

# Insight

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## 409A Plans: Top Hat Plan



The Pension Studio  
1426 North Federal Highway  
Lake Worth, Florida 33460

## 409A Top Hat Plans

### What is a Top Hat Plan?

A top hat plan is an unfunded plan that is maintained primarily to provide deferred compensation for a select group of management or highly compensated employees. Employers often use these plans to attract and retain employees for top management positions.

The Department of Labor has held that to be a top hat plan, a plan must constitute either an employee welfare benefit plan or an employee pension benefit plan under the Employee Retirement Income Security Act of 1974 (ERISA).

ERISA defines an “employee pension benefit plan” as any plan, fund or program maintained by the employer for the purpose of providing retirement income to its employees. Therefore, top hat plans typically provide benefits upon reaching retirement age.

Although top hat plans satisfy the requirements of being a plan within the meaning of ERISA, they are exempt from many of the requirements of ERISA. Top hat plans are not subject to ERISA’s substantive vesting, participation, funding and fiduciary provisions. However, they must still comply with certain provisions of ERISA pertaining to enforcement actions.

### **To qualify as a top hat plan, the plan should be structured so it is:**

- Unfunded;
- Primarily for the purpose of providing deferred compensation; and
- For a select group of management or highly compensated employees.

### **What Does an Unfunded Plan Look Like?**

A plan is considered unfunded as long as its assets, if there are any, are available to the employer's general creditors in the event of the employer's bankruptcy or insolvency and plan participants have no greater rights to plan assets than any other of the employer's general creditors. An additional measure the courts look to is the form of participant contributions. The plan will be more likely to meet the "unfunded" standard if participants make contributions to the plan on a pre-tax basis. If employees are allowed to contribute to the plan with after-tax contributions, the courts can argue that the risk of loss is forfeited and employees have a legal right to have their contributions returned at some point in the future.

### **Does the Plan Primarily Exist to Provide Deferred Compensation?**

To qualify as a top hat plan, the primary purpose of the plan should be to provide deferred compensation to the plan participants. Courts often rule that the plan provides deferred compensation when the benefits under the plan provide that some type of the participants' compensation earned in the current year is to be paid in a future year or over a period of future years.

### **How Select Must a Select Group Be?**

Meeting the "select group" criteria for top hat plans requires an analysis of both quantitative and qualitative measures.

The most important quantitative factor that the courts look to is the number and percentage of employees eligible to participate in the plan. In *Loffland Brothers Co. v. Overstreet*, the court found that a plan was a top hat plan where 40 out of 4,738 employees (a mere 0.84 percent) were eligible to participate.

However, courts have also held that plans with a much greater percentage and number of employees covered by the plan may qualify for top hat status. In *Demery v. Extebank Deferred Compensation Plan*, a plan covering 15.34 percent of employees was held to be a top hat plan. And in *Gallione v. Flaherty*, 33 percent of employees were covered under a plan deemed to be a top hat plan. However, the court in *Darden v. Nationwide Mutual Insurance Co.* held that 18.7 percent was too great to be considered "select."

As a practical matter, the percentage of the workforce covered necessary to qualify as a top hat plan should be permitted to vary by the industry and the knowledge and experience of the group of plan participants. Not permitting the percentage of the workforce covered to vary based on industry would, in effect, mean prohibiting top hat plans in certain industries.

If the percentage of employees eligible to participate in a plan is relatively high, favorable qualitative measures may work in favor of a top hat determination. A plan should limit eligibility for participation to high-level employees only. Generally, high-level employees perform some type of management or supervisory role within the company. Courts have also looked at the ability of eligible participants to influence the terms and conditions of the plan as indicating that such individuals are part of a "select group."

## Which Employees Are Considered Management?

Little guidance has been issued on the “management” standard for top hat plans. The legislative history of ERISA refers only to “top executives” with respect to top hat plans. Whether the covered employees constitute “management” will be determined based on the relevant facts and circumstances.

## Which Employees Are Considered Highly Compensated?

For employees who qualify as “highly compensated,” a facts and circumstances test should be applied. The IRC Section 414(q) “highly compensated employee” test does not apply in this context. To determine whether a specific employee is highly compensated, a comparison between that employee’s compensation and the average compensation of all employees should be made. Generally, where an employee’s compensation is three times the average compensation of all employees, a finding of “highly compensated” will be made.

## Should Plan Sponsors Be Cautious of Top Hat Plans?

Employers should take great care in reviewing their top hat plans. If an employer holds out a deferred compensation plan as a top hat plan, but the plan fails to qualify as one, the company could risk incurring significant litigation costs. If the plan has a faulty design, the employer may be ordered to pay heavy fines, penalties and unexpected benefits.

## How Does the Plan Become Established?

A document is drafted (a 409(a), 457(b) or 457(f)). Typically a rabbi trust is also drafted which provides some assurance to the participant of funding. The document is then filed with the IRS. 457(b) plans are subject to the deferral limitation, currently \$16,500. This is not combined with the 401(k) limit.

## Taxation on Top Hat Plans

### Employer:

Benefits paid to the key employee are fully tax deductible by the employer in the year they are paid. If investing with insurance, premiums are not tax deductible; the policy cash values accumulate income tax free. When they exceed premiums paid, the cash value has a positive impact on the employer’s financial statements. Death proceeds from life insurance contracts are normally received income tax free by the company.

### Employee:

Participating key employees have no reportable income under the plan prior to the receipt of plan payments. Therefore, all compensation deferred by the key employee, any matching contributions by the employer, and the earnings credited to the deferral account are only taxed when they are actually paid to the key employee. 457(b) contributions will be reflected on the employee’s W-2.

### Beneficiary:

Payments made to the key employee’s beneficiary will be taxed as ordinary income when received.

## Where is the Money Invested?

The Pension Studio primarily uses an open architecture platform via MG Trust. To view the funds available, please go to: [www.msconline.com](http://www.msconline.com).

### Login information:

Username: guest  
Password: fund

**For more information on Top Hat Plans, or to review your company’s plan design, contact The Pension Studio:**

Phone: 866-497-5501

Web: [www.thepensionstudio.com](http://www.thepensionstudio.com)