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THE EXECUTIVE COMPENSATION THREAT TO RETIREMENT

by

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ABSTRACT

In recent years a new phenomenon has appeared on the retirement savings landscape: the expansion into middle management ranks of a traditional tool of executive compensation, the so-called “top hat” pension plan. Top hat plans are unfunded deferred compensation programs for a “select group of management or highly compensated employees.” Properly structured, top hat plans amass retirement resources that are taxed to employee-participants only when distributed. From the participant’s viewpoint, that delayed inclusion appears comparable to the tax deferral accorded qualified retirement plan savings, yet top hat plans are exempt from all of the Code’s qualification conditions. They are

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likewise excused from virtually all of ERISA's pension plan participant protections, including vesting, funding and fiduciary responsibilities.

This regulatory immunity licenses three interconnected pathologies that undermine core retirement policy objectives. The inapplicability of ERISA's worker protections, combined with preemption of state law, relegates top hat plan participants to a uniquely precarious position: their retirement savings are more exposed to deprecation and vulnerable to loss than if ERISA had never been enacted. The inapplicability of the Code's qualified plan nondiscrimination requirements allows employers to offer additional retirement savings to highly-paid managerial, technical and professional employees without having to pay comparable benefits to rank-and-file workers. And the dramatic disparity, post-2017, between income tax rates applicable to corporations and high-income individuals incentivizes that favoritism with a substantial tax subsidy that is unmeasured and generally overlooked.

This article explores the unresolved ambiguity that has enabled top hat plan metastasis into upper-middle compensation ranges. It documents the sources of the pathologies associated with the expansion of top hat pensions and traces their consequences. And it surveys the leading responses to these developments, some of which offer only partial solutions, while others could be accomplished only by legislation.

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INTRODUCTION

The United States spends more than \$200 billion annually subsidizing retirement savings in tax-qualified retirement plans.¹ That subsidy is delivered in the form of preferential tax treatment, specifically tax deferral. Congress has long understood that such a tax-based incentive for saving, if delivered on an individual basis, would yield perverse results: higher income individuals, who face larger tax liabilities, obtain the most benefit from tax deferral, yet these are the people with sufficient resources to save adequately without assistance. Since 1942, the central condition imposed on a pension, profit-sharing or stock bonus plan seeking favorable tax treatment is the requirement that the plan not discriminate in favor of highly compensated employees with respect to either participation (meaning the workers covered by the plan) or the contributions or benefits provided.² (Plans that satisfy the requirements for favorable tax treatment—that qualify for special tax privileges—are called “qualified plans.”)³ The nondiscrimination rules produce a complex, covert and clunky cross-subsidy intended to encourage firms to extend retirement savings to low- and middle-income employees—those workers who often lack sufficient discretionary income to save adequately on their own, and whose personal income tax exposure is too modest for tax deferral to lure them to save.⁴

1. According to the U.S. Department of the Treasury, the net cost of the preferential treatment of qualified retirement plans is projected to be approximately \$176 billion in fiscal year 2022 (\$229 billion if IRAs and Keogh plans are included). OFF. OF MGMT. & BUDGET, EXEC. OFF. OF THE PRESIDENT, ANALYTICAL PERSPECTIVES, BUDGET OF THE UNITED STATES GOVERNMENT, FISCAL YEAR 2023, at 160 (2020), <https://www.govinfo.gov/content/pkg/BUDGET-2023-PER/pdf/BUDGET-2023-PER.pdf> [<https://perma.cc/ZC92-A2JF>]. Going by congressional estimates, the figure is \$331 billion for employer plans (\$373 billion if IRAs and Keogh plans are included). JOINT COMM. ON TAX’N, JCX-23-20, ESTIMATES OF FEDERAL TAX EXPENDITURES FOR FISCAL YEARS 2020–2024, at 34 (2020).

2. §§ 401(a)(3)–(5), 410(b).

3. The term derives from § 401(a), the statutory definition of a “qualified trust,” on which hinges the exemption from tax of investment income, § 501(a), the employer’s immediate deduction for amounts contributed, § 404(a)(1)–(3), and the delay in taxing participants until actual distribution. § 402(a).

4. See *infra* notes 147–158 and accompanying text.

To the extent that highly paid workers save for retirement on a tax-advantaged basis outside of qualified plans, the redistributive force of the nondiscrimination rules is blunted. It was for that reason that Congress restricted tax-favored savings through individual retirement accounts (IRAs), which, because they are personal rather than employer-sponsored savings vehicles, do not induce redistribution.⁵ But there is a new threat to the retirement savings of most Americans: the unmonitored expansion into middle management ranks of a traditional tool of executive compensation, the so-called “top hat” pension plan.⁶ Top hat plans are unfunded deferred compensation programs for a “select group of management or highly compensated employees.”⁷ If a top hat plan is properly structured, the plan’s participants are not currently taxed on the value of benefits earned each year, nor on any investment income credited to them. Taxation is deferred until actual receipt of benefits.⁸ From a participant’s perspective, this delayed inclusion mimics the taxation of qualified retirement plan benefits, fostering an impression of comparable value.

Despite this superficial resemblance, top hat plans do not receive the same tax treatment accorded qualified retirement plans because top hat plan earnings are currently taxable and the employer’s deduction is

5. IRA contributions, other than rollover contributions from a qualified plan or another IRA, are limited by an annual dollar cap (\$6,000 in 2022, or \$7,000 in the case of an individual age 50 or older). §§ 219(b), (c), 408A(c)(2). That cap is reduced in certain circumstances. The deduction for contributions to a traditional IRA is phased out at high income levels if the taxpayer or her spouse is an active participant in a workplace retirement plan, § 219(g), and contributions to a Roth IRA are also phased out for high-income taxpayers, § 408A(c)(3). Congress set the phase-out range for permissible Roth contributions considerably higher than the deduction cut-back range for contributions to a traditional IRA. *Compare* § 219(g)(2), (3) *with* § 408A(c)(3) (A), (B). In the case of a single individual, the income phase-out range for Roth IRA contributions is \$129,000 to \$144,000 in 2022, while a single individual covered by a workplace retirement plan faces phase-out of deductible IRA contributions for income between \$68,000 and \$78,000. Notice 2021-61, 2021-47 I.R.B. 738.

6. For the origin of the term, *see infra* note 62.

7. Employee Retirement Income Security Act of 1974 §§ 201(2), 301(a)(3), 401(a)(1), 4021(b)(6), 29 U.S.C. §§ 1051(2), 1081(a)(3), 1101(a)(1), 1321(b)(6).

