Finseca Report
Marketplace

This Finseca Report Marketplace was prepared exclusively for Finseca Influencer members by Jim Earle, Christopher P. Stock, and Brianna Hourihan at **Troutman Pepper**.

Rabbi Trusts as "Informal Funding" for Nonqualified Deferred Compensation Plans – The Fundamentals

Market Trend: Employers sponsoring nonqualified deferred compensation ("NQDC") plans may want to set aside assets to secure those benefits. A "rabbi trust" can be that vehicle without running afoul of tax or ERISA compliance issues resulting from "funded" NQDC plan benefits.

Synopsis: Under both the Internal Revenue Code and ERISA, NQDC plans must be "unfunded" and "unsecured." But employers and participants often want to have assets set aside to pay NQDC plan benefits. A "rabbi trust" is a special type of trust that allows for assets related to a NQDC plan to be set aside and invested by a third party without causing the NQDC plan to be considered "funded." A rabbi trust is able to achieve this result primarily because the assets held in the trust must remain available to pay the employer's general creditors in the event of the employer's insolvency. The IRS has issued a model rabbi trust that includes a number of optional and alternative trust provisions for employers to consider. This article explores the basic framework of rabbi trusts and outlines the various choices employers have if adopting a version of the model rabbi trust.

Takeaways: Whether an employer wants to informally fund its NQDC liabilities through a rabbi trust requires a balancing of considerations between the employer's desire to maintain flexibility and the participants' interest in maximizing benefit security. An employer considering whether to adopt a rabbi trust should discuss the various alternatives with its key financial and legal advisors before identifying an institution willing to serve as the trustee based on the desired terms.

"Funding" Nonqualified Deferred Compensation ("NQDC")

NQDC plans come in various shapes and sizes, including account-based elective deferred compensation plans and defined benefit supplemental executive retirement plans ("SERPs").[1] No matter the type of NQDC plan, companies need to ask themselves whether, and to what extent, the benefits under the plan can be funded. This article discusses the high-level funding considerations for NQDC plans and, more specifically, the use of so-called "rabbi trusts."

Unlike a tax-qualified retirement plan, benefits under a NQDC plan must be "unfunded" and "unsecured." A failure to ensure that benefits are unfunded and unsecured can result in significant, costly compliance failures under both the Internal Revenue Code (the "Code") and Employee Retirement Income Security Act of 1974, as amended ("ERISA"):

- **Compliance with the Code**. NQDC plans are intended to defer recognition of income to the participant until benefits are actually paid. But if plan benefits are either funded or secured, taxation will occur at the time of funding. The long-standing "economic benefit doctrine" states that a benefit is immediately taxable if assets are set aside for the benefit of the participant that are beyond the reach of the employer's general creditors, such as amounts placed into a separate trust, escrow account, or certain insurance products (like life insurance or annuity contracts) where the participant holds the beneficial ownership rights. Similarly, Code Section 83 requires taxation of transfers of "property" to a participant when the participant's rights in the property are transferable or no longer subject to a "substantial risk of forfeiture." The regulations under Section 83 make it clear that an unfunded, unsecured promise to pay is not property.

- **Compliance with ERISA**. A NQDC plan must qualify as a "top hat" plan under ERISA.[2] ERISA requires, among other things, that a top hat plan be "unfunded." A "funded" NQDC plan becomes subject to many of ERISA's substantive requirements, such as minimum participation and vesting rules, fiduciary duties regarding the investment of plan assets, annual Form 5500 reporting requirements, etc. NQDC plans will almost never be able to satisfy these requirements, exposing the employer to employee claims for ERISA compliance breaches and potential Department of Labor ("DOL") enforcement actions.

Participants, however, likely want assurances that the promised NQDC plan benefits will in fact be paid, especially for elective NQDC plans where the benefits derive from the participant's earned salary or cash incentives that would have otherwise been paid. The employer may also desire to set aside assets to provide an economic hedge against the NQDC plan liabilities and create a disciplined approach to ensure necessary cash is reserved to pay future benefits.

So what can be done to meet these goals without causing the NQDC plan benefits to be considered funded? An employer can always set up its own investment account as a source to provide future

---

[1] For our article about common design features and consideration for nonqualified deferred compensation plans and SERPS click here and here.
[2] For more information on top hat plans, see our prior article click here.

benefits. But participants may want further assurances and prefer that the assets are held by a third party. The only sure way to meet this goal while preserving unfunded status under both the Code and ERISA is to hold and invest assets through a "rabbi trust."

What is a Rabbi Trust?

