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Rabbi Trusts: Key Legal and Business Considerations

MARKET TREND: Rabbi trusts remain a permissible means to informally fund nonqualified deferred compensation ("NQDC") plan liabilities but adopting a rabbi trust implicates important business and legal considerations.

SYNOPSIS: While the Internal Revenue Code (the "Code") and the Employee Retirement Income Security Act of 1974 ("ERISA") both require that NQDC plans to be "unfunded" and "unsecured," employers sponsoring a NQDC plan may wish to set aside assets to "informally" fund those benefits for a number of reasons. A rabbi trust is a vehicle that provides for such informal funding without running afoul of tax or ERISA compliance issues resulting from "funded" NQDC plan benefits. This article addresses key questions to consider when adopting a rabbi trust, including (i) whether the rabbi trust should be irrevocable; (ii) even if irrevocable, when can assets revert to the employer; (iii) should the rabbi trust include enhanced protections upon the employer's change in control; (iv) what kind of investments should the rabbi trust hold and what kind of control over those investments should the employer retain; and (v) can the rabbi trust hold employer stock?

TAKEAWAYS: An employer should consider a range of business and legal issues before setting up a rabbi trust. The business rationale for the rabbi trust should drive the trust's design and related decisions about trust investments. The employer should seek advice from its financial and legal advisors, with input from its own finance and accounting teams.

BACKGROUND ON RABBI TRUSTS

In order to effectively defer taxation and qualify as a "top hat" plan under the Employee Retirement Income Security Act of 1974, as amended ("ERISA"), nonqualified deferred compensation ("NQDC") plans must avoid being considered "funded." Therefore, an employer is unable to utilize a true third-

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party trust (like with a 401(k) plan) to secure NQDC plan benefits. However, there is a special type of trust that employers may use with a NQDC plan that generally should not cause the NQDC plan benefits to be considered funded – the so-called “rabbi trust.” In this article, we explore strategic decisions to make when adopting a rabbi trust.[1]

A “rabbi trust” – so named because the first of its kind was established to provide NQDC plan benefits to a rabbi[2] – is a grantor trust that employers can use to informally fund NQDC plan liabilities payable 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 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 and other taxable earnings. Further, the grantor does not receive a tax deduction on contributions to the trust when contributions are made but may take a deduction in the year in which the employee receives a distribution from the trust.

Following the issuance of the Internal Revenue Service’s (“IRS”) initial private letter ruling on rabbi trusts, many other employers sought their own private letter rulings regarding their rabbi trusts. In 1992, the IRS sought to provide broader guidance on rabbi trusts by issuing Revenue Procedure 92-64 (the “Revenue Procedure”).[3] The Revenue Procedure contains a model rabbi trust document (the “Model Trust”) for employers to adopt and maintain in connection with their NQDC plan.[4] Under the Revenue Procedure, the Model Trust serves as a “safe harbor” for maintaining the unfunded status of NQDC plan benefits for tax purposes. Further, the Revenue Procedure indicates that the Department of Labor (“DOL”) is likely to consider benefits “unfunded” for ERISA purposes if the Model Trust is used.

In a typical rabbi trust, a third party, often a bank or other financial institution, receives contributions from the employer and separately holds and invests those contributions. Critically, however, the assets held in a rabbi trust must remain available to satisfy claims of the employer’s general creditors in the event of the employer’s bankruptcy or insolvency. Accordingly, an employee whose NQDC plan benefits are secured by assets in a rabbi trust will have rights no greater than those of a general, unsecured creditor of the employer.[5] 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).

What Business Purposes Can a Rabbi Trust Serve?

The law does not require employers to use a rabbi trust for their NQDC plans. If assets held in a rabbi

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[1] For additional information on rabbi trusts, see our July 2022 article, “*Rabbi Trusts as “Informal Funding” for Nonqualified Deferred Compensation Plans – The Fundamentals,*” in the Finseca Resource Library.

