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A PRIMER ON RABBI TRUSTS

“Be wise today, it is madness to defer.”

Edward Young

By George Chamberlin

A recurring issue in the context of creating financial strategies for our clients is how we may most effectively address executive compensation. Highly compensated executives and key employees are subject to the highest income tax rates as well as limitations on their exemptions and deductions which limitations result in an even greater income tax burden. In addition, the constraints of qualified retirement plan vehicles make it difficult for these persons to accumulate significant amounts within the plans. Issues of executive compensation may be particularly thorny in the context of closely-held businesses both in terms of handling actual current compensation¹ and planning for business continuity and succession.

In light of these problems, a broad range of tools and techniques have been developed for the purpose of addressing the issue of executive compensation, including stock options² and other equity deferred compensation, bonuses, defined benefit plans under IRC section 412³ and other insurance strategies. Many of these approaches are designed to permit highly compensated executives to obtain the benefits of deferring some portion of their compensation so that they may receive income at a future date and avoid paying taxes until actual receipt of that income. Though, in the words of Edward Young, we should not defer wisdom, it is often wise to defer taxation if and when possible. This article will address the rabbi trust, a popular technique designed to provide tax deferral for executive compensation under specific circumstances. It will also address recent changes in the tax laws affecting the design and operation of the rabbi trust. Note that a rabbi trust may also be used for executive benefits other than deferred compensation, though that is beyond the scope of our discussion.

Background and Definition

The rabbi trust had its origin in a determination by the IRS that an irrevocable trust established for a rabbi by the rabbi's congregation was not subject to current income taxation of the assets therein because the assets remained subject to the claims of the congregation's general creditors.⁴ This ruling was important since, in effect, the ruling permitted a trust to accumulate assets that would ultimately be distributed to a desig-

nated person - the participant, in this case the rabbi - without the necessity of the trust or the participant currently paying income taxes on the funds contributed. Further, the assets of the trust are protected from any claims other than those of the employer's general creditors and are otherwise outside the reach of the employer where the trust is irrevocable. The concept was popular as an approach to executive compensation issues and the IRS was inundated with requests for rulings approving a variety of these so-called "rabbi" trusts. The IRS responded with the issuance, in 1992, of a Revenue Procedure⁵ laying down the requirements of a model rabbi trust, thereby providing detailed guidance for employers who wished to make use of an unfunded deferred compensation arrangement (the rabbi trust technique).

Examining the requirements of the model rabbi trust, we see that the rabbi trust must be a grantor trust in which the grantor is the employer. The employer and not the trust is taxable on the income earned in the trust. The trust may be revocable, irrevocable or may become irrevocable upon the occurrence of a specified event.⁶ The trust may be terminated in accordance with its provisions and only under specified circumstances. The trust instrument may define the initial employer contribution. Further, the plan must express that the parties intend that the trust be unfunded for tax purposes and for purposes of Title I of ERISA.⁷ This means that the participants will not have a currently vested right in any of the trust assets.

The trustee of the trust must be an independent third party that may be granted corporate powers pursuant to state law. A trustee may be a bank or trust company or other similar entity but it is not likely that an individual will qualify. The rabbi trust must be a valid trust under applicable state law. The requirements of a rabbi trust do not define the investment powers available to the trustee. This deliberate omission allows the parties broad scope to define the duties of the trustee with respect to investments. The model trust allows the trustee some discretion in terms of investments and this allowance may limit the ability of a participant to direct investments in the rabbi trust. The model trust does permit the employer to choose that the trustees may invest in securities of the employer or may forbid that investment.⁸ Further, the employer is not generally prohibited from directing the selection of investments in the trust.

The trust assets must be subject to the claims of general creditors of the employer. What this means is that the employees eligible to participate in the trust - those executives with deferred compensation - do NOT have a current interest in the trust assets. This is completely unlike other arrangements, such as a 401k plan, where a participant has a vested right in the contributions even though income tax has been deferred. The executives therefore take the risk of insolvency of the employer since general creditors will be able to reach the trust assets in preference to the participants. In the event of insolvency, the trustee of a rabbi trust is prohibited from making distributions to participants and the employer is subject to the requirement of providing the trustee notice in the event of insolvency.

