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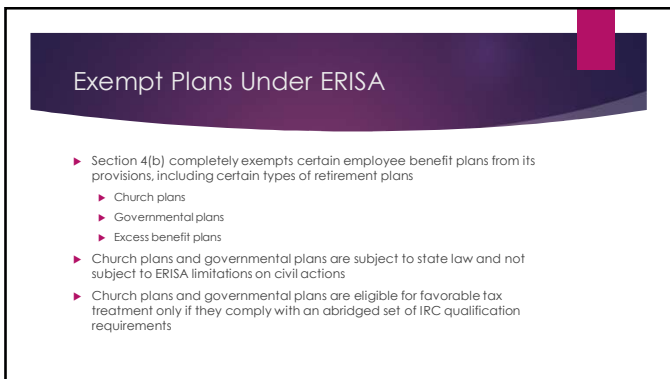
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## Top-Hat Plans: A Partial Exemption

- ▶ Top-Hat plans are partially exempt from ERISA
- ▶ Not subject to ERISA funding, vesting, or fiduciary provisions (or certain other substantive protections, including spousal protections)
- ▶ But are subject to ERISA enforcement provisions
  - ▶ Thus, subject to ERISA preemption—state law unavailable
  - ▶ Subject to ERISA limitation on remedies
  - ▶ Subject to plan limitations on venue, statute of limitations, etc.
- ▶ Also subject to ERISA disclosure rules, but DOL has adopted an "alternative" compliance option in which employer need only file with Department of Labor a list of its top-hat plans.
- ▶ Participants thus must contend with a legal regime in which they have none of the benefits of ERISA but are subject to all of the detriments of ERISA

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## Definition of Top-Hat Plan

- ▶ Part 2, Part 3, and Part 4 of ERISA each exempt from their requirements "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."
- ▶ Plenty of ambiguity in the definition

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## Plan Forms

- ▶ A top-hat plan can be either a
  - ▶ defined contribution plan, including a cash-or-deferred arrangement
  - ▶ defined benefit plan
- ▶ Difference between excess benefit plan and top-hat plan
  - ▶ Excess benefit plan is paired with qualified plan and provides benefits in excess of 415 limits

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### Reason for the Exemption

- ▶ Legislative is not clear, although legislative history does provide that exemptions to the statute should be narrowly construed.
- ▶ Department of Labor in 1990 wrote "It is the view of the Department that in providing relief for "top-hat plans from the broad remedial provision of ERISA, Congress recognized that certain individuals, 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, and therefore would not need the substantive rights and protections of Title I." Advisory Opinion 90-14A.
- ▶ As subsequently discussed, such plans today routinely cover as much as 20% of an employer's workforce.

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### Primer on Tax Treatment of Non-qualified Deferred Compensation

- ▶ Unfunded deferred compensation, if properly structured and negotiated, is tax to participant only when received.
  - ▶ Taxed to employer in interim
  - ▶ From employee's perspective, has the look and feel of a qualified plan
  - ▶ Participant rights are subordinate to creditors of the employer
  - ▶ Governing rules are constructive receipt doctrine and IRS Section 409A.
  - ▶ Rabbi trusts
  - ▶ Reduced corporate tax rates and aggressive tax planning can create substantial tax advantages to participants
- ▶ Funded deferred compensation is taxed to participant when benefit becomes substantially nonforfeitable

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### Reasons why top-hat plans have spread to mid-level employees

- ▶ Employer can avoid non-discrimination rules
- ▶ Employer can use plans to motivate employees
- ▶ Some middle management employees wish to defer more income to 401(k) plan than permitted under 402(g); top-hat plans are a tool for accomplishing this
- ▶ Middle-management employees, insurance salesmen, skilled employees like them because they confer value and prestige
- ▶ Employees outside upper management do not fully appreciate the risks

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### Top-hat plan risks

- ▶ Assets are subject to claims of employer's creditors
- ▶ Employers can include forfeiture provisions, including forfeitures for violating non-compete clauses
- ▶ Unexpected tax problems

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### When Things Fall Apart

- ▶ Arguments generally must come from plan document
  - ▶ Note: generally no summary plan description
- ▶ Argue not a top-hat plan
  - ▶ Either because plan was funded
  - ▶ Or because plan was not primarily for purpose of providing deferred compensation for a select group of management or highly compensated employees

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### Some interpretative issues

- ▶ What does highly-compensated mean under top-hat plan definition?
- ▶ Who is a management employee?
- ▶ Do the covered employees have to be able to negotiate or otherwise protect themselves
  - ▶ Note: this is the Department of Labor's position
  - ▶ 1<sup>st</sup> Circuit rejected this position in *Alexander v. Brigham & Women's Physicians Organization, Inc.*, 513 F.3d 37 (1<sup>st</sup> Cir. 2008), cert. denied, 555 U.S., 2008).
- ▶ What percentage of the workforce is too much?
  - ▶ *Demery v. Extebank Deferred Comp. Plan*, 216 F.3d 283 (2<sup>nd</sup> Cir. 2000) (15.7 % of workforce participating in plan does not invalidate top-hat status).
  - ▶ Meaning of primarily—can plan cover some low paid workers?

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