



Rabbi Trusts May Need Amendment to Avoid Code Section 409A Trap

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Companies maintaining so-called "rabbi trusts" to fund deferred compensation should consider amending the trust to avoid a Code Section 409A violation arising if the funding level of the company's qualified defined benefit plan falls below 80%.

After it was enacted, Code Section 409A(b) was amended to penalize executives in companies that fund rabbi trusts after the company's qualified defined benefit plan becomes "at risk." A defined benefit plan is "at risk" for this purpose if plan funding falls below 80% of the adjusted funding target attainment percentage ("AFTAP").

SERPs affected. Code Section 409A(b) provides that any contributions added to a rabbi trust when the qualified defined benefit plan is "at risk" must be treated as contributions to a taxable trust with respect to current and former Code Section 162(m) executives. If the rabbi trust funds a SERP or other defined benefit-type arrangement, taxable trust assets will be allocated to participants according to actuarial principles under the "secular trust" rules of Code Section 402(b). This means that if qualified plan funding drops below 80% and Code Section 409A(b) kicks in, a portion of any new contributions to the rabbi trust will be allocated to current and former Code Section 162(m) executives and treated as taxable to them. An allocation of even one dollar of these new taxable contributions would be treated as an accelerated distribution under Code Section 409A, causing tax and penalties under Code Section 409A on the present value of the entire SERP benefit of affected executives (and not just the funded piece).

DC-type plans also may be affected. These same results may arise in a nonqualified defined contribution-type plan, such as a 401(k) wraparound plan. Participants may think that their contributions are



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allocable to separate accounts, but this separate accounting is not always provided in the trust instruments, books and records. In this case, the same allocation principles may apply to contributions, with resulting 409A taxation and penalties for the account balances of affected executives.

Recommended amendment. To prevent harsh Code Section 409A results, the rabbi trust can be amended to provide that no contributions made when the qualified defined benefit plan is "at risk" can be used to fund the deferred compensation benefits of present or former Code Section 162(m) executives. An amendment walling off new contributions for these participants will protect against a Code Section 409A failure, while still allowing the rabbi trust assets that were accumulated before "at risk" status to be used to fund the benefits of the restricted participants. It is a good idea to check the underlying plan documents as well, in case any conforming amendments governing plan funding may be needed.

FOR MORE INFORMATION

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