

CODE SECTION 409A AND SPLIT-DOLLAR LIFE INSURANCE ARRANGEMENTS

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The IRS's final regulations under Code section 409A require that all deferred compensation arrangements must be in full compliance with Code section 409A effective as of January 1, 2009. To what extent does Code section 409A govern split-dollar life insurance arrangements? What compliance is required?

Code section 409A governs all arrangements that defer compensation unless the arrangement is either a type of arrangement that is excluded from Code section 409A (e.g., a Code section 401(a) qualified retirement plan), "grandfathered" under Code section 409A (i.e., the compensation was deferred and vested before January 1, 2005 and the arrangement was not materially modified after October 3, 2004), or a "short-term deferral." According to IRS Notice 2007-34, Code section 409A applies to split-dollar life insurance arrangements (that are not grandfathered or involve only short-term deferrals) as follows:

- Code section 409A does not apply if the arrangement provides a death benefit only.
- Code section 409A does not apply to a "grandfathered" portion of an arrangement and rules are provided to allocate increases in policy cash values to the grandfathered component and the non-grandfathered component.
- If the arrangement is not subject to the IRS's final regulations on split-dollar life insurance (i.e., the arrangement was not entered into or materially modified after September 17, 2003), it is subject to Code section 409A if the employee has a legally binding right to compensation that is to be payable in a later year (e.g., upon termination of the arrangement).
- If the arrangement is subject to the IRS's final regulations on split-dollar life insurance and the employee is taxed under the "economic benefit regime," it is subject to Code section 409A if the employee has a legally binding right to compensation that is or may be payable in a later year (e.g., equity split-dollar). This tax treatment is generally applicable to so-called "endorsement" split-dollar arrangements (i.e., the employer

owns the policy, the employer pays the premium, the employee designates the death beneficiary, and the employer recovers some or all of its premium payments or cash surrender value).

- If the arrangement is subject to the IRS's final regulations on split-dollar life insurance and the employee is taxed under the "loan regime," it will generally not be subject to Code section 409A unless a loan amount is waived, cancelled or forgiven. This tax treatment is generally applicable to so-called "collateral assignment" split-dollar arrangements (i.e., the employee owns the policy, the employer pays some or all of the premium, and the employer recovers some or all of its premium payments and cash surrender value).

If the arrangement is subject to Code section 409A but it is not subject to the IRS's final regulations on split-dollar life insurance, amending an arrangement in order to comply with Code section 409A will not constitute a material modification after September 17, 2003 for purposes of those final regulations (i.e., the amendment will not cause the arrangement to become subject to those final regulations) if all of the following requirements are met:

1. The employer or the employee has made a determination that Code section 409A is applicable to the arrangement and that the arrangement does not comply with the requirements of Code section 409A;
2. The employer or the employee has made a determination that the modification either causes the arrangement to comply with Code section 409A or results in Code section 409A no longer being applicable;
3. The modification consists solely of changes to (i) the applicable definitions (e.g., separation from service or disability), (ii) the payment timing requirements, or (iii) 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, Code 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; and

5. The modification does not materially enhance the value of the benefits to the employee under the arrangement.

What should you do prior to January 1, 2009? You should review all of your split-dollar life insurance arrangements in order to determine if they are subject to Code section 409A. If they are, then you should either (i) amend them to comply with the requirements of Code section 409A (e.g., restricting the times when a rollout may occur and modifying the termination provisions) or (ii) terminate them in accordance with Code section 409A's termination rules. Please let us know if you need any assistance in reviewing or amending your arrangements.

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