Payments to the participants are made in accordance with a payment schedule provided by the employer to the trustee.⁹ The schedule should indicate who is entitled to payments, when the payments are due and the manner and amount of each payment. Generally payments will be made on the occurrence of a specified event or events such as retirement, disability, death or termination of employment.¹⁰ The payments are subject to income taxation, of course, and the trustee may be required to withhold taxes from the payments. The employer may be able to take an income tax deduction for the payments made in the year the participant receives payments under the plan. A current income tax deduction for the contributions is not available to the employer.

The rabbi trust also may make allowance for a payment in the event of an unanticipated emergency.¹¹ This is defined as an event beyond the control of the participant where the participant would suffer undue hardship if unable to access funds. The participant may not anticipate, assign or alienate benefits from the rabbi trust and this is in keeping with the paramount rights of the general creditors.¹² If the trust lacks sufficient assets to make payments, the employer will be responsible for the unpaid portion of the payments.¹³

Underlying the model rabbi trust is the requirement that the trust provide effective deferral of compensation if the trust and participants are to receive the benefits of tax deferral. Hence, a basic requirement for any participant is the participant's election to defer compensation. The IRS has provided that the election to defer compensation must be made prior to the period of service for which the compensation is payable - typically the participant's tax year - and for which a portion of the electing participant's compensation is to be deferred.¹⁴ There are limited exceptions for the year in which the rabbi trust is created and the plan commenced as well as for new participants.

Considerations for Participants, including New Legislation

A qualified rabbi trust provides a means of tax deferral for a portion of executive compensation. However, this tax deferral comes with the cost of the potential loss of payments if the employer's general creditors reach the assets. Executives understandably may wish to have more certainty of receiving the deferred compensation than is provided in the model rabbi trust. With the idea of providing more certainty of payment, new variations of the rabbi trust were developed, including the offshore rabbi trust. Since vulnerability to creditors was an issue, the concept simply involved moving the trust assets offshore where presumably it would be more difficult for the employer's creditors to discover and reach the assets. Another approach was the introduction of a rabbi trust payout trigger tied to the financial condition of the employer funding the trust. This development required the payment to executives of deferred compensation from the trust when the trigger - usually a financial ratio - was reached, indicating that the employer was likely to become insolvent. Though the executives would be immediately taxable on the paid out compensation, this would be preferable to losing the entire trust assets to creditors.

In response to these developments and other practices perceived as an abuse by the IRS, Congress introduced some significant changes with the enactment of the American Jobs Creation Act of 2004 (AJCA).¹⁵ The AJCA created a new Internal Revenue Code provision providing that all amounts deferred under a non-qualified deferred compensation plan are currently includible in gross income to the extent not subject to a substantial risk of forfeiture unless certain requirements are met.¹⁶ The provision addresses offshore rabbi trusts directly,¹⁷ providing that amounts set aside or transferred outside the United States will be deemed immediately taxable and thereby ending the use of the offshore rabbi trust to provide executives with greater certainty of payment of deferred compensation. An exception to the rule permits an offshore rabbi trust only where the services rendered in return for the deferred compensation are actually rendered in the foreign state where the assets are located. The financial trigger approach is also directly addressed, with a new provision treating the inclusion of such a financial condition trigger as requiring immediate taxation of the rabbi trust assets even if general creditors are able to reach those assets.¹⁸ The AJCA also imposes new reporting requirements for deferred compensation plans, including the reporting of deferred amounts of compensation annually.

With the requirement that trust assets be available to general creditors of the employer and the elimination of attempts to avoid or reduce the impact of that requirement, it is clear that the ongoing profitability and success of the employer is paramount and that executives will have an increased incentive in that regard.

One factor that may affect executives participating in rabbi trusts in terms of their expectations of receipt of nonqualified deferred compensation is a change in the ownership or effective control of the employer corporation. The model rabbi trust addressed this situation by permitting a trust provision that would make the trust irrevocable upon a change in control. The AJCA also addresses this situation, making a change in ownership, change in effective control or a change in ownership of a substantial portion of the assets of the corporation a distribution event permitting payments to participants.¹⁹ Naturally, payments are currently taxable but the provision provides a level of protection for participants from changes that might affect the employer and the rabbi trust.

