Tax Effects on BOLI & Nonqualified Plans in Bank Mergers & Acquisitions

Brought to you by:

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Agenda

- Background on Our Topic of Discussion Today
- Mergers & Acquisitions' Effect on Bank Owned Life Insurance (BOLI)
    - BOLI in a Stock Acquisition/ Sale
    - BOLI in an Asset Acquisition/ Sale
- Mergers & Acquisitions' Effect on Split Dollar Plans
- Mergers & Acquisitions' Effect on Nonqualified Benefit Plans
    - IRC Sec 280(g)
- Conclusion
- Question & Answer

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Background

- Increase in bank merger activity
- Targeted at small banks with under $250 million in assets due to higher regulatory-based costs
- Banks involved in a merger or acquisition should ask the following questions:
    1. What is the status of the Bank Owned Life Insurance (BOLI) and Nonqualified Benefits in the case of both the buyer and the seller?
    2. What happens to the BOLI in a stock vs. asset acquisition/ sale?
    3. What are the differences between S corporation and C corporation transactions?
    4. What should the bank look at when involved in a transaction?

- Mergers/ acquisitions require due diligence from both the buying and selling sides
- Ramifications:
    - Negative unintended tax effects
    - Potential out of contract payment of a Deferred Compensation agreement
    - Will in force policies support future benefit obligations

Background

- National bank BOLI statistics:

Asset Size	Total Banks	Banks with BOLI: No.	Banks with BOLI: %	Averages for Banks with BOLI ($000): Total Assets	Tier I Capital	BOLI CSV	% BOLI to Tier I Capital	% BOLI to Assets
Over $10 Billion	107	74	69.2%	$ 138,949,538	$ 11,604,771	$ 1,467,398	12.6%	1.1%
$1 Billion - $10 Billion	548	429	78.3%	$ 2,557,429	$ 252,397	$ 36,618	14.5%	1.4%
$750-$999 Million	232	171	73.7%	$ 864,789	$ 88,604	$ 13,997	15.8%	1.6%
$500-$749 Million	443	303	68.4%	$ 609,916	$ 61,812	$ 10,011	16.2%	1.6%
$250-$499 Million	1223	811	66.3%	$ 349,212	$ 35,562	$ 5,810	16.3%	1.7%
$100-$249 Million	2255	1220	54.1%	$ 166,001	$ 17,379	$ 2,869	16.5%	1.7%
< $100 Million	2197	760	34.6%	$ 62,800	$ 6,808	$ 1,184	17.4%	1.9%
Totals	*7005*	*3768*	*53.8%*	*$ 143,559,685*	*$ 12,067,333*	*$ 1,537,887*	*12.74%*	*1.07%*

Source: Thomson Reuters Bank Insight 6/30/13

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Bank Owned Life Insurance (BOLI)

- The bank's BOLI assets must be analyzed from a risk assessment standpoint. Factors include:
  - Financial strength of carriers
  - Performance of the policies both from a historical and current standpoint
  - Types of policies (i.e. general account, separate account or hybrid)
  - Who is insured? Will they continue to be associated with the bank?
  - If there is a post-retirement death benefit, analyzing the sustainability of the policy's death benefit to meet the obligation is critical

BOLI in a Stock Acquisition/ Sale

Stock Acquisition/ Sale

- Policies transfer over to the acquiring bank at the cash surrender value (CSV) as of the merger/ acquisition date

- Taxability
  - Selling bank:
    - No taxability concerns since the accumulation of earnings does not get triggered
  - Acquiring bank:
    - “Steps into the shoes” of the selling bank with carryover cost basis on the policy
    - No deferred tax liability will need to be recorded
    - Annual increases in CSV will be recorded as tax-free, and death proceeds will be tax-free

BOLI in an Asset Acquisition/ Sale

Asset Acquisition/ Sale

- The selling bank recognizes the gain on the BOLI as ordinary income.
- Any gain recognized from the "deemed" asset sale will increase the acquiring bank's basis in the policy.
- Example:
  - If the original premium was $1 million and the cash surrender value was $1.3 million at the time of sale, the selling bank's shareholders will recognize a $300,000 ordinary income gain on the BOLI.
  - The acquiring bank then receives an increase in basis in the BOLI policy and can surrender the policy with no taxable gain at that point or hold the policies until death while recording tax-free earnings for increases in CSV above the $1.3 million.

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BOLI in an Asset Acquisition/ Sale

- "Transfer for Value Rule"
  - Death benefits of any life insurance policy that is acquired/sold may be subject to ordinary income taxation, unless it falls within an exception.
  - Example: If a bank acquires BOLI in an asset sale and the insured on the BOLI policy will be an officer or shareholder of the acquiring bank at the time of acquisition, the death benefit on the BOLI will not be subject to ordinary income taxation. If the insured will not be an officer or shareholder of the acquiring bank, then acquiring the BOLI policy will likely not make sense.

