



Rabbi Trusts – An Important Adjunct to Deferred Compensation Plans Washington Report

Executive Benefits Consultants, Fulcrum Partners LLC, shares AALU WRMarketplace Report

Washington Report

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Executive benefits consulting firm, Fulcrum Partners LLC, is proud to share this AALU WR Marketplace Report on: Rabbi Trusts – An Important Adjunct to Deferred Compensation Plans

In our continuing efforts to educate our clients on the regulatory and tax issues impacting deferred compensation plans, we are sending you this AALU report on Rabbi Trusts. The AALU WRMarketplace Report, prepared by the AALU staff and Greenberg Traurig, one of the nation's leading law firms in tax and wealth management, provides both background and current views on these important issues.

MARKET TREND: Recent increased interest in deferring compensation makes it important for advisors to understand how rabbi trusts might be used to assist clients in establishing and maintaining deferred compensation plans. In addition, corporate owned life insurance ("COLI") has gained popularity in this low-interest and increasing income tax environment. Life insurance, whose cash value grows on a tax-deferred basis, can often provide fixed rates of return that exceed yields available elsewhere. The holding of life insurance by a rabbi trust may provide additional benefits.

SYNOPSIS: Rabbi trusts can provide executives with some security for the future payment of their deferred compensation benefits. While these trusts cannot protect against a losses due to an employer's insolvency, they can protect against threats to payment that may result from such events as a change in management or a change in control of the employer. In addition, rabbi trusts can help an employer hedge its deferred compensation liabilities. Often, the use of life insurance as an investment of the rabbi trust can be particularly advantageous for the employer, although the employer must ensure compliance with the notice and consent requirements under IRC §101(j) to protect the exclusion of the death benefits from gross income. These trusts must be properly structured, however, to defer compensation by avoiding constructive receipt, economic benefit, or violations of the requirements of IRC §409A. While the IRS has created a model trust document, employers still need to take care in drafting the underlying deferred compensation plan.

TAKE AWAYS: Advisors assisting clients in establishing deferred compensation plans must familiarize themselves with the benefits a rabbi trust can offer to both sponsoring employers and participating employees. In addition, the investment of rabbi trust assets in life insurance can provide: (1) a tax-efficient approach to providing an employee benefit; (2) a conservative investment with a possible better market yield; and (3) a means by which the employer can hedge against its future deferred compensation liability, assuming compliance with IRC §101(j) to preserve the tax treatment of policy death benefits.

MAJOR REFERENCES: Revenue Procedure 92-64.

As executives increasingly consider the tax and financial planning benefits of deferring compensation, the issue of the executive's security with respect to the deferred compensation benefit is one that an advisor must be prepared to address. Because the tax principle of "economic benefit" and the requirements of IRC §83 (discussed in Washington Report No. 13-41) require that, for effective tax deferral, an employer's promise to pay deferred compensation must not be "secured," assets that may be used to satisfy the deferred compensation obligation must remain subject to general creditor claims against the employer. Nevertheless, executives can ensure that amounts will be available and used to pay their deferred compensation benefit in circumstances in which the employer is not insolvent, as well as following a change in control of the employer, through the use of a "rabbi trust." A rabbi trust also can be useful to the employer who wants to hedge its ultimate deferred compensation obligations.

RABBI TRUSTS, GENERALLY

A rabbi trust is a grantor trust established by an employer to hold assets to be used in connection with a deferred compensation arrangement. It can be established as a revocable trust or an irrevocable trust. As a further alternative, the trust document can provide that the trust will become irrevocable upon an event, such as a change in control of the employer, or upon the determination of the employer's board of directors. An irrevocable trust structure will provide the employee with greater comfort that the deferred compensation benefit will ultimately be paid, and the trust terms can provide that amounts remaining in the trust after satisfaction of the deferred compensation obligation to the employee can revert to the employer.

The trust agreement may provide that: (1) any amount deferred by a participant will be contributed promptly to the rabbi trust; (2) the amount to be put into the trust is left to the discretion of the employer; or (3) an amount equal to the participant's full deferred compensation benefit must be put in the trust upon the occurrence of an event, such as the change in control of the employer. Again, if the principal purpose of the rabbi trust is to provide security for the employee, maximizing the amount deposited to the trust at any time would seem to be the preferable approach.