Finally, for those clients participating in rabbi trust deferred compensation arrangements, there are a few considerations for modeling the impact of the rabbi trust. The trust itself should not be reflected as an account or present interest since, in fact, it is not current. The payment dates and amounts specified in the plan documents should provide a guide to when and to what extent taxable income should be available to the client executive in the future. These flows may be modeled in a “what if” scenario to show their potential impact but, given their uncertainty, it may be well to model the client’s strategies in a baseline scenario that does not factor the rabbi trust into the analysis.

Effect of Non-Compliance

What happens if an arrangement fails to meet the requirements of the model rabbi trust or the new requirements of the AJCA? First, the rabbi trust would likely be subject to immediate income taxation of any income on the assets within the trust, losing current deferral and possibly exposing assets to double taxation on their subsequent distribution to participants. The rabbi trust might also be subject to interest and penalties in addition to income taxes for failure to meet statutory and regulatory requirements. The non-complying arrangement may be found subject to the many requirements of ERISA, including the rules regarding participation, funding and vesting as well as the fiduciary requirements. This would certainly make it impossible for the arrangement to succeed for its original purpose of deferring compensation for executives.

The tax consequences of non-compliance are severe and remove any of the benefits of pursuing this approach to executive compensation. Thus, it is critical that the plan and rabbi trust be created in compliance with the applicable laws and guidance provided by the IRS.

Summary

The rabbi trust is one of the many effective methods of providing for deferred compensation to executives. However, close adherence to statutory and regulatory requirements is necessary to make the technique work. For clients currently participants in rabbi trusts or who may be participants in the future, the basics of the technique are available here. Probably the most important aspect of these trusts our clients should understand is the current deferral of taxation depends on leaving the trust assets open to potential claims of the employer's creditors. Therefore, although there is no certainty of deferred compensation payments in such situations, in many cases there will be no problems in obtaining rightful deferred compensation payments as arranged. If a considerable amount of compensation is deferred it may prove helpful to include a tax professional in your discussions of the rabbi trust and its inclusion in the client's financial strategies.

Understanding the workings of unfunded deferred compensation arrangements. This is the future of financial advising.

¹ See “Taxation Issues in Compensation of Owners of Closely Held Businesses” November 10, 2004, full text at www.financeware.com/homepage.asp?showsippet=11.10.04.wem

² See “Working with Stock Options in Preparing Advice” October 22, 2003, full text at www.financeware.com/homepage.asp?showsippet=10.22.03.wem

³ See “Defined Benefit Plans under IRC Section 412(j)” March 26, 2003, full text at www.financeware.com/homepage.asp?showsippet=03.26.03.wem

⁴ PLR 8113107

⁵ See Revenue Procedure 92-64. The full text of the procedure, including the provisions and requirements of the Model Trust is available at www.deferral.com/dts/content/legal/irs92_64.asp

⁶ Id, Model Trust section 1(b)

⁷ See Revenue Procedure 92-65, section 3(d); full text at www.deferral.com/dts/content/legal/irs92_65.asp

⁸ Rev. Proc. 92-64, Model Trust section 5(a)

⁹ Id, Model Trust section 2(a)

¹⁰ Rev. Proc. 92-65, section 3(b)

¹¹ Id, section 3(c)

¹² Id, section 3(e)

¹³ Rev. Proc. 92-64, Model Trust section 2(c)

¹⁴ Rev. Proc. 92-65, section 3(a); see also Title 26 US Code section 409A(a)(4)

¹⁵ Public Law 108-357, enacted October 22, 2004

¹⁶ Title 26 US Code section 409A; see IRS guidance on this new statute in Notice 2005-1, full text found at www.irs.gov/irb/2005-02_IRB/ar13.html

¹⁷ Title 26 US Code section 409A(b)(1)

¹⁸ Title 26 US Code section 409A(b)(2)

¹⁹ Title 26 US Code section 409A(a)(2)(A) and Notice 2005-1 (link above, note 16)

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