EMPLOYEE BENEFITS

SPENCER FANE LLP

A "TOP-HAT" PLAN PRIMER

Greg Ash, Partner
913.327.5115
gash@spencerfane.com
Overland Park, KS

SpencerFane®

Companies that consider nonqualified deferred compensation arrangements for their key executives often focus on how those arrangements are treated for tax purposes. But in the midst of the tax discussion (including the effect of Sections 409A and/or 457(f) of the Internal Revenue Code), it is important not to lose track of the *other* federal law that governs these arrangements – ERISA. The interaction of top-hat plans and ERISA is the focus of this article; we will leave the tax consequences of these arrangements for another day.

The phrase "top-hat plan" is commonly used to refer to nonqualified deferred compensation arrangements generally, and to the treatment of those arrangements under ERISA in particular, yet it never appears in the text of the statute. Such arrangements allow employers to provide benefits to key executives in excess of the benefits that may be provided through qualified retirement plans. In order to provide those benefits only to the targeted individuals, however, top-hat plans cannot be subject to the minimum participation, funding, and vesting rules that generally require employers to make benefits available to all employees on a nondiscriminatory basis.

Many mistakenly believe that top-hat plans are *entirely* exempt from ERISA's requirements. With one increasingly rare exception, however, ERISA remains an important consideration in how these arrangements are structured.

The Excess Benefit Plan Exemption

When ERISA was enacted in 1974 Congress included a complete exemption from the new statute's rules for "excess benefit plans." An excess benefit plan is one that is maintained "solely for the purpose of providing benefits for certain employees in excess of the limitations on contributions and benefits imposed by Section 415 of the Internal Revenue Code." Excess benefit plans are not the same as top-hat plans, although they are a subset of the latter.

The problem with the excess-benefit-plan exemption is that it was drafted before the enactment of Section 401(a)(17) of the Code. In 1974, the only real limit on qualified retirement plan benefits was contained in Code Section 415, which caps the amount of contributions to a participant's account under a defined contribution plan or benefits payable to a participant in a defined benefit plan. Section 401(a)(17) was added to the Tax Code some 15 years later to limit the amount of compensation that can be taken into account for qualified plan purposes. Today, qualified plan benefits are capped as much – if not more – by Code Section 401(a)(17) as by Code Section 415.

Many nonqualified retirement arrangements are designed to "make up" for the benefit that could have been provided to participants through a qualified plan, but for the restrictions imposed by Sections 401(a)(17) and 415. Because such arrangements are not "solely" for the purpose of filling the Section 415 gap, however, they do not fall within the excess-benefit-plan exemption from

ERISA. Thus, the vast majority of "supplemental" or "excess" plans remain subject to certain portions of ERISA.

The Top-Hat Exclusion

In order to fulfill their purpose of providing tax-deferred retirement income to a select group of executives, nonqualified plans rely on special carve-outs from ERISA's generally applicable rules. This top-hat exclusion appears in three separate sections of ERISA. Each of those sections excludes from its reach "a plan which is unfunded and is maintained by an employer primarily for the purpose of providing deferred compensation for a select group of management or highly compensated employees." If a plan fits these criteria, it is exempt from ERISA's minimum participation and vesting rules, its funding rules, and its fiduciary responsibility rules (including the trust requirement).

Of these exemptions, the free pass on ERISA's requirement that plan assets be held in trust is the most critical. Placing the assets of a nonqualified deferred compensation plan in trust (other than a "rabbi trust," as described below) will generally lead to immediate taxation of participants, once they become vested. Thus, to fulfill their tax-deferral purpose, nonqualified plans cannot be subject to the trust requirement. Put another way, such plans *must* qualify for ERISA's top-hat plan exclusion.

The top-hat plan exclusion has three prerequisites: (1) the arrangement must be "unfunded"; (2) it must be maintained "primarily" for certain individuals; and (3) it must provide deferred compensation for "a select group of management or highly compensated employees." Failing to satisfy any of these criteria will subject the arrangement to the full panoply of ERISA's requirements, a fate that no nonqualified deferred compensation plan is designed to withstand. Unfortunately, the Department of Labor has never issued regulations to interpret these prerequisites. Thus, left to their own devices, the courts have attempted to define what is, and is not, a top-hat plan, with predictably mixed results.

"Unfunded" Status

Generally, a plan is not "funded" for top-hat purposes unless individual participants have greater rights to plan assets than the sponsoring employer's general creditors. Although counterintuitive, assets *can* be set aside to pay benefits out of a top-hat plan without "funding" the plan. This is the case, however, only so long as the assets that are set aside remain subject to the sponsor's general creditors in the event the sponsor becomes insolvent.

The most common device used for this purpose is a "rabbi trust," which protects assets held in the trust from attachment by creditors (and thus ensures a source of payment for promised benefits),

©2018 Greg Ash

unless and until the sponsor becomes insolvent. Many top-hat plans take advantage of the model rabbi trust language set forth by the IRS in Revenue Procedure 92-64 for this purpose. Others do not set aside assets for benefit payment purposes at all, but merely give participants an unsecured promise to pay those benefits out of the sponsor’s general assets when they are due.

