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Secular Trusts and Annuities

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What is it?

A secular trust is an irrevocable trust that you establish with a third party to hold assets for the exclusive purpose of funding your employees' nonqualified deferred compensation (NQDC) plan benefits. A significant feature of the secular trust is that participants generally have a nonforfeitable and exclusive right to the contributions made to the trust and to the earnings on those contributions. This stands in contrast to the rabbi trust, where trust assets remain subject to the claims of your general creditors.

Tip: Although you establish the secular trust for the benefit of your employees, your participating employees may be treated as if they established the trust for tax purposes. This is usually referred to as an "employee secular trust." While it is possible to have an "employer secular trust," these are rarely used because they have several undesirable tax consequences (discussed later in this article).

Caution: Because NQDC plans that use secular trusts are generally considered funded for tax and Employee Retirement Income Security Act of 1974 (ERISA) purposes, secular trusts are seldom used as funding mechanisms for NQDC plans. One of the main reasons is simply that most employers who set up NQDC plans for their employees wish to avoid strict ERISA requirements, while providing the benefit of tax deferral. Generally, this is only possible with an unfunded NQDC plan. However, where benefit security is the primary concern, a secular trust may be an appropriate funding vehicle for a NQDC plan. Also, a NQDC plan funded with a secular trust can cover a broader range of employees than an unfunded NQDC plan (where coverage is limited to the "top-hat" group).

Types of secular trusts

Employee secular trust

An employee secular trust arrangement allows an employee to choose to receive cash compensation or make contributions to an irrevocable trust that you establish for the exclusive benefit of the employee. Contributions are fully vested. Whether the plan and trust are subject to ERISA may depend on the plan design. If the plan is subject to ERISA, then the plan assets should be outside the reach of your general creditors, and should be protected in the event of either your bankruptcy or the participant's bankruptcy. If the plan is not subject to ERISA, then whether the assets are protected from the claims of your general creditors may be a matter of state law. You should consult a qualified expert before adopting one of these arrangements.

Employer secular trust

In this arrangement, you also make contributions to an irrevocable trust for the exclusive benefit of your employees. However, unlike the employee secular trust, the employee is not given the option to receive cash instead. For this reason, you are considered the settler and owner of the trust. Even though you establish the trust, the Internal Revenue Service (IRS) has ruled that the trust is a separate taxable entity. This means that trust earnings might be taxed twice, first at the trust level, and again when benefits are distributed to your employees. In addition, your employees are taxed on your contributions as they vest, and your highly compensated employees are taxed annually on the increase in their vested earnings, even if the increase is a result of unrealized gains, insurance contract cash value increases, or tax-exempt investments. These adverse tax consequences make employer secular trusts unattractive as a NQDC plan funding vehicle in most cases.

Caution: Although the IRS has issued rulings on secular trusts used to fund NQDC plans, it has not issued a model secular trust similar to the one set forth for rabbi trusts.

Secular annuity

A secular annuity may be used in lieu of a secular trust, or in conjunction with a secular trust. A secular annuity is an annuity you purchase in the name of the plan participant that is either a stand-alone benefit, or that secures the benefit promised under a related NQDC plan. While there are a number of variations, typically your employee owns and controls the annuity contract, and you must rely on the premature withdrawal tax and the policy surrender charges to deter the employee from surrendering the contract for its cash value. If you want more control over when your employee receives the annuity proceeds, you could consider placing the secular annuity inside a secular trust. By doing this, your employee would generally not be entitled to distributions until the time specified in the plan and trust documents.

A secular annuity creates a funded plan for tax and ERISA purposes. The use of a secular annuity places the NQDC plan assets beyond the reach of your creditors and provides full security to your employees that the NQDC plan benefits will be paid (subject to the solvency of the insurer).

Why would you want to establish a secular trust?

Assurance to employees

A secular trust can provide your employees with the assurance that their NQDC plan benefits will not be at risk as a result of your refusal (due to a change of heart or change in control) or inability (due to a change in financial condition) to pay the benefits at a future time. Unlike assets that are held within a rabbi trust, secular trust assets aren't subject to your creditors' claims. The secular trust assets must be used for the exclusive purpose of paying benefits due under the NQDC plan.

Caution: It isn't clear whether an employee secular trust is subject to ERISA. If it is not, then whether plan assets are protected in the event of your insolvency or bankruptcy may depend on state law.

Readily available cash flow

A secular trust allows you to match assets to your NQDC plan liabilities, providing you with the assurance that funds are available for distribution to participants when due from the plan. This can alleviate any fear you may have of not having a readily available cash source for plan distributions.

More flexible coverage

While you must limit participation in an unfunded NQDC plan to a select group of management or highly compensated employees (i.e., a top-hat group), this rule does not apply to funded NQDC plans. So a funded plan may be appropriate where you want to provide additional benefits to an employee who would not qualify to participate in your unfunded NQDC plan.

