Part III – Administrative, Procedural, and Miscellaneous

Guidance Regarding the Application of Section 409A to Split-Dollar Life Insurance Arrangements

Notice 2007-34

I. PURPOSE

This notice provides guidance regarding the application of section 409A of the Internal Revenue Code (Code) to split-dollar life insurance arrangements. This notice also provides that certain modifications of split-dollar life insurance arrangements necessary to comply with, or avoid application of, section 409A will not be treated as a material modification for purposes of § 1.61-22(j) of the Income Tax Regulations.

II. BACKGROUND

A. Section 409A

Section 409A was added to the Code by section 885 of the American Jobs Creation Act of 2004, Public Law 108-357, 118 Stat. 1418 (AJCA). Section 409A(a) generally provides that unless certain requirements are met, amounts deferred under a nonqualified deferred compensation plan for all taxable years are currently includible in gross income to the extent not subject to a substantial risk of forfeiture and not previously included in gross income. Section 409A(a) also provides rules under which deferrals of compensation will not result in such immediate and additional tax liability, including rules about the timing of initial elections to defer compensation, payments of deferred compensation, and changes to the time or form of a scheduled payment of previously deferred amounts.

Section 885(d) of the AJCA and § 1.409A-6 provide that section 409A of the Code generally applies to amounts deferred after December 31, 2004. Section 885(d) of the AJCA and §1.409A-6 further provide that section 409A applies to earnings on deferred compensation only to the extent that section 409A applies to the deferred compensation. Section 885(d) of the AJCA and § 1.409A-6 also provide, however, that amounts deferred in taxable years beginning before January 1, 2005 are treated as amounts deferred in a taxable

year beginning on or after such date if the plan under which the deferral is made is materially modified after October 3, 2004, except as permitted under transition guidance.

Notice 2005-1, 2005-1 C.B. 274, provides certain transition relief with respect to the application of section 409A. This relief was modified and partially extended in the preamble to the proposed regulations regarding the application of section 409A to nonqualified deferred compensation plans (2005-2 C.B. 786, 70 Fed. Reg. 57930 (Oct. 4, 2005)). This relief was again modified and partially extended in Notice 2006-79, 2006-43 I.R.B. 763.

Because certain types of split-dollar life insurance arrangements provide for deferred compensation as defined under § 1.409A-1(b), the requirements of section 409A apply to such arrangements. Split-dollar life insurance arrangements that provide only death benefits (as defined in § 1.409A-1(a)(5)) to or for the benefit of the service provider are excluded from coverage under section 409A under the exception for death benefit plans contained in § 1.409A-1(a)(5). Similarly, arrangements that provide a legally binding right to amounts that are included in income in accordance with the exception for short-term deferrals under § 1.409A-1(b)(4) also do not provide for deferred compensation subject to section 409A to the extent so included.

B. Section 1.61-22 of the Income Tax Regulations

Section 1.61-22 provides rules for the taxation of a split-dollar life insurance arrangement. Section 1.61-22(j)(1)(i) provides that the regulations apply to any split-dollar life insurance arrangement entered into after September 17, 2003. Section 1.61-22(j)(2)(i) provides that, for purposes of the general effective date provision, if an arrangement entered into on or before September 17, 2003 is materially modified after September 17, 2003, the arrangement is treated as a new arrangement entered into on the date of the modification.

Section 1.61-22(j)(2)(ii) provides a non-exclusive list of changes that are not material modifications for this purpose. Section 1.61-22(j)(2)(iii) provides that the Commissioner, in revenue rulings, notices and other guidance published in the Internal Revenue Bulletin, may provide additional guidance with respect to other modifications that are not material for this purpose. This notice is intended to provide such additional guidance with respect to certain modifications related to split-dollar life insurance arrangements covered by section 409A.