8. *See infra* notes 164–167 and accompanying text.

deferred until distribution.⁹ These disparities cause investment income credited to the participant to be taxed at the rate applicable to the employer rather than the employee-participant's rate. If the employer's marginal rate is nearly the same as the employee's, then the combined tax burden of the employer and the employee will be comparable to that borne by individual after-tax savings.¹⁰ In contrast, if the employer's tax rate is lower than the employee's, tax savings can be obtained from top hat pensions.¹¹

Top hat plans are excused from certain labor law protections that ERISA, the Employee Retirement Income Security Act of 1974,¹² imposes on retirement plans, whether tax qualified or not. In particular, a top hat plan is exempt from minimum vesting standards, minimum funding rules and fiduciary obligations.¹³ Thus, a participant's interest in a top hat plan may be substantially less secure (exposed to greater risks of loss) than her interest in a retirement plan protected by ERISA.

The inapplicability of those labor law protections also controls tax timing. Top hat plan classification effectively functions as the gateway to avoiding pre-distribution taxation of benefits.¹⁴ But for the

9. Nonqualified deferred compensation (NQDC) is not deductible until the employee includes the amount in income while the employer generally can deduct funds committed to qualified retirement plans on contribution. *Compare* § 404(a)(5) *with* § 404(a)(1)–(3). Any NQDC income financing benefits will have been taxed as earned at the employer's applicable rate (ordinary income, capital gain, etc.). If plan benefits are backed by assets held in a rabbi trust (an informal funding mechanism, *see infra* note 167 and accompanying text), trust income is taxed to the employer under the grantor trust rules. *See* §§ 671, 677; Rev. Proc. 92–64, 1992–2 C.B. 422, 424 (IRS model rabbi trust § 1(c)).

10. *See* Michael Doran, *The Puzzle of Nonqualified Retirement Pay*, 70 TAX L. REV. 181, 186–87 (2017); Daniel I. Halperin, *Interest in Disguise: Taxing the "Time Value of Money,"* 95 YALE L.J. 506 (1986). *See also* Daniel I. Halperin & Alvin C. Warren, Jr., *Understanding Income Tax Deferral*, 67 TAX L. REV. 317 (2014).

11. *See supra* note 10; *infra* notes 210 and 225–240 and accompanying text.

12. Employee Retirement Income Security Act of 1974 (ERISA), Pub. L. No. 93–406, 88 Stat. 829 (codified as amended at 29 U.S.C. §§ 1001–1461 and in scattered sections of 26 U.S.C.).

13. ERISA §§ 201(2), 203, 301(a)(3), 302, 401(a)(1), 404, 29 U.S.C. §§ 1051(2), 1053, 1081(a)(3), 1082, 1101(a)(1), 1104.

14. *See supra* note 8 and accompanying text.

top hat plan exemption, advance funding would generally be required,¹⁵ and the participant's interest in plan assets would be protected from the employer's creditors by operation of law.¹⁶ An interest in assets shielded from the employer's creditors constitutes "property" for income tax purposes, triggering taxation as soon as the interest is no longer subject to a substantial risk of forfeiture.¹⁷ And because ERISA's mandatory minimum vesting rules would apply, the participant's interest would become nonforfeitable by operation of law in short order, ordinarily once the employee has performed no more than five years of service.¹⁸ Thus, the value of a participant's stake in a nonqualified retirement savings arrangement that is not an exempt top hat pension will ordinarily be taxed to the participant long before receipt.¹⁹ No significant tax savings can be garnered from this state of affairs.

15. ERISA §§ 301(a), 302(a), 29 U.S.C. §§ 1081(a), 1082(a), mandates systematic advance funding of defined benefit plans and money purchase pension plans. Other defined contribution plans, such as profit-sharing and stock bonus plans, can be structured as discretionary contribution programs, but any contributions withheld from employees' pay promptly become plan assets subject to ERISA. 29 C.F.R. § 2510.3-102 (2021).

16. ERISA §§ 401(a), 403(c)(1), 29 U.S.C. §§ 1101(a), 1103(c)(1). The anti-inurement rule, which provides that "the assets of a plan shall never inure to the benefit of any employer," bars access by the employer's creditors.

17. § 83(a); *see* Treas. Reg. § 1.83-3(e) (property for purposes of section 83 includes a beneficial interest in assets, including money, transferred or set aside from the claims of creditors of the transferor).

18. ERISA §§ 3(19), 201, 203(a), 29 U.S.C. §§ 1002(19), 1051, 1053(a). Once the participant is fully vested, all subsequent contributions or earnings credits would be taxed immediately.

19. Top hat pensions can escape taxation in advance of distribution because they are excused from compliance with ERISA's pension plan vesting, funding and fiduciary rules. A deferred compensation program that does not satisfy ERISA's definition of a "pension plan" can likewise escape taxation in advance of distribution, again because ERISA's pension vesting, funding and fiduciary rules do not apply. An arrangement that does not provide retirement income or result in deferral to the termination of employment or beyond is not a pension plan within the meaning of ERISA § 3(2)(A), 29 U.S.C. § 1002(2)(A). Short-term deferred compensation calling for in-service distribution, such as bonuses or stock-based compensation payable upon completion of five years of service, exemplifies this type of non-pension NQDC. Such arrangements, which are often referred to as "golden handcuffs," are subject to the same income tax treatment as top hat pensions. *See infra* notes

Top hat plans actually pose a triple threat to the retirement savings system. This article shows how three interconnected pathologies undermine core retirement policy objectives.

First, top hat plans expose participants to risks of benefit loss that ERISA was designed to eliminate.²⁰ In particular, top hat plans are exempt from ERISA's labor law worker protections—including the anti-forfeiture rules (vesting), advance funding, spousal protections and fiduciary obligations²¹—apparently on the view that top executives call the shots and can look out for themselves. But the definition of top hat plan is fuzzy, and over the decades since enactment of ERISA, top hat plans have increasingly included middle-management employees who are not in a position to protect themselves by negotiating their compensation package.

Second, a top hat plan participant not only avoids current taxation as benefits are earned, but the total tax burden on her savings is also reduced if the employer's tax rate is lower than her own. Since 2018, the corporate income tax rate has been a flat 21%, while the progressive rate schedules of the individual income tax go up to 37%—actually 40.8% once account is taken of the surtax on net investment income.²² Hence, saving through a top hat plan potentially offers tax savings to any corporate employee whose marginal rate exceeds 21%.²³ Moreover,

164–172 and accompanying text. For that reason, the discussion herein of tax considerations refers to NQDC generically, rather than to top hat pensions specifically.

20. See *infra* Part I, notes 82–95 and accompanying text.

21. See *supra* note 13; ERISA §§ 205, 206(d)(3), 29 U.S.C. §§ 1055, 1056(d)(3) (spousal protections).

22. Compare § 11(b) with §§ 1(j), 1411.

23. Investment returns attributable to amounts deferred under a top hat plan are taxed to the employer during the period of deferral (accumulation phase), rather than to the participant-employee, as would be the case if the employee received current compensation and invested the after-tax amount herself. Assuming that investment opportunities available to the employer and the individual employee are comparable, if the employer's tax rate is lower than the employee's rate, then the fund will grow faster when left in the employer's control as NQDC. See *generally infra* notes 225–230 and accompanying text. Currently, many individuals face marginal rates above 21%. In 2022, the 22-percent tax bracket starts at only \$41,776 in taxable income for unmarried individuals, or \$83,551 for married couples filing jointly. Rev. Proc. 2021–45, 2021–48 I.R.B. 764. As a point of comparison,

even if the prescribed individual and corporate income tax rates were aligned, many corporations face an effective tax rate of zero in many years because net operating loss deductions may be available to shield investment earnings from tax.²⁴ In short, a huge swath of the population could benefit, taxwise, from top hat plan participation if they wanted to save more for retirement than they can under a qualified plan. Top hat plan saving, in other words, is now partially to fully subsidized for workers earning upper-middle or higher levels of compensation. Yet, top hat plans are not subject to the nondiscrimination regime that is the bedrock of the qualified retirement plan system.

