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### What is a Top-Hat Plan?

#### In general

A top-hat plan is a type of nonqualified deferred compensation (NQDC) plan that is established to provide unfunded (employers don't formally set aside funds for these benefits; instead, they use their general assets) deferred compensation benefits only to a select group of management or highly compensated employees. A top-hat plan is exempt from most of the strict Employee Retirement Income Security Act (ERISA) requirements that govern qualified benefit plans and funded NQDC plans. As a result, top-hat plans can be extremely flexible in terms of which employees they benefit, the amount of the benefits, and when employees are entitled to the benefits.

**Tip:** A "supplemental executive retirement plan" (or SERP) is a specific type of top-hat plan that supplements an employee's qualified plan benefits, although sometimes the term "SERP" is used synonymously with "top-hat plan." SERPs are discussed in more detail later in this article.

**Caution:** A top-hat plan must be unfunded and only provide benefits to a select group of management or highly compensated employees. An NQDC plan that fails to meet both of these requirements will generally be subject to substantial ERISA regulation.

**Tip:** For a full discussion of the differences between funded and unfunded NQDC plans, see [Funding the Incentive Package](#).

#### What constitutes a "select group of management or highly compensated employees?"

While there is no formal legal definition of a "select group of management or highly compensated employees," it generally means a small percentage of the employee population who are key management employees or who earn a salary substantially higher than that of other employees. Over the years, the courts and the Department of Labor (DOL) have looked at one or more of the following factors: the number of employees in the firm versus the number of employees covered under the NQDC plan; the average salaries of the select group versus the average salaries of other employees; the average salary of the select group versus the average salary of all management or highly compensated employees; the range of salaries of employees in the select group; and the extent to which the select group can negotiate salary and compensation packages.

The DOL has also indicated that the phrase refers only to the group of employees who, by virtue of their position or compensation level, have the ability to affect or influence the design or operation of the deferred compensation plan. In other words, according to the DOL, the select group should consist of employees who would typically be in a position to negotiate their compensation packages. Under this view, a NQDC plan could benefit only a very small percentage of the employee population. However, the courts have typically been more liberal than the DOL.

#### Why would you want to establish a top-hat plan?

##### To provide employer-paid deferred compensation to key executives

With a top-hat plan, key executives who are in a high tax bracket get the benefit of deferring their income until retirement, when they most likely will be in a lower tax bracket. The economic benefit of this deferral is significant, especially if funds are deferred for a substantial period of time. This benefit can help you to attract and recruit qualified employees and provide an incentive for an executive to remain with your company.

##### To provide deferred benefits to key executives above and beyond the limitations on contributions and benefits under qualified plans



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Qualified plans are subject to a number of limitations on contributions and benefits. These limitations have a particularly harsh effect on highly paid executives. For example, the total amount of employer and employee contributions plus forfeitures that may be contributed to a participant's annual account in a qualified defined contribution plan is limited to the lesser of \$44,000 (for 2006, \$42,000 for 2005) or 100 percent of the participant's compensation. The maximum annual benefit that can be paid from a qualified defined benefit plan is the lesser of \$175,000 (for 2006, \$170,000 for 2005) or 100 percent of final average pay. In addition, the maximum annual compensation that can be considered when making these calculations is \$220,000 (for 2006, \$210,000 for 2005). These are only a few of the restrictions on contributions for qualified benefit plans. However, a top-hat plan allows you to provide your key employees with deferred compensation without the restrictions and limitations that accompany qualified plans in regard to contribution amounts and plan benefits.

### **To provide an incentive for early retirement**

In order to have the funds to retire early, your key employees may need to participate in both a qualified retirement plan and a top-hat plan. Since a qualified plan has numerous restrictions and limitations on contribution amounts, an employee may not have sufficient funds to retire early if he or she only participates in a qualified plan. In addition, a qualified plan carries a hefty early distribution penalty tax. By participating in both the qualified plan and the top-hat plan, an employee can accumulate sufficient funds to have a successful and fruitful early retirement.

### **To avoid certain ERISA requirements**

Retirement plans that are subject to ERISA must comply with strict participation, vesting, funding, fiduciary, distribution, and reporting rules. However, a top-hat plan is exempt from most of these rules. The theory behind this exemption is that high-level executives don't need the protection of ERISA because they have the power to negotiate their own compensation arrangements with their employers.

ERISA does not apply to governmental and most church retirement plans. NQDC plans maintained by governmental and tax-exempt employers are subject to a special set of rules, and are referred to as 457 plans.

## **How does a top-hat plan work?**

### **In general**

You typically pay the benefits provided under a top-hat plan out of your general assets at the time the payments become due. As a result, the executive must rely solely on your unfunded promise to pay the benefits and assumes the risk that these benefits may not be paid at all. To provide your employees with varying degrees of assurance that the promised benefits will be paid, you can choose to informally fund your top-hat plan with a rabbi trust or company-owned life insurance. However, any vehicle you use to informally fund your top-hat plan must remain subject to the claims of your general creditors. Therefore, your employees may lose their benefits in the event of your insolvency or bankruptcy. From an employee's perspective, this is one of the major disadvantages of an unfunded NQDC plan.

**Caution:** Top-hat plans must comply with the rules of Internal Revenue Code (IRC) Section 409A that govern NQDC plan deferral elections, distributions, and funding.