Commentators expressed concerns about the impact of changes to a split-dollar life insurance arrangement to comply with section 409A, where the split-dollar life insurance arrangement was entered into on or before September 17, 2003 and is not otherwise subject to the regulations set forth in § 1.61-22. Commentators suggested that modifications necessary to comply with section 409A may cause the split-dollar life insurance arrangement to be treated as

materially modified for purposes of § 1.61-22(j)(2). Comments were requested as to the scope of changes that would be necessary to comply with, or avoid application of, section 409A, and under what conditions those changes should not be treated as material modifications for purposes of § 1.61-22(j)(2). The Treasury Department and the IRS have considered all of the comments submitted in formulating this notice providing guidance under which certain modifications will not be treated as material modifications for purposes of § 1.61-22(j).

C. IRS Notice 2002-8

Notice 2002-8, 2002-1 C.B. 398, provides guidance regarding split-dollar life insurance arrangements entered into before the date of publication of final regulations (*i.e.*, before September 18, 2003). Specifically, Notice 2002-8, Part IV.2 provides that, for split-dollar life insurance arrangements entered into before September 18, 2003, in cases where the value of current life insurance protection is treated as an economic benefit provided by a sponsor to a benefited person under a split-dollar life insurance arrangement, the IRS will not treat the arrangement as having been terminated (and thus will not assert that there has been a transfer of property to the benefited person by reason of termination of the arrangement) for so long as the parties to the arrangement continue to treat and report the value of the life insurance protection as an economic benefit provided to the benefited person. This treatment will be accepted without regard to the level of the remaining economic interest that the sponsor has in the life insurance contract.

Notice 2002-8, Part IV.3 also provides that, for split-dollar life insurance arrangements entered into before September 18, 2003, the parties to the arrangement may treat premium or other payments by the sponsor as loans. In such cases, the IRS will not challenge reasonable efforts to comply with the requirements of sections 1271-1275 and section 7872 of the Code. To qualify for this treatment, all payments made by the sponsor from the inception of the arrangement (reduced by any repayments to the sponsor) before the first taxable year in which such payments are treated as loans for Federal tax purposes must be treated as loans entered into at the beginning of the first year in which such payments are treated as loans.

III. APPLICATION OF SECTION 409A TO SPLIT-DOLLAR LIFE INSURANCE ARRANGEMENTS

A. Section 409A Grandfathered Benefits

1. In General

Section 409A is not effective with respect to amounts deferred in taxable years beginning before January 1, 2005, unless the plan under which the amount deferred was made is materially modified after October 3, 2004 (section 409A grandfathered benefits). For purposes of determining whether section 409A is applicable with respect to an amount, the amount is considered deferred before January 1, 2005 and therefore grandfathered from application of section 409A if, before January 1, 2005, the service provider had a legally binding right to be paid the amount, and the right to the amount was earned and vested. See § 1.409A-6(b).

Section 409A is effective with respect to earnings on amounts deferred only to the extent that section 409A is effective with respect to the amounts deferred. Accordingly, section 409A is not effective with respect to earnings on section 409A grandfathered benefits. See § 1.409A-6.

2. Determination of Section 409A Grandfathered and Non-Grandfathered Benefits under a Split-Dollar Life Insurance Arrangement

For purposes of applying § 1.409A-6, earnings on section 409A grandfathered benefits under a split-dollar life insurance arrangement include an increase in the policy cash value, or an increase in any portion of the policy cash value, that is attributable to the section 409A grandfathered benefits. For this purpose, earnings on section 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.

Where benefits under a split-dollar life insurance arrangement have a component that is a section 409A grandfathered benefit and a component that is a section 409A non-grandfathered benefit, the calculation of the section 409A grandfathered component of the benefit may be made under any reasonable method that allocates increases in policy cash value attributable to the section 409A grandfathered benefit. For this purpose, a method will not be treated as reasonable if it allocates a disproportionate amount of policy costs and expenses to the section 409A non-grandfathered component.

