ASSOCIATION FOR ADVANCED LIFE UNDERWRITING
WASHINGTONREPORT

Additional Analysis of IRS Notice 2007-34 - Guidance for Applying 409A To Split-Dollar Life Insurance Arrangements

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Major References: Final Treasury Regulations Under Code Section 409A; IRS Notice 2007-34

Related Reports: 07-38, 07-34, 06-131, 06-118, 06-114, 06-96, 06-70, 06-44, 06-16, 06-06, 06-02, 04-173

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As announced in our Washington Report No. 07-38, the Internal Revenue Service issued last week the long-awaited final regulations under Revenue Code section 409A along with IRS Notice 2007-34, which provides specific guidance regarding the application of that Code section to split-dollar life insurance arrangements. Both items of guidance will be the subject of an AALU teleseminar on Monday, April 23rd. This Bulletin, which considers the relationship of split-dollar arrangements to 409A, is one of a series of follow-on pieces to Washington Report No. 07-38 that will provide a more detailed analysis of the guidance.

Consistent with the preamble to the section 409A proposed regulations, the final regulations do not contain any special provisions for purposes of applying the regulations to split-dollar life insurance arrangements, which are subject to the general section 409A rules. However, the IRS issued Notice 2007-34 to provide additional guidance for purposes of applying those general rules to split-dollar insurance.

At the outset, Notice 2007-34 emphasizes two general rules that apply for purposes of determining whether a split-dollar arrangement is subject to section 409A. First, such arrangements that provide only death benefits (i.e., non-equity type arrangements) are not subject to section 409A under the statutory exception for death benefit plans. Second, arrangements that provide for a legally binding right to amounts that are included in income in accordance with the exception for short-term deferrals are not subject to section 409A (i.e., generally inclusion within 2-1/2 months of the end of the tax year

in which such amounts are no longer subject to a substantial risk of forfeiture).

The Extent to Which a Split-Dollar Arrangement is 409A Grandfathered

Section 409A generally does not apply to amounts deferred before January 1, 2005, unless the arrangement is materially modified after October 3, 2004 ("409A Grandfathered Benefits"). For purposes of determining whether an amount is a 409A Grandfathered Benefit, it is considered deferred before January 1, 2005 if the service provider (e.g., employee) had a legally binding right to the amount which was earned and vested as of January 1, 2005. Earnings on 409A Grandfathered Benefits are also treated as 409A Grandfathered Benefits.

For purposes of determining the extent to which a split-dollar arrangement is 409A Grandfathered, Notice 2007-34 provides that earnings on 409A Grandfathered Benefits under a split-dollar arrangement include an increase in all or a portion of the policy cash value that is attributable to the 409A Grandfathered Benefits. However, the notice also provides that earnings on 409A Grandfathered Benefits do not include any increase in the policy cash value attributable to continued services performed, compensation earned, or premium payments or other contributions made on or after January 1, 2005.

Although the notice does not expressly address what amounts are deferred under a split-dollar arrangement in determining the extent to which a split-dollar arrangement may be 409A Grandfathered, it appears from the other guidance in the notice that the "amounts deferred" primarily include the policy cash value to which a service provider may be entitled to in a future taxable year.

The notice also addresses how to determine the 409A Grandfathered Benefits when a split-dollar arrangement has both a grandfathered and non-grandfathered component. Under the general rule, a taxpayer can use any reasonable method that allocates increases in policy cash value attributable to 409A Grandfathered Benefits. The notice provides, however, that a method will not be treated as reasonable if it allocates a disproportionate amount of policy costs and expenses to the 409A non-grandfathered component. The notice also includes a safe harbor "proportional allocation method," which defines the 409A Grandfathered Benefit (including grandfathered earnings) as of any valuation date as equal to the greater of:

(1) the portion of the policy cash value at December 31, 2004 that was earned and vested, reduced by any amount securing an amount owed to the service recipient; and

(2) the policy cash value on the valuation date multiplied by the following fraction:

$$\frac{\text{grandfathered premiums actually paid on the policy}}{\text{all premiums actually paid on the policy}}$$

For purposes of determining the grandfathered premiums paid, the notice provides that the grandfathered premiums include both premiums actually paid on or before December 31, 2004 that were earned and vested as of such date and premiums paid after such date pursuant to a legally binding right that was earned and vested as of such date. This is potentially a very significant rule, which could cause all or a greater portion of a split-dollar arrangement to be classified as 409A Grandfathered.

