2020 Advisory Council on Employee Welfare and Pension Benefit Plans

Examining Top Hat Plan Participation and Reporting

Witness Testimony: Trisha Morrison

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Issue Chair: Jason Bortz

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Witness: Trisha Morrison, Chief Operating Officer, The Pangburn Group

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Biography:

Trisha Morrison graduated summa cum laude from Louisiana State University in 2000, where she earned a Bachelor of Science degree in business management with a concentration in human resources. In 2003, Trisha joined The Pangburn Group, one of few privately owned, fee-for-service, nonqualified executive benefit plan recordkeepers and consultants operating on a national basis. In operation for almost 25 years, The Pangburn Group services over 2,000 plans covering a broad spectrum of clients from small corporations and community banks to Fortune 500 public companies.

Trisha began a successful career in the retirement industry working her way up through the ranks from an Account Manager to now Chief Operating Officer and co-owner of the company. During her 17+ years at The Pangburn Group, Trisha played an integral role in development and management of processes and services to enhance the client experience. Trisha has assisted hundreds of clients in designing, establishing, and implementing their nonqualified plans. In addition, Trisha has established and maintained business relationships with life insurers, trust companies, and financial advisor firms.

Trisha regularly provides training and speaks on nonqualified plan topics at conferences, seminars, and webcasts. She is an active member of Finseca (formerly the Association of Advanced Life Underwriters (AALU)) and the National Association of Plan Advisors (NAPA), where she has offered support and expert guidance in their development and implementation of a nonqualified plan education initiative.

Witness Testimony:

As the 2020 ERISA Advisory Council contemplates the recommendations of the recently published Government Accountability Office (GAO) report on top hat plans entitled "Private Pensions: IRS and DOL Should Strengthen Oversight of Executive Retirement Plans," it is important to understand the landscape of executive nonqualified plan marketplace. The GAO report and its conclusions were based on information obtained from data purchased from the Main Data Group who compiled data from 2013 – 2017 Securities and Exchange Commission disclosures on executive retirement plan benefits provided to top executives at public companies. While this information is useful in its assessment, it only includes a portion of the landscape, namely the top executives at public companies. Throughout this testimony, in addition to addressing the questions requested in the scope document, I will provide additional information on valuable benefits these plans offer in the small to mid-sized market and shed insight on the broader reach of these plans.

Since 1975, pursuant to 29 CFR §2520.104-23, nonqualified plans follow the alternative method for compliance, which requires a one-time filing with the Secretary of Labor to identify the establishment of a plan for a select group of management or highly compensated employees. Through the Freedom of Information Act, data recorded through these filings is publicly available. An analysis of the over 90,000 records as of December 31, 2018 in the Department of Labor (DOL) database yields the following interesting statistics:

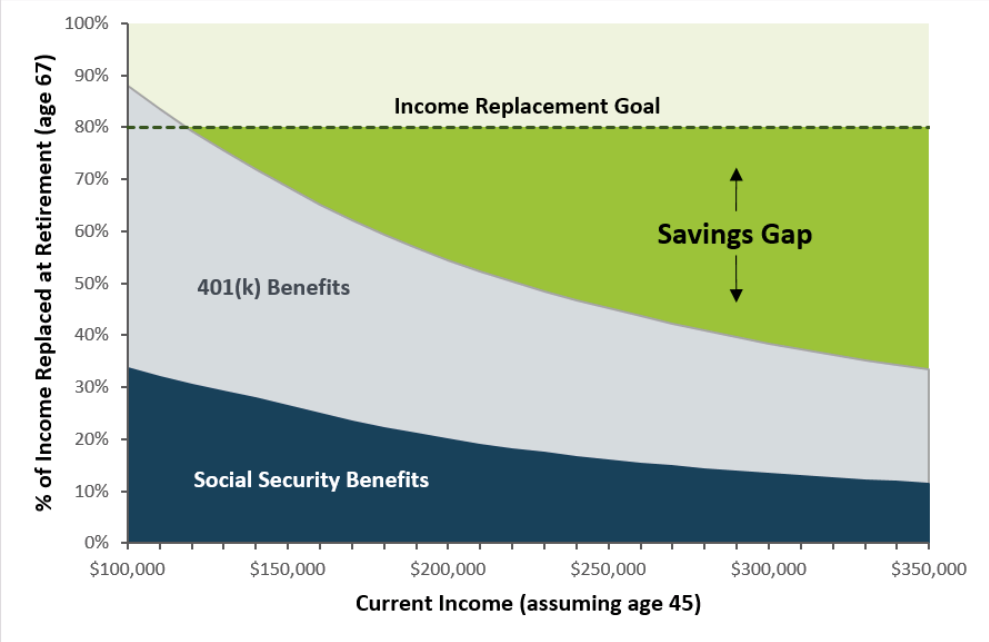
- 41.7% of all plans filed have 1 participant
- 78.8% of all plans filed have 10 or less participants
- 94.2% of all plans filed have less than 50 participants

