

time the estate tax return is due, the estate will have to forego a deduction and compute the tax liability accordingly; the remedy for overpayment caused by such uncertainty will be the filing of a claim (or, if need be, a protective claim) for refund as provided by Code Sec. 6511, once the claim is settled. ♦

INSURANCE PLANNING

IRS Considers Application of Code Sec. 409A to Split-Dollar Arrangements

CCH: On the same day that the final regulations under Code Sec. 409A (T.D. 9321) were released, the IRS issued Notice 2007-34, I.R.B. 2007-17, 996, which concerns the application of rules on nonqualified deferred compensation to split-

In conjunction with the release of final regulations concerning nonqualified deferred compensation under Code Sec. 409A, the IRS has issued guidance in the form of a Notice as to the application of Code Sec. 409A to split-dollar life insurance arrangements. The following interview with Lee Slavutin, MD, CLU, a principal of Stern Slavutin-2 Inc., an insurance and estate planning firm in New York City, and a member of the CCH Financial and Estate Planning Advisory Board, provides an analysis of this guidance along with some practical tips for advisors.

dollar life insurance arrangements. Before you discuss the Notice, could you provide our readers with a brief overview of Code Sec. 409A and its reach?

Dr. Slavutin: Code Sec. 409A was enacted as part of the American Jobs Creation Act of 2004 (P.L. 108-357) in reaction to perceived abuses

involving nonqualified deferred compensation plans of large public companies. Even though there had been considerable case law on the subject of deferred compensation and most practitioners were aware of how it should properly be taxed, Congress felt the need to effectively “tighten up” the law and prevent some of these abuses. Code Sec. 409A provides new restrictions on distributions, elective deferrals, and anti-acceleration provisions.

Material Modifications of SDAs

After enactment of the statute, followed by proposed regulations (NPRM REG-158080-04) and other guidance, it became clear that some split-dollar arrangements (SDAs) would be impacted by Code Sec. 409A. Unanswered until the release of Notice 2007-34 were questions concerning the treatment of grandfathered arrangements and, in particular, whether a modification of a SDA to comply with 409A would cause loss of grandfathered tax benefits.

Unless stated otherwise, the term “grandfathered SDA” in this interview refers to SDAs grandfathered for pur-

poses of the 2003 split dollar regulations. It does NOT refer to grandfathering for 409A.

CCH: Could you elaborate on this particular problem?

Dr. Slavutin: This is an issue that many practitioners struggled with after enactment of Code Sec. 409A. If, in reviewing existing SDAs, it is determined that a there may be a problem with Code Sec. 409A, before Notice 2007-34, we were stymied in suggesting a course of action to our clients. When the split-dollar regulations (T.D. 9092) were issued in 2003, effective September 17, 2003, they made it clear that any SDA established after that date would be subject to the new regulations as would any SDA that was “materially modified” after that date. We had hoped that those regulations would include clear guidance on what constitutes a material modification of an existing arrangement. Unfortunately, the regulations included only a list of certain administrative or ministerial modifications that would not be considered material. For example, one such permitted modification involves a change in the address to send the premium payment. Another is a change in mode of premium payment from monthly to quarterly. Generally, these were changes that no one would reasonably have expected to be deemed material. On the other hand, the really important situations, such as the replacement of an insurance policy used in a SDA, were not addressed.

CCH: What does Notice 2007-34 say on this issue?

Dr. Slavutin: The really *good news* is that the Notice tells us that if we have to modify an existing SDA to comply with Code Sec. 409A, such modification will not cause the arrangement to lose its grandfathered status under the 2003 split-dollar regulations so long as the modification meets the requirements of Notice 2007-34. In addition, the requirements set forth in the Notice to achieve this are not onerous.

Timely Review of SDAs in 2007

CCH: Now that the Notice has been released, what should practitioners be doing in reaction to it?