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

[3] *See* Rev. Proc. 92-64, 1992-2 C.B. 422

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

[5] A secular trust can instead be used by the employer as its assets are not subject to the company's general creditors. However, because use of a secular trust does not permit the employee to defer taxation, secular trusts are less commonly used to fund NQDC plans.

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trust for a NQDC plan benefits are subject to the claims of the employer's general creditors, why would an employer even consider using a rabbi trust? There are several possible business reasons, as outlined below.

First, setting aside assets to be used to pay future NQDC plan benefits can represent good financial discipline for the employer and can function as an economic hedge against the related NQDC plan liabilities. Absent a rabbi trust, the employer can either set aside assets in an investment account it owns or simply pay the NQDC plan benefits out of its future cash flow (*i.e.*, a "pay-as-you-go" approach). Setting up a separate employer-owned investment account does not in any way restrict the employer's use of the funds. If the employer later decides to reinvest the funds in its business, it may do so. The pay-as-you-go approach effectively reinvests the NQDC plan benefits in the employer. A rabbi trust can be an effective alternative for setting aside current assets and appropriately investing them in order to have sufficient funds to pay benefits in the future. Rabbi trusts also provide additional security in the event future cash flow is insufficient to pay NQDC plan benefits when due.

Second, NQDC plan participants may perceive a degree of added security that their benefits are secure, which in turn may encourage their participation in the plan, especially in the case of a NQDC plan that is based on elective deferrals by employees. Once assets are deposited into a rabbi trust, they can generally only be used only for the purpose of paying NQDC plan benefits. Therefore, a rabbi trust limits the employer's ability to divert the assets to other business purposes (unlike an employer-owned investment account). Although the rabbi trust cannot protect the employee's benefits if the employer becomes insolvent, it can protect the employee if the employer attempts to renege on plan benefit promises. If providing participants with this type of psychological comfort is important to the employer, the rabbi trust should be set up so that it is irrevocable by the employer. In this case, the terms of the underlying NQDC plan should also be reviewed to see if it requires deferrals to be deposited in a rabbi trust.

Third, a rabbi trust can provide heightened protection for NQDC plan benefits in case of a change in control of the employer. The Model Trust specifically contemplates several protections that may be triggered by a change in control, such as:

- **Springing funding**: The rabbi trust is required to be funded with assets not less than the total NQDC plan liabilities as of the change in control;
- **Irrevocability**: The rabbi trust, if not previously irrevocable, becomes irrevocable upon the change in control;
- **Trustee changes**: The employer cannot remove the rabbi trustee, and if the rabbi trustee resigns, a court will appoint the successor; and
- **No amendments**: Upon a change in control, the employer cannot amend the rabbi trust.

In some cases, employers may consider including additional protections for participants triggered by a change in control not specifically contemplated by the Model Trust. For example, some employers include a provision that limits employer discretion as to the direction of trust investments following a change in control or that directs the trustee to respond directly to participant NQDC plan benefit

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requests. However, these types of added protections require finding a trustee willing to accept those heightened duties. Many institutional trustees only want to be directed trustees and do not want any independent, discretionary duties. As a result, these added change in control protections may be difficult to apply in practice.

When Should Rabbi Trust Assets be Recoverable by the Employer?

As noted above, a rabbi trust may be set up as irrevocable or may become irrevocable upon a change in control. So how and when do assets come back to the employer?

An employer will often want to directly pay any NQDC plan benefits from its payroll in order to more easily satisfy its tax withholding and reporting obligations related to the payments. In this case, the employer should make sure that the rabbi trust includes language that allows the employer to recover from the rabbi trust any NQDC plan benefits that the employer pays directly. Otherwise, assets can become "stuck" in the rabbi trust, and the rabbi trust will become increasingly overfunded.[6]

While the rabbi trust assets are often intended to correspond closely to the NQDC plan liabilities, sometimes they do not align. This disconnect frequently arises with defined benefit supplemental executive retirement plans ("SERPs"). In some cases, the rabbi trust assets may grow faster than the related NQDC plan liabilities. In these cases, the rabbi trust becomes overfunded. Employers concerned about this possibility can include a provision in the rabbi trust agreement that allows the employer to have certain "excess assets" returned upon request. The employer should determine how much of a funding buffer is appropriate in defining "excess assets" – *e.g.*, "excess assets" might be those in excess of 125% of NQDC plan liabilities.