This situation presents a risk that top hat plan saving might substitute for increases in qualified retirement plan benefits.²⁵ While top hat plan saving is preferable to individual after-tax saving for many well-paid employees, qualified plan saving, under which investment returns are fully tax exempt, can be still more beneficial.²⁶ At first glance that

Social Security Administration data report the 2021 national average wage as \$60,575. *Nat'l Average Wage Index*, U.S. SOC. SEC. ADMIN. (2021), <https://www.ssa.gov/OACT/COLA/AWI.html#Series> [<https://perma.cc/GQZ5-2WJH>]. The divergence in tax rates on investment returns inside and outside a plan is less dramatic for some types of income. An individual's net capital gain, for example, is currently taxed at 23.8% or less (including the surtax on net investment income, §§ 1(h), 1411), while capital gains realized by a corporate employer are subject to the generally applicable 21% corporate income tax rate. § 11. (Prior to 2018, the 35% corporate tax rate made it disadvantageous to earn long-term capital gain through a top hat plan.) Accordingly, a rational investor might construct an inside-plan portfolio of investment assets whose returns would otherwise be taxed as ordinary income and hold assets producing capital gains outside the plan. The rate differential on dividend income is also somewhat compressed (ordinarily 23.8% or less if taxed to the employee, or 10.5% if taxed to the corporate employer, taking into account the 50% dividends received deduction, § 243). See generally David I. Walker, *The Practice and Tax Consequences of Nonqualified Deferred Compensation*, 75 WASH. & LEE L. REV. 2065, 2112–18 (2018); Doran, *supra* note 10, at 196–98.

24. See *id.* at 198–200.

25. Nearly all firms that sponsor a top hat plan also sponsor one or more qualified plans. See *infra* note 31 and accompanying text. Apparently, top hat plans do not entirely displace (i.e., provide a complete substitute for) qualified retirement plan coverage in most workplaces.

26. If the qualified plan nondiscrimination rules operated to completely redistribute the tax subsidy associated with retirement savings for high-income participants, then the apparent advantage of the tax exemption

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might seem to alleviate substitution risk. Unfortunately, it does not. The choice between saving for retirement through a top hat plan versus a qualified plan is not left to the employee: the employer must be willing to offer these programs, and the employer sets their terms and conditions. Consequently, the employer is positioned as gatekeeper, able to grant or withhold access to these differently taxed saving opportunities. If the employer determines that top hat plan coverage is more cost-effective than increasing qualified retirement plan benefits, the company can direct savings for a “select group of management or highly compensated employees” into top hat pensions. The considerable burdens imposed by the tax law’s qualification requirements—most importantly the nondiscrimination rules—may make top hat plan saving relatively more cost effective from the employer’s perspective. In contrast, broadly distributing retirement saving (under the demands of the nondiscrimination rules) may require increasing total labor compensation costs.²⁷

Third, beyond evading redistribution, this cost-containment strategy comes fraught with externalities. With nonqualified deferred compensation (NQDC) now subject to lower tax rates than the individual would face outside the plan, revenue losses attributable to top hat plan savings mount. The tax regime applicable to NQDC—hitherto overlooked or excused from annual tax expenditure reckonings—cries out for expert quantification and focused assessment.²⁸ The grand irony is that rank-and-file employees, whose pensions are not enhanced when their employer offers retirement savings through a top hat plan, pay income taxes that finance (in part) the favorable tax treatment enjoyed by their “select” highly compensated coworkers.

After almost 50 years, there is still no clear definition of “select group of management or highly compensated employees”—the set of workers who may participate in a top hat plan. Part I of the Article examines the ambiguity that still enshrouds permissible top hat plan

would actually redound to the benefit of rank-and-file employees. In those circumstances, the ostensible tax benefits for highly paid plan members would be illusory. As will be shown, however, the nondiscrimination rules do not function optimally, see *infra* notes 154–159 and accompanying text, and consequently, highly paid workers at many firms retain a large share of the tax subsidy generated by their qualified plan savings.

27. See *infra* Part III, notes 193–196 and accompanying text.

28. See *infra* Part IV, notes 209–240 and accompanying text.

membership, explains the vulnerability of top hat benefits and explores how that vulnerability should inform strictures on top hat plan coverage from a retirement policy perspective. Part II briefly explains the logic and limits of the qualified plan nondiscrimination rules. Part III turns to the interaction between the labor law exemption and the qualified retirement plan system, focusing on the potential for expansive top hat plan coverage to suppress demand for increased qualified plan benefits, and the deleterious effect that may have on the retirement savings of the middle class. The tax advantage currently afforded top hat plan saving amounts to an implicit subsidy, which continues to escape identification as a tax expenditure, as explored in Part IV. That omission, and the resulting ignorance of revenue loss magnitude, obscures threats to national retirement policy, allowing them to grow unchecked. Cognizance of the threats points to possible solutions, such as the responses briefly surveyed in Part V: (1) requiring plan sponsors to periodically warn top hat participants with specificity of all risks of loss of their accrued benefits under the plan; (2) substantially restricting eligibility to participate in a top hat plan; and (3) ending preferential tax treatment of top hat plan savings by requiring accrual-based taxation of NQDC.

I. TOP HAT PLAN MEMBERSHIP AND ITS CONSEQUENCES

Top hat pension plans are a type of NQDC arrangement.²⁹ Employers maintain NQDC plans for a number of reasons, including recruiting employees, incentivizing employees to remain employed for a specified period (sometimes referred to as a “golden handcuffs” arrangement) and—important for this study—supplementing benefits provided under qualified retirement plans.³⁰

Top hat plans are almost always offered alongside qualified retirement plans. Ordinarily, a top hat plan does not substitute for a

29. The discussion in this part of the article closely follows ADVISORY COUNCIL ON EMPLOYEE WELFARE AND PENSION BENEFIT PLANS, REPORT TO THE U.S. SECRETARY OF LABOR, EXAMINING TOP HAT PLAN PARTICIPATION AND REPORTING (Dec. 2020), <https://www.dol.gov/sites/dolgov/files/EBSA/about-ebsa/about-us/erisa-advisory-council/2020-examining-top-hat-plan-participation-and-reporting.pdf> [<https://perma.cc/JPA4-M8R8>][hereinafter EAC TOP HAT PLAN REPORT]. One of the authors contributed to that report.