- Notice and Consent Requirement of §101(j)(4)
  - Requires an employer to give notice to an employee of its intent to purchase life insurance on the employee, and that the employee consents in writing prior to the purchase.
  - Recommended best practice is for the acquiring bank to obtain a new notice and consent signed by the insured of the acquired BOLI policy.

- Moral of the story: Whether you are the seller or the buyer, be aware of how BOLI will affect the transaction and its value before and after the merger.

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Split Dollar Plans

- Split dollar plans give a portion of the death benefit proceeds to those that are insured under the BOLI plan. There are two types of split dollar plans that we see in banks:

- Pre-retirement Plans
  - In place while the participant is employed by the bank, and at separation of service, the plan is terminated.
  - Most common type of plan seen at banks.
  - No cost to the bank, and the insured will receive an economic benefit that must be reported as imputed income.
  - If these plans are in place by the seller, the plans generally go with the acquiring bank under the change of control provision.
  - As soon as the employee leaves, no matter what the reason, the split dollar benefit terminates. This pertains to both C and S corporations.

- *27% of executives have Split Dollar according to Executive Benefits Network's compensation survey.*

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Split Dollar Plans

- Post-retirement Plans
  - Extends the life insurance benefit past the participant's retirement.
  - Only pertains to those that are vested in the benefit according to the specific agreement.
  - Tapered off due to the FASB requirement to accrue the present value of the post-retirement benefit on a company's financial statements prior to the employee's separation of service.
  - Agreement will specify what happens upon a change of control. Usually the benefit goes to the acquiring company, but many times the participants on the plan are the key employees and may be separated from service as part of the merger.
  - Liabilities that go along with the accrual can be substantial and should be carefully analyzed by the acquiring bank. This pertains to both C and S corporations.

- Moral of the story: Know when the split dollar benefit terminates, and know whether or not the split dollar benefit has accrual requirements.

Nonqualified Benefit Plans in a Change of Control

- Nonqualified plans are those that are regulated by ERISA and IRC 409(A). They may be deferred income plans, defined benefit plans or defined contribution plans.

- IRC 409(A)
  - Specifically addresses the definition of Change of Control (COC)
  - Almost always very specifically defined in the agreement
  - Some COC benefits are triggered if there is just a COC, while others are triggered if there is both a COC and separation of service

- Past
  - Full retirement benefit was paid if there was a COC, and the payout began immediately.
  - Example: If the full retirement benefit was $50,000 a year, that was the benefit that began after COC and separation of service regardless of age.
  - Gross up provision in the agreement– if there were any 280(g) issues as a result of the COC, the company would gross up the benefit to pay for the taxes that went along with it

- Today
  - Acceleration of vesting at the change of control– amount paid is based on the accrual balance as opposed to the projected benefit amount
  - If there is an acceleration of vesting of the benefit where the participant will either get paid out immediately or at a later date , it may trigger 280(g) and 4999 IRS issues.

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IRC 280(g): Golden Parachute Payments

- Addresses "Golden Parachute" payments to executives at a change of control
  - **C corporation**: Parachute payments are a big issue and can be very costly to both the acquiring bank and the participant.
  - **S corporation**: Parachute rules do not apply.

- Covers: bonus payments, severance payments, certain fringe benefits, acceleration of vesting of long term incentive plans and SERP's (Supplemental Executive Retirement Benefit Plans), stock options and other equity based compensation

- Payments are in violation of IRC 280(g) if the aggregate present value of the payments equals or exceeds an amount three times the base amount of compensation. Penalties include:
  - 20% penalty of the future benefits to be paid assessed to the participant
  - Payments to the participant are permanently non-deductible by the company

- Moral of the story: It is important to get advice from your CPA and law firm before any merger to ensure the selling and buying banks are compliant.

Conclusion

In summary, whether you are the buyer or the seller, a C corporation or an S corporation, or it's an asset or stock transaction:

1. Be aware of how the value of BOLI changes at change of ownership, and how BOLI affects the transaction for the buyer and the seller.

2. Find out if the split dollar plans are pre- or post-retirement plans.

3. Have a third party double check that the transaction follows all necessary rules and regulations and does not inadvertently trigger an IRC 280(g) violation.

Coming Soon!

Below is a list of educational pieces in the works at Executive Benefits Network:

- Bank Compensation and Benefits Study
- Strategies to Succession Planning
- Basel III and its Effects on Executive Compensation

Q&A

- Thank you!

- To receive a copy of this presentation, please contact Nikki at nkook@ebn-design.com

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