

## HOW SAFE ARE YOUR NONQUALIFIED BENEFITS?

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Literally billions of dollars of nonqualified deferred compensation and supplemental retirement benefits are being promised to key employees across the country. All of these benefits involved unsecured promises, dependent upon the good intentions and ultimate financial solvency of the employer sponsoring the plan.

What does this mean to the executive hoping to secure a meaningful retirement through a benefit package comprised largely of nonqualified benefits?

Today, most nonqualified plans are designed to fill the gap caused by qualified plans, and in many cases have similar benefit designs. However there are some important differences.

In a qualified plan, the executive's retirement benefits are secured by a special trust to insulate them from the company's creditors (i.e. the plan is "funded"). If there is a change of control, change in financial condition, change of heart or even the bankruptcy of the sponsoring employer, the executive's benefits are still protected.

In a nonqualified plan, however, the executive is an unsecured general creditor of the company. To avoid current taxation to the participating executive, a nonqualified plan must be "unfunded". If the institution were to "fund" a nonqualified plan, the executive would be taxed currently on the value of those benefits—even though he/she was not yet entitled to receive those benefits.

Because the executive is relying on retirement benefits coming from nonqualified plans, it is not surprising that they have some concerns regarding the "security" of their benefits. Over the last two decades, many tax practitioners have designed several methods to enhance the security of the participants in nonqualified retirement plans. Unfortunately, the adoption on new legislation under 409A has limited what is available.

Still the most commonly utilized security vehicle is called a "rabbi" trust. Other devices which may be employed include: indemnification insurance, secular trusts and the ISOP<sup>®</sup> Trust.

While the security achieved through any of these methods is not as complete as that provided by a qualified retirement plan trust, substantial protection can be obtained from the treats of change of control or change of heart where the employer could default. It is also possible to significantly enhance a participant's security in a nonqualified plan in the event of a change in financial condition (i.e. short of insolvency or bankruptcy). Should the company become insolvent or bankrupt, in most arrangements, the assets are subject to the claims of general creditors, which the executive is one.

## Nonqualified Plan Security Devices

Security devices have increased in prevalence over the last few years. It appears that three factors are mainly responsible for this trend:

1. The general creditor status of plan participants;
2. The increase in prevalence of nonqualified plans in general, and;
3. The concern over company failures like Enron, Arthur Andersen and others.

A variety of security arrangements, including both trust and non trust approaches, have been designed to help mitigate the risk of loss related to the factors mentioned above. The first step in determining what device to use, is to determine who or what event you are trying to be protected against. Figure 1 outlines the four factors that could contribute to benefit loss. This article discusses a couple of these arrangements. RCG has released a complete study, “Securing Nonqualified Plan Benefits After 409A” that can be downloaded from [www.retirementcapital.com](http://www.retirementcapital.com).

**Figure 1**



## Rabbi Trust

The term Rabbi Trust generally refers to a trust an employer establishes as a source of funds for the future payment of benefits to participants.

In the early 1980s, a synagogue received a watershed IRS ruling that confirmed tax deferral for a rabbi who was the beneficiary of a trust established to pay him retirement benefits; hence the name Rabbi Trust.

In its typical form, a Rabbi Trust is structured as an irrevocable employer-established grantor trust, which means items of annual income and expenses will flow back to and be reportable by the employer for accounting and tax purposes. The employer controls how much money or how assets are placed in the trust. The employer also determines if benefits are to be paid from the trust in all events, or only in the event they are not paid from general assets of the company. Caution should be used in constructing an irrevocable trust. A recent RCG survey found that a number of trusts intended to be irrevocable were structured as revocable, often against the intent of those who designed them.

Most Rabbi Trusts engage an independent trustee, usually a major bank. A “trustee” is designated to distribute assets as interpreted by the fiduciary, and has no plan fiduciary responsibility. One of the most overlooked and confusing areas is the trustee’s fiduciary duties to protect trust assets for the benefit of the participant, but not for the plan itself. Most Rabbi Trusts will designate a third party, possibly the same institution as the trustee, to take over the plan fiduciary responsibility. This provision needs to be incorporated into the plan documents. Many benefit provisions are lost in a change of control situation due to the lack of this provision, even if the Rabbi Trust is fully funded.

