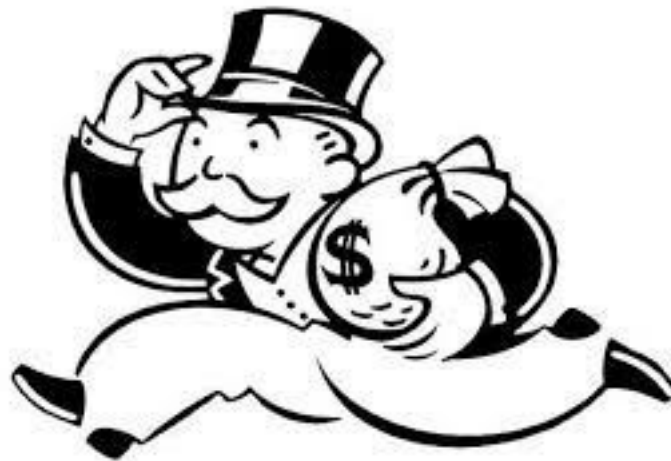


Top Hat and Excess Benefit Plans



Executive Retirement Plans

- ERISA created two categories of exempt plans, which generally cover management and highly compensated employees
 - Excess benefit plans, which are exempt from ERISA
 - Top hat plans, which are exempt from some, but not all, ERISA provisions
 - Top hat plans are subject to the “bad” ERISA provisions
 - preemption
 - deferential standard of review
 - limitations on remedies
 - and more!

Executive Retirement Plans

- Why important
 - Top hat plans are becoming more common in middle income ranks
 - The PRC has been asked to provide assistance on a few of these plans
 - Anticipate more problems in future

Excess Benefit Plans

- Plans that pay only the difference between what a participant would have earned under a qualified plan and what the section 415 limits permit—see ERISA Section 3(36)
 - assume a defined benefit plan provides a retirement annuity equal to 50% of final pay.
 - A participant's final pay is \$600,000 per year
 - 50% of final pay is \$300,000
 - Section 415 provides that plan benefit cannot exceed \$230,000
 - Excess benefit plan would pay a benefit of \$70,000

Excess Benefit Plans

- plans that pay only the difference between what a participant would have earned under a qualified plan and what the section 415 limits permit
 - assume a defined contribution plan provides annual employer contributions of 15% of compensation
 - An employee has \$600,000 annual compensation
 - 15% of compensation is 90,0000
 - Section 415 provides that plan contribution cannot exceed \$58,000
 - Excess benefit plan would get contribution of \$32,000

Excess Benefit Plans

- excess benefit plans can be either funded or unfunded
- typically they are unfunded to avoid possibly adverse tax consequences
- use of rabbi trusts does not cause plan to be funded
 - trust that must be used to pay benefits unless employer becomes insolvent, in which it will be treated as a corporate asset that can be reached by creditors

Top Hat Plans

- Top hat plans are a nickname for an exemption from
 - ERISA Part 2: vesting, accrual, and participation, benefit distribution rules
 - ERISA Part 3: funding rules
 - ERISA Part 4: fiduciary rules
- The exemption: “a plan which is unfunded and maintained by an employer primarily for the purpose of providing deferred compensation for a select group of management or highly compensated employees”
 - ERISA sections 201(a)(2), 301(a)(3), 401(a)(1)

Top Hat Plans

- Exemption appears to have been included to allow employers to establish unfunded deferred compensation plans for key executives
 - The likely rationale: such employees have sufficient bargaining power to protect themselves
- In 1974, when ERISA was enacted, Congress did not appreciate that such plans could in some cases confer significant tax benefits
 - but from *employee's* perspective, tax treatment is similar to that of qualified plan—if properly structured, no income to employee until benefits are paid
 - aggregate tax benefit will generally exist if and to extent employer's marginal tax rate is lower than that of plan participants
 - since 2017 Trump tax bill, which lowered corporate tax rates to 21%, more top-hat plans confer tax benefits than at any time in recent history
 - in some cases, the tax benefits can rival those provided in qualified plans

Top Hat Plans

- Three common types of top-hat plans:
 - supplement executive retirement plan (“SERP”)
 - usually a defined benefit style for senior management
 - elective deferral plans/mirror 401(k) plans
 - plans that allow employees to reduce salary in exchange for participation
 - defined contribution format
 - sometimes used to allow employees to defer in excess of the 402(g)(1) limit on elective deferrals to qualified plan, sometimes with a match equal to that of the 401(k) plan (these are called mirror plans)
 - bonus plans
 - plans in which employer contributes to selected employees, often a discretionary year-end bonus
 - generally in a defined contribution format

Top Hat Plans

- Trend in top-hat plans is to cover middle management employees and employees with above average compensation
- Plans have sometimes covered 15% of all employees
- Many participants in such plans need ERISA protections because they cannot protect themselves through contract negotiation

Top Hat Plans

- Participants in top-hat plans are in uniquely vulnerable position
 - no substantive ERISA protection (other than some disclosures)
 - participants are subject to ERISA dispute resolution provisions, so
 - Firestone standard of review
 - venue limitations are permissible
 - short-fuse contractual limitations period
 - exhaustion of administrative remedies
 - limitation of remedies to benefits or equitable relief
 - subject to ERISA preemption of state law

Top Hat Plans

- Legal Issues
 - Entitlement to benefits under plan terms
 - ERISA “common” law, if there is one
 - Does the plan qualify for the top-hat exemption?
 - What percentage of workforce included?
 - Compensation levels of participants, compared to other workers
 - What does select group refer to—all employees or a select group of management employees
 - Does inclusion of one person outside “management or highly compensated” employees kill the exemption?
 - Do employees have to be in position to negotiate with employer to participate in top-hat plan? (DOL position adopted in 1990 but rejected by some courts)
 - Is there a plan in the first place? (Is a one-person deferred compensation agreement an ERISA plan?)