

Statement of Richard W. Skillman, Caplin & Drysdale, Chartered

1. **Background:** I am a member of Caplin & Drysdale, Chartered in Washington, D.C. I have done tax and employee benefits work, including extensive work relating to executive compensation, for more than 45 years. While most of my executive compensation and other employee benefits work has been on the tax side, I have also advised clients for many years on whether executive deferred compensation plans qualify as a top hat plans under Title I of ERISA and on the one-time ERISA registration requirement for such plans.
2. **Summary of Position:** Without regard to the resources available to the Department of Labor, I recommend against further regulatory action in this area unless and until there is significant evidence of abuse or a demonstrated need for additional guidance for employers. Given the wide variation in the nature and size of the businesses and workforces of the employers that maintain executive deferred compensation plans, as well as in the nature of the benefits provided under such plans, it would be extremely difficult to fashion regulations that reasonably limited the scope of the top hat exemption based on objective factors, and there is a risk that such regulations would unnecessarily restrict the scope of the exemption or have other unintended consequences. Furthermore, since top hat plans are subject to relatively minimal substantive requirements under ERISA, it is difficult to see a good reason to subject them to significantly more extensive reporting obligations; at most, I would recommend that employers be required to update their top-hat registration statements every five or ten years.
3. **Scope of the top-hat exemption:** We have lived with the ambiguous parameters of “a select group of management or highly compensated employees” for 46 years. So far as I am aware, there is no significant evidence that such plans have commonly been used to avoid ERISA requirements by providing unfunded retirement benefits to rank-and-file employees or to curtail the use or generosity of funded plans that are subject to ERISA and qualified under the Internal Revenue Code. There are undoubtedly exceptions, as there always are to such generalizations, but I have rarely if ever seen them in my practice. Moreover, to the extent employers have limited the use or generosity of qualified plans for rank-and-file employees in favor of top-hat plans for their most highly compensated employees, a more restrictive regulatory definition of the exemption might only limit the coverage of the top-hat plans without increasing the use or generosity of qualified plans.

Although the court cases that have addressed the scope of the exemption, almost all of which have involved claims by aggrieved former employees, have not been entirely consistent in their analysis, the prevailing view is that a plan’s top-hat status depends on qualitative as well as quantitative considerations, and, as I interpret the

cases, the qualitative considerations have often been dispositive. That, I believe, is how this exemption should be applied.

The primary reason why I believe the top-hat exemption should continue to be based, at least in significant part, on qualitative consideration is the inherent difficulty of devising appropriate objective rules in this context. One possibility, of course, would be to look to the percentage of the employer's workforce that participates in a plan, which the courts have generally looked to as one factor. But what percentage limitation would make sense? Based on the nature and size of the employer's business and workforce, there are obviously cases in which 10% of the employer's employees would include many rank-and file employees, but there are other cases (certain small employers in certain professions) in which limiting participation to, say, 30% of the employer's employees would needlessly exclude very highly paid employees, in some cases including owner-employees. A percentage of employees limitation might be refined by allowing higher participation percentages for employers with fewer employees and perhaps further refined by in some manner comparing the range of compensation of the covered group of employees with that of other employees.

In my view, however, it is almost inconceivable that the Department of Labor (or any regulator) would be able to devise a formula or guideline or set of guidelines that would appropriately take the myriad factual circumstances into account. Instead of drawing hard lines, another alternative would be for regulations to establish presumptions or safe harbors for determining top-hat status, or perhaps also unsafe harbors. Apart from the fact that such an approach would still need to deal with the wide factual variations in the size and composition of employer workforces, my concern is that presumptions and safe harbors often come to be perceived as the equivalent of rules, or are at least read as creating inferences, and thus such an approach might serve as an invitation for lawsuits against employers whose plans did not qualify for a favorable presumption or safe harbor.

In a perfect world, employers and their advisors would be able to determine with certainty whether their executive deferred compensation plans were classified as top-hat plans for ERISA purposes, and there have been times in my practice when I have wished I could provide my clients with more certainty on this question. In particular, certain of these plans, while they might be classified as "pension plans" within the meaning of ERISA, are not designed to provide retirement income as such, are not equivalent to either defined benefit or defined contribution plans, and could not possibly be conformed to ERISA requirements for pension plans; thus, such plans would have to be terminated if top-hat status was not preserved. To minimize that risk, there have been cases where I have advised clients to limit participation in such plans more narrowly than they preferred and more narrowly than I believed was necessary to prevail in a potential lawsuit that challenged top-hat status. Nonetheless, I believe that level of uncertainty is preferable to a regulatory definition or guidelines that fail to give adequate weight to an employer's unique facts and circumstances.

