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FUNDING *insight*

Funding and Benefit Security Issues for Non-Qualified Deferred Compensation Plans

Events during the past two decades have increased executives' focus on the security of their non-qualified arrangements. This heightened awareness of benefit security comes at a time when companies, shareholders and the media are focused on proper disclosure and managing earnings costs and volatility. This combination of factors has led many companies to review and reconsider past decisions with respect to funding and securing non-qualified plans.

FORMAL AND INFORMAL FUNDING

The concept of funding non-qualified deferred compensation arrangements typically means "informal funding" rather than "formal" funding.

When a non-qualified plan is ***formally funded***, plan assets are set aside for the sole benefit of plan participants. As a result, participants are generally subjected to current income taxation based on the economic benefit doctrine. Depending on the structure of the funding, the plan may also be subject to substantial ERISA requirements (i.e., well beyond the more limited requirements applicable to unfunded "top hat" plans, as further discussed below).

In order to avoid these negative tax and ERISA consequences, non-qualified plans are generally only ***informally funded***, whereby assets can be segregated or "earmarked" to provide a source of financing for the plan, but remain assets of the company. While informal funding the plan does not create immediate income taxation for the participants, it also cannot alleviate benefit security risk entirely. To avoid the plan being considered formally funded, the assets must remain subject to the claims of the company's creditors in the event of corporate bankruptcy/insolvency. This will be discussed in further detail under the benefit security sections of this article.

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WHY CONSIDER INFORMAL FUNDING?

Companies today consider informally funding their non-qualified plan liabilities for a variety of reasons, most fundamentally to help:

Avoid the Social Security Syndrome – By their nature, non-qualified benefit plans have a cost to the sponsor company. If a company does not informally fund their benefit obligations, they have effectively pushed those costs downstream to future management.

Improve Benefit Security – Participants in non-qualified plans face numerous risks, including the risks of change in control, change of heart, change of management, or employer insolvency. Informally funding non-qualified liabilities and placing the assets inside of a security device like a rabbi trust is a way of reducing some, but not all, of the risks participants face.

Ensure the Availability of Cash – Recent surveys report that companies with all plan sizes recognize the need to earmark assets for future distribution. Companies enjoying financial success may also find that the right time to consider informal funding is in periods when cash is readily available versus when cash might be at a premium.

Mitigate Earnings Volatility – According to recent surveys almost all non-qualified deferred compensation plans provide participants with a range of market-based notional investment choices. The inclusion of these notional investments may provide the stimulus for employers to consider informally funding the liabilities with investments similar to the notional investments being offered to participants. In doing so, the employer can hedge the liability and reduce the potentially significant negative impact and volatility to the company's earnings that can result from market-driven changes to plan balances (and therefore the company's liability related to the plan).

Address Auditor Concern with Unfunded Liabilities – Companies may be encouraged by their auditors to eliminate or reduce unfunded liabilities on their balance sheets. For this reason, the informal funding of non-qualified benefit liabilities may be recommended by auditors as a means to accomplish this goal.

REASONS NOT TO FUND

There are a few reasons companies may choose not to informally fund non-qualified plan liabilities:

Company has High Hurdle Rate – The primary argument against informal funding is that the company can earn more on its money by reinvesting cash in operations than it can by setting it aside to meet non-qualified benefit liabilities. On the surface, this seems obvious. A company that would earn more through funding versus its own operations would be in serious trouble. An example of this approach would be an early stage high-tech company that needs current cash to sustain its growth, and thus chooses to temporarily defer informally funding non-qualified plan liabilities. However, the inevitable result of the decision to postpone informal funding is that the company passes on the cost of benefits to future management, and obligates them to find a way to pay for plan liabilities in the future.

Company has Underfunded Qualified Pension Obligations – If a company's qualified plans, such as a defined benefit pension plan, are underfunded, fully funding executive plans can be construed as self-serving by shareholders and analysts. Further, the Pension Protection Act of 2006 places restrictions on a company's ability to fund non-qualified plans (including informally funding obligations through a rabbi trust) if the qualified pension plan is underfunded.

PROVIDING BENEFIT SECURITY

As previously discussed, plan participants' non-qualified retirement benefits are at particular risk because of the requirement that non-qualified plans generally must remain unfunded to avoid current income taxation and additional ERISA obligations. Qualified plans require that the company adhere to the funding and other requirements found in ERISA, which are designed to provide basic protections to all plan participants. In contrast, non-qualified plans that are unfunded "top hat" arrangements (i.e., restrict participation to a select group of highly compensated or managerial employees) are exempt from many of the more burdensome ERISA requirements, such as the annual reporting requirements (e.g., Form 5500) and the funding requirements.