### **Employee elective salary and bonus deferrals**

A top-hat plan can be structured to allow participants to elect to defer a portion of their salary and/or bonus into the NQDC plan. This is often referred to as an "elective" NQDC plan, as compared to a "nonelective" plan that provides benefits financed solely by the employer. The election must generally be made in writing before the tax year that the compensation is actually earned. In some cases, elections to defer bonuses can be made as late as six months prior to the



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end of the performance period, if the performance period is at least 12 months. In general, an employee must also elect the timing and form of payment at the time he or she elects to defer the compensation. There is no dollar limit on the amount of compensation a participant can defer into a top-hat plan, unlike a qualified plan where (in 2006) deferrals are limited to \$15,000 (\$20,000 if age 50 or older) and total contributions are limited to \$44,000. Participants are usually fully vested in their own elective deferrals, and any related earnings.

### **Discretionary employer contributions**

A top-hat plan can also provide for employer contributions in addition to, or sometimes in place of, employee salary deferrals. Such employer contributions are generally discretionary. That is, most plans are set up to allow an employer to make contributions at the employer's complete discretion. No deposits are required to be made by the employer in any given year. Employer contributions are often subject to a vesting provision. For example, a plan may require that employer contributions and related earnings are forfeited if an employee fails to work for the employer for a particular number of years, or terminates employment before a specified age.

### **Accounting and investment control**

There are two main types of unfunded NQDC plans--defined contribution (or individual account) plans and defined benefit plans. Defined benefit plans pay a pension-like benefit, often based on years of service and/or final average pay. Often the plan will provide benefits in excess of what can be provided under an employer's qualified pension plan. In an individual account plan, the employee's benefit depends entirely on the value of his or her individual deferred compensation account. This is not a real, funded account, but is a bookkeeping account that is credited with employee deferrals and employer "contributions" and investment earnings. These are often referred to as "hypothetical" or "notational" earnings to reflect the fact that they are simply credits to the participant's NQDC plan bookkeeping account. Often, employees can "direct" the investment of their individual account. Usually, the employer (or trustee in a NQDC plan informally funded with a rabbi trust) is not obligated to actually invest any assets in the manner selected by the participant. The participant's investment election merely controls the amount of hypothetical earnings that the employer agrees to credit to the participant's bookkeeping account on a periodic basis. The IRS has suggested in the past that if the employer (or trustee) is obligated to actually invest assets as directed by the participant, this "dominion and control" by the participant may result in immediate taxation under the constructive receipt or economic benefit theories.

### **Top-hat plans that supplement qualified plan benefits--SERPs**

A common form of nonelective top-hat plan provides for a post-retirement pension benefit that supplements the employee's qualified plan benefits and Social Security benefits. These plans are often called supplemental executive retirement plans, or SERPs. Such SERPs may, for example, calculate a certain pension for the employee, then offset that by the benefits the employee actually receives from the employer's qualified plans and Social Security; the resulting difference is the NQDC plan retirement benefit paid by the employer to the employee after the employee's retirement. These plans often include a vesting provision, or are tied to the vesting schedule in the employer's qualified plan.

### **Payment of benefits**

As the employer, you can structure a top-hat plan to pay benefits upon retirement, separation from service, disability, death, unforeseen emergency, or at a specified time. Benefits can be paid either in a lump sum or in a series of annual payments. Life annuities or payments for a fixed number of years (such as 5 or 10 years) are common. Since most ERISA requirements will not apply if you structure the plan correctly, you generally have some flexibility in establishing your own vesting schedule and forfeiture provisions. For example, you can stipulate that employees will forfeit their rights to benefits if they fail to work for your company until retirement age.



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ERISA requirementsAs noted above, top-hat plans are exempt from most of ERISA's burdensome requirements. However, when implementing a top-hat plan, there are generally two ERISA requirements that you must be sure to follow. First, you (or more specifically, the plan administrator, which is typically the employer) must send a one-page notification letter to the Department of Labor indicating your company's name and address, your company's employer identification number, the number of top-hat plans you maintain, the number of participants in each plan, and a declaration that the employer maintains the plan(s) primarily for the purpose of providing deferred compensation for a select group of management or highly compensated employees. The letter must be filed with the DOL within 120 days of the plan's inception; otherwise the plan will be subject to all of ERISA's reporting and disclosure requirements. Second, since top-hat plans are subject to ERISA's administrative provisions, you must inform plan participants about the ERISA claims procedures that apply to your plan (these will generally be described in the NQDC plan document).

### Federal income tax treatment

#### Employer considerations

You are entitled to deduct amounts you contribute to the top-hat plan when they are includable in your employee's gross income. In other words, you can generally take the deduction when your employee actually receives the money from the plan. You can also deduct earnings when paid from the plan.

**Caution:** If you set aside assets to informally fund future benefits under the plan (for example, in a rabbi trust), you must pay income tax on any earnings attributable to those allocated funds. For this reason, corporate-owned life insurance (COLI) is often used to informally fund top-hat plans, because the inside cash value builds up on a tax deferred basis (unless the alternative minimum tax rules apply).

#### Employee considerations

In most cases, your employee doesn't incur any income tax on amounts contributed to a top-hat plan until the funds are actually paid to him or her from the plan.

**Caution:** In some cases, it may be possible for an employee to be subject to federal income tax on amounts contributed to a top-hat plan prior to the actual receipt of the funds by the employee. For more information, see Nonqualified Deferred Compensation Plans.

#### Internal Revenue Code Section 409A

IRC Section 409A, enacted as part of the American Jobs Creation Act of 2004, contains election, distribution, and funding rules that apply to top-hat plans. These new rules generally apply to compensation deferred after December 31, 2004 (although compensation deferred earlier is also covered in some cases). If a plan fails to comply with Section 409A's requirements, then affected participants will be subject to income tax and penalties on their accrued benefits in the year of the failure (or if later, when those benefits vest). You should consult your pension professional regarding the potential impact of Section 409A before adopting any top-hat plan. For additional information see IRC Section 409A (Governing NQDC Plans).