



THE INSURANCE DESIGN CENTER, LLC

ADVISOR ALERT

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SPLIT DOLLAR RUN AMUCK

We now know most of the rules and limitations imposed on split dollar life insurance plans. So, does split dollar life insurance still make sense? What are we doing to monitor the split dollar plans our clients still have in place? How can we provide appropriate due diligence to review those plans, give unbiased advice and understand our client's options?

The new regulations completely restructured split dollar and created two alternative plans. A plan would either be subject to the loan or economic benefit regime. The loan regime categorizes premiums paid as a loan, subject to interest at the applicable federal rate (AFR) appropriate for the time period. With endorsement split dollar the employer (often termed the "service recipient") generally owns the policy, the heirs of the insured typically receive the death benefit net of the split dollar liability; and, the death benefit to the heirs is recognized as an economic benefit. With collateral assignment split dollar the employer, trust, children, etc. can be the owner. For a policy treated under the economic benefit regime (and, this can be either endorsement or collateral assignment) the value of the death benefit will either be paid for by the employee or charged as an economic benefit.

New tables were put in place ("the 2001 tables") for both joint and individual life expectancies. The option of using actual term insurance rates from the insurance company that underwrote the policy is still available. The snag with the term rate alternative is these rates must come from a term insurance policy currently available for sale from that company (they must be made available to all purchasers of term insurance *and* regularly sold by the company). The 2001 tables are generally less expensive on an individual basis than the old PS58 costs, and much less expensive for survivor life insurance than the PS38 tables were under the pre-2001 split dollar rules.

A LOOK BACK

Split dollar life insurance was born as an employee benefit. It provided a vehicle to allow employers to choose a select group of employees (or one individual) to receive an additional benefit of life insurance without requiring the employer to provide this benefit to all employees. Once the financial community recognized the gift tax implications of the split dollar structure, it was a short leap to a new array of planning alternatives that had the splits occurring between individuals and their trusts (private split dollar) and many other variations on this theme.

The "split" in split dollar is what made it such a unique planning tool. A basic wealth transfer plan structured with insurance held in an irrevocable life insurance trust has limits on the gifts it can provide to heirs unless the testator is willing to pay gift taxes. At the time, these limits were equal to the total unified credit plus the annual exemption amount multiplied by all of the beneficiaries of the trust. Once these limits were breached (exceeded), significant gift taxes were imposed on the gifted premiums.

> Continued



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A split dollar plan segregated out the insurance benefit to the trust, and only recognized the “cost” as the insurance cost calculated to benefit the heirs. This cost was either based on the IRS tables or the insurance company’s least expensive term insurance rates. The cost was calculated on the net death benefit minus the split dollar liability.

The myriad of structures created to support split dollar provided for a number of ways to recognize the cost. If the plan was employer sponsored it would typically be a 1099 income item, or could have been paid directly by the employee or their trust. Once you understand how the charges for the life insurance accelerate as the insured ages (life expectancy tables provide the basis for determining these charges), it is apparent that split dollar plans should be put in place with exit strategies that do not require the death of the insured for their success. In other words, the plan should be designed with enough additional funding to pay off the liability on the policy at a future date (or designed with an outside exit strategy put in place to create such funds). The policy may also have an increasing death benefit that includes the split dollar liability until the time it is paid off. This provides for a level death benefit to the beneficiaries and the capacity to meet the split dollar obligation, should the insured die while that liability still exists.

It became increasingly clear that split dollar life insurance provided an enormous wealth transfer loophole to move assets with a minimum of gift tax exposure. In 2001, the IRS fired their shot across the bow. Without immediately creating the final regulations, they took the initial steps to restructure the rules governing split dollar.

WHAT PLANS ARE SUBJECT TO INTERNAL REVENUE CODE SECTION 409A?

409A applies to those plans where the employee has a right to cash values in the policy (equity arrangements). Generally, these plans would fall under the heading of non-qualified deferred compensation. Where 409A applies, any equity in the insurance policy that exceeds total premiums paid by the employer will be taxable to the employee. It initially seemed as though policies treated under the loan regime would not be subject to 409A. However, if the loan will become due, or interest due will be forgiven at some future date, then it would be subject to 409A as deferred compensation.