30. For explanation of the types of NQDC, particularly the distinction between golden handcuffs and top hat pensions, *see supra* note 19.

qualified plan.³¹ NQDC plans are not subject to statutory limits that apply to qualified plans, such as limits on the annual amount of benefits received under a defined benefit plan, the annual amount of contributions made on behalf of a participant under a defined contribution plan and the annual compensation level used to determine benefits and contributions.³² Nor is a NQDC plan subject to the minimum coverage and nondiscrimination rules applicable to qualified plans, rules that are designed to ensure that rank-and-file employees, and not merely highly compensated or key employees such as owners and executives, participate in and receive benefits from the plan.³³ And a top hat plan is not subject to ERISA rules pertaining to plan funding, vesting, benefit accrual or fiduciary responsibility.³⁴ Top hat plans are nevertheless able to mimic, from the perspective of the employee-participant, the favorable tax treatment of a qualified plan,³⁵ and in some cases, top hat plan benefits are accorded a meaningful tax subsidy.³⁶

In NQDC programs, compensation earned in one year is paid in a subsequent year, often on separation from service or retirement.³⁷ The amount deferred under a nonqualified plan can be left to the employee's choice, by giving the participant an election to direct a portion of her compensation (salary or bonus) into the saving plan, or the amount

31. EAC TOP HAT PLAN REPORT, *supra* note 29, at 34–35; *see also infra* note 133 and accompanying text (top hat plan proliferation has not reduced the number of qualified plans but may suppress benefits).

32. §§ 401(a)(16), (17), 415.

33. §§ 401(a)(3)–(5), 410(b).

34. ERISA §§ 201(2), 301(a)(3), 401(a)(1), 29 U.S.C. §§ 1051(2), 1081(a)(3), 1101(a)(1).

35. Taxation of the employee is generally deferred until actual distribution. *See infra* notes 165–166 and accompanying text. In addition, the features of some top hat plans are designed so that the program appears to offer a seamless extension of an underlying qualified plan. *See infra* notes 198–205 and accompanying text.

36. *See supra* note 10; *infra* notes 210, 225–240 and accompanying text.

37. A NQDC plan can be structured to require in-service distributions after a short period of deferral (five years, for example). Where compensation is not systematically deferred to the termination of covered employment or beyond, the program may escape classification and labor law regulation as an ERISA pension plan. ERISA § 3(2)(A), 29 U.S.C. § 1002(2)(A); 29 C.F.R. § 2510.3–2(c) (2021).

deferred may be set by the employer under a nonelective program. Under an elective deferral program, the election is generally made before the start of the taxable year in which the employee earns the compensation.³⁸ Alternatively, the employer may require that a portion of an employee's compensation be paid at a future date pursuant to the terms of a nonelective NQDC plan.³⁹ Nonqualified plans can be structured in many different ways. Some plans simply promise payment of the participant's account balance (contributions plus any earnings credits) at a future date (this is a defined contribution form of NQDC).⁴⁰ Others promise payment of a specified sum on a future date or determine the amount payable based on a formula (defined benefit type NQDC).⁴¹ Elective contribution programs typically credit the amount deferred to a bookkeeping account to which notional interest or earnings are also periodically credited. Some NQDC plans are designed to mimic qualified plans, providing the employee the right to direct the investment of his or her deferred compensation, typically among the same menu of options that are available under the employer's qualified plan.⁴²

A participant in a NQDC plan typically faces current taxation, as noted above, unless the plan qualifies for the top hat exemption, which requires that a plan be "unfunded and . . . maintained by an employer primarily for the purpose of providing deferred compensation for a select group of management or highly compensated employees."⁴³ ERISA does not define the phrase "select group of management or highly compensated employees," nor does it clarify what it means for a plan to be maintained "primarily for the purpose of providing deferred compensation" to such a group. No regulation fills that gap. ERISA's legislative history is suggestive but supplies no clear standard. Case law has not resolved the ambiguity. The opinions invoke a variety of qualitative and quantitative factors, but the courts have not settled upon a hierarchy or

38. § 409A(a)(4)(B).

39. Nonelective plans are sometimes referred to as supplemental executive retirement plans, or SERPs.

40. See ERISA § 3(34), 29 U.S.C. § 1002(34).

41. See ERISA § 3(35), 29 U.S.C. § 1002(35).

42. See *infra* nn. 121–128 and accompanying text. Because NQDC plans are unfunded and may represent only a contractual commitment to pay specified amounts in the future, such participant-directed investments merely serve to define the notional earnings credited to the account.

43. ERISA § 201(2), 29 U.S.C. § 1051(2).

uniform analytical approach.⁴⁴ Informal administrative guidance exists, but it has been broadly ignored in practice.⁴⁵ Over time, the archetypal top hat plan has evolved from an unfunded promise of deferred compensation made to a few senior executives (sometimes including non-management employees comparably compensated) to an asset-backed deferred compensation program covering 10% or more of a sponsor's workforce.⁴⁶

A. Legislative History of the Top Hat Plan Exemption

ERISA's legislative history fails to supply specific guidance on the intended scope of the top hat plan exemption.⁴⁷ It does demonstrate a general congressional expectation that the exemption would apply narrowly.

The initial Senate pension reform bill in the 93rd Congress, S. 4, in 1973, included an exemption from its vesting and funding rules for a plan that "is unfunded and is established or maintained by an employer primarily for the purpose of providing deferred compensation for a select group of management employees and is declared by the employer as not intended to meet the requirements of section 401(a) of the Internal Revenue Code."⁴⁸ (This language was carried forward from pension reform bills sponsored by Senator Jacob Javits dating as far back as 1967).⁴⁹ This exemption, however, did not apply to the fiduciary

44. See *infra* nn. 73-81 and accompanying text.

45. ERISA Adv. Op. 90-14A (May 8, 1990); EAC TOP HAT PLAN REPORT, *supra* note 29, at 36, 61.

46. See *infra* nn. 102-114 and accompanying text.

47. Portions of this section are derived from *Statement of Norman Stein Before the ERISA Advisory Council Working Group on "Examining Top Hat Plan Participation and Reporting,"* U.S. DEP'T OF LABOR, at 11-15 (Sept. 18, 2020), <https://www.dol.gov/sites/dolgov/files/EBSA/about-ebsa/about-us/erisa-advisory-council/2020-examining-top-hat-plan-participation-and-reporting-stein-written-statement-09-18.pdf> [<https://perma.cc/4MV6-XBJP>].

48. S. 4, 93d Cong. § 104(b)(6) (1973), *reprinted in* 1 SUBCOMM. ON LABOR OF THE SENATE COMM. ON LABOR AND PUBLIC WELFARE, 94TH CONG., 2D SESS., LEGISLATIVE HISTORY OF THE EMPLOYEE RETIREMENT INCOME SECURITY ACT OF 1974, at 93, 113 (Comm. Print 1976) [hereinafter ERISA LEGISLATIVE HISTORY].

