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A top hat plan checklist for employers

This article originally appeared in the October 2018 issue of Employee Benefit Plan Review.

A top hat plan is a nonqualified deferred compensation plan that is designed to defer taxation and avoid key provisions of the Employee Retirement Income Security Act of 1974, as amended (ERISA). Typically, top hat plans benefit executives whose annual compensation exceeds the limit for compensation that can be taken into account under a qualified retirement plan.[1] Because top hat plans provide significant tax and economic benefits, they have been the subject of participant lawsuits as well as scrutiny by the Internal Revenue Service (IRS) and Department of Labor (DOL).

The following is a checklist for employers with steps that can be taken to minimize the impact of participant lawsuits and governmental audits and investigations with respect to top hat plans.

Monitor the group of eligible employees

Top hat plans are plans maintained "primarily for the purpose of providing deferred compensation for a select group of management or highly compensated employees." (ERISA Sections 201(2), 301(a)(3) and 401(a)(1)) Plans with top hat status are exempt from the eligibility, vesting, funding, and fiduciary rules under ERISA.

Neither ERISA nor the regulations thereunder clearly define the "select group" that can be covered under a top hat plan. For example, neither the term "highly compensated" nor the term "management" has been defined for purposes of determining top hat plan status. Nor is there a numerical test for the size of the group. As a result, participants have sometimes sued employers, arguing that they are entitled to certain ERISA protections, e.g., vesting, because a plan's eligibility group is too broad. In addition, because of the sizable benefits provided thereunder, the eligibility provisions of a top hat plan have, on occasion, been scrutinized by the DOL.

In a footnote to a 1990 Advisory Opinion, the DOL first provided its interpretation of the term "primarily" as used in the top hat plan exemptions under ERISA. The DOL stated that the word "primarily" refers to the purpose of the plan, i.e., the provision of benefits, and not to participant composition under a plan. In 2015, the DOL filed an amicus brief with the U.S. Court of Appeals for the Fourth Circuit in which it reiterated its position that the word, "primarily" modifies the phrase "for the purpose of providing deferred compensation and does not modify the phrase "for a select group of management or highly compensated employees." As a result, it is not advisable to include in a top hat plan individuals that do not fit within the select group.

In *Sikora v. UPMC*, the U.S. Court of Appeals for the Third Circuit held that bargaining power over plan design was not a factor in determining whether a plan covers a select group of highly compensated or management employees. Similarly, in *Alexander v. Brigham & Women's Physicians Org., Inc.*, the U.S. Court of Appeals for the First Circuit held that the bargaining power of plan participants should not be taken into account in determining whether a plan is a top hat plan. In contrast, several other Circuits, relying upon the language in ERISA Advisory Opinion Letter 90-14A which describes Congress' intent in creating the top hat plan exemption, have concluded that bargaining power is a relevant factor in determining the top hat group.[2]

The above illustrates that, in the absence of a bright line test for top hat plan status, courts and the DOL have developed guidelines, sometimes conflicting, that should be heeded by employers. Employers must guard against expanding the eligible group of employees to include individuals that a court or government agency may determine to be outside the "select group."

Clearly define your eligible group

It is advisable to clearly identify the eligible group in the plan document. Alternatively, if the plan's eligibility provision merely reflects the language of the ERISA top hat exemption, the employer should develop guidelines

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that clearly define the eligible group. In the case of a borderline participant, it is advisable to prepare a written analysis supporting the inclusion of such individual in the top hat plan and keep it with plan records.

Give your plan administrator the power to issue binding determinations

In the *Firestone* case, the U.S. Supreme Court held that, if a plan administrator has been given the discretion to interpret and apply the provisions of a plan subject to ERISA, then judicial review of a benefits denial by the plan administrator will be conducted applying an arbitrary and capricious standard of review.

There is a split in the federal Circuits regarding the standard of review that should be applied in cases involving top hat plans. The Seventh and Ninth Circuits have applied the arbitrary and capricious standard if the plan administrator has been granted the requisite discretion required under *Firestone*.[3] In contrast, the Third and Eighth Circuits have held that a *de novo* standard applies since plan administrators of top hat plans are not subject to the ERISA fiduciary rules.[4]

Notwithstanding the split in the Circuits on this issue, a top hat plan document should grant to the plan administrator the discretion to determine eligibility for benefits and to make all other determinations necessary for the administration of the plan. In addition, the plan should provide that all determinations by the plan administrator are binding unless determined to be arbitrary and capricious by a court having jurisdiction. Even if a court holds that ERISA rules relating to the applicable standard of review do not apply, it may decide to enforce such plan provisions as a matter of contract law.

Require participants to exhaust the ERISA claims procedures

Although exempt from many ERISA requirements, top hat plans are subject to the ERISA enforcement provisions, including the ERISA claims procedures. Therefore, a top hat plan document must include claims procedures that comply with ERISA. A top hat plan document should also state that (i) a participant must exhaust the claims procedures under the plan, and (ii) failure to do so will cause a denial of benefits to be final and binding and preclude the participant from filing suit with respect to the claim. This should also be stated in plan summaries provided to participants.