WHAT DO ADVISORS NEED TO DO?

Have existing split dollar arrangements reviewed by an attorney who thoroughly understands 409A.

If they are subject to 409A and have accumulated equity since 1/1/2005, they must be modified prior to year-end to comply with 409A limitations, or the equity will be subject to income tax plus a 20% penalty. For endorsement split dollar, beginning in 2007, a liability and the related expense must be recorded to reflect the post retirement benefit payable to the employee.

DOES SPLIT DOLLAR STILL PROVIDE UNIQUE PLANNING ADVANTAGES?

In a word – yes. Both loan arrangements and non-equity collateral assignment split dollar arrangements can be effective gift tax leveraging tools. The latter generally works better with younger insureds and survivorship policies, while the former works better with older insureds. The loan regime, with a well designed exit strategy, currently provides a fixed interest rate significantly lower than any outside financing alternatives (the mid-term AFR for October, 2007 was 4.39%, the long term rate was 4.89%). If a funding source is put in place simultaneously (perhaps a grantor retained annuity trust or a qualified personal residence trust), the assets transferred can provide the capital to continue premium payments once the liability has been satisfied and the split dollar arrangement terminated. Many of the risks and uncertainties of premium financing can be avoided with a carefully structured split dollar arrangement.

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Part III – Administrative, Procedural, and Miscellaneous

Notice of Additional 2008 Transition Relief under Section 409A

Notice 2007-86

SECTION 1. PURPOSE

This notice provides additional transition relief regarding the application of section 409A of the Internal Revenue Code to nonqualified deferred compensation plans. Generally, this notice extends to December 31, 2008, the transition relief that was scheduled to expire on December 31, 2007, as provided in Notice 2006-79, 2006-43 IRB 307, and the preamble to the final regulations under section 409A (72 Fed. Reg. 19234 (April 17, 2007)) (the final regulations preamble). This transition relief revokes and supersedes the transition relief provided in § III of Notice 2007-78, 2007-41 IRB 780, and modifies the relief provided in § IV of Notice 2007-78 related to employment agreements, as described below. This transition relief does not affect the guidance provided in § IV of Notice 2007-78 related to predetermined cashout features, or the guidance provided in § VI of Notice 2007-78, related to the application of section 409A(b) (restrictions on certain trusts and other arrangements).

SECTION 2. BACKGROUND

Section 409A provides certain requirements applicable to nonqualified deferred compensation plans. If a plan does not meet those requirements, participants in the plan are required to immediately include amounts deferred under the plan in income

and pay additional taxes on such income. Beginning with Notice 2005-1, 2005-1 CB 274 , the Treasury Department and the IRS have issued several notices and other guidance providing transition relief intended to permit and promote compliance with the requirements of section 409A. The Treasury Department and the IRS also issued proposed regulations under section 409A (70 Fed. Reg. 57930 (Oct. 4, 2005)) (the proposed regulations), and final regulations under section 409A in April 2007 (the final regulations).

On September 10, 2007, the Treasury Department and the IRS issued Notice 2007-78, granting certain transition relief intended to facilitate compliance with the written plan requirements set forth in the final regulations. See §1.409A-1(c).

Commentators stated that although the Notice 2007-78 transition relief was helpful, the transition relief in that notice did not adequately address the need for additional time for service recipients and service providers to analyze all of their plans and make informed and reasoned decisions regarding the changes that would be necessary to bring existing arrangements into compliance with the final regulations. This notice addresses these concerns by generally extending the transition relief currently scheduled to expire on December 31, 2007 through December 31, 2008. Section III of Notice 2007-78 is revoked and superseded by this notice.

SECTION 3. EXTENSION OF TRANSITION RELIEF

.01 Extension of Transition Relief Provided in Notice 2006-79

Section 3 of Notice 2006-79 is modified and superseded in accordance with paragraphs (A) and (B) of this § 3.01.