For purposes of this section III.A.2, the use of the proportional allocation method described in this paragraph will be treated as a reasonable method. The proportional allocation method defines the section 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 (as defined in § 1.409A-6(b)) reduced by any amount securing an amount owed to the service recipient; and

(2) an amount equal to the policy cash value on the valuation date multiplied by a fraction, the numerator of which is the sum of the grandfathered premiums actually paid on the policy and the denominator of which is the sum of all premiums actually paid on the policy by the valuation date.

For purposes of this paragraph, grandfathered premiums include both premiums actually paid on or before December 31, 2004 that were earned and vested (as defined in § 1.409A-6(b)) as of such date and premiums paid after such date pursuant to a legally binding right that was earned and vested (as defined in § 1.409A-6(b)) as of such date.

B. Arrangements Subject to § 1.61-22

This section III.B addresses a split-dollar life insurance arrangement, or a portion of a split-dollar life insurance arrangement, that is not grandfathered under § 1.409A-6, but is subject to the rules under § 1.61-22 (but not § 1.7872-15) (including an arrangement or portion thereof that defers compensation in taxable years beginning before January 1, 2005, if the arrangement is materially modified (within the meaning of § 1.409A-6(d)) after October 3, 2004). Except where such an arrangement provides for only a short-term deferral excluded from coverage under § 1.409A-1(b)(4), a split-dollar life insurance arrangement the taxation of which is governed by the rules of § 1.61-22(d) – (g) generally provides for deferred compensation if, under the terms of the arrangement and the relevant facts and circumstances, the service provider has a legally binding right during a taxable year of the service provider to compensation that, pursuant to the terms of the arrangement, is or may be includible in the income of the service provider in a later taxable year of the service provider.

A split-dollar life insurance arrangement does not constitute a nonqualified deferred compensation plan for purposes of section 409A to the extent the arrangement constitutes a death benefit plan. See § 1.409A-1(a)(5). For purposes of this section III.B, the right to compensation described as the cost of current life insurance protection in § 1.61-22(d)(2)(i) and (3) is treated as provided under a death benefit plan under § 1.409A-1(a)(5) and thus is excluded from the requirements of section 409A, even if additional economic benefits are

available under the arrangement that are subject to the application of section 409A.

Accordingly, a split-dollar life insurance arrangement covered by this section III.B provides for deferred compensation for purposes of section 409A if, under the terms of the arrangement and the relevant facts and circumstances, the service provider has a legally binding right during a taxable year of the service provider to economic benefits described in § 1.61-22(d)(2)(ii) (policy cash value to which the service provider has current access within the meaning of § 1.61-22(d)(4)(ii)) or § 1.61-22(d)(2)(iii) (any other economic benefits provided to the service provider) that, pursuant to the terms of the arrangement, are payable to (or on behalf of) the service provider in a later taxable year of the service provider, and such legally binding right does not qualify as a short-term deferral for purposes of § 1.409A-1(b)(4). For purposes of the application of section 409A, the excess of the policy cash value over the aggregate premium payments is treated as earnings. See §1.409A-3(e) for the treatment of earnings for purposes of satisfying the requirements of section 409A.

C. Arrangements Subject to § 1.7872-15.

This section III.C addresses any split-dollar life insurance arrangement, or portion of a split-dollar life insurance arrangement, that is not grandfathered under § 1.409A-6, but is subject to § 1.7872-15 (and not § 1.61-22) (including an arrangement or portion thereof that defers compensation in taxable years beginning before January 1, 2005, if the arrangement is materially modified (within the meaning of § 1.409A-6(d)) after October 3, 2004). Split-dollar life insurance arrangements pursuant to which payments are treated as split-dollar loans under § 1.7872-15 generally will not give rise to deferrals of compensation within the meaning of section 409A. However, in certain situations, such an arrangement may give rise to deferrals of compensation for purposes of section 409A, for example, if amounts on a split-dollar loan are waived, cancelled, or forgiven.