MODEL TRUST AGREEMENT

In Revenue Procedure 92-64, the IRS issued a model trust agreement that could be used to establish a rabbi trust. Under the revenue procedure, the IRS indicated that, if the model trust language was used, an employee would not be in constructive receipt of income or incur an economic benefit solely on account of the adoption or maintenance of the trust.

According to the revenue procedure, "[t]he model trust language in this section contains all provisions necessary for operation of the trust except for provisions describing the trustee's investment powers. Provisions agreed to by the parties should be used to describe investment powers. The trustee, who can be any person or entity that has trust powers under state law, must be given some investment discretion, such as the authority to invest within broad guidelines established by the parties (e.g., invest in government securities, bonds with specific ratings, or stocks of Fortune 500 companies)." The model contains both mandatory provisions and optional provisions (for which the employer may substitute its choice of language, if consistent with the model trust). Perhaps most crucial to achieving the desired tax effect is the provision, required to be in any trust intending to follow the model, stating that "at all times during the continuance of this Trust, ... the principal and income of the Trust shall be subject to claims of general creditors of Company under federal and state law as set forth below."

The model trust agreement contains only language for the trust, not for the underlying plan. In that regard, the revenue procedure specifically notes that "the desired tax effect will be achieved only if the nonqualified deferred compensation arrangement effectively defers compensation. Thus, no inference may be drawn by reason of adoption of the model trust concerning constructive receipt or economic benefit issues that may be present in the underlying nonqualified deferred compensation plan." Accordingly, care must be taken in drafting the underlying deferred compensation plan to avoid constructive receipt and economic benefit, as well as to comply with the requirements of IRC §409A (which was enacted subsequent to the issuance of Rev. Proc. 92-64).

CAUTION UNDER IRC §409A

IRC §409A takes away some of the flexibility an employer has with respect to revocability and the timing of depositing assets into a rabbi trust. Specifically, under §409A, there is a prohibition against amounts becoming restricted to the payment of deferred compensation upon a change in the employer's financial health. In other words, the employer cannot limit the manner in which corporate assets can be used. Thus, if a rabbi trust were to become irrevocable upon a change in the employer's financial health, or amounts were to be contributed to an irrevocable rabbi trust upon a change in the employer's health, the participant would be taxable on the amount in the trust and would be subject to a 20% additional tax penalty. Thus, it may be advisable to establish the trust either as an irrevocable one or as one that becomes irrevocable only upon the occurrence of an event unrelated to the financial health of the employer.

IRC §409A also prevents an employer from setting assets aside in an offshore trust for purposes of paying nonqualified deferred compensation. There is a limited exception for assets located in a foreign jurisdiction if the services giving rise to the deferred compensation were performed in that foreign jurisdiction.

PAYMENT OF DEFERRED COMPENSATION BENEFITS

As noted above, use of a rabbi trust requires a separate written agreement setting forth the terms of the deferred compensation plan. That plan document, perhaps taken together with elections made by the participant, will indicate when the deferred compensation is to be paid to the employee. Frequently, a rabbi trust is established so that the employer provides a payment schedule to the rabbi trustee. Care must be taken to ensure that the trustee makes the payments in accordance with that schedule to avoid inadvertently creating an acceleration or further deferral of the payment in violation of IRC §409A.

TAXATION OF RABBI TRUSTS

As noted above, a rabbi trust is a grantor trust for federal income tax purposes with regard to the employer maintaining the deferred compensation arrangement. The employer, as grantor of the trust, is considered as the owner of the assets and taxable on any income earned on those assets. Thus, employers often consider investing trust assets in life insurance, which grows in value on a tax-deferred basis and provides death benefits which are not generally subject to taxation. Whenever considering the acquisition of life investment by a rabbi trust, however, the employer must review application of IRC §101(j), which generally taxes death benefits paid to owners in excess of premiums paid on "employer-owned life insurance" ("EOLI") contracts if the insured employee does not receive notice of, and consent to, the purchase of the EOLI contract prior to issuance. The potential for death benefit taxation under IRC §101(j) extends very broadly and impacts all forms of EOLI, including rabbi trust arrangements. Owners of EOLI contracts must also comply with the reporting requirements under IRC §6039I, including filing Form 8925 with their annual federal tax returns for each year that an EOLI contract is owned to report certain information regarding the EOLI contracts.