Dr. Slavutin: Because the Notice provides the opportunity to modify problem agreements before the end of 2007, initially, at least, the Notice should trigger all of us with clients having existing SDAs to go back and review the relevant agreements. It is important to note that one cannot make blanket generalizations about existing agreements. You cannot say, “all collateral assignment split-dollar agreements that were grandfathered under the split-dollar regulations are not going to have a problem.” You have to look at these agreements one by one because there may be some unusual provision present that is going to trigger a 409A issue. Some of these agreements have been in exis-

tence for 15 or 20 years and you cannot hope to remember all of the specific details. That is why nothing less than a thorough review is in order.

CCH: In doing this review are there any particular points that practitioners should be looking for?

Dr. Slavutin: Yes, remember there are actually three sets of guidance that practitioners need to be familiar with in making a decision concerning a client's SDA. First is the recently issued Notice 2007-34. There are also the final 2003 split-dollar regulations, in particular Reg. §1.61-22 and Reg. §1.7872-15. And, finally, there is Notice 2002-8, 2002-1 CB 398, which is still valid for SDAs that were in existence before January 28, 2002. Most of our clients' SDAs were established prior to Notice 2002-8 and the September 17, 2003 regulations. Accordingly, Notice 2002-8 is very relevant for many of our clients because it is the main source of tax guidance on grandfathered SDAs.

Notice 2007-34

CCH: Could you provide our readers with more detail on the application of Notice 2007-34?

Dr. Slavutin: First, let me emphasize that Notice 2007-34 comes as no surprise. We were told in the proposed regulations that some SDAs could be subject to Code Sec. 409A. As to its structure, the Notice is divided into four major sections. *Section III* is specifically devoted to consideration of the application of Code Sec. 409A to split-dollar life insurance arrangements. *Section III* is further divided into four parts which deal with (A) benefits grandfathered under Code Sec. 409A, (B) SDAs subject to Reg. §1.61-22, (C) arrangements subject to Reg. §1.7872-15, and (D) arrangements grandfathered under the 2003 Reg. §1.61-22(j).

CCH: Do you consider all of these items of equal importance?

Dr. Slavutin: I would say, no. Several of them can be dealt with relatively quickly because I think they are of limited practical application. *Section III. A.* deals with benefits grandfathered under Code Sec. 409A and should not be confused with split-dollar plans that are grandfathered under the 2003 split-dollar regulations. When we talk about benefits in *Section III. A.* we are generally talking about any cash value of the policy that is potentially available to the employee as taxable income. The question comes down to, how do you divide up the cash value into parts that are grandfathered versus not grandfathered for purposes of 409A? The allocation of cash value made on the basis of a formula taking into account premiums paid would be a reasonable methodology. Consequently, if the client has paid \$100,000 in premiums from the time the split-dollar

arrangement was established until today and of that amount, \$70,000 was paid on or before December 31, 2004 and earned and vested as of such date, then 70 percent of the cash value is not going to be subject to Code Sec. 409A. In addition, if the portion of the cash value that was earned and vested at December 31, 2004 is greater than this fraction, \$70,000 in our example, then the greater amount is not subject to 409A.

Sections III. B. and *III. C.* address split-dollar arrangements subject to the 2003 split-dollar regulations, i.e., Reg. §1.61-22 or Reg. §1.7872-15. Again, in my experience and based on my conversations with many people dealing with SDAs, most SDA's predate the 2003 regulations. Thus, with one very important exception, only a small minority of clients have SDAs subject to the 2003 regulations.

CCH: And what is that exception?

Dr. Slavutin: After the split-dollar regulations were finalized, split-dollar as we knew it became much less popular. For the most part, split-dollar was replaced by a type of loan arrangement referred to as premium financing. Whereas, in the past when doing estate planning we might have set up an SDA between the client's business and the life insurance trust, today we would instead do a loan arrangement between the corporation or third party lender and the insurance trust. Even though such a loan arrangement is not "classical" split-dollar it is most likely subject to the split-dollar regulations because there is still a splitting of the benefits of the policy. Notice 2007-34 states that generally such loan arrangements will not be subject to Code Sec. 409A. The one qualification is that if the loan arrangement provides for forgiveness of debt, there is the possibility of triggering 409A because forgiveness of debt is taxable income and, therefore, might be a form of deferred compensation.