409A Non-Grandfathered Benefits Which Are Subject to the Final Split-Dollar Regulations

Notice 2007-34 also provides guidance for purposes of applying 409A to the extent a split-dollar

arrangement includes 409A non-grandfathered benefits and the arrangement is subject to the final split-dollar regulations. The final split-dollar regulations generally divide split-dollar arrangements into two different tax regimes depending on the party that is designated as the beneficial owner of the policy - (1) the economic benefit regime for endorsement method arrangements where the service recipient (e.g., employer) is designated as the owner of the policy (taxed in accordance with Regulations sections 1.61-22(d) - (g)), and (2) the loan regime for collateral assignment method arrangements where the service provider is designated as the owner of the policy (taxed in accordance with Regulations section 1.7872-15).

The notice states that endorsement split-dollar arrangements that are taxed under the economic benefit regime generally provide for deferred compensation subject to section 409A if the service provider has a legally binding right during a taxable year to compensation that is or may be includible in his or her income in a later taxable year. This is the same general standard that applies for purposes of determining whether other non-split-dollar arrangements are subject to section 409A. Although the notice does not expressly so state, it appears that the compensation that may be includible in a later taxable year with respect to an endorsement method split-dollar arrangement is the policy cash value in excess of the amount repayable to the service recipient (i.e., the equity under the split-dollar arrangement). In this regard, the notice provides further that the cost of current life insurance protection (which must generally be recognized by the service provider under Regulations section 1.61-22) is treated as provided under a death benefit plan that is statutorily excepted from the requirements of section 409A. As a result, it would appear that the only "benefits" that would be subject to section 409A would be the equity and the value of any economic benefits other than current life insurance protection. In addition, the notice provides that, for purposes of applying 409A, the excess of the policy cash value over the aggregate premium payments is treated as earnings.

The notice provides that collateral assignment split-dollar arrangements that are taxed under the loan regime generally do not give rise to deferrals of compensation, and therefore, such arrangements generally are not subject to section 409A. However, the notice does provide that collateral assignment split-dollar arrangements may give rise to deferrals of compensation in certain situations (presumably after applying the general 409A rules for making such a determination). The notice includes three examples of such situations: if the amounts on a split-dollar loan are waived, cancelled, or forgiven. Note that the preamble to the proposed regulations described slightly differently the situations in which a split-dollar arrangement taxed under the loan regime may give rise to deferrals of compensation:

"Also, split-dollar life insurance arrangements treated as loan arrangements under section 1.7872-15 generally will not give rise to deferrals of compensation within the meaning of section 409A, provided that there is no agreement under which the service recipient will forgive the related indebtedness and no obligation on the part of the service recipient to continue to make premium payments without charging the service provider a market interest rate on the funds advanced."

Because Notice 2007-34 does not mention below-market interest, it appears that the IRS no longer believes that below-market interest gives rise to the deferral of compensation. AALU will attempt to confirm this interpretation with representatives of the IRS and Treasury and will specifically address in the AALU teleseminar on April 23rd.

409A Non-Grandfathered Benefits That Are Not Subject to the Final Split-Dollar Regulations

Split-dollar life insurance arrangements that were entered into before September 18, 2003 and are not materially modified thereafter are not subject to the final split-dollar regulations. Rather, such arrangements are subject to the rules prescribed in IRS Notice 2002-8, which, in addition to some

transition rules that expired on December 31, 2003, generally describes a number of general tax principles that apply to such split-dollar arrangement and includes a statement that no inference should be drawn from the notice regarding the appropriate Federal income, employment and gift tax treatment of split-dollar life insurance arrangements entered into before the date of publication of the final regulations. The general tax principles described in Notice 2002-8 generally apply without regard to which party is designated as the owner of the policy. Notice 2007-34 provides guidance regarding 409A Non-Grandfathered benefits that are not subject to the final split-dollar regulations (i.e., those split-dollar arrangements entered into before September 18, 2003 that have not been materially modified thereafter).

With respect to split-dollar arrangements that have elected to be taxed as a loan, Notice 2007-34 provides that they are analyzed under section 409A in the same manner as collateral assignment method split-dollar arrangements that are subject to the final regulations - that is, they are generally not subject to section 409A unless they otherwise give rise to deferrals of compensation (e.g., if all or a portion of the payments on the loans are waived, cancelled, or forgiven).

