



### OVERVIEW

A Top-hat plan is a type of Nonqualified Deferred Compensation Plan (NQDCP) and is often referred to as a top-hat plan because of its purpose and definition under the Employee Retirement Income Security Act of 1974 (ERISA), which states that a Top-hat plan is an unfunded nonqualified plan maintained "primarily for the purpose of providing deferred compensation for a select group of management or highly compensated employees."<sup>1</sup>

### EMPLOYER'S GOALS & OBJECTIVES

Qualified defined contribution plans and nonqualified deferred compensation plans share similar benefits:

- Compensation is deferred on a pre-tax basis
- Participant deferrals and investment returns are exempt from federal taxes until distribution

But that's where similarities end. Most qualified plans, such as a 401(k) plan, generally do not allow an executive to take full advantage of the deferral limit because of inherent nondiscrimination compliance testing rules involved with bringing a qualified plan to the masses. Employers typically offer a nonqualified top-hat plan to "supplement" a qualified plan for the purposes of creating an opportunity for the executive to defer as much as possible.

From a tax standpoint, it is usually better for an executive or highly paid employee to defer money until lower-income years such as retirement. The benefit here is that money paid after retirement is usually taxed at a much lower rate, resulting in greater after-tax income for the employee.

Other reasons are as follows:

- Provide a pension supplement to attract an older executive in a case where the years of service factor in the employer's benefit formula would limit the executive's benefits under the plan
- Provide the opportunity for an executive to retire early with combined qualified plan/top-hat plan benefits equal to what would have been the executive's normal retirement age qualified plan benefit
- Recruiting tool for top executives
- Retention tool for star executives
- Reward performance of top executives

### GENERAL DEFINITION UNDER ERISA

Top-hat plan must  
be as follows:

"unfunded" and "maintained by an employer primarily for the purpose of providing deferred compensation for a select group of management or highly compensated employees."<sup>2</sup>

<sup>1,2</sup> ERISA §§201(2), 301(a)(3), 401(a)(1)

- Avoids the 10% penalty tax on early distributions from qualified plans under Code Section 72(t)
- Avoids the strict minimum distribution requirements imposed on qualified plans under Code Section 401(a)(9)



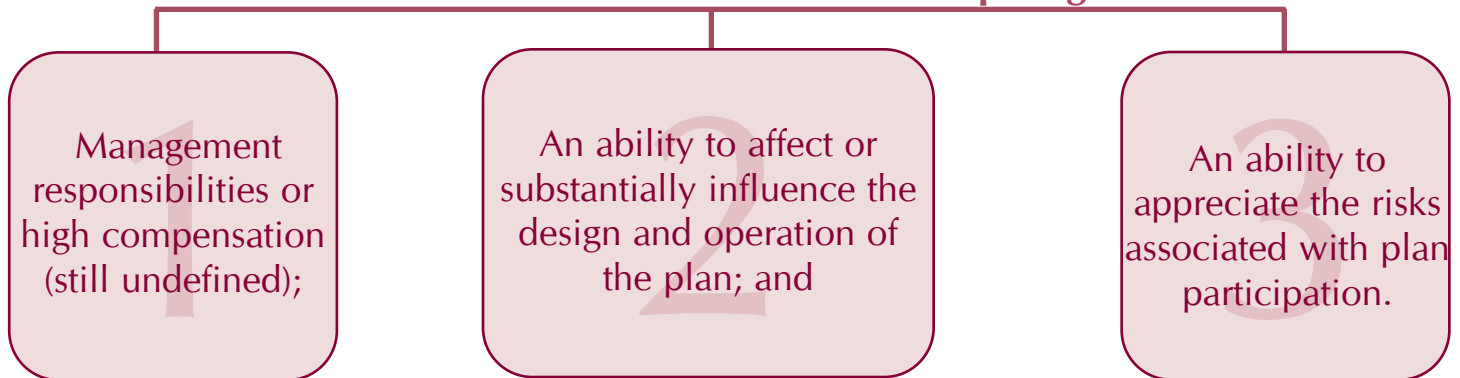
### INTERPRETATION & ANALYSIS

There are no current regulations that address the need for interpreting the ERISA definition of a top-hat plan. Advisory opinions and case law exists only to guide Employers and their counsel in the due diligence process of implementing a top-hat plan.

