Lowenstein Sandler's Employee Benefits & Executive Compensation Podcast: Just Compensation

Episode 39 – Puttin' on Your Top Hat: How to Effectively Structure a Deferred Compensation Plan as a "Top Hat" Plan

By Darren Goodman, Megan Monson, Jessica I. Kriegsfeld

AUGUST 2024

Megan Monson: Welcome to the Lowenstein Sandler podcast series. Before we begin, please take a moment to subscribe to our podcast series at Lowenstein.com/Podcasts, or find us on Amazon Music, Apple Podcasts, Audible, iHeartRadio, Spotify, SoundCloud, or YouTube. Now let's take a listen.

Jessica Kriegsfeld: Welcome to the latest episode of Just Compensation. My name is Jessica Kriegsfeld and I'm an associate in Lowenstein Sandler's Executive Compensation and Employment and Benefits Practice Group. I'm joined today by two partners in the same practice group, Darren Goodman and Megan Monson.

Megan Monson: Pleasure to be here.

Darren Goodman: Hi everyone.

Jessica Kriegsfeld: Today's discussion will focus on the basics of top hat plans, including what they are, when they are used, and the requirements for structuring them. A top hat plan is a common name used to describe non-qualified deferred compensation plans that are exempt from most of the requirements of ERISA.

As always, this is not intended to be an exhaustive discussion. So we encourage you to consult with your legal counsel if you wish to adopt an arrangement that is intended to be a top hat plan. To start, what's a top hat plan?

Darren Goodman: So the technical definition is that a top hat plan is a plan maintained by an employer primarily for the purpose of providing deferred compensation for a select group of management or highly compensated employees. So these are the people at the top of the organizational chain, hence the name top hat plan. So we'll talk a bit about the requirements to be a top hat plan in further detail.

But a common example is a supplemental executive retirement plan, which is a retirement plan usually geared towards senior executives, that aims to provide additional retirement income to plan participants beyond what they would receive under the company's qualified plan, which typically is a 401k. So a 401k of course has contribution limits which limits what executives can put in and then ultimately get out of the plan. The supplemental executive retirement plan is intended to allow further deferrals of income beyond what could be deferred under the 401K.

Another example is a deferred compensation plan that allows executives to defer compensation such as base salary or bonus to a future year. So there are a number

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of different regulations that govern that type of plan. But just big picture, hypothetically, if you have an executive who's approaching retirement but is in their peak earning years when they're paying the highest marginal tax rates, they might wish to delay the payment of some of their base salary, perhaps some of their bonus, into their retirement years when they're in lower tax brackets, and that's possible to do. The top hat rules are one thing to take into account, and then there are a whole other separate set of rules as well covered in other podcast episodes.

Jessica Kriegsfeld: Megan, what's ERISA?

Megan Monson: ERISA is the acronym that stands for the Employee Retirement Income Security Act of 1974. ERISA is a federal law that sets forth certain minimum standards for most retirement and health plans, such as providing participants with certain plan information, setting minimum standards for participation, investing and funding, minimum standards for benefit accrual. And providers of ERISA plans also have fiduciary duty requirements that they are required to comply with.

These requirements can be difficult or impossible for some type of plans to comply with, that fall under the umbrella of retirement or health plans that would be swept into ERISA world. So for example, in the context of non-qualified plans, for example, for tax reasons, supplemental executive retirement plan is typically funded via a rabbi trust, which is a trust whose assets remain subject to the claims of creditors in the event of bankruptcy. This would be inconsistent with the ERISA funding requirement.

And so you look for an exemption of can we structure this plan in a way that would be exempt from certain requirements of ERISA? In particular, if you have a plan that is a top hat plan, as you mentioned at the onset, a top hat plan is a type of non-qualified deferred compensation plan that can be exempt from some of these requirements of ERISA.

So if it meets the top hat plan requirements, it's exempt from ERISA's minimum participation investing rules, funding rules. So it can be structured the way I just mentioned via a rabbi trust, and it's also exempt from certain fiduciary responsibility rules.

Jessica Kriegsfeld: What's needed for a top hat plan to comply with ERISA?