Specify the court in which lawsuits must be filed

One way to ensure consistent plan interpretations and conserve resources is to include a forum selection clause in top hat plan documents. A forum selection clause specifies the court in which lawsuits involving the plan must be filed. The Sixth Circuit Court of Appeals in *Smith v. Aegon Companies Pension Plan*, and the Seventh Circuit Court of Appeal in *In re Mathias* upheld forum selection clauses in ERISA plans. In declining to review the *In re Mathias* case, the U.S. Supreme Court allowed the Seventh Circuit's decision upholding a forum selection clause in an ERISA plan to stand. The plan summaries should also include the name of the court in which lawsuits involving the plan must be filed.

Limit the period for filing suit

ERISA does not include a limitations period for filing a lawsuit to recover benefits. In the absence of a specified limitations period, courts generally apply the most analogous state statute of limitations.[5] This is typically the state statute of limitations for a contract claim.

In *Heimeshoff v. Hartford Life & Accident Insurance Company*, the U.S. Supreme Court held that a plan may provide for a particular limitations period, even if it starts to run before the cause of action accrues if the period is reasonable. Based on subsequent cases, a limitations period of one year should be considered reasonable.[6]

A key issue is when the statute of limitations begins to run. A number of Circuits have adopted the doctrine that a formal denial of a claim is not required to start the limitations period if there has been a clear repudiation of the benefits that was made known to the participant or beneficiary.[7]

Based on the above, the plan document should be drafted to limit the period during which a lawsuit may be filed to a specified period after the cause of action has accrued, e.g., one year. The top hat plan document should also provide that a cause of action accrues on the earlier of the date (i) the participant has exhausted the claims procedures under the plan, or (ii) the plan or plan administrator has clearly repudiated the participant's or beneficiary's right to benefits (even if not yet filed) and such repudiation is known to the participant. These limitations should also be included in plan summaries provided to plan participants and in any letters denying claims or appeals.

Comply with special employment tax rule if applicable

Although federal employment taxes are generally due in the year wages are paid, there is a special timing rule for nonqualified deferred compensation (NQDC) which provides that NQDC is subject to employment taxes in the later of the year in which (i) the services are performed, or (ii) the NQDC vests. If employment taxes are withheld and deposited with respect to NQDC in the year of vesting, subsequent earnings on the NQDC will not be subject to employment taxes. If the special timing rule is not followed, then NQDC will be taxed in the year of payment. Typically, this results in the participant paying more employment taxes.

In *Davidson v. Henkel*, a federal district court held that an employer was responsible for additional FICA taxes owed by a NQDC plan participant due to the employer's failure to follow the special timing rule. The court based its decision on the fact that the plan document stated that the company would withhold applicable taxes and the employer failed to do so.

Employers should be careful to administer top hat plans in accordance with the special timing rule to the extent applicable. In addition, based on the *Henkel* decision, the top hat plan document should be drafted to indicate that, although the employer has the right to deduct from amounts otherwise payable under the plan any federal, state, local or other applicable taxes, the employer does not guarantee the tax consequences of the plan and has no obligation to indemnify any person against any taxes attributable to benefits provided under the plan. Such provisions will help protect the employer should inadvertent violations of the special timing rule occur.

Beware Section 409A

Section 409A imposes rules on the deferral and distribution of NQDC. It is beyond the scope of this article to summarize hundreds of pages of Section 409A regulations. Employers should seek legal counsel whenever adopting or modifying a top hat plan to ensure compliance with these complicated rules. Our previous article provides a good overview: Section 409A: Top 10 rules for compliant non-qualified deferred compensation

Conclusion

Although top hat plans are exempt from many of the onerous provisions of ERISA and need not comply with the numerous regulations applicable to qualified retirement plans, there are still pitfalls that can be avoided through careful drafting and vigilant plan administration.

1. Retirement plans that are qualified under Section 401(a) of the Internal Revenue Code of 1986, as amended cannot take into account compensation in excess of $275,000 (for 2018). ↩

2. Demery v. Extebank Deferred Comp Plan (B), 216 F.3d 283, 289 (2nd Cir. 2000); Bakri v. Venture Mfg. Co., 473 F.3d 677, 678-79 (6th Cir. 2007); Duggan v. Hobbs, 99 F.3d 307, 312 (9th Cir. 1996) ↩

3. Comrie v. IPSCO, 636 F.3d 839, 842 (7th Cir. 2011); Sznewajs v. U.S. Bancorp Amended and Restated Supplemental Benefits Plan, 572 F.3d 727, 733 (9th Cir. 2009) ↩

4. Goldstein v. Johnson & Johnson, 251 F.3d 433.443 (3rd Cir. 2001); Craig v. Pillsbury Non-Qualified Pension Plan, 458 F.3d 748, 752 (8th Cir. 2006) ↩

5. Johnson v. State Mutual Life Assurance Co. of America, 942 F.2d 1260, 1261-63 (8th Cir. 1992). 134 S. Ct. 604, 610 (2013) ↩

6. Tumiello v. Aetna Life Insurance Company, 2014 WL 572367(S.D. N.Y. 2/14/2014) (nine month limitations period upheld; Lundsten v. Creative Community Living Services, Inc. Long Term Disability Plan, 2015 WL 1143114 (E.D. Wis. 3/13/2015) (six month limitations period upheld). ↩

7. Miller v. Fortis Benefits Ins. Co., 475 F.3d 516, 520-21(3rd Cir. 2007); Carey v. International Brotherhood of Electrical Workers Local 363 Pension Plan, 201 F.3d 44, 47 (2nd Cir. 1999). ↩

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