

**W3 Wealth Management,
LLC**
Shelby Morgan
90 N. Miller Road
Akron, OH 44313
330-836-3805
Shelby@W3wealth.com

Rabbi Trusts

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What is it?

A rabbi trust is a trust that you establish in order to informally fund your obligation to provide your employees with benefits under a nonqualified deferred compensation (NQDC) plan. It's called a rabbi trust because a rabbi was the beneficiary of the first such trust to receive a favorable IRS ruling. The primary reasons for establishing a rabbi trust are to provide your employees with assurance that assets will be available, and that payment of the deferred compensation will be made when payment is due under the terms of the NQDC plan. The trust provides a degree of security for your employees' deferred compensation by holding the plan assets apart from the corporation. By segregating sufficient funds in a rabbi trust, you will avoid the possible financial strain of having to pay a large amount of deferred compensation whenever the payment is due, and at the same time, will obligate the trustee of the rabbi trust (who is normally independent of the employer) to pay the deferred compensation from the trust assets when payment is due under the terms of the NQDC plan.

Caution: Although the rabbi trust assets are held apart from the corporation's assets, the rabbi trust assets are still subject to claims of the corporation's creditors, and benefits may be lost in the event of the employer's insolvency or bankruptcy.

Tip: A rabbi trust can be in the form of either a revocable or irrevocable trust (or a revocable trust that becomes irrevocable upon the occurrence of a certain event, for example, a change in control of the employer). If a rabbi trust is irrevocable, the employer gives up the use of the NQDC plan assets and can't get them back until all benefit obligations under the plan are satisfied. The assets are there to provide the NQDC benefits to your employees, except in the case of either a bankruptcy or insolvency. If bankruptcy or insolvency occurs, rabbi trust assets become accessible to your general creditors.

How do you establish a rabbi trust?

You as settler or grantor establish a rabbi trust by entering into a trust agreement with a trustee (usually a bank or trust company). The trustee then holds the NQDC plan contributions and investment earnings.

Tip: A single rabbi trust can benefit more than one employee.

Why should you establish a rabbi trust?

A rabbi trust is a major step forward in providing benefit security for plan participants. An irrevocable rabbi trust, coupled with placement of sufficient assets into the trust, can largely eliminate the risk of nonpayment for every reason except your bankruptcy or insolvency. For employees who worry about nonpayment primarily by reason of a hostile takeover or a similar occurrence ("change in control"), or where the employer refuses to pay ("change of heart"), an irrevocable rabbi trust is an ideal device. If nonpayment as a result of your insolvency or bankruptcy is your employees' primary concern, however, you may consider formally funding your NQDC plan with a secular trust or secular annuity.

Model rabbi trust

The Internal Revenue Service (IRS) has created safe harbor language in the form of a model rabbi trust that demonstrates how to structure a trust in order to achieve tax deferral of NQDC benefits. This model trust contains certain language that must be adopted as is, as well as optional provisions and language that can be modified as long as the changes aren't inconsistent with the suggested model trust language. The IRS will not issue favorable rulings on any rabbi trust that doesn't conform to the model trust language. For more information on the model trust provisions, see Revenue Procedure 92-64.

Tip: The creation of the rabbi trust doesn't cause the plan to be considered "funded" for the purposes of the Employee Retirement Income Security Act of 1974 (ERISA).

Tip: You may wish to follow the model rabbi trust language in order to be sure that your trust arrangement will effectively defer taxation for your employees. What happens if you don't follow the model in setting up your rabbi trust? If challenged by the IRS, you may have to prove to the IRS that your plan is not funded for tax purposes. You can establish and operate a NQDC plan with a rabbi trust without applying for a favorable IRS ruling (this is common).

Tip: The model trust contains optional provisions that allow you to customize the trust to meet your and your employees' needs. For example, Revenue Procedure 92-64 permits "springing" rabbi trusts, that is, a rabbi trust that has little or no assets until a triggering event occurs (for example, a change in control of the employer).

Federal income tax treatment of rabbi trusts

Employee

The funds held in a properly designed rabbi trust are generally includable in the gross income of your employee when the NQDC plan benefits are paid to the employee.

Caution: However, the IRS may tax an employee on contributions made to a NQDC plan prior to the receipt of plan assets under the doctrine of constructive receipt (which requires taxation when funds are available to the employee without substantial restrictions), the economic benefit doctrine, or in the event the NQDC plan fails to meet the requirements of IRC section 409A. For more information, see Nonqualified Deferred Compensation Plans and IRC Section 409A (Governing NQDC Plans).

Employer

Because the rabbi trust is a grantor trust and you, the employer, are the grantor, the IRS treats you as the owner of the trust for tax purposes. As a result, you must include the rabbi trust income, deductions, and credits when you calculate your tax liability. Corporate-owned life insurance (COLI) is often used as a funding vehicle because cash values accumulate on a tax-deferred basis (unless the alternative minimum tax (AMT) rules apply), and upon your employee's death you receive the life insurance proceeds tax free.

You can deduct rabbi trust contributions in the year benefits under the plan and trust are includable in the gross income of your employees. Generally, this means that you will be able to take the deduction when your employee actually receives the NQDC plan benefits. Deductions are permitted only to the extent that such amounts constitute ordinary and necessary business expenses.

Tip: You can deduct the full amount paid to a participant (contributions plus investment earnings).

Risks and costs associated with rabbi trusts

There are risks and costs associated with rabbi trusts. The creation and maintenance of a rabbi trust often results in an increase in legal and administrative costs. You are subject to tax on the trust's investment income (corporate-owned life insurance is often used as a rabbi trust investment to avoid current taxation). In addition, if the trust is irrevocable, you won't have access to the trust assets, and you can't use the assets in the case of a corporate emergency or opportunity. Also, the trust assets aren't protected in the case of your insolvency or bankruptcy.

Internal Revenue Code (IRC Section 409A)

IRC Section 409A, enacted as part of the American Jobs Creation Act of 2004, contains new funding rules that apply to rabbi trusts. Under Section 409A, if a rabbi trust invests in offshore assets, or if the trust may become

funded as a result of a trigger based on the employer's financial health, then NQDC plan benefits are generally subject to federal income tax and penalties when they vest (i.e., when they are no longer subject to a substantial risk of forfeiture). Again, this may be prior to the time the employee is entitled to receive payments from the plan. If you maintain, or are considering adopting, a NQDC plan informally funded with a rabbi trust, you should consult a pension professional regarding the application of this important new law.

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