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2901 Telestar Court
Falls Church, VA 22042
Phone: (703) 641-9400
Fax: (703) 641-9885
www.aalu.org

Additional Analysis of Pre-September 18, 2003 Split-Dollar Life Insurance Arrangements and Section 409A

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Major References: ;
200734;
409A

Related Reports: 07-48, 07-44, 07-41, 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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SEE THE CIRCULAR 230 DISCLAIMERS APPENDED TO THE CONCLUSION OF THIS WASHINGTON REPORT.

IRS Notice 2007-34 was issued in conjunction with the final regulations under Revenue Code section 409A to provide guidance regarding the application of that section to split-dollar life insurance arrangements (See Washington Reports 07-44 and 07-38.) In addition to other guidance, Notice 2007-34 specifically addresses split-dollar arrangements that were entered into before September 18, 2003 and have not been materially modified since then. Those arrangements are not subject to the final split-dollar regulations and are referred to here as "pre 9-18-03 split-dollar." In Washington Report 07-41, we indicated that the guidance provided in Notice 2007-34 was not entirely clear with respect to pre 9-18-03 split-dollar. This Washington Report provides additional analysis regarding the application of 409A to such arrangements.

The final section 409A regulations do not contain any special guidance regarding their application to split-dollar life insurance arrangements, other than treating split-dollar arrangements as a separate category of plans for purposes of the plan aggregation rules (which treatment the AALU has been actively pursuing). In contrast, recently issued IRS Notice 2007-34, as indicated above, attempts to supply that otherwise missing guidance.

Pre 9-18-03 split-dollar arrangements (which were included in Notice 2007-34 among the arrangements somewhat imprecisely designated as "grandfathered" under Treas. Regs. § 1.61-22(j)) are not subject to the final split-dollar regulations, provided they are not materially modified after September 17, 2003. Rather, such arrangements are subject to the rules prescribed in IRS Notice 2002-8, which include a statement that "no inference" should be drawn from the notice regarding the appropriate Federal income, employment and gift tax treatment of pre 9-18-03 split-dollar arrangements.

Pre 9-18-03 Split-Dollar Arrangements

Notice 2007-34 states that split-dollar arrangements that provide only death benefits (i.e., non-equity split-dollar) are not subject to 409A. Similarly, the Notice provides that such arrangements that are taxed as loans in accordance with Notice 2002-8 are generally not subject to section 409A unless they otherwise give rise to deferrals of compensation (e.g., if any portion of the payments on the loans are waived, cancelled, or forgiven).

Notice 2007-34 is not as clear with respect to other types of pre-9-18-03 split-dollar arrangements - namely, equity split-dollar that is not taxed as a loan. The notice states that such arrangements may provide for deferred compensation subject to 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).

Notice 2007-34 indicates that, in accordance with Notice 2002-8, in cases where the value of current life insurance protection is treated as an economic benefit, the IRS will not consider the arrangement as having been terminated for so long as the parties to the arrangement continue to report that value as an economic benefit. The notice then goes on to provide further that, if all of the requirements of Notice 2002-8 are satisfied, the IRS will not assert that, for purposes of section 409A, there has been a transfer of property to the service recipient by reason of termination of the arrangement. The precise meaning of this language has been questioned by readers. For example, query whether the language went beyond the guidance provided by Notice 2002-8? That guidance does not address the taxation of split-dollar following the termination of the arrangement, other than through the "no-inference" language. A literal reading of the language in Notice 2007-34 suggests that the IRS may not assert that there is a taxable transfer even upon termination if all of the other requirements of Notice 2002-8 are satisfied (i.e., primarily treating the value of the current life insurance protection as a taxable economic benefit).

In the April 23, 2007 AALU Teleseminar on the final 409A regulations and Notice 2007-34 (see our Washington Report No. 07-48), Dan Hogans, Attorney-Advisor with the U.S. Department of Treasury and a primary drafter of the regulations and notice, clarified that Notice 2007-34 does not change or expand the guidance provided in Notice 2002-8. Thus, Notice 2007-34 does not provide any additional guidance with respect to the taxation of pre 9-18-03 split-dollar following termination of the arrangement. However, Mr. Hogans also commented that it is the Treasury's view, notwithstanding the limitations placed on the Treasury's expression of views by the "no inference" language in Notice 2002-8, that such a split-dollar arrangement, which is not taxed as a loan, is generally taxable upon arrangement termination. If the Treasury is successful (without reliance on the inference) in arguing that such an arrangement is taxable upon termination (i.e., on rollout), that arrangement may include deferred compensation that is subject to 409A.