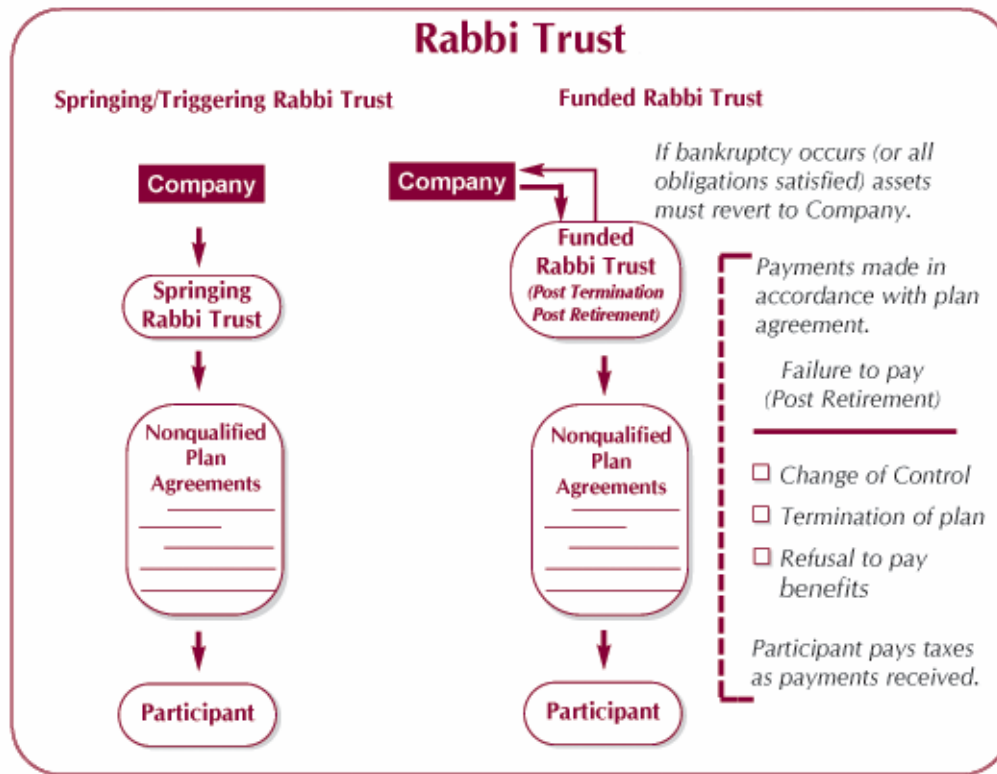
The Rabbi Trust is governed by a legal document that typically restricts the employer’s ability to suspend benefit payments at will, to amend the trust vehicle, or to cancel benefits which it informally funds.

In IRS Revenue Procedure 92-64, the IRS established a model Rabbi Trust. The use of the IRS model Rabbi Trust form provides a safe harbor for taxpayers who adopt and maintain the grantor trust in connection with unfunded or informally funded deferred compensation arrangements.

Most companies go beyond the model trust language and rely on best practices based on approximately 300 private letter rulings. One such provision is the establishment of a legal reserve fund.

**Springing vs. Funded Rabbi Trust (Figure 2)** A Springing Rabbi Trust is a Rabbi Trust that receives only minimal assets at the time it is established. When a specifically-defined contingency occurs, such as change in control, the employer is immediately required to contribute sufficient assets to the trust to enable it to satisfy all benefit promises in existence at that time. These arrangements are less prevalent today as companies in hostile takeover situations have had difficulty producing the necessary cash at the time of the event.

**Figure 2**



Most companies using Rabbi Trusts today are informally funding their benefit obligations with assets in the trust. With a grantor trust, the assets are carried on the balance sheet as company assets. Informally funding a previously unfunded trust can create special challenges for a company. Depending on the size of the benefit liabilities, and the desire to maintain a balance between company cash flow and the impact on its earnings, a company may choose to informally fund the plan over a period of time, e.g. five or seven years.

**Security of Benefits** Assets set aside in a Rabbi Trust must be subject specifically to the claims of an employer's general creditors in the event of bankruptcy or insolvency. If a company enters bankruptcy, participants' rights to their benefits are no greater than those of other general creditors. Note that in *Bank of America, N.A. v. Moglia*, 330 F.3d 942 (7th Cir. 2003) executives with assets in a Rabbi Trust prevailed against secured creditors.

Because the assets set aside in a Rabbi Trust are subject to the claims of creditors, participants are not currently taxed because they are not in “constructive receipt” of the benefits, nor have they received an “economic benefit.” The participants will only be taxed when their benefits are actually paid.

**Fiduciary Provision** The lack of a Fiduciary Provision in a trust document could be a costly mistake. Since the trustee of the Rabbi Trust is not the plan fiduciary, a change of control could create a situation where the assets of the trust may be diverted from the payment of benefits to executives.

Example:

Under Supplemental Retirement Income Plan:

“Administrative Committee means a committee consisting of the Senior Executive Vice President - Human Resources and two or more other members designated by the Senior Executive Vice President - Human Resources who shall administer the Plan.”

