



Memorandum

Date: August 15, 2008

To: Advanced Underwriting Subscription Service Clients

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Re: Recent Split-Dollar Issues: The Section 409A Deadline For Compensatory Split-Dollar Arrangements; The Availability of Alternative Term Rates For Split-Dollar Arrangements; and Employer Reporting of Equity on Termination of Pre-Final Regulation Arrangements

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CIRCULAR 230 DISCLOSURE

To ensure compliance with the requirements imposed by the IRS, we inform you that any U.S. federal tax advice contained in this communication is not intended or written to be used, and cannot be used, for the purpose of (i) avoiding penalties under the Internal Revenue Code, or (ii) promoting, marketing, or recommending to another party any transaction or matter addressed herein.

The Section 409A For Split-Dollar Arrangements Deadline Looming

As a reminder, all Split Dollar Arrangements that are subject to Section 409A must be amended to bring the arrangement into compliance with Section 409A by the end of 2008. We are attaching a copy of the memo we sent to you last year regarding the potential effect of Section 409A and Notice 2007-34 on compensatory split-dollar arrangements, for your review.

As always, we are happy to answer any questions any of your clients or their advisors have about this issue or this deadline.

The Availability of Alternative Term Rates

Two recent issues have come up in our practice relating to the availability of an insurer's Alternative Term Rates to measure the economic benefit in a split-dollar arrangement which we wanted to call your attention to.

First, a question has been raised as to whether post-Final Regulation economic benefit split dollar arrangements can continue to use the insurer's Alternative Term Rates to measure the cost of current life insurance protection, in light of the publication of the Final Regulations.

For example, AALU Washington Report 08-47, dated June 9, 2008, discussing PLR 2008-2203, dealing with a pre-Final Regulation arrangement, states:

We note that, had the arrangement in PLR 200822003 – which was a non-equity arrangement – been entered into after the effective date of the final regulations, the parties still would have been entitled to use the economic benefit regime (instead of the loan regime) (*see* Treas. Reg. Section 1.61-22(c)(1)(ii)(2)), but the value of the economic benefit (current life insurance protection) provided to the Trust presumably could not have been computed using the insurer's lower alternative term rates (*see* Treas. Reg. Section 1.61-22(d)(3)).

The Regulation Section cited in the Report for the proposition that the insurer's term rate "presumably" could not have been used if the arrangement had been entered into after the Final Regulations provides (in part):

The cost of current life insurance protection provided to the non-owner for any year (or any portion thereof in the case of the first year or the last year of the arrangement) equals the amount of the current life insurance protection provided to the non-owner multiplied by the life insurance premium factor designated or permitted in guidance published in the Internal Revenue Bulletin

Under Notice 2002-8, Part III, paragraph 3, arrangements entered into prior to the date of "future guidance" may continue to use the Insurer's Alternative Term rates, so long as they meet certain requirements. The use of an insurer's Alternative Term Rates, rather than the rates set forth in Table 2001, (which the Notice refers to as a "premium rate table") is permitted under Notice 2002-8 for arrangements entered into before the effective date of "future guidance" – an undefined term. The issue is whether the term "future guidance" as used in Notice 2002-8 refers to the Final Regulations or to guidance that specifically addresses the valuation of the cost of current life insurance protection for arrangements subject to the Final Regulations, and is, as the Final Regulations indicate, designated (presumably, required) or permitted in published guidance provided in the Internal Revenue the Bulletin.

One possible interpretation is that Table 2001 is the "future guidance" referred to in the Notice and the table of premium factors referred to in the Regulations; another is that the Regulations are the "future guidance"; and a third is that Table 2001 can't be the "future" guidance referred to in the Notice and that the Regulations reference to "life insurance premium factor(s)" refers to a yet unpublished table, which may (when issued) prohibit the future use of Alternative Term Rates, perhaps even for future years of prior arrangements.

While it is not free from doubt, it seems unlikely that Table 2001, which was published with Notice 1002-10, could be “future” guidance in 2002, and since the Regulations don’t provide any “guidance” – future or otherwise since on the use of Alternative Term Costs, at least until a table of premium factors is published in the Internal Revenue Bulletin, the better answer is that – for now – Alternative Term Rates which meet the more stringent requirements of Notice 2002-8 for post-January 28, 2002 arrangements (as described below) can be used for post-Final Regulation arrangements.

Even if the Final Regulations do not preclude the use of the Insurer’s Alternative Term Rates for post-Final Regulation arrangements, under prior rulings, they are only permitted to be used so long as such rates are published premium rates that are available to all standard risks for initial issue one-year term insurance. The IRS will not consider such rates to qualify under this standard for periods after December 31, 2003, if the arrangement was entered into after January 28, 2002 (“new plans”), unless: “(i) the Insurer generally makes the availability of such rates know to persons who apply for term insurance coverage from the Insurer, and (ii) the insurer regularly sells term insurance at such rates to individuals who apply for term insurance coverage through the Insurer’s normal distribution channels.”

