MAYER • BROWN

ERISA, EMPLOYEE BENEFITS & EXECUTIVE COMPENSATION UPDATE

Limit on Rabbi Trust Contributions Resulting from Asset Depreciation in Single-Employer Defined Benefit Plans

December 9, 2008

Recent drops in the value of assets for qualified defined benefit pension plans may effectively preclude employers from making any contributions in coming years to a rabbi trust or similar arrangement used to set aside amounts for nonqualified deferred compensation plan benefits.

Many companies maintain rabbi trusts to pay benefits under nonqualified deferred compensation plans. Assets in a rabbi trust must be subject to the claims of the company's creditors upon an insolvency of the company. A rabbi trust sometimes provides that the decision to make contributions is within the discretion of the company. A rabbi trust may also require the company to make contributions, although contributions may be required only in certain specified circumstances, such as upon a change in control.

Tax code section 409A(b) provides that if a contribution is made by a company to a rabbi trust or other similar arrangement during a period in which a single-employer defined benefit plan of the company or a member of the company's controlled group is in a "restricted period" (as described below), the company's named executive officers, and other executive officers and directors subject to section 16(a) reporting under the Securities Exchange Act of 1934 (sometimes referred to as "insiders"), will recognize income to the extent the contributed assets are for the benefit of such officer. The above-described limitation on contributions does not apply to contributions made prior to a restricted period. (The rules also require accelerated income recognition if amounts that were previously set aside in the trust become restricted to the provision of benefits in connection with a restricted period. Discussion of these provisions is beyond the scope of this Client Alert.)

The above-described limitation applies to contributions made on a mandatory or on a discretionary basis. It applies to contributions to rabbi trusts used to fund nonqualified defined contribution plans and nonqualified defined benefit plans, as well as contributions to rabbi trusts used to fund deferred compensation benefits under individual arrangements such as employment agreements.

A restricted period with respect to a single-employer defined benefit plan is any period during which the plan sponsor is in bankruptcy, the period extending six months before and six months after the termination of the plan if the plan has insufficient assets to cover its termination liabilities, or any period in which the plan is in "at-risk" status.

A single-employer defined benefit plan must be tested, as of the beginning of each plan year, to determine whether it is in at-risk status. If the plan is not sufficiently funded[1] as of the beginning of a plan year, the plan will be in at-risk status for the next following plan year. Ordinarily, this is a determination that is made by the actuary for the single-employer defined benefit plan as part of the actuary's regular computations. Once it has been determined that a plan is in at-risk status for a given plan year, the plan will remain in at-risk status until at least the following plan year.

In view of the dramatic loss of value of many qualified pension plan assets, it is important that the individual(s) responsible for making contributions to the rabbi trust confirm that none of the qualified defined benefit plans maintained by any company in the controlled group are in at-risk status before making the contribution. Companies should also review existing trusts to determine whether they contain triggers for mandatory contribution (for example, upon a change in control) and, if so, these mandatory contribution requirements should generally be modified to waive the contribution requirement during a restricted period.

Endnote

1 Generally, a single-employer defined benefit plan is in "at-risk" status for a plan year if (i) the funding target attainment percentage for the preceding plan year is less than 80%, and (ii) the funding target attainment percentage for the preceding plan year (using additional actuarial assumptions as prescribed under the tax code) is less than 70%. A special transition rule applies for plan years beginning in 2008, 2009 and 2010 such that the 80% threshold in (i) above is reduced to 65%, 70% and 75% respectively. A plan's funding target attainment percentage is the ratio of the plan's assets to the plan's liabilities valued in accordance with rules under the tax code.

If you have any questions regarding this topic, please contact any of the lawyers listed below or any other member of our Employee Benefits & Executive Compensation practice.

Maureen J. Gorman
+1 650 331 2033
mgorman@mayerbrown.com

Karen F. Grotberg
+1 312 701 7923
kgrotberg@mayerbrown.com

Debra B. Hoffman
+1 312 701 7219
dhoffman@mayerbrown.com

Herbert W. Krueger
+1 312 701 7194
hkrueger@mayerbrown.com

Wayne R. Luepker
+1 312 701 7197
wluepker@mayerbrown.com

Anna M. O'Meara
+1 312 701 7196
aomeara@mayerbrown.com

Edward A. Pionke
+1 312 701 8937
epionke@mayerbrown.com

Cecilia A. Roth
312 701 8566
croth@mayerbrown.com

Mayer Brown is a leading global law firm with approximately 1,000 lawyers in the Americas, 300 in Asia and 500 in Europe. Our Asia presence was enhanced by our combination with JSM (formerly Johnson Stokes & Master), one of the largest and oldest Asia law firms. We serve many of the world's largest companies, including a significant proportion of the Fortune 100, FTSE 100, DAX and Hang Seng Index companies and more than half of the world's largest investment banks. We provide legal services in areas such as Supreme Court and appellate; litigation; corporate and securities; finance; real estate; tax; intellectual property; government and global trade; restructuring, bankruptcy and insolvency; and environmental.

OFFICE LOCATIONS AMERICAS: Charlotte, Chicago, Houston, Los Angeles, New York, Palo Alto, São Paulo, Washington
ASIA: Bangkok, Beijing, Guangzhou, Hanoi, Ho Chi Minh City, Hong Kong, Shanghai
EUROPE: Berlin, Brussels, Cologne, Frankfurt, London, Paris

ALLIANCE LAW FIRMS Mexico City (Jáuregui, Navarrete y Nader); Madrid (Ramón & Cajal); Italy and Eastern Europe (Tonucci & Partners)

Please visit our web site for comprehensive contact information for all Mayer Brown offices.

www.mayerbrown.com

This Mayer Brown LLP publication provides information and comments on legal issues and developments of interest to our clients and friends. The foregoing is not a comprehensive treatment of the subject matter covered and is not intended to provide legal advice. Readers should seek specific legal advice before taking any action with respect to the matters discussed herein.

IRS CIRCULAR 230 NOTICE. Any advice expressed herein as to tax matters was neither written nor intended by Mayer Brown LLP to be used and cannot be used by any taxpayer for the purpose of avoiding tax penalties that may be imposed under US tax law. If any person uses or refers to any such tax advice in promoting, marketing or recommending a partnership or other entity, investment plan or arrangement to any taxpayer, then (i) the advice was written to support the promotion or marketing (by a person other than Mayer Brown LLP) of that transaction or matter, and (ii) such taxpayer should seek advice based on the taxpayer's particular circumstances from an independent tax advisor.

© 2008. Mayer Brown LLP, Mayer Brown International LLP, and/or JSM. All rights reserved.

Mayer Brown is a global legal services organization comprising legal practices that are separate entities (the "Mayer Brown Practices"). The Mayer Brown Practices are: Mayer Brown LLP, a limited liability partnership established in the United States; Mayer Brown International LLP, a limited liability partnership incorporated in England and Wales; and JSM, a Hong Kong partnership, and its associated entities in Asia. The Mayer Brown Practices are known as Mayer Brown JSM in Asia. "Mayer Brown" and the "Mayer Brown" logo are the trademarks of the individual Mayer Brown Practices in their respective jurisdictions.

1208