“Administration Committee means a committee of three or more members, at least one of whom is a senior manager, who shall be designated by the Vice President - Human Resources to administer the Plan pursuant to Section 3.”

- *This committee could be NewCo, leaving interpretation to new management.*

Without clear direction from a Fiduciary, participants are leaving retirement benefits in the hands of other people not familiar with them or their situation. This provision should name individuals in a third party to act in the capacity of Fiduciary in the event of a change in control of the company. A difference exists between a “trustee” and a “Fiduciary.”

Because nonqualified plans have become so prevalent, and make up such a large portion of an executive’s retirement benefits, the search for the right security/funding device continues to be a critical aspect of plan design.

**Moglia Rabbi Trust Provision** The *Moglia* case (supra) may be a major breakthrough in nonqualified plan benefit security. In *Moglia*, Outboard Marine Corporation declared bankruptcy while \$14 million was held in its Rabbi Trust. The Rabbi Trust contained the standard language that its assets were subject to the claims of the company’s “general creditors.”

Bank of America was the agent for Outboard’s “secured” creditors, and the language of its security agreement was broad enough to describe the assets of the Rabbi Trust. The Bankruptcy Court held that Bank of America and the other secured creditors could not reach the assets in the Rabbi Trust. As a result, the \$14 million in the Rabbi Trust was available for distribution to Outboard’s “unsecured creditors,” including the executives in the nonqualified deferred compensation plan.

With a Moglia Rabbi Trust the assets inside the Rabbi Trust should only be available to the company's "unsecured creditors," which includes participants in the nonqualified plans. Read your Rabbi Trust document. Does it say assets are subject to the claims of "creditors," or—like the Moglia variety—"unsecured general creditors"?

Several steps must be followed to create an effective Moglia Rabbi Trust:

1. *Timing. Fund Rabbi Trust "before the security agreement gets executed."*
2. *Documents. Trust corpus ... Shall remain at all times subject to the "claims of the general creditors" of the company.*
3. *State in which Trust is held. Moglia was decided by the Seventh Circuit court of appeals (which covers Illinois, Indiana, and Wisconsin).*

**Taxation** Executives are not taxed at the time assets are placed in the trust, and are not taxed annually on the trust's earnings. Plan participants are taxed upon receiving distribution from the trust or when the trust assets are no longer subject to a substantial risk of forfeiture.

On the employer's side, the organization does not receive a deduction on trust contributions. The deduction comes only when benefits are paid. The trust earnings are taxable to the employer on an annual basis as earned, unless they are invested in tax-exempt vehicles, e.g. life insurance or tax-exempt bonds.

The Department of Labor has indicated that a compliant Rabbi Trust will be considered unfunded for purposes of Title I of ERISA, even though assets have been set aside.

A funded Rabbi Trust can provide participants with protection against a change in control, change of heart and change in financial condition (short of bankruptcy). Figure 3 outlines the advantages and disadvantages of a Rabbi Trust.

**Figure 3**

<b>Advantages</b>	<b>Disadvantages</b>
<b>To the extent the plan is informally funded it provides security in all cases except company bankruptcy.</b>	<b>Plan is subject to claims of creditors in bankruptcy.</b>
<b>Participant does not pay tax on income until benefits are actually paid.</b>	<b>Company does not receive a tax-deduction until benefits are actually paid.</b>
<b>Participant may be given the choice between investment options.</b>	<b>Trust earnings are taxable to the company (unless earnings are invested in tax-sheltered assets).</b>
<b>Plan is not considered to be a funded plan for ERISA purposes.</b>	<b>Company assets are tied up.</b>

**How Secure is a Rabbi Trust?** The following list discusses areas that are frequently overlooked:

- *Irrevocability:*
  - *Through many reviews, RCG has found trust drafted as “Revocable.”*
- *Speed of Funding:*
  - *What does the trust say about funding?*
  - *When and how fast does it “spring”?*
- *Level of Funding:*
  - *Most trusts do not specify how much value should be funded.*
- *What does your plan say about:*
  - *Professional fees;*
  - *Maximum asset level;*
  - *Trustee’s use of fiduciary consultant;*
  - *Loans against and substitution of assets;*
  - *Powers passed to successor management;*
  - *Trustee experience?*

## Secular Trust

Secular Trusts are so named to distinguish them from Rabbi Trusts. A major distinction between a Secular and a Rabbi Trust is that an employer's bankruptcy creditors cannot reach the money held in Secular Trusts. Therefore, a Secular Trust provides benefit payment security to an extent somewhat similar to that provided under a tax-qualified retirement plan trust.