With respect to split-dollar arrangements that have elected to be taxed under a modified economic benefit regime, the guidance in Notice 2007-34 is not as clear. The notice provides that such split-dollar arrangements provide for deferred compensation for purposes of section 409A if the service provider has a legally binding right during a taxable year to compensation that is payable to (or on behalf of) the service provider in a later year (e.g., upon termination of the split-dollar arrangement). The notice then goes on to provide further that, if all of the requirements of Notice 2002-8 are satisfied, including treating the value of the current life insurance protection as an economic benefit provided by the service recipient, the IRS will not assert that there has been a transfer of property to the service recipient by reason of termination of the arrangement for purposes of section 409A. The notice provides further that in such cases, the IRS will not treat the right to the economic benefit of current life insurance protection as deferred compensation for purposes of section 409A, which is consistent with the treatment prescribed by the IRS for split-dollar arrangements that are subject to the final split-dollar regulations (as described above).

Although not entirely clear, the language in Notice 2007-34 seems to indicate that, if the requirements of Notice 2002-8 are satisfied by split-dollar arrangements that are taxed under the modified economic benefit regime, such arrangements effectively will not be subject to section 409A. If so, then both split-dollar arrangements taxed under the modified economic benefit and loan regimes, that are also not subject to the final split-dollar regulations, are generally not subject to section 409A. However, it is also not clear the extent to which, if any, the "no inference" language in Notice 2002-8 applies for purposes of 409A. Notice 2007-34 do not address the no inference language and, as discussed above, a literal reading of the notice suggests that 409A many not apply to arrangements that otherwise satisfy the requirements of Notice 2002-8. Because this is not clear from the language under Notice 2007-34, AALU will attempt to confirm this interpretation with representatives of the IRS and Treasury and will specifically address in the AALU teleseminar on April 23rd.

Notice 2007-34 also addresses the extent to which 409A non-grandfathered split-dollar arrangements that are not subject to the final regulations (i.e., those entered into before September 18, 2003) can be modified to comply with 409A and not be treated as being materially modified for purposes of the final split-dollar regulations. Specifically, the notice provides that a modification of a split-dollar life insurance arrangement necessary to bring such arrangement into compliance with section 409A, or to avoid application of the section, will not be treated as a material modification for purposes of the final split-dollar regulations if each of the following requirements is met:

(i) there is a reasonable determination that section 409A is applicable to the arrangement, and that the arrangement does not comply with the requirements of section 409A;

(ii) there is a reasonable determination that the modification causes the arrangement to comply with section 409A or results in section 409A no longer being applicable to the arrangement, or that the modification is a necessary part of a number of actions that together cause the arrangement to come into compliance with section 409A or result in section 409A no longer being applicable to the arrangement;

(iii) the modification to the arrangement consists solely of changes to the applicable definitions or changes to the payment timing requirements, including election provisions related to the time and form of payment, or changes to the conditions under which all or part of the benefit under the arrangement will be forfeited, reasonably intended to conform the arrangement to the requirements of, or to qualify for an exclusion from, section 409A;

(iv) the modification establishes a time and form of payment, or establishes potential times and forms of payment that are consistent with times and forms of payment under which the benefits could have been paid under the terms of the arrangement before the modification; and

(v) the modification does not materially enhance the value of the benefits to the service provider under the arrangement.

Plan Aggregation Rules - New Category for Split-Dollar Arrangements:

As mentioned above, the final 409A regulations generally do not include special rules for split-dollar arrangements. The IRS issued Notice 2007-34 to provide additional guidance for purposes of applying the general 409A rules to split-dollar arrangements. However, the final 409A regulations do modify the proposed regulations by providing that split-dollar arrangements are a new, separate category of plans for purposes of applying the plan aggregation rules under the final 409A regulations. The proposed 409A regulations generally provided that all amounts deferred with respect to a service provider under all plans of a service recipient falling within a particular category would be treated as deferred under a single plan (i.e., account balance plans, nonaccount balance plans, separation pay plans, and all other plans). These plan aggregation rules are important if one or more plans within a category of plans does not satisfy the 409A requirements. If so, all of the other plans in the same category are deemed not to satisfy the 409A requirements as well. The final regulations provide additional categories of plans for purposes of the aggregation rules, including new categories for split-dollar life insurance arrangements, reimbursement plans, stock right plans subject to 409A and foreign plans. The final regulations also subdivide account balance plans between elective and nonelective plans.

A more extensive analysis of the final 409A regulations will be provided in one or more Washington Reports to be issued in the near future. In addition, to the extent the guidance applicable to split-dollar arrangements (primarily Notice 2007-34) is clarified by further analysis, AALU will provide an additional Bulletin.

Any AALU member who wishes to obtain a copy of the final 409A regulations or IRS Notice 2007-34 may do so through the following means: (1) use hyperlink above next to "Major References," (2) log onto the AALU website at http://www.aalu.org/ and enter the *Member Portal* with your social security number and select *Current Washington Report* for linkage to source material or (3)

email Angela Street at street@aalu.org and include a reference to this *Washington Report*.

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