One problem we have encountered with some of our client’s use of the Insurer’s Alternative Term Rates to determine the economic benefit in a split dollar arrangement is that, since the IRS has provided no guidance on how the tests set forth in Notice 2002-8 for new plans are to be met, some carriers now will only provide facts to support those two tests, leaving the decision about whether their rates qualify up to the insured’s advisors.

Furthermore, we have been informed that some carriers are not providing Alternative Term Rates for any new plans, and will only provide alternative rates for arrangements entered into prior to January 28, 2002 (“grandfathered plans”). It is apparently their position that they are unable or unwilling to comply with the more stringent requirements that are required for new plans in order to qualify the rates. For new plans where the carrier does not have rates that comply with the new guidelines, the higher Table 2001 rates, as outlined in Notice 2002-8, will be the only rates available.

In fact, in some of the situations we have become aware of, there was no general notification provided to insureds or their agents about the carrier’s unwillingness to support alternative term rates for new plans, and the insurance company representatives who had been providing the term costs to the agents were themselves unaware of the situation. In fact, in some of the cases, the rates hadn’t been available for a year or more before the agent discovered that fact and the insureds had been (incorrectly, as it turned out), using them to report economic benefits for income and gift tax purposes.

Finally, we understand that some employers are being advised by their accountants and/or counsel of their responsibilities under Sections 3403, 3102 and 3111 for income tax withholding and both the employer’s and employee’s share of FICA taxes for reporting the equity on termination of a compensatory pre-Final Regulation split-dollar arrangement. Obviously, if the employer were to report the equity in such an arrangement, the employee would be at great risk in not reporting the equity as income (under the “no inference” provision of Notice 2002-8, or otherwise).

As always, please feel free to contact either of us if you have any questions or comments about this Memo or the attachment.



Memorandum

Date: December 5, 2007
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CIRCULAR 230 DISCLOSURE

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Our July 16, 2007 memorandum outlined the provisions of Notice 2007-34, which set forth how Section 409A applies to Compensatory Split-Dollar Arrangements ("SDAs"), and provided our initial thoughts about the practical implications of that application. On November 4, 2007, we sent you a more detailed (and more technical) explanation of the application of Section 409A to compensatory SDAs. This memorandum incorporates our last memo but also includes our most recent conclusions about the impact of the Final Section 409A Regulations on the type of Split Dollar Arrangements which will be most effected by these new rules – compensatory, pre-final split-dollar regulation, equity, collateral assignment arrangements.

Application of Section 409A to Certain Compensatory Split-Dollar Arrangements.

Section 409A was added to the Internal Revenue Code in 2004, and applies to nonqualified deferred compensation plans. In April, 2007 Final Regulations to Section 409A were issued, and in conjunction with those Regulations, Notice 2007-34 was issued, which dealt exclusively with the application of Section 409A to SDAs.

The IRS has taken the position since 2004 that Employee/Employer (compensatory) SDAs will be considered nonqualified deferred compensation plans for purposes of Section 409A;

however, as discussed below, it has concluded that certain compensatory SDAs will not be subject to Section 409A.

Death benefit plans are not considered deferred compensation; therefore, a compensatory SDA which provides only death benefits will not be subject to Section 409A. Although the economic benefit portion of a premium (the cost of life insurance protection) that an Employer pays in an SDA is compensation income to the Employee, Notice 2007-34 provides that the economic benefit portion of the premium provides a death benefit¹ and therefore this portion of the premium is not subject to Section 409A. Accordingly, (i) a non-equity economic benefit compensatory arrangement and (ii) that portion of the premium paid under an equity economic benefit compensatory arrangement that is allocable to the cost of life insurance protection, is not subject to Section 409A.

Most (if not all) Pre-Final Split-Dollar Regulation compensatory SDAs (“Pre-Final Split-Dollar Regulation SDAs”) were equity arrangements, which provide both lifetime benefits as well as death benefits, and the lifetime benefits cannot qualify for this exemption from Section 409A..²

Notice 2007-34 provides that split-dollar loan arrangements, whether they are pre- or post-Final Split-Dollar Regulation SDA arrangements, will generally not give rise to deferred compensation subject to Section 409A. However, if the all or a portion of the payments on the loans are waived, cancelled or forgiven, the amounts so waived, cancelled or forgiven will give rise to deferred compensation subject to Section 409A in “certain situations”; the Notice does not elaborate on those situations.

Accordingly, it appears that only pre- or post- Final Split-Dollar Regulation equity, economic benefit, compensatory SDAs are the only SDAs which will generally be subject to Section 409A. Given the fact that few, if any post-Final Regulation SDAs are being done as equity arrangements, the impact of Section 409A and Notice 2007-34 on SDAs will be limited to pre-Final Split-Dollar Regulation SDAs that are equity arrangements.³

¹ The economic benefit portion of the premium is also immediately includable in the Employee’s income and is therefore not deferred compensation in any case.

