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Split Dollar Intersection with Deferred Compensation: IRS Notice 2007-34

SITUATION

As part of the 2004 American Jobs Creation Act, Congress enacted IRC Section 409A that introduced much tougher rules for non-qualified deferred compensation arrangements (NQDC).

PROBLEM

Under the finalized split dollar regulations, there is a possibility that certain kinds of split dollar agreements may also contain an element of NQDC and be subject to IRC Section 409A. For example, an employer might create an endorsement split dollar arrangement wherein the employer promises to release the cash surrender value at time of the employee's retirement. This additional promise confers an additional economic benefit (beyond the current life insurance protection) on the taxpayer which is form of NQDC.

Split dollar arrangements entered into on or before 9/17/2003 enjoy some preferable tax attributes provided they are not "materially modified" after that date. These plans are referred to as "grandfathered plans." (If they are materially modified, they would lose these benefits.)

The intersection of these two concepts raised some difficult issues for taxpayers. For example, if taxpayer had a "grandfathered" split dollar arrangement, but needed to make some changes to comply with the NQDC rules, would these changes cause the loss of the "grandfather" status of split dollar plan? As a companion to the recently released (397 pages) of regulations on NQDC, the IRS also released Notice 2007-34 which addresses the intersection of these two concepts. The following bullet points are a "headline" summary of the key conclusions regarding grandfathered contracts:

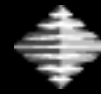
- A straightforward endorsement split dollar plan (entered into before 9/18/2003) will not lose its grandfather status provided the "service provider" (employee) continues to report the economic benefit of the life insurance protection.
- A loan arrangement split dollar plan (entered into before 9/18/2003) generally will not give rise to NQDC within the meaning IRC Section 409A. But a different result would occur is the agreement promises to cancel, waive or forgive the debt at some future date.
- Generally, a modification of a split dollar agreement necessary to bring the arrangement into compliance IRC Section 409A (or to avoid the application of IRC 409A) will not be treated as a material modification of the split dollar arrangement which would jeopardize the grandfathered status of split dollar arrangement.

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SIGNIFICANCE

A few comments about split dollar and the NQDC market. It appears that this Notice intends to exempt “plain vanilla” endorsement and loan regime split dollar plans from the reach IRC Section 409A. (It also exempts so called IRC Section 162 bonus arrangements because such plans have no deferral attributes.)

Prior to enactment of IRC 409A, NQDC was a relatively simple planning idea (often “informally funded” with life insurance) that required little effort to set up and administer. Many plans were drafted with simple agreements and no annual administration was required. There were few tax penalties (if any) for these “loose arrangements.” IRC 409A did not change the underlying tax architecture. But it did radically alter the reporting requirements and limits some of the flexibility that used to be associated with these plans. IRC Section 409A also carries stiff tax penalties for violations—current income tax and 20% penalty. Given these penalties, many employers will need the services of third party administrator (TPA) to comply the increasing complexity of this topic.

SOLUTION

Life insurance (with its tax deferred growth) remains a popular method of for informally funding NQDC arrangements. Increasingly, we are seeing employers who are looking for alternatives to NQDC plans. One tool that seems to be gaining popularity is the so called “162 Bonus Plan”. In such plans, the employer “bonuses” additional compensation to select employees, who, in turn, purchase a life insurance contract. (Assuming the compensation is reasonable, the compensation should be deductible as an “ordinary and necessary business expense” under IRC Section 162) Using withdrawals and loans, the employee can supplement his/ her retirement income.

This article should not be used as a basis for legal and/or tax advice. In any specific case, the parties involved should seek the guidance and advice of their own legal and tax counsel.