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Notice 2007-34, Guidance Regarding the Application of Section 409A to Split-Dollar Life Insurance Arrangements



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SITUATION

In connection with the issuance of the final regulations on the taxation of non-qualified deferred compensation under Internal Revenue Code section 409A, the IRS has issued specific guidance on how section 409A applies to split-dollar life insurance arrangements.

General Application of 409A to split-dollar arrangements:

The Notice clarifies that section 409A applies to split-dollar arrangements that provide for deferred compensation. These arrangements are those under which the employer (service provider) has a legally binding right during a tax year to economic benefits that are payable to or on behalf of the service provider in a later tax year of the service provider.

Issues to Consider

Arrangements excluded from 409A:

Split-Dollar arrangements that provide death benefits only

1. Split-Dollar arrangements taxed under section 7872 (loan regime).
These arrangements may fall within section 409A if amounts on the split-dollar loan are waived, cancelled or forgiven.
2. Split-dollar life insurance arrangements that provide a legally binding right to amounts that are included in income in accordance with the exception for short-term deferrals
3. Grandfathered amounts - Amounts deferred before January 1, 2005 if the employee had a legally binding right to be paid the amount and the right to the amount was earned and vested.
 - o Includes post January 1, 2005 earnings on these grandfathered amounts.
 - o Includes increases in the policy cash value or an increase in any portion of the policy cash value attributable to pre-January 2005 benefits.
 - o If the plan under which the amount deferred was paid was materially modified after October 3, 2004, the grandfathered treatment is lost.

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Arrangements covered by 409A

1. Amounts deferred after January 1, 2005 in split-dollar arrangements if the employee had a legally binding right during the taxable year to economic benefits (such as access to cash value) that are payable to the employee in a later taxable year.
 - o Includes any increase in cash value attributable to continued services performed, compensation earned or premium payments or other contributions made on or after January 1, 2005.
 - o Where benefits under a split-dollar arrangement have a component that is excluded due to 409A grandfathering and a component that is non-grandfathered, there is an allocation of policy cash value made to each portion. The Notice provides for proportional allocation and provides a method for so allocating.
2. Split-dollar arrangements entered into after September 17, 2003 which are taxed under the economic benefit regime.
3. Split-dollar arrangements entered into before September 17, 2003 (before split-dollar regulations were finalized) under which the employee has a legally binding right to compensation that is payable to the employee in a later year (such as upon termination of the split-dollar arrangement).

Modification of Split-Dollar Arrangements

With respect to split-dollar arrangements entered into before September 18, 2003, modifications which are necessary to bring such arrangement into compliance with section 409A or to avoid application 409A will not be treated as a material modification such that the arrangement would be treated as entered into after September 17, 2003. The concern was to avoid any changes necessary under section 409A that would cause loss of split-dollar grandfather (and thus become subject to the economic benefit regime in the split-dollar regulations).

The modifications must meet the following requirements:

1. The employer or employee has made a 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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2. The employer or employee has made a determination that the modification at issue, either alone or in combination with other actions, causes the arrangement to comply with section 409A or results in section 409A no longer being applicable to the arrangement;
3. The modification consists solely of changes to the applicable definitions or changes to the payment timing requirements or changes to the conditions under which all or part of the benefit under the arrangement will be forfeited;
4. The modification establishes a time and form 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
5. The modification does not materially enhance the value of the benefits to the employee under the arrangement.

Accordingly, if the split-dollar arrangement provides that the employee can receive payments at a time that is not permitted under section 409A, the split-dollar arrangement can be modified to alter the timing of payments to a later date without being a material modification for purposes of the application of the split-dollar regulations. The type of modification permitted will depend on which aspects of the split-dollar arrangement are at odds with section 409A.

If the split-dollar arrangement is not modified to comply with section 409A, the penalty provisions of section 409A could become applicable to the split-dollar arrangement.

If you have any questions, please do not hesitate to call us at 440-740-0130.

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