Maintained “Primarily” for the Benefit of Certain Individuals

Top-hat plans also must be maintained “primarily for the purpose of providing deferred compensation” to a select group of people. Unfortunately, the DOL has in the past espoused a fairly unique – and grammatically questionable – interpretation of this clause. In a 1990 Advisory Opinion (Adv. Op. 90-14A), the DOL opined that the term “primarily” refers to the purpose of the plan (*i.e.,* to the type of benefits provided), and not to the composition of eligible participants. In its view, “primarily” modifies only the phrase “for the purpose of providing deferred compensation,” and *not* the immediately following phrase “to a select group.” Under this interpretation, the entire top-hat plan exclusion could be lost if even one participant is not a member of the select group.

Courts generally have not adopted the DOL’s interpretation of the “primarily” requirement. Instead, they have interpreted the statutory exclusion as requiring that the plan be “primarily” intended to provide deferred compensation *and* “primarily” to benefit management or highly compensated employees. Thus, the participation of a few individuals who arguably are not “highly compensated” or within “a select group of management” employees should not destroy top-hat plan status.

A “Select Group of Management or Highly Compensated Employees”

The DOL also explained its understanding of the “select group” requirement in its 1990 Advisory Opinion, arguing that this term refers to those employees who, “by virtue of their position or compensation level,” have the ability to negotiate the terms of their deferred compensation arrangement, and thus do not need the substantive rights and protections afforded by ERISA. The courts have been more liberal in their interpretation of the types of employees who may participate in a top-hat plan, generally looking at the participant’s sophistication as only one of many factors to consider. Unfortunately, the underlying facts and circumstances of each case weigh heavily in the analysis, making it difficult to draw broad conclusions.

Courts tend to look at the percentage of an employer’s total work force who participate in a plan. Coverage of between one and five percent of an employer’s work force has been held to satisfy the select group requirement, while a plan covering 20 percent was held to fall outside that requirement. Courts often draw a distinction between large and small employers, generally accepting a greater percentage participation in plans maintained by small employers. In measuring whether employees are “highly compensated,” salary alone may not be enough to place one in the

©2018 Greg Ash

top-hat group. Instead, courts focus on whether there is a significant disparity in the average compensation level of plan participants and other employees.

ERISA Remains Relevant for Top-Hat Plans

Sponsors of nonqualified deferred compensation arrangements that successfully design their plans to fall within ERISA’s top-hat plan exclusion cannot simply close the statute book without a backward glance. Top-hat plans are exempt only from ERISA’s participation, vesting, funding, and fiduciary rules, as well as the trust requirement. Such plans remain subject to the reporting and disclosure rules (although those rules are significantly relaxed for top-hat plans) and ERISA’s enforcement rules.

The exemption from ERISA’s annual reporting requirement is important, but it is not automatic. The reporting and disclosure requirement exemption for top-hat plans is satisfied only if the plan sponsor notifies the DOL of the plan’s existence within 120 days of its adoption. That notice can be submitted electronically. Thereafter, the plan’s sponsor need not file an annual Form 5500.

ERISA’s general enforcement rules remain applicable to top-hat plans. This means, for instance, that top-hat plans must comply with the normal claims and appeals procedures that apply to qualified plans. It also means that the only remedies available to top-hat plan participants are those set forth in ERISA. And because top-hat plans are not subject to ERISA’s fiduciary duty rules, those remedies essentially will be limited to the benefits promised under the terms of the plan document. Finally, lawsuits challenging benefit denials may be removed to federal court, because the top-hat plan exclusion does not apply to ERISA’s state-law preemption rules.

Unlike litigation over a plan administrator’s decision to deny payment of a benefit from a qualified plan, however, a top-hat plan administrator’s decision is not automatically entitled to deference by a court. Many federal courts have held that the ordinary “abuse of discretion” standard of review that applies to ERISA-covered plans does not apply in the top-hat plan context, with one important caveat. If the top-hat plan document *itself* includes a clause giving the administrator discretion to construe the plan’s terms, that clause may be given effect as a matter of ordinary contract law, so long as the administrator exercises its discretion in good faith.

Thus, there is much for an employer who sponsors a nonqualified deferred compensation arrangement to consider beyond the arrangement’s tax consequences. As is the case with all benefit plans, careful drafting can prevent costly errors down the road.

©2018 Greg Ash

About the Author:

As the leader of the firm’s Employee Benefits Practice Group, Greg Ash helps his clients maximize the value and minimize the risks inherent in their benefit plans. With 25 years of experience, Greg translates complicated legal issues under ERISA and the Internal Revenue Code into meaningful decision points for employers. He forecasts risk and identifies opportunities to help his clients meet their business objectives.

Greg uses his substantive knowledge of ERISA and the Tax Code to create unique litigation avoidance strategies and, when necessary, winning defense arguments. He recently served as a panel presenter at the American Conference Institute’s National ERISA Litigation Conferences in New York City and Chicago.

For more information, contact Greg Ash at 913.327.5115 or gash@spencerfane.com.

©2018 Greg Ash

SpencerFane®