Darren Goodman: So to fall within the top hat exclusion, first the plan needs to be unfunded, which can literally mean that it's unfunded. The employer just pays benefits out of its general assets. Or it can mean that the plan is funded via a rabbi trust, as Megan mentioned, and with the important qualification there being that the assets of the trust are subject to creditors.

So if the employer goes bankrupt, there's no assurance that the benefits will ultimately be paid out to employees. And that's important for participants to understand because sometimes they don't appreciate that amounts deferred under the plan are at risk of not ultimately being paid out.

And just for some tax reasons, rabbi trusts are set up that way because it's the only effective way to put the money aside in the trust while simultaneously deferring tax. If you have a trust that is not subject to claims of creditors and the money is assured of being paid out, it's called a secular trust, and you can defer taxation in the same way that you can under a rabbi trust.

Another requirement is that the plan has to be maintained primarily for the benefit of a select group of management or highly compensated employees. That's not a hard

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and fast rule or percentage. You have to look at the facts and circumstances. Courts do tend to look at the total workforce as compared to those participating in the plan, to see if the plan is for a select group of management or highly compensated employees.

One other aspect of this, and this is kind of a trap that some employers can fall into, is that there is a short filing that's required with the Department of Labor within 120 days of the plan's adoption. It's all online. It's not that complicated. You just have to know that the requirement exists and follow through with the filing. If you miss that deadline, you can file a notice late, but there's a small penalty associated with doing so.

Megan Monson: And I'll just add that if you do the filing timely, there is no fee associated with the filing itself. So it is a pretty straightforward, easy thing to do. You just have to be aware of the requirement to do so.

Darren Goodman: That's a great point, Megan.

Jessica Kriegsfeld: Are there any other considerations to be aware of?

Megan Monson: So we talked about what provisions of ERISA do not apply to top hat plans, but there are other provisions of ERISA that do. So the general enforcement principles under ERISA will apply to a top hat plan. So for example, they need to follow the claims and appeal procedures that apply to qualified plans, have that language in the plan, and that would be what participants would utilize if they wanted to challenge a decision that's made with respect to those benefits.

The only remedies that participants would have available to them are those that are set forth under ERISA. Since top hat plans are not subject to the fiduciary duty rules, those remedies that participants have, and again, the recourse are really just limited to the benefits that they're promised under the plan. So again, just to be aware of that, they don't have the same widespread choices to go after the plan for various other aspects that they may not be happy about.

Top hat plans and generally non-qualified deferred compensation plans require navigating complicated tax rules, as we mentioned at the onset of this discussion. And so care should be taken to ensure compliance. And a pitfall that we see come up from time to time is that if an employer intends for an arrangement to be a top hat plan, but it doesn't actually meet the requirements that Darren mentioned, it would be subject to ERISA.

And if it was unintentional and they're not aware of it, it's very possible that the plan would be in violation of ERISA. Not completing the annual filings, not having the documentation properly amongst other things, and that could result in a variety of penalties that could be very significant. So it just really emphasizes the importance of seeking guidance early by an expert before implementing any such type of arrangement.

Darren Goodman: And I'd add there, Megan, another consideration is to just even be mindful of ERISA when you're putting in place any sort of deferred compensation arrangement. Whether that's a plan that expressly provides for payments to be made post termination of employment, like a supplemental executive retirement plan that pays out in installments post-retirement. Or whether it's just possible that payment is made after termination of employment.

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There's a whole body of guidance on when that is and is not a pension plan. And so you want to think about ERISA and think about could I be creating a pension plan? And if I am, do I have a top hat plan so that I do avoid those pitfalls that you mentioned, Megan? And it's a lot easier to think about these things upfront before you create an arrangement, than after the fact when you look back and you try to see, did we comply? Did we not comply? How can we fix it if we have an issue?

Megan Monson: Yeah, that's a great point, Darren. It's always better to be thoughtful at the onset than to try to figure out how can we correct this? And what's our risk and area of exposure?

Jessica Kriegsfeld: As you heard today, top hat plans can be a useful tool for employers looking to provide deferred compensation benefits to certain key employees. However, care must be taken to ensure compliance with the relevant requirements of ERISA and Section 409A. This episode is intended to be a high-level overview but is by no means an exhaustive discussion. Thanks for joining us today. We look forward to having you back for our next episode of Just Compensation.

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