(A) General rule. During 2008, taxpayers are not required to comply with the requirements of the final regulations. Instead, they are required to operate a nonqualified deferred compensation plan in compliance with the plan's terms, to the extent consistent with section 409A and the applicable guidance (including Notice 2005-1). Where a provision of Notice 2005-1 is inconsistent with the final regulations, taxpayers may rely upon either Notice 2005-1 or the final regulations. To the extent an issue is not addressed in Notice 2005-1 or other applicable guidance, taxpayers must apply a reasonable, good faith interpretation of the statute. Reliance upon the final regulations is treated as applying a reasonable, good faith interpretation of the statute.

Taxpayers may not rely upon the provisions of the proposed regulations for periods after December 31, 2007, except that taxpayers may continue to rely on sections II.E and VI.E of the preamble to the proposed regulations (relating to the application of section 409A to partners and partnerships) until further guidance is issued and sections XI.C (relating to changes in payment elections or conditions) and XI.H (relating to substitutions of non-discounted stock options and stock appreciation rights for discounted stock options and stock appreciation rights) of the preamble to the proposed regulations continue to apply to the extent provided in § 3 of Notice 2006-79, as modified and superseded by paragraph (B) of this § 3.01.

(B) Section 3 of Notice 2006-79 modified and superseded.

(1) Paragraphs .01, .02, .03 and .04 of § 3 of Notice 2006-79 are modified and superseded to reflect the general rule provided in paragraph (A) and to read as follows:

.01. Amendment and operation of plans adopted on or before December 31, 2008

A plan adopted on or before December 31, 2008 will not be treated as violating section 409A(a)(2), (3) or (4) on or before December 31, 2008 if the plan is operated through December 31, 2008 in compliance with the provisions of section 409A and applicable provisions of Notice 2005-1 and any other generally applicable guidance published with an effective date prior to January 1, 2008, and the plan is amended on or before December 31, 2008 to conform to the provisions of section 409A and the final regulations under section 409A (70 Fed. Reg. 19234 (April 17, 2007)) with respect to amounts subject to section 409A. For such periods, to the extent an issue is not addressed in an applicable provision of Notice 2005-1 or other generally applicable guidance published with an effective date prior to January 1, 2008, the plan must be operated consistent with a good faith, reasonable interpretation of section 409A, and, to the extent not inconsistent therewith, the plan's terms. For purposes of this notice, "generally applicable guidance published with an effective date prior to January 1, 2008" does not include the final regulations.

Compliance with the proposed regulations is not required and compliance with the final regulations before January 1, 2009 is not required. However, for periods before January 1, 2008, compliance with the proposed regulations or the final regulations will constitute reasonable, good faith compliance with the statute. For periods after December 31, 2007 and before January 1, 2009, compliance with the final

regulations (but not the proposed regulations) will constitute reasonable, good faith compliance with the statute. To the extent that a provision of either the proposed regulations or the final regulations is inconsistent with a provision of Notice 2005-1, or a provision of the proposed regulations is inconsistent with a provision of the final regulations, for periods before January 1, 2008, the plan may comply with the provision of the proposed regulations, the final regulations or Notice 2005-1. To the extent that a provision of the final regulations is inconsistent with a provision of Notice 2005-1, after December 31, 2007 and before January 1, 2009, the plan may comply with the provision of the final regulations or Notice 2005-1.

A plan will not be operating in good faith compliance if discretion provided under the terms of the plan is exercised in a manner that causes the plan to fail to meet the requirements of section 409A. For example, if an employer retains the discretion under the terms of the plan to delay or extend payments under the plan in a manner that violates section 409A and exercises such discretion, the plan will not be considered to be operated in good faith compliance with section 409A with regard to any plan participant. However, an exercise of a right under the terms of the plan by a participant solely with respect to that participant's benefits under the plan, in a manner that causes the plan to fail to meet the requirements of section 409A, will not be considered to result in the plan failing to be operated in good faith compliance with respect to other participants. For example, the request for and receipt of an immediate payment permitted under the terms of the plan if the participant forfeits 20 percent of the participant's benefits (a haircut) will be considered a failure of the plan to meet the

requirements of section 409A with respect to that participant, but not with respect to all other participants under the plan.