MANAGING THE DEFERRED COMPENSATION PLAN AND HEDGING THE EMPLOYER'S DEFERRED COMPENSATION OBLIGATION

While rabbi trusts are most frequently associated with the concept of protecting an employee's right to payment of deferred compensation, particularly following a change of control or in management, they also are frequently used to assist an employer in hedging its obligation to pay deferred compensation. Almost all deferred compensation plans provide that an employee's deferred amounts are credited with notional earnings or losses, and that the employee is entitled to the total balance credited as of the time payment is due. Many plans base the amount of

notional earnings on the performance of one or more hypothetical investment measures selected by the employee and applied to the amount deferred by the employee. Typically, employees may change their hypothetical investment measures fairly frequently.

Because effective deferral of taxation requires that an employee have no rights in any actual assets of the employer, the employee's deferred compensation benefit is often described as a bookkeeping record maintained by the employer. However, if an employer merely maintained a bookkeeping record of the hypothetical investment measures chosen by the employee over the course of his or her participation in the deferred compensation plan, it would quickly become very burdensome to maintain an accurate record of the employee's deferred compensation balance. Also, if the employer did not actually invest assets in the investment vehicles chosen as the hypothetical investment measures by the participant, the employer runs the risk of not having earned as much on the amounts deferred under the plan as the employee would be entitled to receive when payment is due.

To address both of these issues, employers often (1) deposit into the rabbi trust the amount deferred by participants and (2) invest those amounts in the actual investments selected by the employees. For tax reasons, however, it is advisable that the [deferred compensation plan](#) and the rabbi trust document make it clear that the employee may select the hypothetical investment measure and, while the employer or trustee may choose to make an actual corresponding investment, the employee is not actually directing the investment of the assets of the rabbi trust, and the employer and/or trustee retains the right to invest trust assets as it deems appropriate. To allow the employee the unfettered right to control the actual movement of money held in the rabbi trust could result in current taxation, on a theory that the employee effectively received the deferred amounts and immediately gave them back to the employer to invest solely as the employee directed.

An employer can accomplish this result perhaps even more effectively – or possibly in a way that increases the employee's deferred compensation balance – by investing rabbi trust assets in a life insurance contract that offers a variety of investment options and letting the employee select the ones to be used as the hypothetical investment measures. The investment income generated by the rabbi trust assets held in the insurance contract will not be subject to current income taxation and, as a result, will produce no current tax liability for the employer. In addition, the assets can grow to a greater amount than non-insurance investments because of the tax-deferred growth of life insurance. To the extent the deferred compensation plan backed by the rabbi trust provides for payment at a specified time or at termination of employment, rather than at death, the surrender of the life insurance contract to pay the benefit will produce taxable income to the extent of gain in the contract, but the employer may well be entitled to a corresponding deduction for a compensation expense when that amount is used to pay the deferred compensation. Variations on this arrangement can also be implemented. The key consideration is that the features of the life insurance contract match up with the terms of the benefit promise made under the terms of the deferred compensation plan.

If, instead, the deferred compensation is to be paid on the death of the participant, and the death benefit is equal to the participant's account balance under the plan rather than the death benefit under the policy, the death benefit provided under the contract can be paid to the rabbi trust and should not be taxable to the employer (assuming the proper notices were provided and consents were obtained in accordance with §101(j) as noted above). These amounts, however, likely will be taxable to the participant's designated beneficiary under the deferred compensation plan. The excess of the death benefit over the amount of the deferred

compensation obligation can revert to employer. If, in contrast, the death benefit under the deferred compensation plan is the death benefit payable under the life insurance contract and the employee participant is given the power to designate the beneficiary of the death benefit, he or she may be taxable during life on the value of the current life insurance protection being provided to him or her under the economic benefit principle, but the death benefit may be nontaxable to the designated beneficiary.

CONCLUSION

Rabbi trusts are a popular vehicle used in connection with the establishment and operation of nonqualified deferred compensation plans. While they cannot provide security that an employee will receive his or her deferred compensation in the event the employer becomes insolvent, they can ensure against a “change of heart” on the part of the employer resulting from a change in control, a change of management, or other influences. In addition, they can help an employer operating a deferred compensation plan maintain accurate records of a plan participant’s deferred compensation benefit and ensure that amounts to be paid as earnings on deferred compensation amounts are actually earned by the employer. Assuming compliance with IRC §101(j) notice and consent requirements, the purchase of a life insurance contract with rabbi trust assets may be the investment vehicle of choice in that it may provide a more tax-effective result for the employer while maximizing the deferred compensation benefit for the employee and hedging the employer’s ultimate deferred compensation liability.

For more information about the topic discussed in this Washington Report, please contact press@fulcrumpartnersllc.com.

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