The Department of Labor (DOL) has been providing guidance on this issue. In 1990, the DOL released an Advisory Opinion stating that ERISA's top-hat exemption is limited to plans which solely cover individuals who:

"by virtue of their position or compensation level, have the ability to affect or substantially influence through negotiation or otherwise, the design and operation of their deferred compensation plan, taking into account any risks attendant thereto."

### This view establishes an informal 3-prong test:



### OTHER CONSIDERATIONS

**"PRIMARILY"** - DOL Advisory Opinion 90-14A stated that the term "primarily" as used in the ERISA definition of a top-hat plan "refers to the purpose of the plan and not the participant composition of the plan". Therefore, several cases have supported the notion that a top-hat plan could include employees outside of the group.

**"SELECT GROUP OF MANAGEMENT OR HIGHLY COMPENSATED EMPLOYEES"** - The courts have focused on the percentage of the select group in relation to the employer's total work-force. In its most recent decision, the Second Circuit Court of appeals held that a nonqualified deferred compen-



sation plan that covered 15.34% of the employer's employees qualified as a top-hat plan<sup>3</sup>. The Second Circuit held that "while [this percentage] is probably at or near the upper limit of an acceptable size" for a "select group" within the meaning of ERISA, the plan qualified as a top-hat plan because:

"all of these participants were selected officers of the bank, were in management positions and were highly compensated in comparison to bank employees at large."<sup>4</sup>

The decision reflects what are general rules of thumb summarized in the following table, which presumes plan participation is limited to the highest-paid employees, and that each plan participant earns at least 50% more than the Social Security wage base:

Percentage of workforce participating in plan	Likelihood of being classified as a Top-hat plan
Less than 7%	Very Likely
7% to 12%	Probable
13% to 20%	Questionable
More than 20%	Very Questionable

**"MANAGEMENT"** - This term also remains undefined with the DOL. However, the DOL generally takes a limit view of the employees who may be considered management for purposes of the top-hat plan. In one of several withdrawn rulings, the DOL has stated that the top-hat definition was met where:

1. A plan covered key executives and managerial employees selected by the compensation committee;
2. Number of participants eligible in any single year was limited to an absolute number; and
3. Fewer than 4% of the employer's active employees were covered by the plan.<sup>5</sup>

In another withdrawn ruling, DOL defined "management" as the following:

1. The participant earned at least a particular stated amount;
2. The participants were classified as key employees by the plan's administrative committee; and
3. The participants were exempt from the Fair Labor Standards Act as administrative, supervisory, or professional employees.<sup>6</sup>

<sup>3</sup>Demery v. Extebank Deferred Compensation Plan (B) [216 F 3d 283 (2d Cir 2000)].

<sup>4</sup>Demery v. Extebank Deferred Compensation Plan (B) [216 F 3d 283 (2d Cir 2000)].

<sup>5</sup>DOL Adv Op 85-37A

<sup>6</sup>DOL Adv Op 75-64; DOL Adv Op 75-63

**"HIGHLY COMPENSATED EMPLOYEES"** - The DOL's position is unclear on this term. However, the DOL is clear that the definition used by qualified plans under Code Section 414(q) may not be used for top-hat plan purposes. The Department of the Treasury agrees.