Finally, the rabbi trust agreement should be clear that once all underlying NQDC plan liabilities have been paid, the rabbi trust can be terminated, and any excess assets returned to the employer. This language is included in the Model Trust.

Because the rabbi trust is a grantor trust for tax purposes, the return of assets from the rabbi trust to the employer should not be a taxable event to the employer. For tax purposes, the rabbi trust assets were the employer's assets all along.

What Kind of Investments Should a Rabbi Trust Hold?

The Model Trust authorizes the rabbi trustee to invest in a broad range of investment categories, including mutual funds, other securities, and life insurance policies. In most cases, the trustee of the rabbi trust will require the employer to provide direction as to the specific investments held (*i.e.*, a "directed trustee"), and the rabbi trust typically allows the employer to cause specific assets to be swapped out for other assets of equivalent value. The Model Trust includes the right to swap assets of equal value as optional language.

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[6] The Model Trust contemplates that the rabbi trustee will make payments directly to participants pursuant to a "payment schedule" provided by the employer, or that the employer may pay benefits directly. But the Model Trust does not include clearly indicate that the employer can be paid from the trust for those benefit payments it makes directly.

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The employer should consider the types of investments held in the rabbi trust based on its business rationale for having a rabbi trust in the first place. For example, if the NQDC plan is a "shadow" 401(k) plan, meant to mimic the employer's tax-qualified 401(k) plan,[7] the employer may want the rabbi trust to hold assets that closely mimic the deemed investment choices made by the participants in the NQDC plan. If the NQDC plan is a defined benefit SERP, the employer may want less volatile underlying investments that hedge against interest rate risks and can grow in value with the underlying SERP benefits.

As a grantor trust, taxable transactions in the rabbi trust will be taxable to the employer. For example, if the rabbi trust investments generate taxable dividends or other taxable income due to the buying and selling of securities within the trust, the employer must pay those taxes. The rabbi trust agreement will need clear language if the employer intends any such taxes to be paid from the rabbi trust assets rather than from the employer's own cash reserves. And if the NQDC plan liabilities are determined without regard to taxes on rabbi trust assets, those taxes can effectively erode the benefit security and economic hedge provided by the rabbi trust.

Some employers will explore holding investments in the rabbi trust with favorable tax treatment for the employer, especially permanent life insurance policies on the key executives who have NQDC plan benefits. For example, a variable life insurance policy owned by the employer (or trustee) with sub-accounts that permit investments mirroring participant deemed investments in the NQDC plan may provide an effective financial hedge on the NQDC plan liabilities without triggering taxation to the employer for the underlying investments.

Whether life insurance is a suitable investment alternative in the rabbi trust is a decision that the employer should make with input from its financial and legal advisors. In that case, the rabbi trust should include language specifically authorizing investments in life insurance policies and addressing related issues, such as who may designate the beneficiary for death benefits, whether the employer may access policy cash values or take policy loans, etc. The employer should also make sure it has flexibility to cause policies to be swapped or exchanged, *e.g.*, if the employer wants to change insurance carriers.

Because NQDC plans should be "top hat"[8] plans under ERISA, these decisions about the investment of rabbi trust assets should not implicate ERISA fiduciary duties. Ultimately, the rabbi trust investment strategies are business decisions that should be driven by the business purpose of the rabbi trust.

Can a Rabbi Trust Hold Employer Stock?

Some employers sponsor NQDC plans that allow employees or non-employee directors to defer receipt of stock award payments under the employer's equity compensation plan. For accounting reasons, the deferrals are commonly payable in shares at the end of the deferral period. The employer could simply issue the shares at the end of the deferral period from the equity compensation plan. In some cases, however, the employer would prefer to issue the shares at the original vesting date into a

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[7] Participants in a NQDC plan that is a "shadow" 401(k) plan often select from the same menu of investment options offered in the 401(k) plan.