49. Pension and Employee Benefit Act of 1967, S. 1103, 90th Cong. § 101(b)(6) (1967), *reprinted in* 113 CONG. REC. 4653, 4655 (1967); *id.* at 4659 (statement of Jacob Javits); see *Pension and Welfare Plans: Hearing on S.*

provisions of S. 4, which were framed as amendments to the Welfare and Pension Plans Disclosure Act (WPPDA) of 1970.⁵⁰ The introduction of S. 4 was accompanied by a summary of its provisions, which described the exemption as pertaining to “certain plans for key executives.”⁵¹ The report of the Committee on Labor and Public Welfare on S. 4 states in relevant part, “[i]t is intended that coverage under the Act be construed liberally to provide the maximum degree of protection to working men and women covered by private retirement programs. Conversely, exemptions should be confined to their narrow purpose.”⁵²

3421, S. 1024, S. 1103, and S. 1255 Before the Subcomm. on Labor of the S. Comm. on Labor and Public Welfare, 90th Cong. 91, 106, 164, 210 (1968). This bill was the first comprehensive pension reform proposal introduced in Congress. JAMES A. WOOTEN, *THE EMPLOYEE RETIREMENT INCOME SECURITY ACT OF 1974: A POLITICAL HISTORY* 129–30 (2004). In a statement accompanying introduction of the bill, Senator Javits explained that portions of the bill were modeled after the Ontario Pension Benefits Act, 1965, and noted that that statute might be useful in interpreting the bill. 113 CONG. REC. 4659 (1967). The Ontario Act did not contain an exception for unfunded plans or plans covering only management, however, and although it authorized regulations exempting a class of employees or pension plans from the application of the statute, no exception akin to S. 1103’s carve-out was issued before the bill was introduced. The Pension Benefits Act, 1965, S.O. 1965, c 96, § 25(f) (Can.); see Regulation Made Under the Pension Benefits Act, 1965, O. Reg. 188/65, § 9 (Can.) (setting registration fee for plans having nine or fewer members); Regulation Made Under the Pension Benefits Act, 1965, O. Reg. 103/66, §§ 8, 15 (Can.) (also setting registration fee for plans having nine or fewer members and exempting certain profit-sharing plans).

50. The WPPDA exempted plans covering not more than 25 participants. WPPDA § 4(b)(4), 29 U.S.C. § 303(b)(4) (1970), *repealed by* ERISA § 111(a)(1), 29 U.S.C. § 1031(a)(1). S. 4 defined “fiduciary” as a person acting with respect to an “employee benefit fund,” and fiduciary obligations governed the discharge of duties with respect to such fund. Accordingly, no exemption from the fiduciary provisions was necessary for unfunded plans, even plans covering more than 25 employees. S. 4, 93d Cong. §§ 502(a), 510 (1973) (adding WPPDA §§ 3(17), (25), 15(b)), *reprinted in* 1 ERISA LEGISLATIVE HISTORY, *supra* note 48, at 146, 147, 150, 169–72.

51. Summary of Major Provisions of S. 4—Williams–Javits Pension Reform Bill, *reprinted in* 1 ERISA LEGISLATIVE HISTORY, *supra* note 48, at 191, 192.

52. S. REP. NO. 93-127, at 18 (1973), *reprinted in* 1 ERISA LEGISLATIVE HISTORY, *supra* note 48, at 587, 604.

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In the Senate, members of the Finance Committee introduced competing tax-based pension reform legislation, which placed new vesting, funding and fiduciary rules under the jurisdiction of the IRS.⁵³ The new standards applied to qualified plans and thus did not include exemptions; a nonqualified plan would simply be stripped of preferential tax treatment.⁵⁴

The leadership of the Senate Finance and Labor Committees ultimately crafted compromise legislation. The vesting and funding provisions were housed in the Internal Revenue Code and the fiduciary rules incorporated in both federal tax and labor law.⁵⁵ The fiduciary rules did not include an exception for plans covering select management employees.⁵⁶ The bill's fiduciary rules only imposed duties with respect to an "employee benefit fund," however.⁵⁷ Consequently, fiduciary monitoring simply did not apply to completely unfunded programs, regardless of their coverage.

As was the case in the Senate, pension reform proceeded on two tracks in the House, with pension bills emerging from both the House Committee on Education and Labor and the House Committee on Ways and Means. The Ways and Means bill, which made vesting a qualification condition, did not include a top management exemption. The House committees ultimately crafted a joint bill, H.R. 2, which amended both

53. See WOOTEN, *supra* note 49, at 193–96; Peter J. Wiedenbeck, "Ninety-Five Percent of Them Will Not Be Missed": *Recovering the Tax Shelter Limitation Aspect of ERISA*, 6 DREXEL L. REV. 515, 522–25 (2014).

54. A subsequent Senate Finance bill would have granted tax-favored treatment to plans that did not comply with the vesting and funding rules if the coverage of such plans was restricted to five percent of shareholders or corporate officers. S. 4, 93d Cong. §§ 222, 262(a) (1973), *reprinted in* 1 ERISA LEGISLATIVE HISTORY, *supra* note 48, at 1271, 1305, 1336.

55. S. 4, 93d Cong. §§ 221 (vesting), 241 (funding), 511 (labor fiduciary rules), 521 (tax fiduciary rules) (1973), *reprinted in* 1 ERISA LEGISLATIVE HISTORY, *supra* note 48, at 1271, 1288, 1307, 1440, 1454.

56. S. 4, 93d Cong. §§ 511 (proposed WPPDA § 15(k)), 521(a)(2), *reprinted in* 1 ERISA LEGISLATIVE HISTORY, *supra* note 48, at 1451, 1454.

57. S. 4, 93d Cong. §§ 501(a), 511 (amending WPPDA by adding the definition of "employee benefit fund," defining "fiduciary" as person acting with respect to an employee benefit fund, and imposing fiduciary responsibilities in relation to an employee benefit fund), *reprinted in* 1 ERISA LEGISLATIVE HISTORY, *supra* note 48, at 1412–13, 1440–42.

the Internal Revenue Code and federal labor law with virtually identical vesting and funding requirements.⁵⁸

The labor provisions of the House legislation included the exemption for unfunded deferred compensation, but with an important addition: the exemption now applied to “unfunded plans maintained primarily for the purpose of providing deferred compensation to a select group of management or highly compensated employees.”⁵⁹ This first appearance of “highly compensated employees” in the demarcation of the exemption’s scope passed without remark in the written record. The report of the Committee on Education and Labor describes the exemption in one place as applicable to “[e]xecutive deferred compensation plans,” and in another place indicated that the exemption covered “[u]nfunded deferred compensation schemes of top executives.”⁶⁰ This was the bill passed by the House, which was considered together with S. 1179 by the conference committee.

The conference committee report on H.R. 2 included an example that seems to contemplate a quite restrictive application of the exemption.

