a bank holding company (Bank B) transfer to the LLC existing life insurance policies – some fixed, some variable – on the lives of current and former employees. In exchange, Bank A receives more than 50% of the LLC membership interests, and Bank B receives less than 50% of the membership interests (the Manager presumably has a much smaller interest). It is anticipated that additional banks will contribute policies and become members of the LLC in the future, reducing the membership interests of Banks A and B. It is also anticipated that the LLC might exchange existing life insurance policies for new policies, but if so, the new policies will comply with any insurable interest laws.

[1] See OCC Bulletin 2004-56 (Dec. 7, 2004).

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Rulings

The IRS issues several favorable rulings, including the following:

1. No gain or loss is recognized by any parties when the policies are transferred to the LLC,

2. Bank B's unrelated interest expense deductions are not disallowed under § 264(f), and

3. Death benefit received from policies in the LLC that insure employees of Bank B are not subject to § 101(j).

Reasoning

1. Because the LLC is taxed as a partnership, no gain or loss is recognized when property is contributed by members (§ 721), unless the LLC is treated as an "investment company" under § 351. The LLC is not treated as an investment company because its primary assets are not securities. The ruling doesn't say it explicitly, but the I.R.S. presumably does not view the life insurance policies as securities for purposes of § 351, even though some of them are variable contracts.

2. Section 264(f) disallows a tax deduction for companies with unrelated interest expense allocable to policies with unborrowed cash values unless the insured is an at least 20% owner, officer, director, or employee of the company at the time of policy issue. Here, neither bank owns the policies. So no problem, right? Wrong. All members of a controlled group are treated as one taxpayer for this purpose, so a policy owned by one is a policy owned by all.

   Because Bank A owns more than 50% of the LLC, Bank A and the LLC are part of a controlled group.[2] Therefore, the policy owned by the LLC will be treated as owned by Bank A, so a portion of Bank A's unrelated interest expense deductions will be disallowed unless the insured is an at least 20% owner, or an employee, director, or officer of either Bank A or LLC.

   However, because Bank B holds less than 50% of the LLC, it is not part of a controlled group with the LLC. Therefore, the policies in the LLC do not cause disallowance of Bank B's unrelated interest expense deductions.

3. Section 101(j) covers life insurance policies on the life of an insured who is an employee of the "applicable policyholder." Similar to the 264(f) rules, "applicable policyholder" includes entities in a controlled group.

   Since Bank A owns more than 50% of the LLC, it is part of a controlled group with the LLC and is treated as an applicable policyholder. Therefore, § 101(j) applies to policies owned by the LLC that insure employees of Bank A. As such, the death benefit of those policies will

[2] Section 264 adopts controlled group rules of § 52 (a) and (b), and § 414. The regulations under § 52 treat a partnership and its majority owner as one entity.

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be taxable to the LLC unless the requisite written "notice and consent" was obtained before the policies were issued.

However, because Bank B owns less than 50% of the LLC, it is not treated as an applicable policyholder. Therefore, § 101(j) does not apply to policies owned by the LLC that insure employees of Bank B.

Observations

This ruling is apparently telling us that banks (and presumably other businesses too) that own life insurance policies can contribute them to an LLC or partnership to avoid disallowance of interest deductions under § 264(f) and income taxation of death benefit under § 101(j). Although this might look like a valuable technique at first, there are reasons to temper our enthusiasm.

First, § 264(f) rarely applies to begin with. Again, it never applies if the insured is an employee (any level), officer, director, or at least a 20% owner at the time the policy is issued. This basically means that only those policies purchased on non-employee owners who hold less than 20% of the business would trigger the provision. If the insured didn't hold even that role, it is hard to see how the business would have an insurable interest, so the policy probably wouldn't be issued at the outset. But, for those less-than-20%-owner situations, the technique of contributing the contract to an LLC or partnership might have some merit.[3]

As for § 101(j), contributing the policy to a LLC or partnership presumably would be valuable to those businesses that had failed to acquire the requisite notice and consent initially.[4]

But even where this technique might be valuable for side-stepping § 264(f) or § 101(j), there is a real cost to doing it. Due to the controlled group rules, the business that transfers the policy would have to be willing to be a mere minority owner of the receiving entity, effectively giving up not only control, but also enjoyment of most of the policy's cash value and death proceeds whenever the LLC or partnership decided to make distributions.

Lastly, there are other concerns that this ruling did not address. For example: (i) when a business applies for a new policy, does it have to disclose to the insurance company any intent it has to transfer the policy to the LLC? (some insurers require it in reaction to stranger-owned life insurance promotions); and (ii) do the bank-owned life insurance OCC regulatory rules, such as the requirement that bank officers and directors take an active role in oversight of BOLI, still apply after the policy is transferred to the LLC?

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[3] A policy is treated as newly issued at the time of a § 1035 exchange for purpose of (re)testing § 264(f). Rev. Rul. 2011-9. If an insured employee quits and the LLC later wants to do § 1035 exchange, then it seems the current ruling would be valuable to the extent it avoids § 264(f) altogether. But a purchase on a *former* employee – § 1035 demands that the insured remain the same – might not always meet insurable interest rules, unless, say, there was a nonqualified deferred compensation plan or something similar in place for that ex-employee.

[4] Nonetheless, the facts of the ruling state that notice and consent had always been, and would always be, obtained.

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