.02. Change in payment elections or conditions on or before December 31, 2008

The transition relief provided in section XI.C of the preamble to the proposed regulations generally continues to apply through December 31, 2008, with certain clarifications described below, and subject to limitations for certain discounted stock rights also described below. Accordingly, with respect to amounts subject to section 409A, a plan may provide, or be amended to provide, for new payment elections on or before December 31, 2008, with respect to both the time and form of payment of such amounts and the election or amendment will not be treated as a change in the time or form of payment under section 409A(a)(4) or an acceleration of a payment under section 409A(a)(3), provided that the plan is so amended and elections are made on or before December 31, 2008. With respect to an election or amendment to change a time and form of payment made on or after January 1, 2006 and on or before December 31, 2006, the election or amendment may apply only to amounts that would not otherwise be payable in 2006 and may not cause an amount to be paid in 2006 that would not otherwise be payable in 2006. With respect to an election or amendment to change a time and form of payment made on or after January 1, 2007 and on or before December 31, 2007, the election or amendment may apply only to amounts that would not otherwise be payable in 2007 and may not cause an amount to be paid in 2007 that would not otherwise be payable in 2007. With respect to an election or amendment to change a time and form of payment made on or after January 1, 2008 and on or before December 31, 2008, the election or amendment may apply only to amounts that would

not otherwise be payable in 2008 and may not cause an amount to be paid in 2008 that would not otherwise be payable in 2008. So, for example, where an amount would otherwise be payable upon an event, such as a separation from service, an election in 2008 cannot change the amount that would be payable in 2008 if the service provider separated from service in 2008. In addition, a deferral election may be made with respect to an amount that is a short-term deferral within the meaning of proposed §1.409A-1(b)(4), provided that the election is made before January 1, 2008 and before the year in which the amount would otherwise have been paid. Also, a deferral election may be made with respect to an amount that is a short-term deferral within the meaning of final §1.409A-1(b)(4), provided that the election is made before January 1, 2009 and before the year in which the amount would otherwise have been paid.

This provision applies to elections or amendments by a service provider, a service recipient, or both a service provider and a service recipient. A service provider or service recipient may make more than one change or amendment under this relief, provided that each such change or amendment is made in accordance with the deadlines and conditions set forth in the applicable transition relief. For example, a service provider that in 2005 elected to change the time and form of payment of deferred compensation to a lump sum payment in 2010, may elect again in 2006, 2007 or 2008 to change the time and form of payment in accordance with this paragraph. However, a service provider that in 2005 elected to be paid an amount in 2008 (and that did not change such election in 2006 or 2007) may not in 2008 change the time and form of payment to be paid in a later year.

Similarly, except as provided below with respect to certain discounted stock rights, an outstanding stock right that provides for a deferral of compensation subject to section 409A may be amended to provide for fixed payment terms consistent with section 409A, or to permit holders of such rights to elect fixed payment terms consistent with section 409A, and such amendment or election will not be treated as a change in the time and form of payment under section 409A(a)(4) or an acceleration of a payment under section 409A(a)(3), provided that the option or right is so amended, and any elections are made, on or before December 31, 2008. For this purpose, a stock right will not be treated as payable in a year solely because the stock right is exercisable during that year, if the stock right is also reasonably expected to be exercisable in a subsequent year.

.03 Payments linked to qualified plans and certain other plans

The ability to link a payment election under a nonqualified deferred compensation plan to an election under a qualified plan is extended through 2008. In addition, this relief is extended to payment elections under nonqualified deferred compensation plans that are linked to certain additional employer plans, including section 403(b) annuities, section 457(b) eligible plans, and certain foreign broad-based plans. Accordingly, (i) for periods ending on or before December 31, 2007, an election as to the time and form of a payment under a nonqualified deferred compensation plan that is controlled by a payment election made by the service provider or beneficiary of the service provider under a qualified employer plan described in proposed or final §1.409A-1(a)(2), a plan that includes a trust described in section 402(d), a plan described in section 1022(i)(1) or (2) of the Employee Retirement Income Security Act, or a foreign broad-based plan