A "rabbi trust" – so named because the first of its kind was established to provide NQDC benefits to a rabbi – is a grantor trust that employers can use to informally fund NQDC liabilities due to employees. A grantor trust is a type of trust where the party establishing the trust – *i.e.*, the "grantor" – retains sufficient rights such that the assets of the trust are still considered to be beneficially owned by the grantor. The trust itself is a disregarded entity for tax purposes. As a result, the grantor must pay all taxes on trust transactions.

The concept of a rabbi trust was first established on December 31, 1980 by Private Letter Ruling 8113107, which asked whether a rabbi would be immediately taxed under the economic benefit doctrine by virtue of the funding of a trust for his NQDC benefits by his congregation.[3] Under the terms of the trust, the trustees were to manage, invest and reinvest the trust estate and pay the net income to the rabbi at least quarterly. Upon the rabbi's death, disability, retirement or termination of service, distributions of principal and income were to be made to the rabbi (or his beneficiaries) in accordance with the trust agreement. Furthermore, the trust agreement provided that the congregation could not alter, amend, revoke, change or annul any provisions of the trust, and the trust's assets were subject to the claims of the congregation's creditors to the same extent as its general assets. Lastly, the rabbi's interest in the trust could not be assigned, alienated or encumbered.

After examining the economic benefit and constructive receipt doctrines under the Code, the Internal Revenue Service ("IRS)" determined that the transfer of assets to the trust would not constitute a taxable event for the rabbi until the assets were actually distributed or otherwise made available to him, primarily because the assets of the trust were subject to the claims of the congregation's general creditors.[4]

In a typical rabbi trust, the assets in the trust are segregated from the employer's other assets and held and invested by a third party, often a bank or other financial institution. Critically, however, the assets held in the rabbi trust must remain available to satisfy claims of the employer's general unsecured creditors in the event the employer becomes bankrupt or insolvent. Accordingly, an employee whose NQDC is secured by assets in a rabbi trust will have rights no greater than those of a general, unsecured creditor of the employer. The amounts contributed to a rabbi trust are not included in an employee's gross income until they are actually paid (or made available) to the employee (subject to compliance with all other tax requirements applicable to NQDC plans, such as Section 409A of the Code, if applicable).

Although a rabbi trust will not protect an employee from the risk of an employer's insolvency, it can provide an employee with some assurance that the employer will pay the promised benefits. As discussed below, the rabbi trust can be designed with degrees of employee protections, including in connection with a change in control of the employer. Additionally, assets held and invested in the rabbi trust can provide employers with a financial hedge against their NQDC plan liabilities and ensure a source of cash to pay future NQDC benefit obligations.

[3] *See* I.R.S. Priv. Ltr. Rul. 8113107 (Dec. 31, 1980).
[4] *Id.*

As private letter rulings provide assurances only to the taxpayer who requested it, following the issuance of the original rabbi trust private letter ruling, many other employers sought their own private letter rulings regarding their rabbi trusts. In 1992, the IRS sought to provide more broadly applicable guidance on rabbi trusts by issuing Revenue Procedure 92-64 (the "Revenue Procedure"). The Revenue Procedure contains a model rabbi trust document (the "Model Trust") for employers to adopt and maintain in connection with their NQDC plan.[5] Under the Revenue Procedure, the Model Trust serves as a "safe harbor" for maintaining the unfunded status of NQDC plan benefits for tax purposes. The Revenue Procedure also reports that the DOL is likely to consider benefits as unfunded for ERISA purposes if the Model Trust is used.

Rabbi Trust Design Considerations Under the Model Trust

Although the Model Trust contains certain required provisions (especially provisions requiring that trust assets be available to pay the employer's general creditors in case of the employer's insolvency), it also includes a number of optional and alternative provisions. These optional and alternative provisions give employers considerable discretion in determining the design of the rabbi trust, subject to finding a trustee willing to serve on those terms. However, because the Model Trust is intended to serve as a safe harbor, employers should be careful when modifying the provisions in the Model Trust, as certain changes could cause the trust to fail to qualify as a grantor trust or remove the ability of the employer to rely on the Revenue Procedure. The following discussion reviews several of the key areas of choice under the Model Trust.

Revocability. The Model Trust requires employers to specify whether the rabbi trust is revocable, irrevocable, or irrevocable on the occurrence of a specified event (*e.g.*, a change of control). In an irrevocable trust, assets once contributed cannot be returned to the employer and can be used solely for purposes of paying NQDC plan benefits (other than in case of the employer's insolvency). Usually, assets may also be returned to the employer if there are any remaining assets after all related NQDC plan benefits have been satisfied.[6]

When deciding between these alternatives, employers should balance their desire to maintain access to the trust assets with the employee's desire for greater assurance that their NQDC benefits will be paid when due. A revocable trust provides an employer with the most flexibility, while an irrevocable trust provides employees with the most comfort that trust assets will be available to satisfy any obligations under a NQDC plan. NQDC plans based on employee elective deferrals are often established as irrevocable because employees want the greatest assurances possible that their earned compensation will be set aside and used to pay their NQDC plan benefits.