² The 409A Regulations provide that an SDA cannot be amended to remove the lifetime benefits it provides in order to qualify the SDA for the death benefit only exemption. However, Notice 2007-86 grants an extension of time to amend agreements to either comply with the requirements of Section 409A or remove the agreement from the application of Section 409A altogether. It is not clear whether or not an agreement can be changed to a death benefit only plan prior to January 1, 2009 to avoid the application of Section 409A. Why this should not be allowed isn’t clear to us, since once the arrangement no longer provides lifetime benefits, it seems to qualify for the death benefit exemption. A more logical approach would be to allow plans to be amended to remove lifetime benefits prior to January 1, 2009 (thereby created a death benefit only plan). After this date, however, the prohibition against amending plans to create death benefit only plans would apply, and this issue is not likely to be resolved prior to January 1, 2009.

³ As discussed below, that will require determining how much (if any) of the equity on termination of such an arrangement will be subject to Section 409A and therefore taxable at that time.

Post-Final Regulation Equity Economic Benefit Compensatory SDAs Subject to Section 409A

A split-dollar economic benefit arrangement entered into after September 17, 2003 or entered into before that date but materially modified after that date, that is governed by the rules of Section 1.61-22(d)-(g), generally provides for deferred compensation if the Employee has a legally binding right to be paid in any later taxable year: (i) any economic benefits described in Section 1.61-22(d)(2)(ii) which is the policy cash value to which the Employee has current access, as defined in the Final Split-Dollar Regulations; and (ii) any other economic benefits provided to the Employee pursuant to the terms of the SDA.

As noted above, Notice 2007-34 states that the right to current life insurance protection is treated as provided under a death benefit plan under Section 1.409A and thus is excluded from the requirements of Section 409A, even if additional economic benefits are subject to the application of Section 409A.

As a practical matter, however, few (if any) post-Final Split-Dollar Regulation equity economic benefit arrangements are being done.

Pre-Final Regulation Equity Economic Benefit Compensatory SDAs Subject to Section 409A

Notice 2007-34 holds that since the equity in a compensatory equity economic benefit SDA created by the premium payments advanced by the Employer under the arrangement “is or may be payable to the Employee in a later taxable year”, it is considered deferred compensation and therefore subject to Section 409A (to the extent not grandfathered, as discussed below).

Loss of the “No Inference” Protection of Notice 2002-8 for Pre-Final Regulation Compensatory Equity SDAs Subject to Section 409A on Termination

Notice 2007-34 states that pre-Final Split-Dollar Regulations SDAs “provide for deferred compensation for purposes of Section 409A if, under the terms of the arrangement and the relevant facts and circumstances the Employee has a legally binding right during the taxable year to compensation that pursuant to the terms of the arrangement is payable to (or on behalf of) the Employee in a later year **(for example upon termination of the split-dollar arrangement)**”. [Emphasis added].

In an AALU Teleseminar on the Final Section 409A Regulations, while Dan Hogans, Attorney-Advisor with Treasury stated that the Notice does not change or expand the guidance in Notice 2002-8 (with its “no inference” language), he also stated that it is Treasury’s view that equity SDAs that did not terminate already under the safe harbor provisions of Notice 2002-8 are generally taxable on termination.

Notice 2002-8 provides interim rules that essentially give the parties to a split-dollar arrangement a choice – they may treat the arrangement as involving a series of loans from the Employer to the Employee or they may treat the arrangement as one in which the Employer provides an “economic benefit” to the Employee each year under the arrangement.

If the parties had elected (as almost all had) to treat the arrangement in the traditional manner (as providing an “economic benefit” to the Employee), and if it were an equity split-dollar arrangement (as almost all were), then, under the Notice, the IRS would not treat the policy equity as having been transferred to the Employee unless and until the Employer no longer had an interest in the policy during the Employee’s lifetime (that is, until termination of the arrangement during the Employee’s life – “roll-out”). At that point, subject to the special rules discussed below applicable to pre-January 28, 2002 arrangements, the IRS would take the position that the policy equity was taxable to the Employee under Section 83.

However, under what is referred to as the “no inference” provision of Notice 2002-8, the IRS may not use either Notice, or any proposed or final split-dollar regulations, as support for such a position. Similarly, a taxpayer would not be able to invoke either Notice or any such regulations for purposes of making an argument that they represented a change in the law and that, therefore, the equity would not have been taxable under prior law. Essentially, both the IRS and the taxpayer would be required to rely on the law as it existed before Notice 2001-10 for purposes of bringing, or defending, a claim that policy equity in an equity split-dollar arrangement should be taxed to the Employee on termination of the arrangement.