described in proposed or final §1.409A-1(a)(3)(v), will not violate the requirements of section 409A, provided that the determination of the time and form of the payment is made in accordance with the terms of the nonqualified deferred compensation plan that govern payment elections, as in effect on October 3, 2004 and (ii) for periods ending after December 31, 2007 and before January 1, 2009, the rules discussed in (i) will be applied by reference to the provisions of the final regulations only. For example, where a nonqualified deferred compensation plan provides as of October 3, 2004, that the time and form of payment to a service provider or beneficiary will be the same time and form of payment elected by the service provider or beneficiary under a qualified plan, it will not be a violation of section 409A for the plan administrator to make or commence payments under the nonqualified deferred compensation plan on or after January 1, 2005, and on or before December 31, 2008, pursuant to the payment election under the qualified plan. Notwithstanding the foregoing, other provisions of the Internal Revenue Code and common law tax doctrines continue to apply to any election as to the time and form of a payment under a nonqualified deferred compensation plan.

.04 Substitutions of non-discounted stock options and stock appreciation rights for discounted stock options and stock appreciation rights

Notice 2005-1, Q&A-18(d) provides that it will not be a material modification to replace a stock option or stock appreciation right otherwise providing for a deferral of compensation under section 409A with a stock option or stock appreciation right that would not have constituted a deferral of compensation under section 409A if it had been granted upon the original date of grant of the replaced stock option or stock appreciation right, provided that the cancellation and reissuance occurs on or before December 31,

2005. Section XI.H of the preamble to the proposed regulations extended the period during which the cancellation and reissuance may occur until December 31, 2006, but only to the extent a cancellation and reissuance in 2006 does not result in the cancellation of a deferral in exchange for cash or vested property in 2006. Except with respect to certain discounted stock rights described in § 3.07 of Notice 2006-79, the period during which the cancellation and reissuance may occur is extended until December 31, 2008, but only to the extent such cancellation and reissuance in 2007 does not result in the cancellation of a deferral in exchange for cash or vested property in 2007 and only to the extent such cancellation and reissuance in 2008 does not result in the cancellation of a deferral in exchange for cash or vested property in 2008. For example, a discounted option generally may be replaced through December 31, 2008 with an option that would not have provided for a deferral of compensation, although the exercise of such a discounted option after 2005 and before the cancellation and replacement generally would result in a violation of section 409A unless such exercise complied in operation with the requirements of section 409A and the applicable guidance.

Where replacement stock options or stock appreciation rights that would not constitute deferred compensation subject to section 409A are issued in accordance with the conditions set forth in Notice 2005-1, Q&A-18(d), the preamble to the proposed regulations and this notice, such replacement stock options or stock appreciation rights will be treated for purposes of section 409A as if granted on the grant date of the original stock option or stock appreciation right. For a discussion of certain methods

that commentators proposed to use to compensate option holders for the value of a lost discount, see section XI.H of the preamble to the proposed regulations.

(2) Paragraph .06 of § 3 of Notice 2006-79 is modified and superseded to read as follows:

.06 Other transition issues

Notice 2005-1, Q&A-21 provided relief with respect to certain initial deferral elections, generally providing that certain requirements would not be applicable to elections made on or before March 15, 2005. One of the conditions of the relief was that the plan be amended to comply with the requirements of section 409A in accordance with Notice 2005-1, Q&A-19. Notice 2005-1, Q&A-19 generally required that plans be amended by December 31, 2005. The March 15, 2005 deadline for initial deferral elections was not extended in the preamble to the proposed regulations; however, the plan amendment requirement generally was extended to December 31, 2006. Although the initial deferral election relief contained in Notice 2005-1, Q&A-21 only referred to the requirements of Notice 2005-1, Q&A-19, the Treasury Department and the IRS have become aware that many taxpayers interpreted the extension of the plan amendment deadlines as flowing through to the requirements of Notice 2005-1, Q&A-21. To avoid unintentional noncompliance in this area, the deadline for a plan to be amended to reflect use of the relief provided in Notice 2005-1, Q&A-21 is extended to December 31, 2008. However, taxpayers retain the burden of demonstrating satisfaction of the requirement by showing that the deferral election was made by the March 15, 2005 deadline, in accordance with the plan terms in effect on or before

December 31, 2005 (other than a requirement to make a deferral election on or before March 15, 2005). See Notice 2005-1, Q&A-21.