[T]he labor fiduciary rules do not apply to an unfunded plan primarily devoted to providing deferred compensation for a select group of management or highly compensated employees. For example, if a “phantom stock” or “shadow stock” plan were to be established solely for the officers of a corporation, it would not be covered by the labor fiduciary rules.⁶¹

58. H.R. 2, as passed by the House on February 28, 1974, was an amalgam of H.R. 12906 (the Labor Committee bill) as title I, and H.R. 12855 (the Ways and Means Committee bill) as title II. 120 CONG. REC. 4717 (Feb. 28, 1974) (remarks of Rep. Fulton), *reprinted in* 3 ERISA LEGISLATIVE HISTORY, *supra* note 48, at 3505.

59. H.R. 12906, 93d Cong. § 101(b)(5), 201(b)(4), 301(b)(5) (1974), *reprinted in* 2 ERISA LEGISLATIVE HISTORY, *supra* note 48, at 2761, 2781–82, 2834, 2859 (emphasis added).

60. H.R. REP. NO. 93-533, at 18, 22 (1973), *reprinted in* 2 ERISA LEGISLATIVE HISTORY, *supra* note 48, at 2348, 2365, 2369. *Accord id.* at 3298, 3301 (explanatory statement in the nature of a committee report on the labor law provisions of H.R. 2, the joint House bill).

61. H.R. REP. NO. 93-1280, at 296 (1974) (Conf. Rep.), *reprinted in* 3 ERISA LEGISLATIVE HISTORY, *supra* note 48, at 4277, 4563. The conference

Officers, of course, constitute the top echelon of corporate management, and are ordinarily the *most* highly compensated employees. But in certain organizations, employees with unusual talents, such an athlete, entertainer or a highly skilled programmer, might also be among the most highly compensated employees.

The initial reaction by the legal community to the exemption's semantic ambiguities apparently lay somewhere between puzzlement and genuine concern. There were, prior to ERISA, firms that paid retirement benefits outside a qualified plan, often from the firm's general assets. In 1975, Robert Ridley, a California benefits and compensation lawyer, noted some pre-ERISA examples of problematic arrangements: providing ad hoc cost-of-living awards to retirees on an informal pay-as-you-go basis, and granting nonqualified benefits to a "chosen few," which might include long-service employees or other favored employees without regard to their job status or compensation level.⁶² Ridley also noted that the term "highly compensated" was not defined, and expressed skepticism that the workforce-specific understanding of highly compensated employee, then used by the IRS in implementing the qualified plan nondiscrimination standard, would be adopted for use in defining top hat plans.⁶³

B. Administrative Implementation and Judicial Interpretation

The Department of Labor has not defined the scope of the top hat plan exemption by regulation or other formal guidance having precedential

report refers to the top hat exemptions from the labor title's vesting and funding requirements as "unfunded deferred compensation arrangements" or "unfunded plans maintained by the employer primarily to provide deferred compensation for select management or highly compensated employees." *Id.* at 261, 267, 291, reprinted in 3 ERISA LEGISLATIVE HISTORY, *supra* note 48, at 4277, 4528, 4534, 4558.

62. Remarks of Robert W. Ridley in Norman B. Barker et al., *Pension Reform: The Employee Retirement Income Security Act of 1974, A Panel Discussion*, 27 MAJOR TAX PLAN. 691, at 780–783 (1975). Mr. Ridley's remarks apparently represent the first published usage of the term top hat plan. *Id.* at 780. He recalls the term having been used in meetings with Labor Department officials shortly after ERISA's enactment. Telephone Interview by Norman Stein with Robert Ridley, Farmer & Ridley LLP (Oct. 2021) (notes of the conversation on file with the authors).

63. Remarks of Robert W. Ridley, *supra* note 62, at 781.

effect.⁶⁴ It has instead addressed the issue informally, in response to requests for advisory opinions on the applicability of ERISA,⁶⁵ and in amicus briefs.⁶⁶ Three advisory opinions issued in 1975 summarized facts relating to covered workers' status with respect to job duties or pay levels and the percentage of the total workforce covered by the plan, but, without articulating a rule or standard, the advisory opinions proceeded to simply announce that the plans under consideration were top hat plans.⁶⁷ A 1990 article indicated that officials at the Department of Labor "stated on numerous occasions that these pre-1980 advisory opinions concerning the top hat exemption will be withdrawn by the DOL, and thus the public should no longer rely on them."⁶⁸

Then, in 1985, the Department issued an advisory opinion which concluded that the plan in question failed to satisfy the conditions for

64. What follows is largely drawn from EAC TOP HAT PLAN REPORT, *supra* note 29, at 19–21.

65. ERISA advisory opinions may be relied on only by the parties involved and are generally issued only with respect to planned or prospective transactions. They are not binding on the Labor Department if the facts diverge from the representations on which the opinion was based. ERISA Procedure 76-1 §§ 5, 10, 41 Fed. Reg. 36281, 32282–83 (Aug. 27, 1976). They lack precedential value, but specialists routinely resort to advisory opinions for the insight they offer into the Department's analytical approach to unresolved issues.

66. See Brief for the Sec'y of Labor as Amicus Curiae Supporting Plaintiffs-Appellants, *Bond v. Marriott Int'l, Inc.*, 637 Fed. Appx. 726 (4th Cir. 2016) (Nos. 15–1160(L), 15–1199), https://www.dol.gov/sites/dolgov/files/SOL/briefs/bond_2015-05-28.pdf [<https://perma.cc/KT65-6ABY>].

67. ERISA Adv. Op. 75-48 (Dec. 23, 1975) (plan covered 23 management employees out of 14,000 total employees; management employees earned between \$19,286 and \$67,922); ERISA Adv. Op. 75-64 (Aug. 1, 1975) (plan covered employees exempt under the Fair Labor Standards Act, who earned at least \$18,200 annually); ERISA Adv. Op. 75-63 (July 22, 1975) (plan covered only "key executives and managerial employees" constituting less than 4% of workforce, with compensation of at least \$28,000). Note that the purchasing power of \$1 in July 1975 was about \$5.47 47 years later, in July 2022. *CPI Inflation Calculator*, U.S. BUREAU OF LABOR STATISTICS, https://www.bls.gov/data/inflation_calculator.htm [<https://perma.cc/Q34X-87DY>] (last visited Oct. 6, 2022).

68. Shelby J. Hoover, *Non-Qualified Deferred Compensation*, 40 TUL. TAX INST. [i], 10 (1990).

the exemption.⁶⁹ Also in 1985, the Department added to its regulatory agenda a project on top hat plans.⁷⁰ The Department, in describing the project, wrote:

Neither the statute nor existing regulations define a top hat plan nor specify which employees can be included in it, creating much uncertainty in the employee benefits community. Federal court interpretations have only increased the confusion. . . . In the absence of uniform guidance, other courts could issue conflicting guidelines or definitions that would create even more uncertainty about the operation of top hat plans.