The taxation of the equity at the termination of a pre-Final Split-Dollar Regulation economic benefit, equity arrangement has always been a subject of debate among practitioners; and in Notice 2007-34 the IRS still has not clearly set forth its position. There are several positions that practitioners are taking with respect to the taxation of the equity at the termination of a compensatory pre-Final Split-Dollar Regulation economic benefit, equity arrangement, which are as follows:

(1) The equity at termination is only taxable under Section 409A, so if Section 409A doesn't apply (because, for example when the deferred compensation is grandfathered under Section 409A or the arrangement is not an employer/employee arrangement), there is no taxation of the equity at the termination of the arrangement.

Notice 2007-34, part III.D. addresses pre-Final Split-Dollar Regulations arrangements that are "not grandfathered under Section 1.409A-6". The Notice refers to the language in Notice 2002-8 which states "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 protection as an economic benefit provided to the benefited person." Importantly, Notice 2007-34 then states that "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." Notice 2007-34 does not contain the same "no inference" language that was included in Notice 2002-8, which, as noted, permitted practitioners to take the position that there was no taxation of the equity at the termination of the arrangement by relying on the older Rulings.

(2) The equity at the termination of a pre-Final Split Dollar Regulation employment related arrangement is taxable, but under Notice 2007-34 only non-grandfathered amounts are

subject to the penalties Section 409A.⁴ Notice 2007-34 applies to grandfathered and non-grandfathered employment related split dollar arrangements (both pre- and post- Final Split-Dollar Regulation arrangements), but to no other type of split-dollar arrangements. Therefore the lack of any "no inference" language in Notice 2007-34 does not impact any split dollar arrangement other than employment related arrangements.

(3) The equity at the termination of all pre-Final Split-Dollar Regulation arrangements is taxable in all instances and, in addition, the non-grandfathered amounts are also subject to the penalties of Section 409A if the plan is not properly structured. The "no inference" language of Notice 2002-8 does not prevent taxation of the equity at the termination of the arrangement, because the older Rulings recognized that the equity was a taxable economic benefit provided to the benefited person. Therefore, Notice 2007-34 does not discuss whether the equity is taxable or not, the IRS' position on that issue was resolved in Notice 2002-8, and the Notice is merely defining what portion of the taxable equity is subject to Section 409A.

(4) The equity at the termination of all arrangements which are pre-Final Split-Dollar Regulation arrangements is not taxable due to the "no inference" language of Notice 2002-8, but the non-grandfathered amounts in an employment-related split-dollar arrangement must comply with Section 409A to avoid its penalties.⁵

We believe that it is unclear which is the correct position to take for pre-Final Split-Dollar Regulation SDAs which are compensatory economic benefit equity arrangements and therefore, in light of this uncertainty, it is possible to continue to take the first position described above, namely, that only the non-grandfathered equity in an employment-related split-dollar arrangement is taxable at the termination of the arrangement, because Notice 2007-34 only addresses the treatment of that equity and then only for purposes of Section 409A. It is therefore possible to continue to rely on the "no inference" language of Notice 2002-8 to take the position that the equity in all other pre-Final Split-Dollar Regulation SDAs and grandfathered equity in employment-related pre-Final Split-Dollar Regulation arrangements at termination is not taxable.

Although it has traditionally been unclear whether any equity developed in an arrangement treated under the economic benefit theory is also a gift to a third party owner (either annually or at rollout) consistency (and the extension of the theory of Rev. Rul. 78-420) would appear to require parallel treatment of the equity for both income and gift tax purposes in such a situation, which is the conclusion of TAM 9604001 (without the citation of any authority other than Rev. Rul. 78-420). Both Notices imply that result for pre-final regulation arrangements, since they are stated to apply for gift tax purposes⁶; and a review of prior rulings on this issue leads us to the conclusion that there will be a gift of equity in those circumstances upon the termination of the SDA.⁷

⁴ This would be the same situation for a deferred compensation agreement that was partially funded prior to January 1, 2005. When the deferred compensation is paid out, the grandfathered amounts are still taxable but those amounts are not subject to the rules of Section 409A.

⁵ We believe this is the weakest position of the four positions because Section 409A is based on an initial assumption that the amounts subject to Section 409A are already taxable income.

⁶ The IRS recently issued Private Letter Ruling 200728015 (April 9, 2007), which raises the issue of a gift by the Employee of the equity (minus amounts payable to the Employer) upon termination of the SDA, if the Employee is then-living and has assigned the policy to a third party other than his spouse prior to such termination. The Service

Compensatory SDAs, All or a Portion of Which are Grandfathered from the Application of Section 409A

Amounts deferred in taxable years beginning before January 1, 2005 (regardless of whether the SDA is a pre- or post-Final Split-Dollar Regulation SDA), and the earnings on such amounts, are not subject to Section 409A, unless the plan was materially modified after October 3, 2004 (“Grandfathered Amounts”). An amount is considered deferred in taxable years beginning before January 1, 2005 if before January 1, 2005 the Employee had a legally binding right to be paid that amount, and the right to the amount was earned and vested.

