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

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EBN EXECUTIVE BENEFITS NETWORK insights

TAX EFFECTS ON BOLI AND NONQUALIFIED PLANS IN BANK MERGERS & ACQUISITIONS

A topic of conversation at many conferences has been the increase of bank merger activity. It seems that small banks with under $250 million in assets, as defined by Melaine D. Brandt, CPA of Wipfli, will be the primary target of the mergers due to their higher cost of doing business and their desire to step away from the fray.

Banks involved in a merger or acquisition should ask themselves the following questions:

- What is the status of the Bank Owned Life Insurance (BOLI) and Nonqualified Benefits in the case of both the buyer and the seller?
- What happens to BOLI in a stock vs. asset acquisition/ sale?
- What are the differences between S corporation and C corporation mergers?
- What should the buying and selling bank look at when purchasing or selling a bank?

“A poorly analyzed transaction can have negative tax effects...”

Most banks have Bank Owned Life Insurance (BOLI) on their balance sheet during a merger. The chart below shows BOLI statistics for banks nationally:

		Banks with BOLI		*Averages for Banks with BOLI ($000)*				
Asset Size	**Total Banks**	**No.**	**%**	**Total Assets**	**Tier I Capital**	**BOLI CSV**	**% BOLI to Tier I Capital**	**% BOLI to Assets**
Over $10 Billion	135	106	78.5%	$ 122,856,151	$ 10,817,783	$ 1,267,868	11.7%	1.0%
$1 Billion - $10 Billion	634	525	82.8%	$ 2,690,721	$ 273,112	$ 40,256	14.7%	1.5%
$750-$999 Million	246	196	79.7%	$ 875,994	$ 97,457	$ 14,281	14.7%	1.6%
$500-$749 Million	407	304	74.7%	$ 603,693	$ 64,741	$ 10,706	16.5%	1.8%
$250-$499 Million	1076	783	72.8%	$ 356,212	$ 38,991	$ 6,493	16.7%	1.8%
$100-$249 Million	1613	1000	62.0%	$ 166,172	$ 19,072	$ 3,186	16.7%	1.9%
< $100 Million	1277	541	42.4%	$ 65,020	$ 7,980	$ 1,472	18.4%	2.3%
Totals	***5388***	***3455***	**64.1%**	***$ 127,613,963***	***$ 11,319,136***	***$ 1,344,262***	***11.88%***	***1.05%***

Source: BankTrends (Spotlight Financial, Inc.) 12/31/2018

There are important considerations on both the purchasing and selling sides that require due diligence throughout a merger. A poorly analyzed transaction can have negative tax effects on the buyer or seller and lead to potential out of contract payment of a Deferred Compensation agreement.

BANK OWNED LIFE INSURANCE (BOLI)

What happens when the bank being sold has Bank Owned Life Insurance (BOLI)? First of all, the acquiring bank should be looking at the BOLI from a risk assessment standpoint. This includes:

- Financial strength of the carriers
- Performance of the policies both from a historical and current standpoint
- Types of policies (i.e. separate, hybrid or general account)
- Who is the insured?

STOCK ACQUISITION/SALE

In a stock acquisition/sale, the effect on BOLI in the transaction itself is fairly simple if it passes the risk assessment test above. The policies transfer over to the acquiring bank at the cash surrender value (CSV) as of the merger/acquisition date. Confirmation of these values should be validated. The carrying value transfers to the acquiring bank along with the ownership of the policies.

There are no taxability concerns to the selling bank for the BOLI since the accumulation of earnings on the policy does not get triggered in a merger or stock sale. The acquiring bank “steps in the shoes” of the selling bank with carryover cost basis on the policy. Assuming the intent is to hold the policy until death, no deferred tax liability will need to be recorded; annual increases in CSV will be recorded as tax-free and the eventual death proceeds will be tax-free.

“The acquiring bank should be looking at BOLI from a risk assessment standpoint.”

ASSET ACQUISITION/SALE

BOLI is handled differently in an asset acquisition/sale. If a corporation sells in an asset sale, the selling bank has to recognize the gain on the BOLI as ordinary income. Note that any gain recognized from the “deemed” asset sale will increase the acquiring bank’s basis in the policy. For 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 gets an increase in basis of the BOLI 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.

If a bank’s BOLI is acquired/sold in an asset sale, the acquiring bank needs to be aware of the possible tax issues relative to the “Transfer for Value Rule”. Under this rule, the death benefits of any life insurance policy that is acquired/sold may be subject to ordinary income taxation, unless it falls within an exception to this rule. One exception is a transfer to a corporation in which the insured is an officer or shareholder.