D. Arrangements Grandfathered under § 1.61-22(j)

1. In General

This section III.D addresses a split-dollar life insurance arrangement, or a portion of a split-dollar life insurance arrangement, that is not grandfathered under § 1.409A-6, but is grandfathered under § 1.61-22 (and thus is not covered by § 1.61-22 or § 1.7872-15 unless materially modified).

A split-dollar life insurance arrangement addressed by this section III.D provides for deferred compensation for purposes of section 409A if, under the terms of the arrangement and the relevant facts and circumstances, the service provider has a legally binding right during a taxable year to compensation that

pursuant to the terms of the arrangement is payable to (or on behalf of) the service provider in a later year (for example, upon termination of the split-dollar arrangement), and such legally binding right does not qualify as a short-term deferral for purposes of § 1.409A-1(b)(4), and is not treated as provided under a death benefit plan for purposes of § 1.409A-1(a)(5). Notice 2002-8 provides that, in cases where the value of current life insurance protection is treated as an economic benefit provided by a sponsor to a benefited person under a split-dollar life insurance arrangement, the IRS will not treat the arrangement as having been terminated for so long as the parties to the arrangement continue to treat and report the value of the life insurance protection as an economic benefit provided to the benefited person. In such cases, provided that all other requirements of Notice 2002-8 are satisfied, the IRS will not assert that there has been a transfer of property to the benefited person by reason of termination of the arrangement for purposes of section 409A. In addition, in such cases, the IRS will not treat the right to the economic benefit of current life insurance protection (within the meaning of Notice 2002-8) as deferred compensation for purposes of section 409A.

For split-dollar life insurance arrangements entered into before September 18, 2003, the parties to the arrangement may be eligible to treat premium or other payments by the sponsor as loans under either Part IV.3 or Part IV.4 of Notice 2002-8. In such a situation, the arrangement generally will not give rise to deferrals of compensation within the meaning of section 409A. However, in certain situations, the arrangement may give rise to deferrals of compensation for purposes of section 409A, for example, if all or a portion of the payments on the loans are waived, cancelled, or forgiven.

2. Additional Transition Relief under § 1.61-22(j)

For purposes of § 1.61-22(j), a modification of a split-dollar life insurance arrangement necessary to bring such arrangement into compliance with section 409A, or to avoid application of section 409A, will not be treated as a material modification of such arrangement. For this purpose, a modification of a split-dollar life insurance arrangement is considered necessary to bring such arrangement into compliance with section 409A only if each of the following requirements is met:

(1) The service recipient or service provider participating in the split-dollar life insurance arrangement has made a determination, based upon a reasonable application of section 409A, the regulations, and other guidance, that section 409A is applicable to the arrangement, and that the arrangement does not comply with the requirements of section 409A;

(2) The service recipient or service provider participating in the split-dollar life insurance arrangement has made a determination, based upon a reasonable application of section 409A, the regulations, and other

guidance, 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;

(3) The modification to the arrangement consists solely of changes to the applicable definitions (such as, the definition of a separation from service or a disability) 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 (such as, an acceleration of a vesting requirement), reasonably intended to conform the arrangement to the requirements of, or to qualify for an exclusion from, section 409A;

(4) 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 (including through the exercise of service recipient or service provider discretion in accordance with the terms of the arrangement before modification); and

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

IV. CONTINUED APPLICATION OF SECTION 409A

This notice does not affect the application of section 409A, including the application of the treatment of certain plans that are materially modified after October 3, 2004 as subject to section 409A. In addition, this notice does not affect the application of any transition relief under section 409A. Final regulations under section 409A were released on April 10, 2007. The final regulations generally are applicable for taxable years beginning on or after January 1, 2008. However, taxpayers may rely on the final regulations for purposes of applying this notice to prior periods.

V. DRAFTING INFORMATION

The principal author of this notice is Stephen Tackney of the Office of Division Counsel/Associate Chief Counsel (Tax Exempt and Government Entities). However, other personnel from the Treasury Department and the IRS participated in its development. For further information regarding the application of section 409A, contact Stephen Tackney at (202) 927-9639 (not a toll-free call).