Premiums that were paid on or before December 31, 2004 that were earned and vested as of the date and premiums paid after that date pursuant to a legally binding right that was earned and vested as of that date are considered Grandfathered Amounts. The Final Regulations under Section 409A provide that an amount is considered earned and vested only if the amount was not subject to a substantial risk of forfeiture or a requirement to perform further services.

It is possible in certain circumstances that amounts that are paid after January 1, 2005 may be considered deferred before January 1, 2005, if before January 1, 2005 the Employee had a legally binding right to be paid the amount in the future and the right to the future amount was earned and vested by December 31, 2004. For example, a common feature of SDAs that apply to second-to-die insurance policies is that if the Employee dies first, the agreement provides that the Employer will continue to pay the premiums after the Employee’s death, until the survivor’s death. In this case, premiums paid after January 1, 2005, (and the earnings on such amounts, which Notice 2007-34 makes clear includes policy cash value increases attributable to those payments) should also be grandfathered.

Otherwise, if the Employer only has to continue to pay premiums so long as the Employee is employed by the Employer, and therefore, there is a requirement to perform further services, premiums paid after January 1, 2005 (and cash value increases attributable thereto) will not be grandfathered.

Not only are Grandfathered Amounts are not subject to Section 409A, but, importantly, earnings on Grandfathered Amounts are not subject to Section 409A. These earnings include an increase in policy cash value, or an increase in any portion of the policy cash value, that is attributable to the Grandfather Amounts. However, earnings on Grandfathered Amounts do not include any increase in policy cash value attributable to continued services performed,

expressed no opinion concerning the federal gift tax consequences of the termination of the agreement in the ruling, because at that time there was no cash surrender value in the policy.

⁷ The initial assignment by the Employee of the policy to a third party owner is a gift for gift tax purposes; in addition, under Rev. Rul. 78-420 (revoked as obsolete), there is an annual indirect gift from the Employee to the owner, so long as the arrangement is in effect, resulting from the continuance of the economic benefit of the arrangement provided by the Employer (irrespective of whether the Employer is currently paying policy premiums in cash). But see Private Letter Ruling 200747011 (August 7, 2007) in which the IRS held that there was no gift upon the transfer of a policy to a third party, if the donee paid its share of the premium pursuant to the split-dollar agreement and under the agreement received its allocable share of the policy cash value and the donor continued to pay its share of the premium and continued to be entitled to its allocable share of the policy cash value in accordance with the parties’ agreement.

compensation earned or premium payments or other contributions made on or after January 1, 2005 (except as provided above).

Allocation between Grandfathered and NonGrandfathered Amounts

If a SDA has both grandfathered and non-grandfathered lifetime benefits, a calculation must be made to exclude only the non-grandfathered amounts from Section 409A. Under Notice 2007-34, the calculation of the grandfathered component of the benefit may be made under any reasonable method that allocates increases in policy cash value attributable to the Grandfathered Amount. A method will not be treated as reasonable if it allocates a disproportionate amount of policy costs and expenses to the non-grandfathered benefit.

Requirements of Section 409A that Compensatory SDA Must Satisfy if It Provides Non-Grandfathered Lifetime Benefits

Under Section 409A(a)(2), deferred compensation cannot be distributed earlier than (i) the Employee's separation from service;⁸ (ii) the date the Employee becomes disabled; (iii) the Employee's death; (iv) a specified time (or pursuant to a fixed schedule) specified under the plan at the date of the deferral of the compensation; (v) a change in ownership or effective control of the corporation or in the ownership of a substantial portion of the assets of the corporation; or (vi) the occurrence of an unforeseeable emergency⁹ (the "Permissible Distribution Events").

Most compensatory SDAs do not contain such a limited list of Permissible Distribution Events, and as a result, most SDAs subject to Section 409A must be amended to bring the SDAs

⁸ Section 409A(a)(2)(B)(i) states that in the case of a specified Employee, distributions may not be made before the date which is six months after the date of separation of service (or if earlier, the date of death of the Employee). A "specified Employee" is a key Employee (as defined in Section 416(i), without regard to paragraph (5) thereof) of a corporation any stock in which is publicly traded on an established securities market or otherwise. A "key Employee" is defined in Section 416(i) (without regard to paragraph 5 which includes the beneficiaries of the key Employee) as officers of the corporation with annual compensation of more \$130,000 indexed for inflation, a 5% owner of the company, or a 1% owner of the company with annual compensation of more than \$150,000, indexed for inflation. In 2007 the salary amount is \$145,000. For purposes of Section 416(i), if the person was an officer at any time during the plan year containing the determination date with that salary, the person is a "key Employee". For purposes of Section 409A, which uses the term 'specified Employee' but applies the key Employee rules, the person must be a specified Employee (an officer making the salary amount) on the identification date. The 2007 salary for purposes of Section 409A is also \$145,000. In 2006 the salary amount was \$140,000 for both Section 409A and Section 416(i).