“In an asset sale, the acquiring bank needs to be aware of the ‘Transfer to Value Rule’.”

Banks should also be aware of the notice and consent requirement of §101(j)(4) if BOLI is acquired in an asset sale. To summarize, §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. It is unclear whether the notice and consent obtained by the selling bank would apply to the acquiring bank; therefore, a recommended best practice would be 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.

SPLIT DOLLAR PLANS

Often times when there are BOLI plans, there are also split dollar agreements in place. The 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 and post-retirement plans.

PRE-RETIREMENT PLANS

Pre-retirement plans are exactly what they say—they are in place while the participant is employed by the bank, and at separation of service they are terminated. This is the most common type of plan seen at banks. There is no cost to the bank, and there is an economic benefit that the employee must recognize on his or her W-2 Form.

If these plans are in place by the seller, the plans generally go with the acquiring bank under the change of control provision. Most agreements are clear that as soon as the employee leaves, no matter what the reason, the split dollar benefit terminates. Therefore, if as a result of the merger the employee is no longer employed at the bank, so goes the benefit. This pertains to both C and S corporations.

POST-RETIREMENT PLANS

The other plan we see, but much less common, is a post-retirement plan. A post-retirement split dollar plan extends the life insurance benefit past the participant's retirement. This only pertains to those that are vested in the benefit according to the specific agreement. These types have 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.

"Pre-retirement plans are in place while the participant is employed and is terminated at separation of service."

"A post-retirement plan extends the life insurance benefit past the participant's retirement."

Similar to the pre-retirement benefit, the 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. The liabilities that go along with the accrual should be carefully analyzed by the acquiring bank to make certain the proper amount has been accrued. Depending on the amount of the benefit, this can be a substantial liability on the seller's books. This also 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

Often times there are nonqualified plans in place at the time of a merger. 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.

These plans have a variety of structures when it comes to change of control. IRC 409(A) specifically addresses the definition of change of control (COC). When it comes to what happens at COC, it is 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.

There is a wide variety of benefits that are triggered when there is a change of control. With some of the older agreements, it was common that the full retirement benefit was paid if there was a COC, and the payout was paid out starting almost immediately. In other words, if the full retirement benefit was $50,000 a year, that was the benefit that began after change of control or COC and separation of service regardless of age. Additionally, many times there was a gross up provision in the agreement that stated if there were any 280(g) issues (defined later). As a result of the COC, the company would gross up the benefit to pay for the taxes that went along with it. This is no longer a common occurrence in agreements.

The more common provision to the benefit is to have an acceleration of vesting at the change of control. The amount paid is usually based on the accrual balance as opposed to the projected benefit amount as in the past. 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.

"IRC 409(A) specifically addresses the definition of change of control (COC)."

"Parachute payments require a complicated calculation and can be very costly to both the acquiring bank and the participant."

IRC 280(g)

IRC 280(g) has been around since 1984 and addresses parachute payments to executives at a change of control. They include 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 If the amount of the payments is determined to be excessive, there is a 20% penalty on the participant, and the payments to the participant are permanently non-deductible by the company. The calculation of the excess payments is very complicated but, in essence, 280(g) states that if the aggregate present value of the payments equals or exceeds an amount three times the base amount of compensation, the payments are in violation of 280(g) and may be subject to the penalties.

Parachute payments can be a big issue in any C corporation merger. They require a complicated calculation and can be very costly to both the acquiring bank and the participant. The good news is that the golden parachute rules do not apply to Sub Chapter S corporations.

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.

"Have a thorough understanding of the tax implications for all parties involved."

CONCLUSION

Whether you are the buyer or the seller, a C corporation or an S corporation, or it's an asset or stock transaction—it is crucial to have a thorough understanding of the tax implications for all parties involved, and how these implications are affected according to specific agreements. Having a trusted partner on your side during a merger will help ensure the acquisition process proceeds as smooth as possible.

In summary:

- 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.
- Find out if the split dollar plans are pre- or post-retirement plans.
- Have a third party double check that the transaction follows all necessary rules and regulations.

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ABOUT EXECUTIVE BENEFITS NETWORK (EBN):

As the leading industry advisor, EBN specializes in the customized design, administration, and informal financing of Nonqualified Executive Compensation and Benefit Plans (Deferred Compensation Plans), as well as the procurement of Bank Owned Life Insurance (BOLI) programs to attract, retain, and reward key executive talent. We emphasize the importance of education and build long-lasting relationships with clients in all 50 states, and we have access to the highest rated insurance companies in the nation. Lastly, we believe that no two companies are alike in their needs; therefore, customization of executive benefit and compensation plans is paramount to a successful program.

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