(3) Paragraphs .05 and .07 of § 3 of Notice 2006-79 are not affected by this notice.

.02 Modification of Transition Relief Provided in the Final Regulations Preamble

The relief provided in sections XII and XIII of the final regulations preamble is modified to reflect the extension of the Notice 2006-79 transition relief through December 31, 2008, and the guidance provided in section XIV of the final regulations preamble is modified with respect to periods after December 31, 2007, as follows:

(A) General rule. Sections XII and XIII of the final regulations preamble are applied by substituting references to December 31, 2008 for references to December 31, 2007, and substituting references to January 1, 2009 for references to January 1, 2008. However, references to April 10, 2007 (the date of issuance of the final regulations) and October 3, 2004 (the enactment date of the statute) are not modified.

(B) Section XII.C. With respect to the determination of the fair market value of stock, the last sentence of the second paragraph of section XII.C of the final regulations preamble is modified to delete the words “proposed or” so as to eliminate reliance on the provisions of the proposed regulations.

(C) Section XII.D. With respect to programs established before April 10, 2007 where initial deferral elections have not been made by January 1, 2008, the transition relief provided in the second paragraph of section XII.D of the final regulations preamble remains unchanged (that is, no further transition relief is provided by this notice).

(D) Section XIV. The guidance provided in section XIV of the final regulations preamble (Calculation and Timing of Income Inclusion Amounts, Reporting and

Withholding) on the application of section 409A before January 1, 2008 is extended to apply before January 1, 2009 except that paragraph A of such section is not changed.

SECTION 4. EFFECT ON OTHER DOCUMENTS

Nothing in this notice is intended to limit the scope or applicability of the transition relief provided in Notice 2005-1, the proposed regulations or Notice 2006-79 for periods before January 1, 2008. This notice does not affect the guidance provided in Notice 2006-33, 2006-15 IRB 754 (relating to the application of section 409A(b)), Notice 2005-94, 2005-2 CB 1208 (relating to reporting and wage withholding for 2005) and Notice 2006-100, 2006-51 IRB 1109 (relating to reporting and wage withholding for 2006). Notwithstanding the section of the final regulations preamble entitled “Effect on Other Documents”, Notice 2005-1 is obsoleted only for taxable years beginning on or after January 1, 2009, except for the following sections of Notice 2005-1, which remain effective after that date as modified by any other applicable guidance: Q&A-6 (application to arrangements covered by section 457); Q&A-7 (application to arrangements between a partnership and a partner of the partnership); and Q&A-24 through Q&A-38 (information reporting and withholding guidance).

Pursuant to this notice, Notice 2006-4, 2006-3 IRB 307 (relating to the application of section 409A to certain outstanding stock rights), is superseded by the final regulations with respect to stock rights issued in taxable years of the service provider beginning after December 31, 2008. Notice 2006-64, 2006-29 IRB 88 (relating to the acceleration of payments to comply with certain conflict of interest rules), is superseded by the final regulations effective for taxable years of the service provider beginning after December 31, 2008.

Section III of Notice 2007-78 is revoked and superseded by this notice. Pursuant to this notice, the penultimate paragraph and the first sentence of the final paragraph of § IV.A of Notice 2007-78 are modified by substituting references to December 31, 2008 for references to December 31, 2007. The guidance otherwise provided in § IV of Notice 2007-78 is not affected by this notice. Section 3 of Notice 2006-79 is modified and superseded as provided in this notice. The guidance and relief provided in the final regulations preamble is modified as provided in this notice.

The Treasury Department and the IRS anticipate issuing guidance as soon as possible with respect to the correction program and other matters discussed in § V of Notice 2007-78 and this notice does not affect that section. In addition, this notice does not affect the guidance provided in § VI of Notice 2007-78.

SECTION 5. DRAFTING INFORMATION

The principal authors of this notice are Stephen Tackney and Bill Schmidt of the Office of Division Counsel/Associate Chief Counsel (Tax Exempt and Government Entities), although other Treasury Department and IRS officials participated in its development. For further information on the provisions of this notice, contact Stephen Tackney or Bill Schmidt at (202) 927-9639 (not a toll-free number).