⁹ The term "unforeseeable emergency" is defined in Section 409A(2)(B)(ii) as meaning a severe financial hardship to the participant resulting from illness or accident of the Employee, the Employee's spouse or dependant (as defined in Section 152(a) of the Employee, loss of the participant's property due to casualty, or other similar extraordinary and unforeseeable circumstances arising as a result of events beyond the control of the participant. Section 152(a) defines dependents for purposes of the personal exemption deduction available to taxpayers under Section 151. The deferred compensation that can be distributed upon the occurrence of an unforeseeable emergency is limited to the amounts necessary to satisfy such emergency plus amounts necessary to pay taxes reasonable anticipated as a result of the distribution, after taking into account insurance reimbursements or other compensation and the amount that could be raised by liquidating the Employee's assets (to the extent such liquidation of such assets would not itself cause financial hardship).

into compliance with Section 409A, by the end of 2008; however, beginning in 2008, the agreement must be administered as though such amendments had been made, notwithstanding the extension of time granted to the end of 2008, and it may be safer not to wait until the end of 2008 to make the actual amendments (as discussed below).

One substantive provision which often appears in SDAs that we believe would have to be addressed, is a provision that allows either the Employee (or an insurance trust, if the arrangement involves a third-party owner such as an insurance trust) to terminate the agreement at any time.¹⁰ This ability to terminate the agreement at any time will cause the non-grandfathered portion of the SDA to fail to qualify under Section 409A, since a distribution of the deferred compensation provided under the arrangement could be made at a time that is not one of the permissible, set distribution events provided in Section 409A. Any other provision of the SDA which had the same effect would also have to be eliminated – for instance, a provision which terminated the agreement if the employee (or the trust) failed to pay its share of premiums.

Another substantive provision which often appears in SDAs that we also believe would have to be addressed, for the same reason, is a provision that allows the Employee (or an insurance trust, if the arrangement involves a third-party owner such as an insurance trust) to make withdrawals from the cash value of the policy at any time. While it isn't clear whether a power to borrow from the policy that held by the Employee is analogous to a right to make withdrawals from the cash value, the power to borrow may be a lifetime benefit that would be subject to the requirements of Section 409A. Accordingly, in light of this uncertainty, during 2008, while we wait for clarification from the IRS, we believe the Employee (or owner) should not be permitted to borrow from the policy cash value and should not be permitted to withdraw the cash value without the obligation to repay the withdrawn amount or policy loans at some time in the future. A power to make such withdrawals from the cash value of the policy at any time is analogous to an ability to terminate the agreement at any time, which, as discussed above, will cause the non-grandfathered portion of the SDA to fail to qualify under Section 409A, since a distribution of the deferred compensation provided under the arrangement could be made at a time that is not one of the permissible distribution events set forth in Section 409A.

On the other hand, if the power to terminate the arrangement or to withdraw (or to borrow, for that matter) from the cash value of the policy only arises upon set times or events, then such powers, albeit lifetime benefits, will satisfy the requirements of Section 409A. Accordingly, these powers should either be eliminated entirely or amended to be exercisable only at a set time, such as on January 1st of each year the arrangement is in force.

Eliminating the rights, however, may cause further issues with respect to the grandfathering of the agreement under the final split-dollar regulations, which is discussed below.

Consequences of Failing to Meet the Requirements of Section 409A

¹⁰ The employee cannot have this discretion, either directly or indirectly. Therefore, if the employee is a majority shareholder of the employer or occupies a position that allows the employee to influence the company's decision to terminate the agreement, the company's right to terminate the agreement at any time must be treated in the same manner as the employee's right to terminate the agreement; this will make majority shareholder arrangements even less flexible than they were before.

The consequences of failing to meet the requirements of Section 409A and/or failing to operate the plan in accordance with these requirements are onerous; accordingly, whatever steps should be taken that are necessary to bring compensatory SDAs into compliance with Section 409A by the end of 2007.¹¹ These consequences are as follows:

1. All compensation deferred under the plan for the taxable year and all preceding taxable years shall be includable in gross income of the employee for the taxable year to the extent not subject to a substantial risk of forfeiture and not previously included in gross income.

2. The tax on the compensation that is includable in gross income for the taxable year shall increased by the sum of:

a. an amount equal to 20% of such compensation, and

b. interest at the underpayment rate plus one percent on the underpayments that would have occurred had the deferred compensation been includable in gross income for the taxable year in which first deferred, or if later, the first taxable year in which such deferred compensation is not subject to a substantial risk of forfeiture.¹²

Modifications to Comply with Notice 2007-34 May Not Be Material Modifications for Purposes of the Final Split-Dollar Regulations.