[8] For more information on "top hat plans", see our prior article "New Year Reminder: Have you Filed a Top Hat Plan Statement for Your Non-Qualified Deferred Compensation Plans?" and "The Importance of Claims Procedures in Nonqualified Deferred Compensation Plans" in the Finseca Resource Library.

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rabbi trust to be held and paid at the end of the deferral period. The employer may prefer to do this because the administrative system for the equity compensation plan is not well-equipped to track elective deferrals.

Holding employer stock in a rabbi trust raises unique legal and tax issues as compared to other investment categories. First, the employer will need to check with its corporate counsel to determine whether the shares issued to the rabbi trustee will be considered "issued and outstanding" to a third party (*i.e.*, the rabbi trustee) or whether, given the grantor trust status of the rabbi trust for tax purposes, the shares will still be considered owned by the employer and therefore treated as treasury shares. This determination can impact the internal accounting of authorized shares, reporting with the employer's transfer agent, etc. The employer will also want to confirm the impact of holding shares in the rabbi trust with its accountants for purposes of reporting common shares outstanding, earnings per share, etc., in its financial statements.

Next, the employer should review with its tax advisors the tax consequences of issuing the shares to the rabbi trustee – *e.g.*, the tax treatment to the employer on any dividends paid on the shares while held in the rabbi trust. These tax issues may especially arise when the NQDC plan is sponsored by a parent company that issues the shares but which includes participants at subsidiary employers within the parent's controlled group.

In a series of IRS private letter ruling in the early-to-mid 1990s, the IRS concluded that a rabbi trust could hold employer stock and that:

- The creation of, and contribution of assets to, the trust does not constitute a transfer of property within the meaning of Section 83 of the Code;
- Benefits provided under the NQDC plan are includible in a participant's income when paid or made available from the trust, and neither the constructive receipt nor the economic benefit doctrine causes earlier income recognition; and
- Either the parent company or the appropriate subsidiary-employer may deduct the benefit payments when they are includible in the participant's income in accordance with Section 404(a)(5) of the Code.[9]

These private letter rulings left open, however, questions about the tax treatment to the parent and its subsidiary, such as whether any taxable event occurs on the appreciated value of the shares when they are actually issued by the trust to an employee of a subsidiary. The IRS answered some of these questions in Notice 2000-56.[10] In this Notice, the IRS concluded that subject to certain conditions, the transfer of parent company shares held in the rabbi trust to pay the NQDC plan obligations to the employees of a subsidiary will not trigger a taxable event to either the parent or the subsidiary related to the appreciation in value in the shares while held in the trust. To achieve this result, the rabbi trust assets should be subject to the claims of general creditors of both the parent and its participating

[9] *See*, e.g., IRS. Priv. Ltr. Rul. 9235006 (Dec. 4, 1991). and IRS. Priv. Ltr. Rul. 9609010 (Nov. 20, 1995).
[10] *See* IRS Notice 2000-56, 2000-43 I.R.B. 393.

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subsidiaries, and the rabbi trust should provide that any remaining shares will revert to the parent in case the rabbi trust terminates, or assets of the trust are otherwise reverted.[11]

Conclusion

A decision to informally fund NQDC plan liabilities through a rabbi trust should not be taken lightly. The employer should consider the nature of the NQDC plan liabilities, the business purposes intended to be served, and the various alternatives in the details of the rabbi trust's provisions that those business purposes may suggest. Although the Model Trust provides a solid starting point for drafting the rabbi trust agreement, various optional terms (both contemplated by the Model Trust or otherwise) should be considered. And, of course, the employer will need to find an institution willing to administer the rabbi trust based on those terms. The effort should include input from the employer's financial and legal advisors, as well as its internal finance and accounting teams.

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[11] *See also*, Example 10 at Treas. Reg. § 1.1032-3(e).

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