In order to avoid current taxation of benefits to participants, the plan must also remain unfunded, and any assets set aside as a source of financing for the plan liability must remain subject to the claims of the company's creditors in the event of bankruptcy or insolvency. The unfunded nature of the plan exposes the participant to potential risks arising from a change in control, change of heart, change in management, or employer bankruptcy or insolvency.

The situation becomes even more critical when one considers the limitations on qualified plan benefits facing highly paid executives. Put simply, the limitations on an executive's ability to accumulate retirement benefits via a qualified defined benefit pension plan or a voluntary 401(k) plan means that executives may need to rely on non-qualified plans to provide a significant portion of their retirement income. These plans are typically voluntary deferred compensation plans, and supplemental executive retirement plans, often known as "SERPs."

A well-designed security solution should attempt to address the risks faced by the participants. While there is no perfect solution that addresses all possible risks while still allowing for tax deferral and avoidance of the full ERISA requirements, there are ways to reduce some of the risks that participants may face.

RABBI TRUST - AN INTRODUCTION

As noted above, assets may not be formally set aside for the payment of specific plan participant benefits without the participants incurring current income taxation. This means that there will always be some non-payment risk associated with participation in non-qualified plans, as long as income tax deferral is being sought.

For the last few decades, there has been a virtual cottage industry of practitioners that have attempted to create the next great non-qualified deferred compensation security device that purports to protect plan participants against all risks, including bankruptcy. Most of those ideas eventually are either discredited or involve the significant trade-off of a loss of income tax deferral in exchange for the desired security.

The one method that has been shown to mitigate some level of participant risk without resulting in current income taxation is the rabbi trust.

RABBI TRUST - PROVEN PROTECTION

The rabbi trust is a grantor trust that segregates assets from the company for the protection and purpose of paying participant benefits. The concept originated with a Private Letter Ruling granted by the IRS in 1980 related to a congregation that wanted to offer some level of protection to deferred compensation promised to its rabbi, but without resulting in current income taxation to the rabbi.

Under a rabbi trust, the plan sponsor serves as the grantor for the trust and, accordingly, continues to be the owner of the trust assets for tax purposes. Assets are placed in a trust that is typically structured to be irrevocable, such that once contributed, the assets can only be utilized to pay plan benefits – with one key exception: *the assets contributed to the rabbi trust must remain available to the company's creditors in the event of a bankruptcy or insolvency*. This often leads to the contribution of assets to a rabbi trust being described as "informal funding." Exposure to the risk of bankruptcy/insolvency helps to ensure that the plan is not considered to be formally "funded" (which would have significant ERISA implications) and to prevent current income taxation.

A rabbi trust can ease security concerns related to a plan sponsor having a "change of heart" and refusing to pay a promised benefit and may be able to mitigate certain concerns related to a change in control, but it does not eliminate the risk associated with a corporate bankruptcy or insolvency. The tradeoff for this loss of security related to a bankruptcy/insolvency is that "informal funding" through the use of a rabbi trust does not lead to current income taxation, provided the rabbi trust is structured to follow requirements laid out by the IRS in the early 1990s.

A rabbi trust is the most common form of security protection according to all recent surveys on the subject.

Direct Ownership by Participant – The main alternatives to the rabbi trust are some form of direct ownership of assets by the executive, which is essentially a form of formal funding. The most common forms of direct ownership include the "secular" trust, executive-owned annuities, and executive-owned life insurance arrangements. All of these offer the advantage to the plan sponsor of providing an immediate tax deduction when funded, but each triggers immediate taxation of the benefit to the participant. In addition to the adverse tax consequences to the participant, some structures may also be subject to additional ERISA requirements beyond those applicable to an unfunded "top hat" arrangement.

AN EFFECTIVE SECURITY STRATEGY

An effective benefit security strategy includes a properly designed rabbi trust, a trustee who specializes in rabbi trusts and appropriate funding.

RABBI TRUST DESIGN

As noted above, the requirements for a rabbi trust were articulated by the IRS in the early 1990s. A "model rabbi trust" document was provided at that time (Revenue Procedure 92-64) and strict adherence to the model provides a safe harbor that the use of the trust will not result in income taxation for the participant prior to distribution. Based on the design options/alternatives provided by the model, and in certain instances the incorporation of additional features not discussed in the model, best practices for rabbi trusts have been developed over the last twenty years.

While the IRS model trust permits a rabbi trust to be structured as revocable (i.e., the plan sponsor may pull out the assets contributed as it desires), in order to provide a level of security to plan participants, rabbi trusts are typically irrevocable. As noted above, this would mean that, once contributed, assets could generally only be utilized to pay plan benefits (or creditors, in the event of a bankruptcy/insolvency).

