

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 Hanford

Jim Carlisle

Covington & Burling

Andrew H. Friedman

Roderick A. DeArment

Michael J. Francese

Joan L. Kutcher

AALU

Executive Vice President

David J. Stertzer

VP of Policy/Public Affairs

Tom Korb

VP of Legislative Affairs

Marc R. Cadin

Assoc. Dir. of Policy/Public

Affairs

Jana Barresi

2901 Telestar Court

Falls Church, VA 22042

Phone: (703) 641-9400

Toll free: 888-275-0092

Fax: (703) 641-9885

www.aalu.org

AALU Bulletin No: 05-99

September 30, 2005

Subject: **Highlights of Proposed Deferred Compensation Regulations**

Major References: [Proposed Regulations Under Code Section 409A](#)

Prior Washington Reports: 05-97; 05-89; 05-70; 05-59; 05-26; 05-06

MDRT Information Retrieval Index Nos.: 2400.00

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

This Bulletin will provide a brief overview of some of the significant provisions in the proposed regulations recent released with respect to the deferred compensation rules in Code section 409A. See our Bulletin No. 05-92. A more extensive analysis of these regulations will be provided at a later time.

What follows is a brief overview of some of the more significant provisions of these proposed regulations.

1. **Effective Date Rules.** In general, the proposed regulations are not effective until January 1, 2007. In the interim, just as was the case with Notice 2005-1, taxpayers may rely on a "good-faith" standard for interpreting the statute. A taxpayer who complies with these proposed regulations will be automatically deemed to satisfy the good-faith standard.

Notice 2005-1 also provided a number of transition rules for 2005. Most of those transition rules have been extended through 2006 but not all of them. Most importantly, the deadline by which plan documents must be amended to comply with the provisions of section 409A is extended to December 31,

2006. In addition, the period during which a plan may be amended and an employee (service provider) may be permitted to change payment elections is also extended through December 31, 2006 except that the employee cannot, in 2006, change payment elections with respect to payments that the service provider would otherwise receive in 2006 or cause payments to be made in 2006.

Another effective date issue concerns wrap-around plans and other nonqualified plans that are controlled by a payment election under a related qualified plan. For these plans, an election as to the timing and form of payment under the nonqualified plan that is controlled by the qualified plan will, for periods ending on or before December 31, 2006, be acceptable provided that the determination of the timing and form of the payment is made in accordance with the terms of the nonqualified plan as of October 3, 2004.

Notice 2005-1 also permitted initial deferral elections to be made on or before March 15, 2005. That provision has not been extended into 2006 based upon the IRS and Treasury belief that enough guidance has been provided that timely elections should be made by participants. That means that elections to defer 2006 compensation will need to be made by December 31, 2005, in most cases. Likewise, the period during which an employee may cancel a deferral election or terminate participation in the plan is also not extended. Further, the period during which plans may allow participants to terminate their participation in the plan is not extended. All of these transition rules that are not being extended generally expire at the end of 2005.

2. Application to Split-Dollar Life Insurance Arrangements. As expected (see our *Bulletin No. 05-89*), the proposed regulations themselves do not specifically address split-dollar life insurance arrangements. However, split-dollar life insurance arrangements are specifically discussed in the preamble to the regulations. In general, the preamble indicates that endorsement split-dollar will probably be treated as deferred compensation while collateral-assignment split-dollar will not. That is, collateral-assignment split-dollar will not be treated as deferred compensation provided there is no agreement under which the service recipient (employer) will forgive the related indebtedness and no obligation exists on the part of the employer to continue to make premium payments without charging the employee a market interest rate on the funds advanced.

The preamble also discussed “grandfathered” split-dollar life insurance, i.e., arrangements that were entered into on or before September 17, 2003 and that are not subject to the regulations that were issued on that date. The preamble recognizes that a material modification after September 17, 2003 would result in the arrangement being treated as a new arrangement subject to these regulations. With respect to this issue, the IRS and the Treasury Department explicitly request comments on scope of changes that may be necessary to comply with or avoid application of section 409A and under what conditions these changes should not be treated as a material modification for purposes of the split-dollar regulations. The IRS has established a hearing date for comments on these regulations (January 25, 2006), with comments due by January 6.

3. Short-Term Deferrals. The proposed regulations, to a very large extent, follow the basic approaches used in Notice 2005-1. In general, they expand and elaborate on those approaches but the concepts are largely carried over from the Notice.

Of particular significance is the fact that the 2½-month rule is retained in the proposed regulations. Under this rule, amounts that are paid within 2½ months after the end of the year in which the employee obtains a “legally binding right” to the amounts is not considered deferred compensation and is not subject to these rules. It is likely that a great many arrangements will use the short-term deferral exception as a way of avoiding the application of these rules.

4. Independent Contractors. An issue of considerable interest to many insurance agents is the rule for independent contractors. The rule, found in Notice 2005-1, was largely carried over into the proposed regulations.

Under these rules, section 409A does not apply to an amount deferred under an arrangement between a service provider (independent contractor) and a service recipient (e.g., an insurance carrier) with respect to a particular trade or business if, during the independent contractor's taxable year in which it obtains a legally binding right to the payments, (i) the service provider is "actively engaged in the business of providing services other than as an employee or director;" (ii) the service provider provides "significant services" to two or more service recipients to which the service provider is not related and that are not related to one another and (iii) the service provider is not related to the service recipient.

While the determination of whether providing "significant services" depends on the facts and circumstances, the IRS has created a safe harbor under which if the revenue is generated from services provided to any service recipient during the taxable year do not exceed 70% of the total revenue generated by the service provider, then the service provider will be deemed to provide significant services to two or more service recipients. In other words, the independent contractor should, if the 70% test is satisfied, fit within this exception.

This exception may be very important to many insurance agents who work for more than one insurance company in that delays in payments from those insurance companies will, therefore, not be considered to be deferred compensation within the meaning of these rules.

5. Subsequent Changes in Time and Form of Payment. Considerable controversy has developed around the statutory provision that allows subsequent changes in the time and form of payment of deferred compensation. Under the proposed regulations, subsequent changes are permitted if the following conditions are satisfied:

- (a) the election may not take effect until at least 12 months after the date on which the election is made;
- (b) in general, the plan requires that the "payment" with respect to which the election is made is deferred for a period of at least five years; and
- (c) the election may not be made less than 12 months before the date on which payment is scheduled to be made.

For purposes of these rules, the term "payment" refers to each separately identified amount to which an employee is entitled to payment. Whether an amount is separately identified or not must be objectively determined. For example, 10% of a deferred compensation account balance would be a separately identified amount. However, life annuities and installment payments are considered to be a single payment except that installment arrangements that specify otherwise are treated as a series of separate payments.

Under these rules, therefore, continuing subsequent deferrals may be permissible if properly structured and provided for in accordance with the terms of the plan.

Any AALU member who wishes to obtain a copy of the § 409A Proposed Regulations may do so through the following means: (1) use hyperlink above next to "Major References," (2) log onto the AALU

website at www.aalu.org, enter the *Member Portal* and select *Current Washington Report* for linkage to source material or (3) email Jeff Lavine at lavine@aalu.org and include a reference to this *Washington Report*.

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.