---

[5] For the IRS's "model rabbi trust provisions," see Rev. Proc. 92-64, 1992-2 C.B. 422.

[6] The trust may provide that the NQDC plan benefits are paid directly by the employer, which may be more administratively convenient from a tax reporting and withholding perspective. In that case, the trust should be clear that the employer can be reimbursed from the trust for those direct benefit payments.

Funding. Under the Model Trust, an employer must select how and when the plan will be funded. Under one alternative, the employer maintains broad discretion as to when to make contributions to the trust and in what form (*e.g.*, cash or other property). In another alternative, the Model Trust requires the employer to make contributions to the trust at least equal to the amount of the related NQDC plan benefits upon the occurrence of certain specified events, such as a change in control. This approach is sometimes referred to as a "springing" funding obligation.

When evaluating the options in the Model Trust, employers should consider the purpose of the trust and how it is designed. For example, employers establishing a rabbi trust primarily to protect employees in the event of a change in control may choose to make an irrevocable contribution to fund the rabbi trust only on a change in control.

Investment Authority. The Model Trust requires employers to include provisions describing the trustee's investment powers.

The trust may authorize a wide range of assets that may be held and invested in the trust, including investments intended to mirror the deemed investment returns under the related NQDC plan. Those assets may also include corporate-owned life insurance. If the related NQDC plan includes deferral of employer equity awards, the rabbi trust may hold employer stock. There are, however, additional potential complexities related to holding employer stock in a rabbi trust that should be evaluated with the employer's attorneys and accountants (including whether the shares are considered to be outstanding or, instead, are treasury shares, given the trust's status as a grantor trust).

The Model Trust permits investment authority to be exercised either by the trustee or the employer. As a practical matter, many institutions willing to serve as the trustee of a rabbi trust will do so only if they are directed by the employer as to trust investments. The trust, however, could include provisions limiting employer discretion over investments upon stated events such as a change in control. In the case of corporate-owned life insurance held by the trust, the Model Trust permits the trustee to borrow from the policy and lend those proceeds to the employer.

Other Provisions. The Model Trust includes a number of optional provisions on features such as the trustee's recordkeeping obligations, the trustee's standard of care, the removal/replacement of the trustee, and the extent to which the trust may be amended. In some cases, the Model Trust contemplates alternative provisions related to a change in control, such as provisions limiting the ability to remove the trustee or amend the trust for a specified period after a change in control.

Taxation of Rabbi Trust Assets

As a grantor trust, and unlike with tax-exempt trusts for qualified retirement plans, transactions in rabbi trust assets are taxable to the employer. Taxable events could include receipt of taxable interest or dividends on trust investments or capital gains when trust assets are sold, whether as part of an investment rebalancing or in connection with paying NQDC plan benefits. If the rabbi trust was established as a financial hedge against NQDC liabilities, these taxable transactions can erode the amount of the hedge. Depending on the types of related NQDC liabilities, the employer may want to consider an investment policy for the trust that limits taxable transactions. Alternatively, the employer may want to consider having the trust invested in assets with favorable tax characteristics, such as corporate-owned life insurance.

Next Steps for Employers Considering whether to Establish a Rabbi Trust

To establish a rabbi trust, an employer must identify a trustee that is willing to undertake the responsibilities that the employer wishes to delegate. As noted above, under many rabbi trust agreements, the trustee will only take the role of a "directed trustee" because the trustee does not want to assume any potential liability associated with the investment of trust assets. In this case, the employer will maintain discretionary authority over investments and/or payments.

An employer should also evaluate the permissible features of the rabbi trust to ensure the terms of the rabbi trust align with their intent, including whether the rabbi trust is revocable or irrevocable, how amounts will be paid from the rabbi trust when benefit payments are due (*e.g.*, will they be paid directly from the rabbi trust, or will the employer make the payments and then have the rabbi trust reimburse the employer), and whether a change in control will trigger any additional protections.

Once a trustee is identified and the design decisions are made, employers should work with their counsel and other third-party advisors to draft the rabbi trust agreement, keeping in mind the terms of the Model Trust, to ensure that their rabbi trust will qualify as a grantor trust and aligns with the terms of the NQDC plan.