One exception to the general irrevocability requirement that has developed into a common practice over time is to include a "reversion" provision. A reversion provision would permit the plan sponsor to request that the trustee distribute back to the sponsor excess trust assets, to the extent the trust's funding level significantly exceeds the plan's benefit liabilities. A reversion provision of this sort is typically structured to permit the plan sponsor to request that excess assets above, for example, 125% of the plan benefit obligations, revert back to the plan sponsor upon request. While this feature is not part of the IRS model trust, there has been relative comfort with the inclusion of this provision for quite some time (as noted above, the model does permit a rabbi trust to be completely revocable).

Another important provision to consider for an irrevocable rabbi trust is reimbursement. It may be preferable in certain instances for the plan sponsor to pay plan benefits to participants directly, rather than have the trustee process the distributions. In those instances, it will be important to ensure the trust document permits the plan sponsor to seek reimbursement for any plan benefits it has paid directly; typically, some evidence of payment of plan benefits is necessary to receive trust reimbursement.
This is another example of a feature that is not part of the IRS model trust, but has become commonplace.

Change in control implications are yet another area for consideration with regard to a rabbi trust. Certain trusts have been structured with a "no-fire" provision that prevents the removal of the trustee for some period of time following a change in control, thus preventing the acquirer from replacing a trustee with one that may be more favorable to its interests.

Similarly, certain trusts are structured so that if the trustee is removed or resigns within some period of time following a change in control, the departing trustee has the power to select the replacement trustee, thereby preventing new management from selecting a new trustee once a change in control is complete. A third trust design feature related to a change in control that is occasionally seen is a provision that places restrictions on amendments to the trust for a specified period of time following a change in control.

Some practitioners also recommend the inclusion of so-called "Moglia language." Based on a court case from 2003 (Bank of America v. Moglia [330 F.3d 942, 7th Cir. 2003]), the suggestion here is that, in certain circumstances, having the trust document state that the trust assets are only subject to the claims of general creditors can be beneficial to plan participants. The goal of this wording is to prevent the secured creditors of a company from having a claim against assets in the rabbi trust, without jeopardizing the income tax treatment of the plan or having the trust be considered "funded." It is not entirely clear whether the "Moglia language" would be successful in achieving this outcome under facts differing from those in the specific case or in another judicial circuit.

SELECTING A TRUSTEE

Selecting an experienced and effective trustee is a critical yet easily overlooked step in the process. Instead, a non-qualified plan sponsor might select a trustee on the basis of a banking or other pre-existing relationship. Given the unique nature of non-qualified plans and rabbi trusts, it is important that the selected trustee have direct experience in this area, and not just offer these services as an accommodation. It may be important to ask potential rabbi trustees about the number of non-qualified plans they provide services for and the company's experience in dealing with changes in control (and accompanying changes in the operation of the trust). If the plan sponsor is looking to incorporate trust features that deviate from the strict terms of the IRS model, it will be important to verify that the trust/trustee can accommodate the desired features.

APPROPRIATE INFORMAL FUNDING

A final consideration in creating an effective benefit security solution is the informal funding of the plan.

There are two components to the informal funding equation – enhancing the participant's security, and reducing the company's effective cost of providing the benefits.

From a participant perspective, informal funding helps instill confidence that the company has set money aside to meet what is really just a promise to pay at a future date. Studies show that informally funded plans generally enjoy greater participation than those plans that are unfunded.

From the company's perspective, informal funding is important to reduce the long-term costs of providing plan benefits. Non-qualified plans generate current P&L expense that can be hedged or offset through funding. In addition, they have long-term cash flow expenses that funding can mitigate.

Companies should consider establishing a written informal funding policy for their non-qualified plan(s). The informal funding policy should include a list of appropriate funding vehicles and the frequency and level to which liabilities will be informally funded. The policy should also spell out how often the funding of the trust will be reviewed.

SUMMARY

Non-qualified benefits are often an important component of executives' retirement planning, and it is incumbent upon employers to take the steps necessary to address the various risks inherent in these plans. Carefully combining a well-designed plan, a trustee experienced with non-qualified plans, a well-structured rabbi trust agreement, and appropriate informal funding, can help reduce some – but not all – of the risks and help make non-qualified plans more attractive for highly valued employees.

Mullin Barens Sanford has developed a plan audit process to review a client's benefit security and funding strategies, focusing on each of the issues discussed in this paper. We would be happy to discuss this in depth with you to ensure that your plans are accomplishing your organization's objectives.