WASHINGTON REPORT

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AALU Bulletin No: 08-109 December 10, 2008

Subject: "Funding" Rabbi Trusts -- Impact of the Financial Crisis

Major References: ***Code Sections 409A(b)(3), 430(i) and 436***

Prior AALU Washington Reports: *06-99*

MDRT Information Retrieval Index Nos.: *7400.00*

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Section 409A(b)(3) of the Internal Revenue Code, added by the Pension Protection Act of 2006 (see our Bulletin No. 06-99), imposes restrictions on "funding" rabbi trusts that provide deferred compensation benefits when the employer has a qualified defined benefit pension plan that is considered to be "at-risk." With the tremendous drop in asset values in recent months, many employers with defined benefit pension plans that were not previously at-risk are now facing the possibility that their plans may fall into that category. In addition to the numerous problems that this creates for the pension plan, it may also trigger a freeze on funding the nonqualified deferred compensation plan. Given this possibility, this Bulletin addresses whether employers should consider transferring assets to their rabbi trusts before the end of this year.

Overview of Nonqualified Plan Funding Restrictions

In general, during any "restricted period" (discussed below), if an employer (or a member of the controlled group that includes the employer) maintains both a qualified defined benefit pension plan and a nonqualified deferred compensation arrangement, the ability of the employer to set aside or transfer funds to rabbi trusts or "other arrangements" to fund the nonqualified plan will be restricted. Any such set-aside

or transfer to such a trust for the nonqualified plan during this restricted period will trigger adverse taxation to certain executives covered by the plan.

For purposes of these rules, the term "restricted period" (i.e., the period during which these restrictions apply) covers any of three periods:

1. the time when the qualified defined benefit plan sponsor is a debtor in bankruptcy;

2. six months before or after the date that an underfunded defined benefit plan is terminated; or

3. any period during which a qualified defined benefit plan is "at-risk." under section 430(i).

At-Risk Rules

A qualified defined benefit plan will be at-risk for a particular plan year if, for the preceding plan year, its assets were both (i) less than 80% of its funding target (subject to phase-ins) using its actuarial assumptions and (ii) less than 70% of its funding target using certain special actuarial assumptions.

For purposes of the 80% threshold, there is a transition rule which provides that the applicable funding threshold for determining at-risk status is 65% for 2008, 70% for 2009 and 75% for 2010.

The funding percentage (referred to as the funding target attainment percentage, or FTAP) for a plan year is the ratio, expressed as a percentage, that the value of the plan's assets (reduced by any credit balance carryovers from prior years) bears to the plan's funding target for the year. A plan's funding target for a plan year is the present value of all benefits accrued or earned under the plan as of the beginning of the plan year. The funding percentage, or FTAP, is generally determined by the qualified plan's actuary as of the beginning of a plan year.

Small Plan Exception

The at-risk rules generally do not apply to small qualified plans, which are defined as qualified plans that, on each day during the preceding plan year, have 500 or fewer participants. For purposes of this exception, all qualified defined benefit plans (other than multiemployer plans) maintained by the same employer (or any member of the employer's controlled group) will be treated as 1 plan. Thus, based on the language of the new rules, a qualified plan that qualifies as a small plan for a particular plan year should not be considered to be at-risk for purposes of the nonqualified plan funding restrictions for that plan year. However, guidance under these new rules has not yet been issued and none is expected in the near future. Until such guidance is issued, employers will have to operate under a reasonable, good faith interpretation of the statutory provisions and legislative history (which is minimal).

Covered Employees

The funding restrictions apply to any "applicable covered employee." This term means an individual described in section 162(m)(3) or an individual subject to the requirements of section 16(a) of the Securities Exchange Act of 1934. Under section 162(m)(3), the term "covered employee" applies to the chief executive officer (or an individual acting in that capacity) or to an employee whose total compensation is required to be reported to shareholders under the Securities Exchange Act of 1934 by reason of the employee being among the four highest compensated officers for the taxable year (not counting the CEO).

These definitions raise an interesting question. Since the definitions refer to employees to whom the Securities Exchange Act of 1934 applies (other than the reference to the chief executive officer), read literally, this would suggest that the funding restrictions would apply to the CEO, but would only apply to other employees if the company is a publicly traded company subject to the Securities Exchange Act of 1934. (Generally, only public companies are subject to the Securities Exchange Act of 1934).

Although guidance has not yet been issued and none is expected in the near future, AALU counsel understands that, at least until guidance is issued by the IRS, this more narrow reading of these definitions is likely to be considered reasonable by the IRS. As such, these provisions may currently only apply to the CEO unless the company is publicly traded.

Nonqualified Plan Funding Restrictions

The nonqualified plan funding restrictions restrict assets being "set aside or reserved (directly or indirectly) in a trust (or other arrangement as determined by the Secretary) or transferred to such trust or other arrangement" in order to pay nonqualified deferred compensation. These restrictions also apply if a nonqualified deferred compensation plan provides that assets will become restricted to the provision of benefits under the plan in connection with the restricted period with respect to the qualified defined benefit plan or if the assets are, in fact, so restricted. Although no guidance has been issued under this provision and none is expected in the near future, from the wording of the statute and its legislative history, the new rules would appear to effectively freeze the nonqualified plan funding with respect to the covered employees from the time at which the employer's qualified defined benefit plan (or the qualified defined benefit plan of any member of the controlled group that includes the employer) becomes at-risk, as discussed above.