Impact of 409A on Split-Dollar Plans Grandfathered by Notice 2002-8

CCH: From what you have said up to now it appears that *Section III. D.* of Notice 2007-34 is really the heart of the matter, correct?

Dr. Slavutin: Yes, *Section III. D.* deals with SDAs grandfathered under Reg. §1.61-22(j). This represents the great majority of SDAs in existence today—those that were established prior to September 17, 2003, and, in most cases, prior to January 28, 2002, the effective date of Notice 2002-8. Consequently, that is where we need to focus our attention as to the potential application of Code Sec. 409A.

With respect to this portion of the Notice, we must first look at the traditional classifications for SDAs, specifically endorsement split-dollar and collateral assignment

split dollar. In the typical *endorsement SDA*, the company owns the life insurance policy and endorses a portion of the death benefit to the employee. The employer pays the premiums every year minus a portion paid by employee, which today is the Table 2001 insurance cost component of the premium. This was formerly known as the P.S. 58 rate, or the annual renewal term rate.

For example, consider the case of an employee in his late 40s with a \$1 million life insurance policy owned by the employer. His employer took out the policy as a fringe benefit because he is a key employee. The total annual premium on the policy is \$20,000 while the economic benefit the employee has to pay toward the policy is \$700 in 2007. If the employee were to die today, his beneficiaries would receive the \$1 million. The amount the company paid in premiums would be payable to the company. As designed, the policy provides that the death benefit grows a bit each year to include the original face amount of \$1 million, plus the premiums the company has paid each year. If, after three years, the company has paid a total of \$58,000 in premiums, the death benefit would be \$1,058,000—\$1 million payable to the employee's beneficiaries and \$58,000 to the company.

CCH: Is the type of arrangement you have just described subject to Code Sec. 409A?

Dr. Slavutin: In a typical endorsement SDA, the answer to that question is clearly no, if the employee's family receives only the death benefit.

However, this is another example of why it is important to carefully review the relevant agreement. What does the agreement say about the treatment of any cash value that accumulates in excess of the company's interest in the policy while the employee is alive? Does that excess cash value belong to the employee? If so, can he or she access it before or at retirement? Are there any restrictions on the employee's access to the excess cash value? Are there any triggering events that would allow the employee's access? These are the types of questions that must be considered in reviewing existing SDAs. For example, if the employee will receive the policy at retirement, then the expected policy distribution is taxable compensation which is deferred to a later year. This type of deferred compensation falls within the definition in III. D. 1. and is subject to Code Sec. 409A. The SDA may need to be modified to bring it into compliance.

Collateral Assignment SDA's Grandfathered by Notice 2002-8

CCH: What about the second basic type SDA—collateral assignment split dollar?

Dr. Slavutin: Prior to the 2003 regulations, collateral assignment split dollar was used in two different ways.

One way was in the context of estate planning. Typically, an employer would enter into a collateral assignment arrangement with an irrevocable life insurance trust which owned the life insurance policy. The company and the trust would share in the payment of the premium. The company would pay the bulk of the premium, except the Table 2001 (or P.S. 58 or term insurance) amount, which was paid by the trust.

The big difference between endorsement and collateral assignment split dollar is how the policy is owned. In the endorsement form, the company owns the policy. In the collateral assignment form, the insurance trust or the employee owns the policy. This type of arrangement was advantageous for estate planning purposes because the amount of the reportable gift was based on the Table 2001 (or P.S. 58 or term insurance) economic benefit of the insurance rather than the entire premium, which could have been a substantial amount for a large policy. Consequently, the bulk of the premium was being paid without gift tax consequences.

The second use of collateral assignment split dollar was as a form of supplemental retirement income planning. In this form, the policy was owned by the employee rather than by a trust. The policy was funded in substantially the same way as described previously with most of the premiums paid by the corporation and a small fraction paid by the employee. The policy would build up cash value and at retirement this could be accessed by the employee and would constitute taxable income unless he or she took the money out of the policy as a loan. If anything looks like deferred compensation, this type of arrangement would certainly appear to be it.