Notice 2007-34 also set forth the rules for determining when a modification of a SDA necessary to bring the arrangement into compliance with Section 409A or to avoid application of Section 409A will not be treated as a material modification under the Final Split-Dollar Regulations.

A modification of a SDA is considered necessary to bring the SDA into compliance with Section 409A (the Notice does not refer to avoiding the application of Section 409A in this sentence) only if all of the following requirements are satisfied:

1. The Employer which participated in the SDA has made the following determinations, based on a reasonable application of Section 409A, the regulations and other guidance:

a. that Section 409A is applicable to the SDA; and

b. that the SDA does not comply with the requirements of Section 409A.

2. The Employer has made the following determination (using the same reasonable application of Section 409A and applicable guidance):

a. that the modification causes the SDA to comply with Section 409A, or

b. that the modification results in Section 409A no longer being applicable to the SDA; or

¹¹ Despite the extension of time granted to do so in Notice 2007-86, discussed below.

c. that the modification is a necessary part of a number of actions that together cause the SDA to comply with Section 409A or results in Section 409A no longer being applicable to the SDA.

3. The modification consists solely of one or more of the following provisions and the changes are reasonably intended to conform the SDA to the requirements of Section 409A or qualify for an exclusion from Section 409A:

- a. changes to the applicable definitions;
- b. changes to the payment timing requirements;
- c. changes to the conditions under which all or part of the benefit under the SDA will be forfeited.

4. The modification establishes a time and form of payment, or 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 SDA before the modification.

5. The modification cannot materially enhance the value of the benefits to the Employee under the SDA.

One issue we are concerned about under the “protected” modification provisions of Notice 2007-34 is the elimination of the Employee’s right, directly or indirectly, to terminate the agreement at any time. As noted above, we believe that in order for the SDA to be in compliance with Section 409A, this right (and any rights that are analogous to this right, such as the power to withdraw the cash value of the policy and, possibly, the power to borrow from the policy cash value) must be eliminated or must only arise at a set time or the occurrence of a set event, but by eliminating or limiting this right, are times of payment consistent with the times the benefit could have been paid under the terms of the SDA before the modification, as required in paragraph 4 above? Prior to the modification, the employee could terminate the agreement and receive the “equity” in the agreement at any time, but after the modification, the employee has lost the ability to be paid the benefit at the employee’s discretion. We do not believe the Service intended this type of modification to be considered a material modification for purposes of the Final Split-Dollar Regulations. This modification is clearly not considered a material modification of the agreement for purposes of Section 409A and the modification is necessary to comply with Section 409A. We don’t believe that it is reasonable that the Service issued Notice 2007-34 in order to ensure that split-dollar arrangements could be modified to comply with Section 409A in a way that would not be considered a material modification for purposes of the Final Split-Dollar Regulations, but then subject arrangements with this provision to the Final Split-Dollar Regulations when the split-dollar agreement is amended solely to comply with Section 409A.

We believe there will be further guidance which will clarify this issue in the future, but in the meantime, those employers and employees who amend their Split-Dollar Agreements to either eliminate the employee’s right to terminate the agreement or limit the employee’s right to terminate

the agreement so that it only arises at set (non-discretionary) times, should consult with their tax advisor to determine the consequences of the amendment.¹³

Notice 2007-86

Notice 2007-86 has extended the time period for transition relief under Section 409A until December 31, 2008, and therefore, split-dollar agreements that are operated in a manner that is consistent with Section 409A and any applicable guidance thereunder, and amended to actually comply with Section 409A and the Final Regulations thereto prior to January 1, 2009 will be considered to be in compliance with Section 409A..

We are, however, concerned that parties to a compensatory split-dollar agreement who do not amend their agreements until the end of 2008 run a greater risk of violating Section 409A than those who amend their agreements as soon as possible. Without amending the split-dollar agreements to comply with Section 409A, the parties to the agreement risk an inadvertent violation of Section 409A, because the agreement will contain the old provisions. Retaining the old provisions in the split-dollar agreement will not cause a violation of Section 409A by itself, at least not until January 1, 2009, so long as the parties ignore those provisions and operate the agreement in a manner that is consistent with Section 409A. However, the parties to the agreement may not realize those provisions should be ignored, and if one of the parties actually exercises such a right, the exercise will result in a violation of Section 409A.

As a result, notwithstanding the extended period for transition relief provided by Notice 2007-86, we recommend that parties amend their agreements now and bring them into compliance with Section 409A as soon as possible, and if further amendments become necessary, due to the issuance of further guidance during 2008, the agreements can be amended again when that guidance is issued.