Despite the Treasury's position, there are theories that may support the position that pre 9-18-03 split-dollar arrangements are not taxable upon their termination. For example, under Code section 72 (e), the inside build-up or equity is not taxable until the policy is cashed-in, and therefore, the mere termination of the split-dollar arrangement should arguably not trigger income recognition. In addition, there is the position that there is no transfer of property upon termination of the arrangement because the service provider already owns the policy in the case of a collateral assignment method split-dollar arrangement and Rev. Rul. 64-328 provides that collateral assignment and endorsement method split-dollar should be taxed in the same manner. Thus, to the extent a pre 9-18-03 split-dollar arrangement does not generate any taxable amounts other than the current value of life insurance protection, arguments can be made that the arrangement should not be subject to 409A.

The final 409A regulations expressly provide that a legally binding right to an amount that will be excluded from income when and if received does not constitute a deferral of compensation, unless the service provider has received the right in exchange for, or has the right to exchange the right for, an amount that will be includible in income. As discussed above, taxpayers may thus take the position (although success is not assured) that the termination of a pre 9-18-03 split-dollar arrangement does not generate taxable income.

However, it should be emphasized that, if a pre 9-18-03 split-dollar arrangement is ultimately found to be subject to 409A and fails to comply with the provisions of the section, the service provider may be subject to significant, adverse tax consequences -- current income tax inclusion, 20% additional tax, and interest at the underpayment rate plus 1% during the period of deferral.

If a pre 9-18-03 split-dollar arrangement is determined to be or may be subject to 409A (at least based on the current terms of the arrangement), there are a number of different alternatives that may be available.

First, the parties could elect to modify the arrangement to the extent necessary to comply with 409A (e.g., to provide a specified payment date or payment only upon the occurrence of a permitted distribution event). As discussed below in the next section, Notice 2007-34 includes transition relief to allow pre 9-18-03 split-dollar arrangements to be modified to comply with 409A. Note that sponsors may want to consider this alternative even if it is unclear whether 409A applies or there are good arguments that it should not apply. As discussed above, if a sponsor believes an arrangement is not subject to 409A, but it is subsequently determined to be, there may be significant adverse tax consequences if the requirements of 409A are not satisfied. However, it should also be considered that some of the changes that may be required to comply with 409A may significantly change the nature of the arrangement (e.g., specifying a payment date, when the current terms give the employee complete discretion regarding the termination of the arrangement)

Second, it may be possible to start taxing a pre 9-18-03 split-dollar arrangement as a loan in accordance with Notice 2002-8, and, to the extent there are no other features that give rise to deferrals of compensation, the arrangement may not be subject to 409A under the general principles of Notice 2007-34. However, one condition that must be satisfied under Notice 2002-8 is that all premium payments by the service recipient from the inception of the arrangement until the first taxable year in which such payments are treated as loans must be treated as loans entered into at the beginning of that first year. As a result, depending on the amount of premium payments previously made, the deemed "loan" and taxable compensation to the employee could be significant.

Third, it may be possible to modify the arrangement to fall within one of the exceptions provided under the final 409A regulations. For example, amounts that are paid within 2-1/2 months following the year in which the amount is first no longer subject to a substantial risk of forfeiture are considered "short-term deferrals," which are not subject to 409A. Thus, one alternative may be to modify the arrangement to satisfy the requirements for the short-term deferral exception. However, the final 409A regulations provide that an amount that currently is not subject to a substantial risk of forfeiture (i.e., it is vested) generally cannot be subjected to a substantial risk of forfeiture in order to fall within the short-term deferral exception (i.e., it cannot be "unvested"). Thus, this alternative may work only if an arrangement is currently subject to a substantial risk of forfeiture.

Modifying Pre 9-18-03 Split-Dollar to Comply With 409A

To the extent a pre 9-18-03 split-dollar arrangement is or may be subject to 409A, consideration should be given to complying with 409A by the end of 2007 (e.g., to provide for a specified payment date, or payment upon a permissible distribution event). Before the issuance of Notice 2007-34, there were concerns that any amendments that may be necessary to comply with 409A may constitute material modifications under the final split-dollar regulations and may jeopardize the arrangement's pre 9-18-03 status.

In response to these concerns, Notice 2007-34 addresses the extent to which such arrangements 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 split-dollar life insurance arrangement modification 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;
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> (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;
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> (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;
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> (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
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> (v) the modification does not materially enhance the value of the benefits to the service provider under the arrangement.

It should be noted that a modification that complies with all of the conditions prescribed above could arguably be construed as an acknowledgment that the split dollar arrangement is taxable upon termination -- a proposition respecting arrangement taxability with which some (perhaps many) would not agree. However, a modification to comply with 409A in accordance with Notice 2007-34 may be an alternative (perhaps the only reasonable alternative) for addressing the 409A dilemma. In addition, because it appears that Notice 2007-34 was not intended to modify or expand the guidance provided in

Notice 2002-8, an argument can be made that a modification to comply with 409A should not adversely affect the general income tax treatment of split-dollar arrangements under the principles of Notice 2002-8.

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*.