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Rabbi Trusts:

Benefits, Features, and Key Considerations

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An employer's promise to pay deferred compensation or other non-qualified benefits to a highly compensated employee may be a contract right that avoids the complexities of ERISA. But when it's time to pay, if the funds aren't there or the employer changes its mind (perhaps due to a change in ownership), the employee may be reduced to expensive litigation and an uncollectible judgment. Engaging a corporate trustee to establish a rabbi trust can provide some security against such a turn of events, while offering other benefits to facilitate the administration of non-qualified plans.

FUNDING THE TRUST

Instead of being merely a book entry, amounts to eventually pay compensation that the employee has elected to defer are transferred to a trustee who has a duty to follow the trust agreement provisions outlining distributions and other matters affecting the trust funds. Taxable assets, or tax-sheltered assets such as insurance vehicles, are among the assets the trustee may hold. Often, company stock, mutual funds, or limited partnerships can also be used to fund the trust. Rabbi trusts can be used to provide a source of funds to pay benefits under other executive non-qualified plans designed with long-term incentives to motivate and retain key executives. If the plan has a company stock feature, the employee will be motivated to work for the future success of the company.

ADVANTAGES OF RABBI TRUSTS

An advantage of a rabbi trust, in addition to the protection afforded, is the opportunity for tax deferral by employees on the deferred compensation. The rabbi trust may be taxed like a grantor trust, with taxable income attributed to the employer because funds in the rabbi trust are subject to claims of the employer's creditors. If the plan and trust are properly structured, the employee pays no income tax on the benefits until they are received by the employee. Payments from a rabbi trust may be deductible by the employer for income tax purposes when distributions are made, not when the trust is funded.

Additional advantages include responsibilities being distributed to an independent third party and reducing the potential for conflict of interest. By outsourcing the responsibility for the executive compensation plan to trusted service providers, plan sponsors can also be relieved from time consuming administrative duties, such as preparing consolidated plan statements, processing contributions and disbursements, and handling the respective tax reporting associated with transactions for the plan.

WHAT THE IRS SAYS

The IRS has set forth specific criteria that need to be met in order for there to be a favorable ruling on or favorable tax consequences associated with a rabbi trust. IRS Revenue Procedure 92-64 details what these criteria are and also contains a model rabbi trust that is intended to serve as a safe harbor for taxpayers who adopt and maintain the model trust in connection with a non-qualified plan. By using the model trust, an employer can help to ensure that plan participants will not be considered to be in constructive receipt of deferred compensation or to incur an economic benefit on a account of the establishment of a rabbi trust.

RULES FOR RABBI TRUSTS

To qualify as a rabbi trust, the trust should benefit a select group of employees, limited by both number and rank. Employers may establish a revocable or irrevocable trust, or the trust agreement may provide that a trust will become irrevocable or "locked" upon the occurrence of a specified event, such as a change in control. Generally employers cannot access funds in an irrevocable or "locked" rabbi trust except to pay plan benefits until all benefits have been paid. However, regardless of whether the trust is revocable or irrevocable, the funds must be subject to claims of the employer's creditors in case of the employer's bankruptcy or insolvency. The funds cannot be secured for the plan participants - that is, employees must have the same status vis-à-vis the funds as the employer's general creditors. Employees also cannot assign amounts under the trust.

CUSTOMIZING WITH TRIGGERS

The American Jobs Creation Act of 2004 has restricted some executive compensation plan design options for those employers who want to establish such plans with the tax advantages previously described. However, rabbi trusts may still be customized to address some concerns of the employer and employee. Here are some ways to "tweak" a rabbi trust:

- A non-financial trigger, such as a change in company ownership or other change in control, may result in automatic distribution. Also, adding reimbursement and/or reversion of assets provisions when negotiating the trust agreement may provide flexibility to the company for various funding needs.
- Other provisions may only come into effect in the event of a change of control. For example, the trust could provide that a high percentage (more than a majority) of the beneficiaries must approve any proposed change in the trustee or certain terms of the trust. In addition, responsibility for investment and administration of the trust assets may move to an independent third party in the event of a change in control.