If a transfer is made to a rabbi trust or other funding vehicle during this restricted period, then the amounts transferred are treated as a transfer of property under section 83 (regardless of whether the amounts are available to satisfy the claims of general creditors) and therefore would be subject to taxation (if vested). The amounts so included would also be subject to an additional 20% tax and interest at the IRS underpayment rate plus one percent from the date of the initial deferral or vesting under section 409A. Furthermore, any tax gross-up payments to the executive to ameliorate these adverse tax consequences would also be subject to the same adverse tax treatment (i.e., immediate income inclusion, additional 20% tax and interest at an increased rate). Any such payments would also be nondeductible by the employer.

Impact of Financial Crisis

For companies that maintain (somewhere in their controlled group) a qualified defined benefit plan whose assets have declined sharply this year and that also maintain nonqualified deferred compensation plans for their CEO or other executives, the potential impact of these restrictions should be carefully considered. Because the nonqualified funding restrictions only apply during the restricted period, if the company anticipates that as of January 1, 2009, the assets in its defined benefit plan may cause the funding percentage to be 70% or less, consideration should be given to whether the company wishes to set aside money in a rabbi trust or other similar arrangement for the covered executives in order to avoid the impact of these restrictions, and if so, when does the company need to make that transfer.

Planning Considerations

The answer to this question is complex, especially in light of the absence of any definitive guidance in this area. A number of companies are considering transferring assets to rabbi trusts before the end of 2008 with the intention of avoiding these restrictions. However, based on the wording of the statutory language, such accelerated rabbi trust funding may not be necessary until the end of 2009 because of the one-year lag in determining at-risk status under the new rules.

A qualified plan generally is considered at-risk for a plan year only if the funding percentages for the preceding plan year fall below the applicable thresholds (i.e., 70% in 2009). In addition, the funding percentages generally are determined as of the beginning of a plan year. Thus, if a qualified plan was not at-risk as of January 1, 2008, the at-risk funding restrictions would not apply for the 2009 plan year. If, because of the significant decline in the stock market in 2008, the qualified plan becomes at risk as of January 1, 2009, the qualified plan would be considered at risk beginning with the 2010 plan year and the at-risk funding restrictions would not apply to the nonqualified plan until the beginning of the 2010 plan year.

A second factor to be considered is the exemption for small plans. If the employer’s qualified defined benefit plan (as aggregated with any other qualified pension plan within the employer's controlled group) covers fewer than 500 participants, the employer should not be subject to the at-risk rules at all. If that is the case, the language of the new rules indicates that the at-risk funding restrictions should also not apply.

A third factor to be considered is the fact that the restrictions only apply to transfers or set-asides to a trust or other similar arrangement. The funding restrictions do not appear to restrict accruals of nonqualified benefits -- only set-asides and transfers (or plan provisions that restrict benefits). Thus, it would appear that the employer could continue to accrue benefits under the nonqualified plan, even if the qualified plan is at-risk, although it could not “fund” those benefits with respect to covered employees. It should be kept in mind, however, that the exact meaning of the terms “set aside,” “transfer” and “other arrangement” have not been defined at this point and may not be defined by IRS guidance for another year or two (at the very least). Consequently, any action based on an interpretation of these provisions needs to be carefully weighed given the numerous uncertainties outlined above.

Because the applicability of the at-risk funding restrictions depends on the qualified plan's funding status, companies that may be subject to the funding restrictions should discuss the qualified plan's current funding status and future funding strategies with the qualified plan's actuary before the beginning of 2009.

Qualified Plan Benefit Restrictions Contrasted With At-Risk Rules

Under a separate but related series of rules in section 436, a qualified plan that is substantially underfunded (generally 60% or less) will be subjected to various restrictions on the benefits it can provide. These can include a prohibition against any increases in benefits and a prohibition against lump sums and other accelerated payments from the qualified plan. The rules in section 436, however, are separate from the at-risk rules in section 430 and the applicable percentages for determining a qualified plan’s funding deficiencies and measurement period are different. To illustrate, a qualified plan can be at-risk under section 430 (for example, because its FTAP is below 70%) but not be subject to the benefit restrictions in section 436 because its funding percentage is not as low as required under that section (generally 60%).

In addition, sections 430 and 436 differ concerning when the restrictions apply. For purposes of the benefit restrictions in section 436, the funding percentages are determined on a current plan year basis based on the assets at the beginning of that plan year. By contrast, from the wording of section 430(i), at-

risk status is determined on the basis of a one-year lag; that is, a defined benefit plan will be at-risk in a particular plan year if for the preceding plan year its funding percentage fell below the applicable threshold. For example, if a qualified plan were 90% funded on January 1, 2008 and 68% funded on January 1, 2009 (due to the recent market decline), it appears that the qualified plan would not be at-risk under section 430(i) until 2010 even though some of the benefit restrictions in section 436 might apply to the qualified plan in 2009.

A company that is anticipating a significant reduction in its qualified pension plan's funded status as of January 1, 2009 because of the financial crisis may also want to consider whether it should make additional contributions to the qualified plan in order to avoid at-risk status under section 430 for the 2010 plan year and/or to avoid the benefit restrictions under section 436 for the 2009 plan year. Such companies should discuss the funding strategies with their plan actuaries before the beginning of 2009.

Any AALU member who wishes to obtain a copy of Internal Revenue Code sections 409A(b)(3), 430(i) and 436 may do so through the following means: (1) use hyperlink above next to "Major References," (2) log onto the AALU website at www.aalu.org and enter the *Member Portal* with your social security number and select *Current Washington Report* for linkage to source material or (3) email Ray Harmon at harmon@aalu.org and include a reference to this *Washington Report*.

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