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The Use of Rabbi Trusts in an Inflationary Economy

Based on, “Rabbi Trust: An Important Element of a Nonqualified Executive Benefit Plan during Times of Financial Stress” | Revised 2022

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Overview

The use of nonqualified executive benefit plans, particularly deferred compensation plans, can be a critically important component of an executive's total reward package. Nonqualified plans are widely used across corporate America, and various surveys show a prevalence rate between 85 and 95 percent, depending on the survey. The benefits to the executive who participates in a nonqualified plan are numerous.

Nonqualified deferred compensation plans (NQDC) offer a tremendous opportunity to increase the voluntary pre-tax deferral of compensation for retirement or short-term needs, such as saving for the college education of the plan participant's children. From the plan sponsor's perspective, nonqualified plans help retain, reward, and incentivize the valued members of their leadership team through the development of performance-based retirement incentives.

In a stable economy, senior Human Resource leaders typically use a nonqualified plan to ensure their management and leadership teams are focused on the values and corporate objectives at the core of a company's culture. The efficient funding of the plan to minimize the profit and loss (P&L) impact of offering the plan may be an issue that receives the attention of the CFO quarterly, semi-annually, or annually.

Through decades of experience, our team has observed that the security of the nonqualified plan often receives attention only when:

- A new plan is implemented
- Upon a prospective change in control
- In times of financial crisis

Why Plan Sponsors are Concerned Now

The security of nonqualified plans received significant attention following the 9/11 terrorist attacks and in the early months of the 2008 financial crisis. Although the full economic impact of the COVID-19 pandemic, the compromised supply chain, and our current inflationary economy is not known, plan sponsors understandably are once again concerned about the security of their nonqualified plans.

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This paper provides, in brief form, an overview of nonqualified plan benefit security issues that are important to review during financial or economic turmoil. In particular, the paper focuses on **rabbi trusts, which are the primary benefit security tools available to nonqualified plan sponsors.**

Rabbi Trusts

By design, nonqualified benefit plans will never have the benefit security provided to ERISA[1] qualified plans such as 401(k) plans. However, strategic tools, including rabbi trusts, are available to plan sponsors to protect nonqualified plan participants following a change in control or change of heart, which is the employer's unwillingness to pay benefits before a bankruptcy proceeding.
A rabbi trust cannot protect plan participants if the plan sponsor becomes insolvent or enters into bankruptcy proceedings. However, rabbi trusts are an effective tool to hedge the nonqualified executive benefit plan's liabilities and protect these assets from all events other than insolvency or bankruptcy.

All rabbi trusts must be compliant with IRS Revenue Procedure 92-64, but a well-drafted rabbi trust will go beyond this document with valuable features for the plan sponsors while still being compliant with Revenue Procedure 92-64. These features may also tie specifically to the plan document and decisions offered to plan participants at the time of enrollment into the nonqualified plan.

Plan sponsors should review their trust agreements to ensure they will meet their post-change of control requirements and, at the same time, provide adequate protection to the plan participants.

Specific features for consideration include the following:

- Mandatory Funding upon a Change in Control. Full funding of a trust equal to the plan liabilities should also be a trust agreement requirement. Full funding should be mandated to occur 30 days before the change in control. Additionally, trust funding at 110 percent of plan liabilities is common to provide for trust administrative and legal expenses, should any arise.

- Post Change in Control Trust Administration and Benefit Entitlement Decisions. Decisions concerning the administration of the trust, benefit entitlements, and investments should be made by an individual or group independent of the acquiring company (NewCo). The trustee mustn't

1 The Employee Retirement Income Security Act of 1974 (ERISA). More information: https://www.dol.gov/general/topic/health-plans/erisa

be unduly influenced by NewCo or coerced to change investments or move assets from the trust, which could hurt plan participants whose benefits are dependent on the trust. This change in control function should be included in the trust agreement, with responsibility going to an independent third-party fiduciary or to a group such as a committee responsible for overseeing the plan and trust before the change in control.

- Termination of the Trust. The trust agreement should not provide for post-change in control termination of the trust without written approval from a majority or two-thirds of the participants. NewCo may want to merge trusts following a change in control which could be allowed. Still, the assets of the acquired trust should be held in a separate trust sub-account with protections maintained for trust administration and benefit entitlement decisions as described above.

> While the best rabbi trust agreement will never provide complete security of a nonqualified plan account in the event of an employer's insolvency, a well-designed trust agreement can provide significant protection in the event of a change of heart, change in management, or change in control.

Other Key Components of Rabbi Trusts

Several other important features are commonly found in well-crafted trust agreements. Our executive benefits specialists are experienced in benefit security issues for nonqualified plans. We can assist in reviewing your current trust agreement to help ensure it will maximize benefit security for your plan participants, given the constraints of IRS regulations. Additionally, we can review the assets held in the trust to help ensure the performance of the assets is effectively matching the liabilities of the plan and mitigating to the maximum extent possible the P&L cost of maintaining the plan for the company's most valuable employees.

Finally, as stated above, the long-term impact of the COVID-19 pandemic on the nation's economy cannot be predicted. Before this crisis, corporations across America benefited from one of the longest bull markets in U.S. history, and until recently, balance sheets reflected the strength of the economy.

Whether corporate balance sheets weather the current economy or reflect its impact, questions will arise about IRS requirements to terminate a nonqualified benefit plan and distribute account

balances to plan participants. Ultimately, very few plan sponsors will take any action in this regard. Given that the question of terminating the plan will undoubtedly arise let's review the regulations for termination of a nonqualified plan.

Two primary events allow for the termination of a nonqualified plan:

- Upon the Occurrence of a Change in Control Event. A plan sponsor can terminate and liquidate a nonqualified plan within 30 days before or within 12 months following a change in control event.
- Termination of all Arrangements of the Same Type. A plan sponsor may terminate a plan provided that:

    i. The termination or liquidation does not occur proximate to a downturn in the financial health of the plan sponsor,

    ii. All nonqualified deferred compensation arrangements that are similar in type (i.e., elective account balance plans) are terminated concerning all participants,

    iii. No payments are made in the first 12 months following the decision to terminate the plan other than payments called for under the terms of the plan document,

    iv. All payments are made within 24 months of the decision to terminate the plan, and,

    v. The employer does not adopt a new plan for three years following the date of the termination.

For all your concerns or questions, the team at Fulcrum Partners, a OneDigital Company, is available to provide further clarity for your nonqualified plans and associated trust agreements.

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