In sum, while the current state of the law in this area is not perfect, I do not believe there is any demonstrable need to clarify the scope of the top-hat exemption, and that any attempt to do so may very well do more harm than good.

4. **One-time reporting obligation**: It might be argued that the requirement to file a one-time registration statement for a top-hat plan under section 2520.104-23 of the ERISA regulations is so minimal that, unless amplified, it might as well be eliminated. Minimal as it may be, however, I believe the current reporting requirement for top-hat plans serves some meaningful compliance purposes. First, the fact that the reporting requirement exists requires employers to certify whether a plan or plans are maintained only for “a select group of management or highly compensated employees” and thus hopefully to make a serious, good faith judgment on the applicability of the top-hat exemption. Second, in my experience, this reporting requirement serves to help employers understand that, even if qualifying as a top-hat plan, their plan may still be classified as a “pension plan” under ERISA and thus subject to ERISA preemption and enforcement requirements. Third, because the one-time registration statements are public information that may be searched by employees, they give employees the ability to monitor their employers’ claims of top-hat status.

On the other hand, because such plans are subject to so few substantive ERISA requirements, I do not see a reason to require substantial additional reporting for such plans. I could, however, see the benefit of requiring employers to update their reports, say every five or ten years, because information initially reported (specifically, the number of plan participants) is likely to become outdated and because updated reporting might cause employers to be more vigilant in assuring that their plans continue to qualify for the top-hat exemption.

5. **A comparative look at the treatment of top-hat plans under the Internal Revenue Code**: Although the analogy is not perfect, I think it is instructive to look at what happened when the Treasury and IRS implemented amendments to the Internal Revenue Code regulating nonqualified deferred compensation plans; those amendments apply to essentially every top-hat plan of every private business. Prior to 2004, there were basically no rules under the Internal Revenue Code governing the federal income treatment of unfunded, nonqualified deferred compensation plans, except for provisions limiting the use of such plans by tax-exempt and governmental employers; the income tax treatment of such plans was governed by common law income tax principles and relatively simple regulations explaining these principles that had been on the books for decades. However, following the collapse of Enron, however, during which highly compensated Enron employees were able to receive distributions from Enron’s nonqualified deferred compensation plan while rank-and-file employees saw their 401(k) account balances that were invested in Enron stock disappear, Congress saw fit to enact section 409A of the Code in order to establish more definite and comprehensive rules regulating nonqualified deferred compensation plans for federal income tax purposes.

Section 409A imposes an inflexible series of restrictions on the timing of election and distributions under nonqualified deferred compensation plans, as well as extraordinarily severe tax sanctions if those restrictions are not satisfied by the terms or in the operation of nonqualified plans. (One of the perverse aspects of section 409A is that the onerous tax consequences, including a 20% penalty tax, fall on participating employees, even though they usually derive no benefit from and have no responsibility for the 409A violations that occur.) Following nearly 3 years of interim notices, proposed regulations, and consideration of extensive comments, the Treasury and the IRS adopted final regulations under section 409A in 2006. Those regulations are unusually lengthy and complex and allow almost no latitude for inadvertent or harmless error in the administration of plans covered by the regulations. It is a certainty, I believe, that there are many thousands of small employers who are unaware of section 409A and have no clue that they have contractual arrangements with employees that are subject to and often unambiguously violate the terms of section 409A. However, because the IRS has not trained revenue agents to look for 409A violations and there is virtually no IRS audit activity involving 409A, those employers and their employees bear little or no tax risk under section 409A. Larger employers, on the other hand, are well aware of the tax pitfalls under 409A and pay advisors such as myself to advise on the many nuances and ambiguities under the 409A regulations, substantially all of which bear no similarity to the Enron circumstances that inspired the enactment of section 409A. As should be asked with respect to a possible regulatory clarification of the somewhat ambiguous scope of the top-hat exemption, it is fair to question whether the enactment of section 409A has been a net benefit to the tax system or to the regulation of nonqualified deferred compensation plans?

And, with respect to the possibility of requiring further ERISA reporting by employers that maintain top-hat plans, it is interesting to note that section 6051(a)(13) of the Internal Revenue Code, which was enacted in 2004 conjunction with section 409A, *requires* employers to annually report on employees' W-2's the amount of each employee's annual deferrals under nonqualified deferred compensation plans. Acknowledging the complexity and burden of that requirement, and probably knowing that there is nothing that it would realistically do with such information, the IRS has prudently delayed the applicability of that requirement "until the Treasury Department and the IRS issue further guidance" -- which will presumably be never. Fortunately, the Department of Labor does not need to take disingenuous action to avoid needless information reporting for top-hat plans; it can leave top-hat reporting essentially as it is.