Requests for advisory opinions, comments from professionals who work with benefit plans, and inquiries from other government agencies indicate to the Department that many plan sponsors are reluctant to take advantage of the top hat plan option because of its uncertain scope. In addition, there is evidence that some small companies have been calling their employee benefit plans top hat plans merely to avoid the ERISA requirements. . . .

The Department proposes to clarify the definition of top hat plans by more fully explaining the difference between “funded” and “unfunded” plans and by defining the term “select group of management or highly compensated employees.” This clarification should facilitate informed decisions by plan sponsors

69. ERISA Adv. Op. 85-37A (Oct. 25, 1985) (plan that covered seven employees, each earning compensation between \$11,905 and \$29,255, would have expanded to cover non-management employees).

70. Unified Agenda, 50 Fed. Reg. 17422 (Apr. 29, 1985). The abstract of the project indicated that “[t]his regulation would provide guidance as to what constitutes an unfunded employee benefit plan maintained primarily for the purpose of providing deferred compensation for a select group of management or highly compensated employees (‘top hat’ plans) for purposes of Title I of ERISA.” *Id.* The timetable called for a notice of a proposed regulation in January 1986. The regulation project continued to be listed on the Department’s agenda until 1992, when it was withdrawn. Unified Agenda, 57 Fed. Reg. 16977 (Apr. 27, 1992).

regarding the implementation of this kind of plan as part of their executive compensation programs. . . .

Only the Federal agencies responsible for administering ERISA, and the courts, have the authority to clarify this ambiguity. Although judicial decision making may be a legitimate alternative to rulemaking in some areas, the Department believes that the ad hoc nature of the court decisions will prolong and perhaps even increase the ambiguity among plan sponsors. Thus, there is a significant need for a regulatory definition of “top hat” plan that can provide the certainty and consistency of approach currently lacking in this area.⁷¹

In 1990, five years after listing the regulatory project, the Department announced a standard for defining a select group of management or highly compensated employees. Advisory Opinion 90-14A sets out the following rationale:

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.⁷²

71. OFFICE OF MGMT. AND BUDGET, REGULATORY PROGRAM OF THE UNITED STATES GOVERNMENT, APRIL 1, 1985—MARCH 31, 1986, at 265–66 (1985) [hereinafter OMB REGULATORY PROGRAM, 1985–86].

72. ERISA Adv. Op. 90-14A (May 8, 1990). In addition, a footnote to the 1990 opinion gave the Labor Department’s reading of an ambiguity in the statutory language, stating that “[i]t is also the Department’s position that the term ‘primarily’ [as used in the top hat plan definition] refers to the purpose of the plan (i.e., the benefits provided) and not the participant composition of the plan.” *Id.* at n.1. Others have suggested that as long as a top hat plan was maintained primarily for a select group of management or highly compensated employees, it could include employees outside that group. *See Demery v. Extebank Deferred Comp. Plan (B)*, 216 F.3d 283, 289 (2d Cir.

This view—that a top hat plan participant must have the ability to affect or substantially influence the design and operation of the deferred compensation plan taking into consideration attendant risks—apparently contemplates an intensive examination of the facts surrounding an employee’s sway over deferred compensation and awareness of its vulnerabilities.

A number of cases examining the top hat plan exemption have heeded the approach of the 1990 Advisory Opinion.⁷³ That standard has generally been considered in conjunction with other factors, however, perhaps because the ability to influence plan terms often demands difficult or indeterminate findings of fact.

Some courts have expressly rejected the 1990 Advisory Opinion’s approach. The First Circuit, in *Alexander v. Brigham & Women’s Physicians Organization, Inc.*, found that two plans maintained for surgeons of Harvard Medical School were top hat plans, concluding that individual bargaining power was not relevant to a determination of top hat status.⁷⁴ The surgeon participants were subject to a University-imposed compensation cap but their “excess” earnings were placed into unfunded deferred compensation plans. The court held that the plans met the definition of top hat plans because the plans were maintained for a select group of highly compensated employees based on quantitative and qualitative factors. The group was quantitatively select, as the percentage of participants was small (never more than 8.7% workforce of the hospital surgical group), and qualitatively select, because the participants were the highest-earning surgeons of the employer (on

2000) (suggesting that “primarily” modifies “select group,” so that a plan covering a small number of employees who are not managers or highly compensated might still qualify for the top hat plan exemption); *Guiragoss v. Houry*, 444 F. Supp. 2d 649, 664 (E.D. Va. 2006).

73. See *Duggan v. Hobbs*, 99 F.3d 307, 312–13 (9th Cir. 1996); *Demery*, 216 F.3d at 289–90 (viewing the ability to negotiate plan terms as relevant, but concluding plaintiffs failed to offer evidence showing absence of bargaining power); *Carrabba v. Randalls Food Markets, Inc.*, 38 F.Supp.2d 468, 478 (N.D. Tex. 1999) (“The “evidence does not persuade the court that any significant number of the participants” had “such influence that they can protect their retirement and deferred compensation expectations by direct negotiations with the employer.”); see also *Bakri v. Venture Mfg. Co.*, 473 F.3d 677 (6th Cir. 2007) (noting, among other qualitative factors, that plaintiff had little ability to negotiate compensation or plan terms).

74. 513 F.3d 37 (1st Cir. 2008), *cert. denied*, 555 U.S. 814 (2008).

average, earning five times more than the average workforce salary).⁷⁵ The court rejected an individual bargaining power requirement for top hat plans, finding that Advisory Opinion 90-14A merely explains the congressional rationale for exempting top hat plans from ERISA and does not establish an independent necessary condition for exemption.⁷⁶ The Third Circuit Court of Appeals has since held that the bargaining power of the participant in a nonqualified top hat plan had no bearing on whether the participant was a member of a “select group” and concluded, like the *Alexander* case described above, that individual bargaining power was not relevant to a determination of top hat plan status.⁷⁷ Thus, there is a circuit split on whether individual bargaining power is relevant or dispositive.

Courts addressing the top hat exemption have instead considered several factors, such as the percentage of the workforce eligible to participate,⁷⁸ and the average salary of plan participants compared to that of employees generally,⁷⁹ or to management or the highly

75. The plans’ terms permitted surgeons to participate in the plan in any year in which their hospital income exceeded a designated level. For the years in question, the surgeons constituted 30% of the workforce on average, and, depending on the year, between 12% and 28% of the surgeons participated in at least one of the plans. *Id.* at 41. Dr. Alexander argued that the participants included all surgeons, regardless of whether they reached the income threshold in a particular year. The First Circuit panel held that only those surgeons who met the income requirements by the end of each year were participants in that year. *Id.* at 46.

76. *Id.* at 47. The district court had concluded that even though individual participants lacked power to influence plan design or operation, they could do so collectively. The First Circuit opinion noted that the parties had accepted that determination but expressed “grave doubts” that “collective bargaining power might conceivably be a prerequisite for a top hat plan.” *Id.* at 48.

77. *Sikora v. UPMC*, 876 F.3d 110, 114–16 (3d Cir. 2017).