Furthermore, in evaluating our company's database of over 2,000 small to mid-sized nonqualified plans (defined for the purpose of this testimony as plans covering 1 to 300 participants), we know that 67% of plan participants have less than a $100,000 balance, and in employee deferral plans, 68% of participants defer less than $25,000 annually.

While often the perception is that these nonqualified executive benefit plans are intended for large publicly traded companies, in reality, these plans are a useful tool for companies of all sizes – arguably even more critical for small and mid-sized companies. The primary purposes that companies establish nonqualified plans are for **recruitment and retention** of employees critical to the success of the business. Small to mid-sized companies face unique disadvantages in recruiting and retaining key employees. For example, if a key employee unexpectedly resigns for another job opportunity, or worse, passes away unexpectedly while employed, it is more likely that a large organization has other resources to fill the gap; whereas, a smaller company may have lost a key resource and sole knowledge center of a particular role within their organization. The costs and time involved in replacing an employee can be significant, particularly for a key employee or high demand professions. In addition, in order to compete with publicly traded companies who have at their disposal many means of enticing employees with stock options, restricted stock, or other perks, smaller companies have to find creative ways to compete for high-end talent. Nonqualified benefit plans are a great way for employers to recruit and retain employees or, at a minimum, attempt to level the playing field with their competitors.

In addition to the traditional reasons for establishing nonqualified plans discussed above, there are a number of other beneficial reasons to sponsor a nonqualified plan:

- **Nonqualified plans allow for additional retirement benefits to make up for the "savings gap."** Nonqualified plans are most often a supplement to a qualified retirement plan, not a substitute. The ability for employees to set money aside on a pre-tax basis for retirement is limited not only by the qualified plan limits (2020 401(k) deferral limit is $19,500; $26,000 if over age 50), but also by a potential further reduction in their contribution based on refunds received following non-discrimination testing. A number of industries, such as the restaurant and construction industries, who have low wage earners unwilling or unable to defer compensation into the qualified plan, can severely limit the ability for high wage earners to defer compensation for their future. To understand this savings gap, consider an employee who makes $100,000 per year and has access to full social security benefits plus years of deferring the maximum desired and allowable into the qualified 401(k) plan. In this scenario, the employee can achieve his goal to maintain 80% of income during retirement. On the other hand, an employee making $350,000 has a reduced social security income, and has been limited in pre-tax deferral due to the 401(k) statutory maximums. In this example, this employee falls significantly short of achieving an 80% income replacement. The graph below reflects this savings gap.



- **Nonqualified plans provide an equity alternative for private companies.** While many privately held companies place high value on their key employees, for various reasons they may not want to give up ownership in the company. Employees who think like owners can be major contributors, and nonqualified plans, if structured properly, can function to motivate employees directly related to the performance of the company using synthetic equity rather than actual equity.

- **Nonqualified plans can be structured to support a buy-sell arrangement.** Private companies that prepare in advance for a transition of ownership can often assist an existing key employee (the prospective buyer) with setting aside corporate contributions subject to

a vesting schedule that become available in the event of a change in control or at a pre-determined future date.

- **Nonqualified plans can be used as a reward for tenure and/or performance.** Sign-on bonuses contingent upon remaining with the company for a certain period of time as well as long-term incentive plans aligned to company, departmental, and individual objectives can all be valuable means of rewarding longevity and performance.

While much emphasis in the GAO report is focused on elective deferral plans, as you can see from the examples above, many plans have only employer contributions and are used for many other purposes besides employee deferral of current compensation. In fact, within our company's database of clients, 37% of our clients sponsor defined benefit plans (e.g., promise of a specified dollar benefit or an amount calculable based on a percentage of salary formula). In addition, of the 69% of our clients that sponsor defined contribution plans (i.e., account balance plans), over 56% include only employer contributions.