The absence of the risk of employer bankruptcy causes the Secular Trust to become an after-tax approach, which means contributions to the trust (and annual earnings on trust assets) are immediately taxable to participants when vested. However, most Secular Trusts shelter most earnings from taxation by using insurance tax-exempt investments. The underlying nonqualified plan may be subject to ERISA rules and be considered a funded plan, creating benefit security.

**Security of Benefits** The employee participant has a vested interest in the trust so it will not become property of the company's creditors during bankruptcy proceedings. The Secular Trust protects employees from an employer's bankruptcy because this type of trust represents an irrevocable transfer of assets that cannot be reached by an employer's creditors.

**Taxation** Generally, trust contributions and trust earnings are taxable on a current basis to participating executives. Therefore, distributions ultimately paid from the trust will not trigger an additional tax obligation. Exceptions occur with distributions of appreciated property.

If the Secular Trust is designed to deliver to executives the same after-tax value as a nonqualified plan benefit payment made from general assets, then less cash is needed in the trust when the Secular Trust payments are finally made. To cover the taxes due at the time of contributions to the trust and at the time trust earnings are realized, the employer needs to provide additional cash on a grossed-up basis to cover the executive's tax liability that arises before benefits begin.

In general, employers receive a tax deduction for amounts contributed to the trust when the amount is taxed to the executive. Trust earnings will be taxed to the trust, to the executive, or to both—depending on the specifics of the trust arrangement. Figure 4 outlines the advantages and disadvantages of the Secular Trust.

**Figure 4**

<b>Advantages</b>	<b>Disadvantages</b>
<b>To the extent the plan is funded, it provides security from company's inability and unwillingness to pay benefits as they are incurred including bankruptcy.</b>	<b>Vested company contributions and annual earnings by participants are immediately considered to be taxable income.</b>
<b>Company receives tax deduction on contributions.</b>	<b>Company assets are tied up.</b>
<b>Company has reduced or offset liability on company's financial statements.</b>	<b>ERISA requirements apply.</b>
<b>Participant pays taxes on contributions, setting tax basis for benefit payments.</b>	<b>Once funded and vested, participant can walk away (no golden handcuffs).</b>

Private letter rulings released in 1992 and 1993 caused significant changes in the Secular Trust area. In essence the rulings cause a double taxation on the investment earnings. As a result, a Secular Trust should only be designed as follows:

**Employee Grantor Secular Trust** This approach avoids the double taxation of annual trust earnings by having participants establish trusts for themselves (could be sub-trusts). The employer still funds the nonqualified obligations with tax-deductible payments; however, the employer payments technically are offered first to each participant, who in turn authorizes payment directly to the trust. This slight modification results in an “employee grantor trust” status. Earnings on trust assets are annually taxed to the participant, as the grantor, but not to the trust. The trust is not a tax-paying entity.

The employee is also taxed on trust contributions as they are made by the employer. To avoid the current taxation of trust asset earnings, many employees elect to have trust assets invested in tax-sheltered strategies. The most prevalent funding strategy is variable universal life insurance, which provides flexibility on contributions and the ability to allocate trust assets among funds, similar to 401(k) investments without current taxation on gains. Employers qualify for the purchase of institutionally-priced contracts not normally available to individuals. When properly structured, current laws governing life

insurance give the participant the ability to withdraw payments (principal and earnings) tax-free. This is done by withdrawing cash value first up to the policy tax basis, and then taking policy loans against the remaining balance.

## **ISOP<sup>®</sup>**

The ISOP<sup>®</sup> is very similar to the Secular Trust, its major advantage being on the funding side. The ISOP<sup>®</sup> uses an insurance product that helps the company lower the overall cost of the plan. Unlike the Secular Trust there is no need to gross the executive up for taxes as the product lends the executive his or her taxes until retirement.

## **Non-Trust Arrangements**

There are a number of other devices being used today that do not set assets aside. They instead rely on a third party to make payments should the employer fail. As in the case of secular trusts, these arrangements have their drawbacks.

For example, indemnity insurance is expensive and difficult to obtain. These devices also rely on the financial solvency of the guarantor.

## **A Balancing Act**

Executives continue to search for ways to provide protection of their nonqualified benefits against the risks of change in control, default from their employer or even the company's insolvency.

On the other hand, board of directors may prefer that these nonqualified plans not be secure, but rather be paid only if management is able to build financial stability and growth of the company. This view has changed over the last few years, as boards are recognizing that many times the company's solvency is out of the control of the executive. Also, 409A has laid down new guidelines on what companies can do within reason.

Having a funded Rabbi Trust doesn't guarantee that benefit will be paid either. A well secured plan goes beyond just the trust structure, it is very important to also focus on the plan documentation. With proper planning and documentation, nonqualified programs can provide management a high level of benefit security while delivering fair value to shareholders.

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