CCH: Are either of these forms of collateral assignment split dollar, whether designed for estate planning or for supplemental retirement income purposes, subject to Code Sec. 409A?

Dr. Slavutin: The answer is, "it depends." What you have to determine is whether or not the plan is "equity" or "non-equity." The basic answer is that if the plan is non-equity, in other words all of the cash value belongs to the employer and not to the employee or the insurance trust, it seems clear there should be no deferred compensation problem. It is really a death benefit plan which is not subject to 409A.

On other hand, if, at the termination of the split-dollar agreement by retirement, death of the employee, or some other event, the employer is entitled to the lesser of the premiums it paid or the cash value, that means any excess cash value does not belong to the employer, but rather to the trust or employee. This is what is meant by equity split dollar.

Under III. D. 1., an SDA provides for deferred compensation under 409A if, under the terms of the SDA, the employee (“service provider”) “has a legally binding right to compensation” that is payable to the employee in a later year, for example upon termination of the SDA, and such compensation is not a short term deferral or a death benefit.

If a collateral assignment equity SDA provides for *termination* of the agreement at, say, retirement age 65, and there is equity in the policy, then, at termination, the employee will have to recognize income on the equity (at least that is the opinion of most practitioners based on the language of Section IV. of Notice 2002-8). That income would appear to be the type of deferred compensation described above by Notice 2007-34 in section III. D. 1. That means the SDA is subject to 409A. You may say, so what? The income is taxable and 409A does not change that. That is correct, BUT triggering 409A coverage means that the SDA must comply with ALL the definitions (e.g., separation from service) and restrictions (on distributions and acceleration provisions, etc.) described in the 409A regulations. For example, the distribution of deferred compensation to a key employee in a public company must be delayed for at least six months following the separation from service. That provision must be in the agreement.

If the employee has unrestricted, fully-vested *access to the excess cash value now, prior to retirement*, does this necessarily result in deferred compensation? This is a very difficult question to answer because looking strictly at Code Sec. 409A, the response would probably be, yes. But, if you look at Notice 2002-8, it provides that there is no taxable income during the term of the SDA, if you have complied with the requirements of Notice 2002-8 and are reporting the economic benefit as the cost of term insurance each year.

There is also additional language in Notice 2007-34 to bolster that conclusion. I would direct your readers to Section III. D. 1. of Notice 2007-34, which states the following:

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.

So it seems that termination of an equity SDA triggers the type of deferred compensation contemplated by Notice 2007-34, but access to the policy’s cash value during the term of the SDA may be protected from 409A by Notice 2002-8.

Specific Requirements for Modifications

CCH: With respect to the modification of an existing split-dollar agreement, are there specific requirements that need to be adhered to?

Dr. Slavutin: Yes, in Section III. D. 2. of Notice 2007-34, there are five relatively straight-forward requirements that can be summarized as follows:

1. There has been a determination by the “service recipient or service provider” (in other words, the employer or employee), based upon a reasonable application of Code Sec. 409A, the regulations, and other guidance, that Code Sec. 409A is applicable to the arrangement, and that the arrangement does not comply with the requirements of that provision;
2. There has been a determination, based upon a reasonable application of Code Sec. 409A, the regulations, and other guidance, that the modification would cause the arrangement to comply with Code Sec. 409A or result in that section no longer being applicable to the arrangement, or that the modification is a part of a number of actions that together would cause the arrangement to come into compliance with Code Sec. 409A or result in it no longer being applicable to the arrangement;
3. The modification 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 to the arrangement to the requirements of, or to qualify for an exclusion from, Code Sec. 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.

Plan Aggregation

CCH: Would you like to point out any other potential problem issues?

