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Marc R. Cadin, *Vice President of Legislative Affairs*  
Erik Ruselowski, *Assist. Director of Policy & Public Affairs*

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

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AALU Bulletin No: 08-31

March 28, 2008

Subject: **Changes to Split-Dollar Arrangements That Do Not Change the Insurance Contract Do Not Cause Loss of Grandfather Treatment Under Sections 101(j) and 264(f)**

Major References: [Notice 2008-42](#)

Prior AALU Washington Reports: 08-22

MDRT Information Retrieval Index Nos.: 2400; 4400.05

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

*The Internal Revenue Service recently issued a notice stating that changes to a split-dollar arrangement that do not change the life insurance contract will not cause loss of grandfather treatment under either sections 101(j) or 264(f) of the Code.*

Section 101(j) provides that death benefit proceeds paid on an “employer-owned life insurance contract” will remain tax-free under section 101(a) if the statutorily prescribed notice and consent requirements are satisfied and the contract fits within one of the statutorily designed coverage conditions. See, e.g., our Bulletin No. 08-22. Section 101(j) applies to life insurance contracts issued after August 17, 2006. However, a material increase in the death benefit or other material change will generally cause a pre-August 18, 2006 contract to be treated as a new contract. As a consequence, for an otherwise grandfathered contract, it is important to ensure that the changes being made will not be of the type that can cause the contract to lose its grandfather status.

Section 264(f), which was added to the Code in 1997, generally prohibits deductions for the portion of the taxpayer’s interest expense that is allocable to unborrowed policy cash values with respect to a life insurance policy or an annuity or endowment contract. Section 264(f) applies to contracts issued after June 8, 1997 in taxable years ending after that date. Any material increase in the death benefit or other material change in the contract is treated as a new contract for this purpose. Just as is the case under

section 101(j), contracts issued on or before June 8, 1997 are grandfathered unless material changes are made.

The regulations on split-dollar life insurance generally apply to arrangements entered into after September 17, 2003. If an arrangement entered into on or before September 17, 2003 is materially modified thereafter, the arrangement is treated as a new arrangement on the date of modification. The regulations set forth a nonexclusive list of changes that are not treated as material modifications. However, under the split-dollar regulations, the changes that can cause loss of grandfather treatment are changes to the “arrangement” whereas under section 101(j) and section 264(f), the statute speaks to the changes to the “contract.”

Because of the wording of the split-dollar regulations and the wording of the grandfather rules under sections 101(j) and 264(f), concern has been expressed about the extent to which changes to a split-dollar arrangement could be made without losing grandfather treatment.

In 2006 the Emerging Issues Task Force (EITF) of the Financial Accounting Standards Board (FASB) issued guidance on when employers must accrue deferred compensation costs and post-retirement benefit liabilities that have heretofore not been recorded or reported for financial accounting purposes. These were contained in EITF Issues 06-04 and 06-10. These requirements affect any organization that maintains a split-dollar arrangement providing a post-retirement benefit. Under EITF 06-04 and 06-10, post-retirement benefit obligation will increase the amount of liabilities reported on an employer’s balance sheet, thereby reducing its net worth, increasing its ratio of debt-to-equity and having other similar affects for accounting purposes. In some financial sectors such as banks, this could impair the ability to meet federal and state banking regulations because it would have the affect of reducing capital and adversely affecting reserve requirements. EITF 06-04 and 06-10 are effective for fiscal years beginning after December 15, 2007. Thus, these new accounting standards would apply to financial statements for 2008 and would have an immediate impact on the quarterly financial reports (for calendar year employers) ending in March.

Because of the looming accounting impact of EITF 06-04 and 06-10, and in order to clarify the application of the grandfather rules to split-dollar arrangements, the Service recently issued Notice 2008-42. Notice 2008-42 clarifies that both sections 101(j) and 264(f) apply to a “life insurance contract” as defined in section 7702 as any contract that is a life insurance contract under applicable law but only if the contract meets either the cash value accumulation test of section 7702(b) or meets the guideline premium requirements of section 7702(c) and falls within the cash value corridor of section 7702(d). Under Notice 2008-42, the term “life insurance contract” does not encompass the terms of an arrangement such as the split-dollar arrangement of which the contract is a part.

As a result of Notice 2008-42, if the parties to a split-dollar life insurance arrangement modify the terms of the arrangement but do not modify the terms of the life insurance contract underlying the arrangement, that modification will not be considered a material change in the life insurance contract for purposes of either section 101(j) or section 264(f) even if the modification is a material modification of the split-dollar arrangement for purposes of the split-dollar regulations. This holding clearly delinks the split-dollar regulations from the statutory provisions in sections 101(j) and 264(f) and provides clear guidelines for those employers that have an interest in modifying split-dollar arrangements (but not the contracts) for accounting or other reasons.

As reported in our Bulletin No. 08-22, AALU is preparing, and intends to submit, comments to the Internal Revenue Service concerning proposed regulations under section 6039I relating to the requirements

of section 101(j). A variety of issues, as outlined in Bulletin No. 08-22, will be the subject of those comments.

Any AALU member who wishes to obtain a copy of Notice 2008-42 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](http://www.aalu.org) and enter the *Member Portal* and select *Current Washington Report* for linkage to source material or (3) email Erik Ruselowski at [ruselowski@aalu.org](mailto:ruselowski@aalu.org) and include a reference to this *Washington Report*.

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