

AALU's Washington Report

Premier analysis of federal legislative and regulatory developments for the nation's 2,000 most advanced life insurance planners, focusing on business, estate, qualified and nonqualified retirement planning.

Counsel

Buchanan Ingersoll PC
Gerald H. Sherman
Stuart M. Lewis
Deborah M. Beers
Keith A. Mong

Federal Policy Group
Ken Kies
Patrick J. Raffaniello
Timothy L. Hanford
Jim Carlisle

AALU

David J. Stertz, *Chief Executive Officer*
Tom Korb, *Vice President of Policy & Public Affairs*
Marc R. Cadin, *Vice President of Legislative Affairs*
Jana Barresi, *Associate Director of Policy & Public Affairs*

Ricchetti, Inc.
Steve Ricchetti
Jeff Ricchetti

PricewaterhouseCoopers
William Archer
Donald Carlson

2901 Telestar Court, Falls Church, Virginia 22042
Toll Free: 1-888-275-0092 Fax: (703) 641-8119
www.aalu.org

AALU Bulletin No: 06-70

June 19, 2006

Subject: **Update on Section 409A Guidance**

Prior Washington Reports: 06-02; 05-106; 05-102; 05-99; 05-97

MDRT Information Retrieval Index Nos.: 2400.00; 7400.00

SEE THE CIRCULAR 230 DISCLAIMERS APPENDED TO THE CONCLUSION OF THIS WASHINGTON REPORT.

In recent weeks a number of Treasury and IRS officials have given speeches concerning the status of guidance on deferred compensation arrangements under section 409A. Those speeches provide some indication of what may be contained in the final regulations that will be issued later this year.

One of the most notable inferences from these speeches is the probable delay in the effective date for full section 409A compliance. The government officials have uniformly indicated that the regulations will not be finalized until "late summer" and that the time between the issuance of final regulations and the end of 2006 (which is currently scheduled as the effective date of these regulations) would be too short a time period to expect employers to digest and comply with these new rules. As a consequence, it can reasonably be expected that the effective date of the regulations will be postponed when they are finalized. The question, however, is for how long. The postponement might, for example, be until the end of 2007 but it might be for a shorter period as well. At this stage it appears that no final decision has been made on the exact effective date and that that decision will not be made until just before the regulations are finalized. If the effective date of the regulations is postponed, taxpayers may continue to be subject to currently applicable guidance, Notice 2005-1, in the interim.

1. Split Dollar Arrangements. The government officials have also reiterated their plan to issue separate guidance with respect to split-dollar life insurance arrangements. That guidance will not be contained in the final regulations themselves but will be separately issued, probably in the form of a Notice that will be issued at the same time that the regulations are finalized, i.e., in late summer. That split-dollar guidance will provide more definitive rules as to when a split-dollar arrangement is subject to section 409A. It is also still expected that this guidance will provide some relief for grandfathered split-dollar policies, i.e., split-dollar arrangements grandfathered under the 2003 split-dollar regulations, by providing those policies

with the ability to be modified to come into compliance with section 409A without losing their 2003 grandfathered status.

On the negative side, it appears unlikely that any relief will be provided for grandfathered split-dollar policies that undergo a tax-free exchange under section 1035 of the Code. The IRS has consistently resisted this relief despite continual industry requests that such exchanges not affect grandfathering under the 2003 split-dollar regulations.

2. **Aggregation Rules.** One of the other areas of relief requested by AALU was for the IRS to provide more flexibility on the aggregation rules under the proposed regulations so that actions taken with respect to a split-dollar (or other) arrangement would not inadvertently adversely affect other deferred compensation arrangements of that employer and vice versa. On this front it appears that the Treasury and the IRS have understood the point and are likely to provide a considerable increase in the flexibility under these rules that will avoid these types of inadvertent problems. The government officials who have spoken to the subject have indicated that this may be addressed through an increase in the number of aggregation groups (currently there are only four) and through other modifications to these rules.

3. **Separation From Service.** Another subject that the government officials are currently taking a hard look at are the rules with respect to separation from service which is one of the payment events permitted under section 409A. It is, therefore, critical to determine when an individual actually has a separation from service so that deferred compensation payments can be made to that individual without violating section 409A. Unfortunately, in many situations (for example, where an individual phases down an employment or where an agent changes to part-time status) it may be difficult to know for certain that a separation from service has occurred. The government officials have indicated that they are re-examining this issue but are likely to continue to leave it primarily as a factually based area with a few bright-line safe harbors. As a consequence, there are likely to continue to be difficult situations in which it will be problematic whether an individual has had a separation from service. This may be particularly problematic for life insurance agents who may continue their relationship with a carrier on some modified basis.

4. **"Good Reason" Employment Termination.** Employment contracts often provide that if the executive resigns for "good reason" they may be entitled to certain payments. Under the proposed section 409A regulations, certain types of involuntary terminations qualify for an exemption from the rules of section. The question is primarily whether certain types of good-reason terminations may be the equivalent of an involuntary termination and therefore qualify under these rules. While the proposed regulations appear to take a negative view, the IRS and Treasury officials have indicated that they are re-examining the question.

5. **Substantial Risk Of Forfeiture.** Those who work with tax-exempt organizations will be interested in the definition of "substantial risk of forfeiture" that is applied under section Code 457(f) in contrast to the definition that is applied under section 409A. Since the two definitions are not identical, a number of issues are raised concerning whether an employee of a tax-exempt organization might be adversely taxed under one or the other of those provisions (457(f) or 409A). Various IRS officials have indicated that the definition in section 409A is likely to remain more or less as it is in the proposed regulations. They have, however, suggested that later this year or next year the Internal Revenue Service may start a project to re-examine the definition of substantial risk of forfeiture under section 457(f); they have implied that that definition may be brought in line with the definition under section 409A.

The government officials have indicated that, once these regulations are finalized, they will start the "third tranche" of this project and begin drafting guidance that will deal with the remaining major issues under section 409A. This includes the measurement and inclusion of income as well as the various reporting requirements and the rules concerning deferred compensation in partnerships.

In order to comply with requirements imposed by the IRS which may apply to the *Washington Report* as distributed or as re-circulated by our members, please be advised of the following:

THE ABOVE ADVICE WAS NOT INTENDED OR WRITTEN TO BE USED, AND IT CANNOT BE USED, BY YOU FOR THE PURPOSES OF AVOIDING ANY PENALTY THAT MAY BE IMPOSED BY THE INTERNAL REVENUE SERVICE.

In the event that this *Washington Report* is also considered to be a "marketed opinion" within the meaning of the IRS guidance, then, as required by the IRS, please be further advised of the following:

THE ABOVE ADVICE WAS WRITTEN TO SUPPORT THE PROMOTIONS OR MARKETING OF THE TRANSACTIONS OR MATTERS ADDRESSED BY THE WRITTEN ADVICE, AND, BASED ON THE PARTICULAR CIRCUMSTANCES, YOU SHOULD SEEK ADVICE FROM AN INDEPENDENT TAX ADVISOR.



Preserving and expanding opportunities for advanced life insurance planning through effective federal legislative and regulatory advocacy, information on key developments, and forums to help top practitioners increase their expertise and become more politically involved for the benefit of their clients.