

2020 Advisory Council on Employee Welfare and Pension Benefit Plans

Examining the Top Hat Plan Participants and Reporting

Testimony Date: October 22, 2020

Presenter: Mark West JD, CLU

### **Executive Summary**

Nonqualified deferred compensation plans are a key tool in helping employers attract and retain key talent. For small employers, nonqualified deferred compensation plans are especially important in competing with larger businesses for key talent. The current principles-based framework for determining the select group supports the wide variability of factors considered by employers when designing plans for their specific needs.

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#### **Written Statement-BIO:**

During my 35+ plus year career I have focused on key employee benefits and business owner planning solutions. In my current role as National VP- Business Solutions at the Principal Financial Group, I'm responsible for our business consulting team. An area of focus for this team is nonqualified deferred compensation plans. In partnership with our administration and distribution teams, we work with our clients and their financial advisors, tax, and legal professionals to design and maintain plans to meet each client's objectives.

#### **Principal Deferred Compensation**

Based on the PLAN SPONSOR Defined Contribution Recordkeeping Survey (July 2020), Principal is the leader in administration of nonqualified deferred compensation plans, administering over 2,300 plans. To provide some context around my comments, the following are characteristics representative of our block of business:

- Median number of employees 400
- Median number of eligible plan participants 13
- For profit (closely held to Fortune 500) 70%
- Not for profit organizations 30%
- In business more than 25 years 75%
- Participant's income under \$150K 21%
- Participant's income \$150K-\$300K 44%
- Participant's annual contributions less than \$50K 85%
- Provide a company contribution 57%

#### **Written Statement- Opening Comments:**

In reviewing the questions posed and analyzing them based on my experiences, I believe the first question to address is: **Whether employers are inappropriately including rank and file employees in top hat plans.** A common question that arises in the plan design discussion is who can participate in the plan?

Determining who should be included is more of an art than science since there is not a clearly defined definition. Admittedly “a select group of management or highly compensated employees” leaves room for interpretation. Most of the guidance comes from a few federal court cases. While these cases offer varied and at times inconsistent guidance, most have focused in part on objective measures including the percentage of workforce covered by the plan and the average salary of the select group compared to average salary for the full workforce as part of the assessment.

The available guidance leads plan sponsors, with assistance from their plan administrator and counsel, to evaluate the relevant facts and circumstances to determine the appropriate select group. This principles-based framework provides the flexibility to customize a plan for any employer’s unique situation but does not lead to the inclusion of rank and file employees in the select group definition based on my experience and our block of clientele.

In situations where a need is identified for specific rank and file employees, we help clients understand alternative solutions outside of the nonqualified deferred compensation plan. For example, bonus plans can be an effective solution for specific long-term rank and file employees that an employer wishes to recognize.

In my experience, plans are appropriately applying the available guidance when determining the select group for inclusion in their plans. We don’t have evidence of plan sponsors attempting to expand the group beyond what we expect based on the current guidance. Based on our block of business the median number of participants is less than 4% of the employee group.

There are certainly times a clear, succinct definition of “select group” would make explanation of the available guidance easier. I do believe, however, that such a prescriptive approach would come at significant cost by failing to consider the full facts and circumstances surrounding an employer’s plan, including factors that vary from industry, size of company, entity type and purpose and design of a plan.

When contemplating a guideline, relevant information that must be considered includes:

- Compensation-This can vary significantly based on area of the country, profession and size of company.
- Select Group of Management-When evaluating cases today we look beyond title to consider the role, responsibility and breadth of authority.
- Plan Design- For larger companies, many of the plans are designed to allow employee deferrals. They may or may not include an employer match but generally most dollars going into the plan come from employee deferrals. In other situations, the objective is to recruit, retain or reward key talent where the benefit is financed solely by the employer. For smaller companies it is common to use an employer-financed plan to reward key talent and compete with larger employers. Many of the smaller companies are “flow-through” entities and employee deferrals, for example, result in additional current taxation to the owners. As a result, owners are very thoughtful in determining the need for the plan, who should participate, and limiting the plan to a small group.

Taking into account the variability of these factors, we believe the current principles-based framework for defining a select group is necessary and appropriate. Any introduction of a more-prescribed, definitive rule will lead to unintended consequences.

In considering “ **whether the reporting requirements for top hat plans should be modified to provide additional information,**” my belief is the information currently requested is appropriate. The current requirement to confirm that the plan is for highly compensated or key management encourages companies implementing plans to take seriously the top hat provision. If any additional information were suggested, it may be helpful to request the total number of employees in addition to the number of employees participating in plans. This

would provide some baseline information on the size of businesses implementing plans.

With respect to **“whether the Department should provide specific instructions for companies to follow to correct eligibility errors that occur when rank and file employees are found to be participating in top hat plans,”** in my experience I have only seen a handful of situations in 35+ years where the design was headed down a path that would have led to clear violation of the top hat rule and those were corrected before plan implementation. The limited number of court cases over close to five decades also provides a clear indication that this isn’t a common occurrence. Although I don’t see I need for guidance, if it is determined additional guidance is needed it is imperative that it be coordinated with IRC 409A to avoid unintended tax consequences if the ineligible participant is removed from the plan and benefits are paid out.

In closing, nonqualified deferred compensation plans are a key tool in helping employers attract and retain key talent. For small employers, nonqualified deferred compensation plans are especially important in competing with larger businesses for key talent. The current principles-based framework for determining the select group supports the wide variability of factors considered by employers when designing plans for their specific needs. The plan sponsors, their legal counsel and advisors that we work with understand and apply the current guidelines appropriately. This assessment is reinforced by the data from our clientele’s plans. As a result, I don’t believe there is a need to develop additional formal guidance.