Disadvantages of a secular trust

Tax concerns

If your NQDC plan is funded with an employee secular trust, your employees are subject to federal income tax each year on your contributions to the trust (and trust earnings). If your NQDC plan is funded with an employer secular trust, your employees are generally subject to federal income tax in the year your contributions vest (see discussion below). Unfortunately, the employee doesn't receive the cash to pay the tax on that money until benefit payments commence. However, you can pay your employee a cash bonus, or your employee can receive a distribution from the trust, in order to pay the taxes.

ERISA requirements

Because NQDC plans that use employer secular trusts are funded, they're subject to the same ERISA requirements usually applicable to qualified plans, including those that pertain to reporting and disclosure, participation, vesting, funding, and fiduciary obligations. It isn't clear if ERISA applies to NQDC plans funded with employee secular trusts. This is because ERISA applies only to plans established or maintained by an employer (or employee organization), and employee secular trusts are deemed to be owned by participating employees for tax purposes.

Caution: Excess benefit plans are subject to special rules. A funded excess benefit plan is exempt from ERISA's participation, vesting, and funding requirements. Also, church plans and governmental retirement plans, and plans maintained exclusively for non-employees (for example, company directors) are generally not subject to ERISA.

Federal income tax treatment of secular trusts

Employee

- **Employee secular trust--** If your NQDC plan is funded with an employee secular trust, your employee must include your contributions in gross income each year as they are made. Since your employee is considered the owner of the trust, he or she must also include any taxable trust earnings in gross income each year. Distributions from a NQDC plan funded with an employee secular trust are generally free from federal income tax.
- **Employer secular trust--** If your NQDC plan is funded with an employer secular trust, the taxation is more complicated. In general, if your employee's benefit hasn't yet vested, your contributions will have no current tax impact. However, when the benefit vests, your employee must include the entire value of his or her interest in the trust (your contributions plus any earnings) in gross income at that time. Your non-highly compensated employees must include any additional vested contributions in gross income as you make them, but any additional earnings generally aren't subject to income tax until they are distributed. Similarly, your highly compensated employees (for 2008, generally 5 percent owners and those employees who earned more than \$100,000 in 2007) must include any additional vested contributions in gross income as you make them, but they are also taxed annually on any increase in their vested earnings, even if the increase is a result of unrealized gains, insurance contract cash value increases, or tax-exempt investments.
- **Secular Annuity--** If your NQDC plan is funded with a secular annuity, your employee must generally include the entire value of the annuity in gross income at the time the benefit becomes vested. Any additional premium payments you make will be subject to income tax as they are made, but additional earnings generally won't be subject to tax until paid.

Tip: Thus, in the case of a secular trust or secular annuity, your employee may be taxed on contributions to the plan, and investment earnings, prior to the actual receipt of the plan funds. If desired, you can pay your employee a bonus to cover his or her tax liability, or the plan can provide for a distribution from the trust so that your employee can pay the taxes.

Caution: Distributions from a NQDC plan funded with an employer secular trust or secular annuity may be subject to a 10 percent early distribution penalty if made before your employee reaches age 59½, unless an exception applies.

Employer

In general, you are entitled to a tax deduction in the taxable year your contribution is included in your employee's gross income. This means that you are entitled to the deduction in the year you make your contributions to the plan, or if later, the date your employee becomes vested in those contributions. You are generally not entitled to a deduction for any earnings on your contributions to a funded plan.

Tip: In order for you to be able to receive a deduction for contributions to a NQDC plan funded with an employer secular trust, you must maintain separate accounts for each employee when more than one employee participates. It is not clear if this rule also applies to a NQDC plan funded with an employee secular trust.

Tip: Further, a deduction is permitted only to the extent that the contribution or payment is both reasonable in amount and an ordinary and necessary expense incurred in carrying on a trade or business.

Caution: Publicly-held companies can't deduct total compensation in excess of one million dollars in any one year for certain executives.

The secular trust

An employer secular trust is treated as a separate taxable entity, and is subject to current income taxes on its investment income. This leads to the potential for double taxation of trust earnings, first at the trust level, and again when benefits are distributed to participants. This is in contrast to an employee secular trust, where trust earnings are taxed solely to the employee (the trust is not a separate taxable entity). Often, an employer secular trust will invest in life insurance or tax-exempt bonds in order to avoid the double taxation problem.

Tip: The treatment of a secular trust and the employees having a beneficial interest in the trust is highly complex and should be reviewed by qualified experts.

Internal Revenue Code (IRC) Section 409A

IRC Section 409A, enacted as part of the American Jobs Creation Act of 2004, contains election, distribution, and funding rules that apply to certain NQDC plans. These new rules generally apply to compensation deferred after December 31, 2004 (although compensation deferred earlier is also covered in some cases). The IRS has indicated, in Notice 2005-1 and in proposed regulations, that NQDC plans funded with employer secular trusts are not subject to Section 409A. It seems likely that plans funded with employee secular trusts should also be exempt from Section 409A, but this is not entirely clear, and further guidance is expected from the Service. You should consult your pension professional regarding the potential impact of Section 409A before adopting any NQDC plan. For additional information, see Internal Revenue Code Section 409A.

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