One of the inquiries from the GAO report regarding nonqualified plans is whether or not guidance is needed to define a "select group of management or highly compensated employees" for the purposes of being exempt from the substantive portions of ERISA, namely Parts 2, 3, and 4 of Title I pertaining to participation, vesting, funding, and fiduciary responsibilities. While many practitioners appreciate clear rules and guidance, I have concerns about the unintended consequences that could inadvertently impact certain groups, industries, and smaller sized companies. In my more than 17 years of experience, working with over a thousand clients large and small, I have certainly not observed a systemic problem of including rank-and-file (non-eligible) employees in nonqualified plans. Furthermore, nonqualified plans are required to include exhaustive claims procedures providing a participant recourse if he or she feels the rules are not applied as intended. Courts have interpreted a "select group of management or highly compensated employee" somewhat inconsistently across the various circuits, but in large part due to the various facts and circumstances of the case. Many of these court cases as well as DOL Advisory Opinions, in particular DOL Advisory Opinion Letter 90-14A (May 8, 1990), have yielded "unwritten" rules that are often used by plan sponsors as a guide in determining eligibility:

- **Eligibility limited to a certain percentage of total employees within the company.** While the courts have disagreed on a single percentage due to the relevant facts and circumstances of a case, a general guideline of 15% is often used. This percentage or any percentage applied alone can be flawed for several reasons, including, but not limited to (1) the percentage can be a moving target as the company changes, (2) the structure of an organization with multiple entities can create further gray area in determining whether the percentage is of a single subsidiary, affiliate, unit, or the entire holding company, and (3) the percentage can be manipulated based on the application to active participants or the number of eligible individuals.

- **Eligible employees should have management authority.** The analysis of one's management authority is a qualitative assessment based on the roles and responsibilities expected of an employee. It could be an inaccurate/inadequate method to use titles alone and should instead include a thorough evaluation of the job description.

- **Eligible employees should have significant influence in negotiating compensation and benefit structures.** In DOL Advisory Opinion 90-14A, the Department of Labor stated: "It is the view of the Department that in providing relief for "top-hat" plans from the broad remedial provisions of ERISA, Congress recognized that certain individuals, by virtue of their position or compensation level, have the ability to affect or substantially influence, through negotiation or otherwise, the design and operation of their deferred compensation plan, taking into consideration any risks attendant thereto, and therefore, would not need the substantive rights and protections of Title I." It is important to recognize that often for administrative convenience, particularly in larger organizations, plans may be structured by the plan sponsor without one-on-one negotiation, but participation is voluntary. Negotiation is more likely for smaller plans when variation in design and tracking is more administratively feasible.

- **Eligibility based on minimum compensation thresholds.** For ease of application and creating a clear rule, some plan sponsors apply the IRS highly compensated employee threshold for nondiscrimination testing for qualified plans (currently $130,000 in 2020 or $185,000 for key employees). As a general rule for nonqualified plans, this guideline can be problematic based on significant geographical compensation and cost of living differences. One size does not fit all. Furthermore, Section 414(q) outlines that its definition of highly compensated employee may not be relied upon as a safe harbor for determining top hat plan status. As a result, this unwritten rule, applied alone, should be used with caution.

- **Compensation disparity between top hat participants and other employees.** Another useful tool for assessing eligibility is an evaluation of the compensation level of the intended eligible group compared to rank-and-file employees. However, there is no bright line percentage as to what is acceptable.

While the above "unwritten" rules are helpful, they all can be flawed based on facts and circumstances and none of these rules alone should be sufficient evidence to guarantee that the plan covers only top hat employees. In all cases, both a quantitative and qualitative analysis should be made. For every example that fits these guidelines, counter-examples can be provided. Consider the following scenarios:

- Professional practices such as physicians, engineers, and law firms whose organizations by nature include a significant percentage of highly compensated employees and a strong ability to negotiate either individually or as a group. These employees may not have management authority but could be making hundreds of thousands of dollars each year with only the ability to defer the 401(k) maximum. Are these individuals not disadvantaged in their ability to save for retirement without the use of a nonqualified plan? Are these individuals not in a position to understand the risks involved in participating in such a plan unprotected by the substantive portions of ERISA? Yet, there is concern under the rules that a high percentage of eligibility (e.g., over approximately 15%) would put their plan and organization at risk.

