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Renewed Interest in Secular Trusts?

Some of our clients have recently brought to our attention renewed efforts promoting so-called "secular trusts" to fund executive nonqualified benefits and compensation. The use of secular trusts is now being endorsed as a way to avoid complexities associated with compliance with Internal Revenue Code Section 409A.

What Is a Secular Trust?

A secular trust is a device that has been around now for a couple of decades for funding nonqualified deferred compensation arrangements. The secular trust is sometimes described as the ultimate security device in that the trust's assets are set aside for the exclusive benefit of executives and beyond the reach of the employer's creditors. The assets of other commonly used funding vehicles for nonqualified arrangements, such as "rabbi trusts," must ultimately be subject to the reach of the employer's creditors in the event of bankruptcy or insolvency in order to avoid undesirable consequences under the tax laws and ERISA.

The cost to the executive of this additional security with a secular trust is that he or she is taxed currently on the assets in the trust set aside for his or her benefit once the benefits vest, thereby foregoing a principal advantage of nonqualified deferred compensation (*i.e.*, tax deferral).

What Are Possible Advantages of a Secular Trust?

Advocates of secular trusts suggest advantages that include:

- increased benefit security (*e.g.*, with respect to employers who may become unable or unwilling to pay promised benefits);
- avoidance of complexities of compliance with Code Section 409A;
- the application of potentially lower marginal income tax rates on the compensation (since marginal U.S. income tax rates are currently low from a historical perspective);
- an accelerated tax deduction for the employer; and
- the opportunity to purchase life insurance products with preferred group pricing and policy structure (since secular trusts are often promoted in conjunction with the sale of insurance).

Prevalence of Secular Trusts

There are surveys indicating an increased prevalence of secular trusts. We suspect that this may be largely the result of promotion of these trusts by insurance brokers.

While a properly designed secular trust may put nonqualified deferred compensation or retirement benefits beyond the reach of the employer's creditors, from the employee's point of view, it may be no better than simply receiving immediate cash compensation. The use of a secular trust also presents a number of hurdles that must be carefully negotiated in order to achieve desired results.

VCG Consultants

A Benefits Consulting Firm affiliated with Mazursky Constantine LLC

Is There More to This Story - What Are the Disadvantages?

Complexities and potential disadvantages with secular trusts include:

- financial projections for funding with secular trusts generally illustrate that the executive would receive smaller benefits at distribution (after-taxes) than he or she would under a traditional unfunded arrangement;
- possible double taxation of the earnings on the assets in the trust;
- whether the arrangement is (or should be) adopted by the employer or by the employee;
- possible adverse tax consequences under Section 409A if existing deferred compensation is funded through a secular trust;
- the potential application of ERISA to the arrangement;
- employment taxation (FICA/FUTA) of the arrangement; and
- proxy disclosure and shareholder relations implications.

Even with efforts to maneuver through these various issues, at the end of the day, an employer may end up with an arrangement that practically is no different from simply having paid the executive immediate cash compensation.

What Should Employers Who Are Considering Additional Funding or Security for Their Nonqualified Plans for Executives Do?

Although secular trusts continue to generate some interest, they are not for everyone. They eliminate many of the advantages of traditional nonqualified deferred compensation and retirement arrangements and involve traps for the unwary. Considerable care and expertise is required in structuring such an arrangement.

If you are considering providing additional benefit security or funding for your nonqualified deferred compensation and retirement arrangements, including the possibility of adoption of a secular trust, we are available to discuss those issues and implications with you.

Contact Information. For additional information or for questions relating to secular trusts or other funding/security arrangements for nonqualified plans, please contact Don Mazursky (404.888.8840), Glenn Infinger (404.888.8845) or David Putnal (404.888.8836).