**Note:** *Clients are advised to consult with their ERISA counsel to determine which employees may be covered under their top-hat plan.*

### FAILURE TO SATISFY REQUIREMENTS

If an employer's plan covers more than a top-hat group, the possible consequences include the following:

- Participants could become entitled to additional credits for service or vesting.
- Participants could argue for additional ERISA protections, such as advance notice of plan amendments that decrease benefit accruals, with the potential for invalidation of actions an employer takes without legally sufficient advance notice.
- Plan fiduciaries could be held liable for breaching their responsibilities to act in the best interests of participants - for example, for failing to establish a trust or failing to fully disclose material risks to participants.
- Plan participants could recover preferred rates of return through their attainment of retirement age.
- The Department of Labor could force full funding of a trust, with consequent risk of immediate taxation for all participants. These participants could arguably assert a claim against their employer for the lost benefits of promised tax deferral.

### IMPLEMENTATION

A top-hat plan by definition must be an unfunded plan<sup>7</sup>. Employers ensure compliance with this requirement by having the plan benefits payable out of the employer's general assets and any participant is considered a general unsecured bankruptcy or insolvency creditor of the employer.

From the employee's standpoint, an unfunded plan means that the employee assumes the risk that the employer may refuse to pay benefits owed under the plan due to a merger,



<sup>7</sup> ERISA §§201(2), 301(a)(3), 401(a)(1).

acquisition, insolvency, or other reason. An employee pays tax on the employer's unfunded top-hat plan contributions when the benefits are actually distributed or made available to the employee.

Generally, a plan will be considered funded if its assets are segregated or set aside for the exclusive purpose of providing a source for the payment of plan benefits. However, an employer may still assure that funds are available by using financing vehicles like a **Rabbi Trust**, **Corporate Owned Life Insurance (COLI)**, or a **Secular Trust** and enjoy the exempt status from most of ERISA rules and regulations.

### OTHER RESOURCES

See *Carrabba v. Randalls Food Markets*, 252 F. 3d. 721 (5th Cir. 2001) for a Fifth Circuit decision affirming a verdict awarding \$13.5 million to employees who succeeded in contesting a plan's top-hat status.

**Standard of Review.** De novo review, not Firestone deference, applies per 3rd Circuit decisions noting administrative discretion is subject to implied duty of good faith and fair dealing. *Goldstein v. Johnson & Johnson*, 251 F. 3d 433 (5/25/2002). Contra, applying Firestone standard, *Olander v. Bucyrus-Erie Co.*, 187 F. 3d 599 (7th Cir. 1999).

**Successor Liability.** Federal common law rules apply to ERISA top-hat plans, citing *Fall River Dyeing & Finishing v. NLRB*, 482 U.S. 27 (1987). *Brend et al v. Sames Corporation*, N.D.IL, 7/9/2002.

**The information provided is general information for reference purposes only, and should not be relied upon in any respect. Please consult with their legal counsel in order to assure thorough and proper application of the complex rules that are highlighted here.**

### ABOUT RCG

Retirement Capital Group, Inc. (RCG) is committed to helping companies attract, appropriately compensate and retain their talented executives. This is accomplished first with a thorough assessment of a company's goals, financial and tax status, and more. RCG's recommendations are customized to meet each client's needs. Only then will an innovative and appropriate solution unfold that will meet expectations and deliver the intended results.

William L. MacDonald, a renowned expert in the executive benefits industry, founded RCG in 2002. Mr. MacDonald has built a team of compensation and executive benefits specialists that focus on consultative services for nonqualified executive benefit plans. Although RCG's focus is mid-to-large sized companies, RCG's nationwide network of partners can also provide a Total Retirement Solution. This broadens RCG's offerings to include qualified plans, such as 401(k) plans, etc.

***RCG is known as a leader in innovative and creative executive benefit solutions.***

In regard to administration and plan maintenance, RCG utilizes an unbundled approach. A network of Third Party Administrators (TPAs) track participant contributions and investments. RCG has done extensive research to determine the best plan administrators, and offers its clients a choice, based on needs and culture. This approach to administration is setting new standards in administration quality, and provides companies with options they have never before experienced.

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