Dr. Slavutin: There is another issue that is really outside the purview of Notice 2007-34 and that is the issue of plan aggregation. This point is not mentioned in Notice 2007-34, but is discussed in the final Code Sec. 409A

regulations. In a change from the proposed regulations, the final regulations provide that SDAs are a new, separate category of plan for purposes of applying the plan aggregation rules. The potential problem here is that if one plan fails to satisfy 409A, then all other plans in the same category that an employee is a participant in will be deemed not to satisfy 409A. This could be a concern, particularly in large public companies with multiple benefit plans.

Conclusion

CCH: Could you summarize the planning implications of Notice 2007-34?

Dr. Slavutin: In general, pure death benefit and pure loan SDA's will not be subject to 409A. Grandfathered equity collateral SDA's, which represent perhaps the largest group of pre-2003 SDA's, may be subject to 409A, especially if there is a clearly defined "termination event" at retirement age. I think it represents a classic example of the importance of considering the specific facts and circumstances of a particular case. Between now and the end of the year, practitioners should review existing plans looking for the kind of issues that I have pointed out. Although Code Sec. 409A poses the potential for immediate income tax and penalties, along with the possibility of plan aggregation problems, the good news is that we now have the ability to modify existing agreements within the framework of Notice 2007-34 without adversely impacting grandfathered split dollar agreements. ♦

ESTATE TAX

FLP Assets Included in Gross Estate

In another case of "bad" facts, the value of assets transferred to a family limited partnership (FLP) by a decedent acting through her power of attorney was includible in

While the IRS continues its attacks on family limited partnerships, the Tax Court, in a recent memorandum decision, has ruled on the inclusion of assets transferred to such an entity a decedent's gross estate. her gross estate under Code Sec. 2036 (*H. Erickson Est.*, 93 TCM 1175, CCH Dec. 56,919(M), TC Memo. 2007-107).

After the decedent's diagnosis with Alzheimer's disease, her family requested that a financial report be prepared. The report estimated that the decedent would owe over \$500,000 in federal estate tax when

she died. In May 2001, an FLP was formed, with the decedent's two daughters (Daughter 1 and Daughter 2) receiving both general partnership and limited partnership (LP) interests. Daughter 1 signed the agreement on behalf of the decedent under a power of attorney, herself, and as cotrustee of a credit shelter trust created by the decedent's predeceased husband. The decedent, Daughter 1's husband, and the credit shelter trust were LPs. The FLP agreement contemplated that the parties' contributions would be made concurrently with the execution of the agreement. However, nearly two months after the FLP's creation, Daughter 1 began to transfer the decedent's personal assets from two accounts to the FLP account. On September 27, 2001, the decedent was admitted to the hospital. On the following day, Daughter 1 completed the parties' transfers to the FLP and transferred a portion of the decedent's LP interests to three trusts for the benefit of the decedent's grandchildren. The decedent died on September 29, 2001.

As an initial matter, the court declined to shift the burden of proof to the government because the estate failed to produce credible evidence as to the inclusion issue and, thus, did not meet the requirements of Code Sec. 7491. Turning to the inclusion issue, the court determined that there was an implied agreement among the parties that the decedent retained the right to possess or enjoy the assets after the transfers to the FLP. To support the finding of an implied agreement, the following facts and circumstances were cited: (1) the considerable delay in funding the FLP; (2) the FLP's distributions to the estate to meet its liabilities; and (3) the FLP's minimal practical effect during the decedent's life.

The court further concluded that the bona fide sale exception of Code Sec. 2036(a) was inapplicable. Applying the rationale of *W. Bongard Est.*, 124 TC 95, CCH Dec. 55,955, the court stated that the estate did not establish that the FLP was formed for a "legitimate and significant nontax reason." The court rejected the estate's arguments that the FLP was formed for such a reason. Listing the following as evidence, the court found that no such reason motivated the FLP's formation: (1) the passive assets transferred to the FLP retained the same management both before and after the transfer; (2) the FLP's formation was unilateral with Daughter 1 on all sides of the transaction; (3) the significant delay between the FLP's formation and funding; (4) the estate's reliance on FLP distributions to meet its liabilities; and (5) the decedent's age and health at the time of the transaction. ♦