Factors to Consider Before Executing a 1035 Exchange of BOLI Policies

Over the past two decades, Bank Owned Life Insurance (BOLI) has shown to be a great asset for banks, but occasionally a policy group may need to be replaced with a new product.

There are multiple reasons that banks may elect to replace an existing insurance product with a new one, including: product performance, carrier credit concerns, and/or the opportunity to lower risk-weighting. A replacement is typically executed via tax-free exchange under Internal Revenue Code Section 1035 ("1035 Exchange"). A 1035 Exchange should not be taken lightly, and there are many factors to consider before executing an exchange.

Legislative and Tax Considerations

The basic mechanics of a 1035 Exchange involve the policy owner assigning the policy of the incumbent carrier to the new carrier who, in turn, surrenders the policy and issues a new policy. Because a new policy is issued, certain requirements must be met in order to avoid unnecessary litigation and tax risk. These requirements include compliance with: **state insurable interest law, Internal Revenue Code Section 101(j) ("IRC 101(j)"), and Internal Revenue Code Section 264(f) ("IRC 264(f)")**. The combination of these factors effectively limits the potential population of insureds eligible for exchange to those that are actively employed at the time of the exchange.

State insurable interest law is applied based on the insured's state of residence (which may or may not be the same state where the policy is issued). These laws vary from state to state, but generally require an employer/employee relationship at the time the insurance is purchased and positive consent from the employee. Non-compliance with state insurable interest law creates potential litigation risk to the bank.

IRC 101(j) was established in 2006 and generally requires the following:

- employees must be in the top 35 percent of a wage earners
- employee must complete a positive consent form
- employee must be notified of the maximum amount of insurance the bank will purchase on their life

Under IRC 101(j), any death benefits paid on BOLI policies purchased since its 2006 enactment that do not meet these requirements would be taxable to the bank.

IRC 264(f) requires an interest expense deduction disallowance for any policy a bank purchases on a non-employee. This would apply to policies purchased on former employees, including through a 1035 Exchange. This interest expense deduction disallowance could create a drag on the BOLI product that would effectively negate the tax advantages of BOLI.

Once the population of eligible employee insureds is identified, a policy owner should proceed with the analysis necessary to determine if a 1035 Exchange is in the best interest of the bank. This analysis should include a comparison of short and long-term illustrations from the incumbent and potential new carrier, with appropriate actuarial and gross crediting rate assumptions.

Additional Considerations

The bank should consider the following prior to executing a 1035 Exchange.

- A 1035 Exchange is a new purchase: All regulatory pre-purchase requirements under the Interagency Statement on the Purchase and Risk Management of Life Insurance apply and should be completed.
- 1035 Exchange Fees: Products frequently carry fees that apply on a 1035 Exchange.
- Consideration of any policy guarantees: Newer products frequently have lower guaranteed crediting rates than policies issued 10+ years ago.
- Establishment of new contestability period: The new policies starts a new clock on the carrier's contestability period.

Newport Group has conducted dozens of 1035 Exchange transactions and can assist your bank in determining if an exchange is in the best interest of your bank. If you have any questions, please contact Scott Bethune, VP of BOLI Consulting or Justin Robertson, Senior BOLI Consultant at 336-333-2050.