Our Conclusions About the Application of Section 409A to Compensatory SDAs

As we concluded in our prior memo, we continue to believe that Section 409A and Notice 2007-34 will apply only to the following employment-related split-dollar arrangements:

- (a) Pre-Final Regulation equity collateral assignment arrangements terminated during the employee's lifetime, where there is equity, to the extent the equity is not grandfathered.
 - (i) Based on which position described above regarding the taxation of equity on termination of an arrangement you agree with, if the equity would have been income under Notice 2002-8, in any event – Section 409A seems to effectively eliminate reliance on the Notice's "no inference" provision for the non-grandfathered portion of the equity in such a compensatory SDA.
- (b) Pre- and post-Final Regulation loan arrangements, where the loan is forgiven (regardless of a binding agreement to do so).

¹³ The risk is that such an amendment would change the tax regime applicable to the arrangement to the loan regime.

- (i) If the arrangement included an up-front forgiveness, it may not have been split-dollar in any event.
 - (ii) If not, again, it seems nothing is being deferred, since the deferred compensation element would be taxable when forgiven, not at a later date; however, although it is not clear how it would apply, the IRS stated in Notice 2007-34 that those amounts would be subject to Section 409A.
- (c) Pre- or post-Final Regulation equity endorsement arrangements (again, which were rarely done, even before the Final Split-Dollar Regulations).
- (i) And in post-Final Regulation arrangements, the equity is taxed currently (based on “access”), which will exempt it from the application of Section 409A.
- (d) Again, as a practical matter, it appears that Section 409A and Notice 2007-34 will likely only apply to the termination of pre-Final Regulation equity, collateral assignment SDAs, during the insured’s lifetime, to the extent the equity isn’t grandfathered from Section 409A.

Dealing with Pre-Final Split-Dollar Regulation Equity SDAs Under Notice 2007-34

1. Notice 2007-34 only applies to compensatory SDAs, not, for example, private (donor/donee) arrangements.
2. Notice 2007-34 only applies to equity compensatory SDAs, not non-equity (death benefit only) arrangements.
3. Notice 2007-34 only applies to the non-grandfathered portion of equity compensatory SDAs.
 - (a) Grandfathered equity could arise because the arrangement is fully grandfathered from Section 409A (an arrangement where no premiums are paid after January 1, 2005 – like public company arrangements frozen after the effective date of Sarbanes-Oxley - or an arrangement where the employee’s rights to future premium advances are vested – i.e., not subject to continued employment) or because the arrangement is only partially grandfathered from Section 409A (that part of the equity attributable to pre-January 1, 2005 premiums).
 - (b) Note that a post-October 3, 2004 “material modification” of a grandfathered arrangement would result in a loss of grandfathered protection for purposes of Section 409A.
4. Notice 2007-34 only applies to the non-grandfathered portion of equity compensatory SDAs on termination of the arrangement during the insured’s lifetime (i.e., at rollout).

- (a) So long as the arrangement continues, the equity will not be subject to Section 409A (although withdrawals of the equity or even loans against the equity might be treated as a termination of the arrangement to that extent).

5. To the extent that Notice 2007-34 applies to an arrangement on rollout, the equity will be taxable at that time, for income and transfer tax purposes, without any “no inference” protection.

- (a) This loss of the “no inference” protection of Notice 2002-8 is the most troubling aspect of the application of Notice 2007-34 to pre-Final Regulations SDAs.

6. To the extent that Notice 2007-34 applies to an arrangement on rollout, the penalty provisions of Section 409A will also apply, unless the arrangement is modified before January 1, 2009 to comply with the restrictions of Section 409A (to be sure; for instance, that the payment of the equity is only at fixed times – and not at the discretion of the employee.)

- (a) The modification may not comply with all of the requirements of Notice 2007-34 (since it changes one of the times of payment of the benefit, so that they are no longer consistent with the times of payments provided before the modification) and if it fails to do so, it will convert the arrangement to a post-Final Split-Dollar Regulation arrangement (meaning that it will become a loan regime arrangement).
- (b) Even if the arrangement is not re-documented to comply with Section 409A (“documentary compliance”) by the end of 2008, as required by Notice 2007-86, the arrangement must nonetheless be administered in accordance with Section 409A by January 1, 2008. This is the reason we suggest these changes be made to affected arrangements as soon as possible, even if not required to be made until the end of 2008.

7. Absent further guidance on what qualification of any modifications can be made to comply with Section 409A which will not be considered material modifications under the Final Split-Dollar Regulations, the choice would be violating Section 409A on rollout vs. converting to a loan regime arrangement on the modification.

- (a) While neither of these choices is appealing, our sense is that not complying with Section 409a will be most often chosen, since its implications are postponed until rollout (when there may or may not be equity and when the law may or may not be the same).
- (b) A third choice is to convert the arrangement to a non-equity economic benefit SDA, which would not be subject to Section 409A, but such a conversion could have substantial economic consequences for the employee (or the third party owner, such as a trust), which would be difficult for the employee or third party owner to accept.