Rabbi Trust

A Rabbi Trust is the most commonly used vehicle to set assets aside to informally finance nonqualified plan liabilities.

Background

A Rabbi Trust is a trust established by an employer to provide a source of funds which may be used to satisfy the employer's obligation to executives under a nonqualified benefit plan. The trust is referred to as a Rabbi Trust because the first IRS letter ruling with respect to this type of trust involved a rabbi whose congregation had made contributions to such a trust for his benefit. The ruling stated that the rabbi would not be taxed on the funds in the trust until the funds were distributed to the rabbi (or his beneficiary) upon his death, disability, retirement, or termination of employment.

Implementation

Typically, the Rabbi Trust is set up as an irrevocable trust - the employer must give up all rights to the assets and may not terminate the trust. The trust is also usually considered a grantor trust, with income being taxed to the grantor or employer.

The main purpose of establishing a Rabbi Trust is to offer some level of security to the employee with respect to their nonqualified benefits. This is especially true for a Nonqualified Deferral Plan, where the employee defers compensation with only a contractual promise of the employer to pay the benefits. Employee deferrals will be placed in the trust as deferrals are made. In the event a "locked" Rabbi Trust is established, once funds are placed in the trust, they may not revert to the employer until all benefit obligations are fully discharged. Trust assets must be used to pay benefits under the plan. An "unlocked" Rabbi Trust allows the corporation to access asset values as it sees fit.

How much security is provided?

A key feature of a Rabbi Trust is that the assets must be subject to the claims of the employer's creditors at all times. If the employer becomes insolvent, all trust assets become available to the employer's creditors, including Nonqualified Deferral Plan participants. In other words, if insolvency or bankruptcy occurs, the plan participants stand in line with other employer creditors. So the security given is protection against:

Change of heart– The employer cannot access assets in the trust, once committed.

Change of control– An unfriendly takeover will not affect the assets in the trust. Rabbi Trusts are frequently written with a trigger that requires full funding of designated nonqualified benefit programs upon a change of control, as defined within the document. This mechanism protects participating executives from a change of heart due to a hostile takeover, for example.

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