- Food services industries whose organizational structure is made up of relatively young, part-time employees (e.g., wait staff) with high turnover. These companies struggle to effectively

implement and pay for a costly 401(k) when participation is low resulting in limited ability for highly compensated employees to defer due to the non-discrimination testing for qualified plans.

- Small businesses in rural areas of the United States. Consider a company that employs less than 20 employees but has 6 non-owner employees who helped to grow the successful business, wear many hats, and would be detrimental for the organization to lose. Perhaps these individuals only make $115,000. Should they not be able to benefit from a plan intended to retain them?

While guidelines would be useful, given the variety of scenarios, they could quickly fall short of considering all aspects and inadvertently affect many organizations who rely on these important benefits to compete with other organizations for talent and to satisfy the benefit needs of their critical employees. For many reasons, these plans should be more available rather than further restricted as long as participants understand the risks.

Although there are no statutory requirements to provide participants with notification of the risks of participating in a nonqualified plan, namely, that the benefit is only a contractual promise to pay and that the participant is a general creditor in the event of bankruptcy or insolvency of the company, in practice, plans generally contain provisions within the legal agreement specifying the participants' rights and risks. Additionally, the adoption of Internal Revenue Code Section 409A ("Section 409A") solidified the requirement to document nonqualified plans. This led the industry to re-evaluate all plans, and industry best practices dictate an inclusion of clearly detailing risks not only in the plan agreement, but also in other participant communications such as a participation agreement, enrollment materials, and summary plan description. If the Department of Labor desires to formalize the requirement to notify participants, perhaps a disclosure statement such as the below could be required on initial participant enrollment materials and an annual benefit statement:

> *IMPORTANT NOTICE: This plan constitutes an unfunded, unsecured promise of the Plan Sponsor to make payments. The Plan Sponsor is not required to segregate, set aside, or escrow any amounts for this benefit. Plan benefits are subject to the claims of the company's creditors should the company become bankrupt or insolvent.*

The GAO has also recommended further research into whether reporting requirements should be modified to provide additional information to the Department of Labor. Whether or not this is necessary and the type of information that should be collected depends on the purpose and use of this information. While I feel more information would be interesting, if its purpose is to target companies based on percentages of participation, for the aforementioned examples, it may lead to erroneous conclusions and target certain industries disproportionately. Section 409A added a significant burden on plan sponsors to comply with rules regarding timing of deferral and distribution elections, so to add onerous reporting for these purposes could potentially overburden plan sponsors, particularly smaller businesses who greatly benefit from these arrangements.

One of the primary concerns of the GAO is to ensure that participants in these plans are fully aware of the risks. If participants are required to be provided notice of these risks, perhaps part of the one-time filing to the Department of Labor could include a declaration by the company that they have provided the participants upon plan entry with a disclosure statement as suggested above and are willing to

provide proof of this notice if requested by the Department of Labor. This would be similar to the current declaration that the plan is limited to a select group of management or highly compensated employees and the current acknowledgement that a copy of the document will be provided to the Department of Labor upon request. In addition, while I do not feel any annual reporting is necessary, it would be helpful to require plan sponsors to notify the Department when a plan is terminated. I also suggest a one-time review of the Department of Labor database to remove companies currently on file that have either terminated their plan or whose tax id no longer exists. Requiring a filing at the beginning and end of a plan would provide a database of active plans without the burden on plan sponsors of an annual filing.

Finally, regarding the GAO's concern about creating specific instructions for correcting eligibility errors that occur when rank-and-file employees are found to be participating in top hat plans, I do not believe that would be an adequate use of resources. First, as I mentioned earlier, in my years of experience, abuse of top hat plan eligibility to avoid qualified plan restrictions simply is not a problem in need of a solution – there are no systemic abuses of what a reasonable person would assume to be a select group of highly compensated employee. Second, if a participant is deemed no longer eligible to participate (e.g., demotion), aside from removing their ability to defer for future calendar years and ceasing employer contributions or accruals, Section 409A strictly prohibits accelerating payments except under certain limited circumstances, not including a change in eligibility status.