SELECTING A PROVIDER

When selecting an organization such as Matrix Trust Company to serve as your rabbi trustee, there are several key considerations, including:

- The history, financial stability, and experience of the organization providing corporate trustee services.
- Whether the service is a core competency of the organization (number of plans serviced, dedicated staff, etc.).
- Experience with change of control situations and ability to assume a discretionary trustee role, if necessary, to protect the interest of plan participants.
- Ability and experience with handling multiple types of assets, including: COLI, mutual funds, company stock, and limited partnerships.
- A strategic partnering approach whereby the trustee offers the plan sponsor the flexibility to use experts in respective areas to meet the various needs of the plan, such as: consulting, recordkeeping/administration, investment/insurance offerings, and legal services.
- Fee schedule (one-time costs, annual fees, ancillary/transaction fees, guarantee period, and methodology to charging fees) will vary by provider, but ultimately it's about ensuring that the fee being paid matches your desired level of service and experience.

One other important and often overlooked consideration is that of a conflict-free relationship with your rabbi trust provider. Many times it's easy and possibly somewhat economical to just utilize the bank that provides your company with lending or other financial services. In our current environment of heightened scrutiny of executive benefit and non-qualified plans, it may be well worth the time and nominal cost to select an independent corporate trustee that doesn't present the perception of a potential conflict of interest. In addition, the ability to separate the funding vehicle selection process from the trustee services allows a plan sponsor the flexibility to utilize the most appropriate investment option to meet the objectives of the organization and the plan.

IN SUMMARY

Rabbi trusts permit employers to set aside a source of funds to pay benefits to highly compensated executives deferring compensation in a non-qualified plan. A rabbi trust provides plan participants with a higher level of security, since the employer has undertaken to earmark funds for paying plan benefits and since the trust may be structured so that assets normally can only be used for the payment of benefits. The use of an independent trustee can help protect against a change of heart by current or future management and avoid the potential for a conflict of interest. Administrative duties of a plan sponsor can also be reduced by using a corporate trustee. Once you've made the decision to set aside funds to pay plan benefits, the many advantages of retaining a rabbi trustee typically mean money well spent.

ABOUT THE AUTHOR

Mike Hlavin, CFP®, AIF® is responsible for new business development initiatives for Broadridge Retirement and Workplace. He serves as a resource to the full array of trust, custody, trading and paying agent services offered to plan sponsors, third party administrators, consultants, investment managers and financial advisors. He also facilitates the outsourcing and back office solutions for our strategic alliance partners and other benefit plan providers.

Since 1983, Mike has worked in the financial services industry, with a primary focus in institutional retirement and employee benefit plan services. Prior to joining Broadridge Retirement and Workplace, Mike held Vice President positions with firms including Wilmington Trust/M&T Bank, Lincoln Financial Group, Administrative Management Group, American Financial Group and the Pension and Savings Division of MetLife.

Mike holds a bachelor's degree in Finance from De Paul University, is an EMBA Candidate for the Notre Dame University Mendoza School of Business and earned his Certified Financial Planner® designation from the College of Financial Planning in Denver, Colorado. Mike also maintains FINRA Series 7 and 63 securities licenses.

Mike is involved as an exhibitor, featured speaker and panelist for various industry associations, and was one of the 100 financial professionals selected by Money Magazine to participate in its Project Money initiative to promote community awareness of the importance of retirement and financial planning.

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For non-qualified plans specifically, you can rely on the vital trading, custodial, and consultation services needed for these unique plan types. From plan inception through change in control transactions, you get flexible funding options, discretionary trustee services, paying agent services, and so much more. Leverage Broadridge Retirement and Workplace as your independent third party with 25+ years' experience dedicated to non-qualified plan services.

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