78. See *Duggan*, 99 F.3d at 312–13 (5% coverage); *Belka v. Rowe Furniture Corp.*, 571 F. Supp. 1249, 1252 (D. Md. 1983) (4.6% coverage); *Alexander*, 513 F.3d at 46 (8.7% coverage); *Demery*, 216 F.3d at 289 (15.34% coverage “at or near the upper limit of the acceptable size for a ‘select group’”).

79. *Belka*, 571 F. Supp. at 1253 (the average salary of plan participants was three and a half times that of the average employee); *Demery*, 216 F.3d at 289 (“average salary of plan participants was more than double that of the average salary of all Extebank employees.”).

compensated.⁸⁰ District and appellate court decisions have not coalesced around a uniform set of definitional criteria, much less reached consensus on the weight to be accorded multiple relevant considerations. There is no established analytical protocol or evidentiary hierarchy. The resulting inconsistency underscores the concerns the Department evinced in announcing its regulatory project. In 1992, however, the Department withdrew the project without further explanation.⁸¹

80. *Carrabba*, 38 F. Supp.2d at 478 (“[The court] cannot find from the evidence that the participants of the MSP were ‘a select group’ out of the broader group of management employees or the broader group of highly compensated employees.”); *Demery*, 216 F.3d at 289 (“While [the plan] participants did include assistant vice presidents and branch managers, and therefore swept more broadly than a narrow range of top executives, it was nonetheless limited to highly valued managerial employees.”).

81. *See supra* note 70 and accompanying text. Several former officials at the Department of Labor commented off the record on the regulatory project. Those conversations support the following account, which is consistent with available documentary evidence. File Memorandum from Norman Stein (Aug. 21, 2022) (on file with author) (describing conversations regarding the regulatory project). When the Department announced its regulatory exploration in 1985, there was interpretative and policy disagreement on the best approach. Some officials favored formal rulemaking that would yield a bright-line safe-harbor. This might have entailed, for example, percentage-of-the-workforce limits specifying whether a group of employees was “select,” and a compensation number or formula used to determine whether an employee was highly compensated. Others at the Department believed priority should be accorded the circumstances prevailing in a particular workforce, such as whether participants had the ability to negotiate plan terms and the financial capacity to absorb possible losses. Treasury Department officials participated in these discussions, which also considered the meaning of the terms “unfunded” and “primarily” in the exemption language. A significant change occurred between 1985 and 1988 in the approach the Department was taking to developing top hat guidance, at least as reported in OMB’s annual publication on the regulatory program of the United States. *Compare* OFFICE OF MGMT. AND BUDGET, REGULATORY PROGRAM OF THE UNITED STATES GOVERNMENT, APRIL 1, 1988—MARCH 31, 1989, at 299–300 (1988) [hereinafter OMB REGULATORY PROGRAM, 1988–1989], *with* OMB REGULATORY PROGRAM, 1985–86, *supra* note 71. In 1985, the Department wrote:

[The Pension and Welfare Benefits Administration (PWBA)]
has considered alternatives to issuing regulations. One

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alternative is to provide advisory opinions in response to requests for guidance as to whether specific plans constitute top hat plans. While this would allow [PWBA] to judge every situation on a case-by-case basis, the Agency has decided that rulemaking is a more effective and thorough approach as it would establish uniform guidelines and provide guidance and certainty to plan sponsors, participants, and the benefits community as a whole.

The proposed action is consistent with Administration regulatory policy because it will clarify a major deregulatory provision of ERISA, thus encouraging its orderly use as well as discouraging its abuse. A uniform, nationwide understanding of the scope and limits of top hat plans will facilitate benefit planning by employers and may eliminate administrative costs resulting from unnecessary compliance with provisions of ERISA for which the top hat exemption could be obtained.

OMB REGULATORY PROGRAM, 1985–86, at 266. In 1988, in contrast, the Department wrote:

The [PWBA] has considered alternatives to issuing regulations. One alternative is to provide advisory opinions in response to requests for guidance as to whether specific plans constitute top hat plans. This would allow PWBA to judge every situation on a case-by-case basis, while providing guidance to participants, plan sponsors and the benefits plan community as a whole as to how the PWBA would interpret the law in specific circumstances. In the meantime, exploratory work to develop an appropriate structure for a regulation in this complex area could continue to be undertaken.

The proposed action is consistent with Administration regulatory policy because it will clarify a major deregulatory provision of ERISA, thus encouraging its orderly use as well as discouraging its abuse. A uniform, nationwide understanding as to how PWBA would interpret the law in specific circumstances will facilitate benefit planning by employers, and may eliminate administrative costs resulting from unnecessary compliance with provisions of ERISA with respect to plans for which the “top hat” exemption could be obtained.

OMB REGULATORY PROGRAM, 1988–1989, at 300.

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C. Top Hat Plans and ERISA's Policies

Top hat plan participants' interest in their earned pension benefits may be extremely precarious. Their expectancy is not "property" properly understood: it is mere contract, only as robust as the employer-promisor's commitment and long-term financial viability.⁸² Ironically, the vulnerability of a participant's interest is traceable not only to ERISA's statutory exemptions, but also to its residual coverage of top hat plans.

Top hat plans are exempt from all of the substantive requirements of ERISA, including its participation, vesting, spousal protection, funding and fiduciary responsibility rules.⁸³ As a result, a top hat plan

Subtle differences in language between the two publications are revealing. In 1985, the Department wrote that it "has decided that rulemaking is a more effective and thorough approach" than addressing the problem outside regulations on a "case-by-case" basis." OMB REGULATORY PROGRAM, 1985–86, at 272. The 1988 version deleted the preference for rulemaking and changed the language calling for a "uniform, nationwide understanding of the scope and limits of top hat plans" to a "uniform, nationwide understanding *as to how PWBA would interpret the law in specific circumstances*" (emphasis added). OMB REGULATORY PROGRAM, 1988–1989, at 300. And while the 1985 publication had projected a final regulation by 1987, the 1988 report indicated that the goal was to "complete review with respect to feasibility and form of policy guidance" by September 1988. *Id.*

In 1990, the Department issued ERISA Adv. Op. 90-14A (1990), suggesting that determination of whether a plan was entitled to the top hat exemption would include a focus on whether plan participants "have the ability to affect or substantially influence the design and operation of their deferred contribution plan." *See supra* note 72 and accompanying text. Then, in 1992, the Department dropped the top hat regulatory project, apparently indicating that advocates of case-by-case guidance rather than formal rulemaking ultimately prevailed. *See supra* note 70. Yet courts have often ignored the Department's understanding of the scope of the top hat exemption, focusing instead on the percentage of the workforce included in a plan and the compensation levels of a plan's participants, *see supra* notes 74–80 and accompanying text, contributing to general neglect of the Department's standard in practice. *See infra* notes 105–114 and accompanying text.

82. *See generally* Peter J. Wiedenbeck, *Untrustworthy: ERISA's Eroded Fiduciary Law*, 59 WM. & MARY L. REV. 1007, 1037–51, 1048 n.175 (2018).

83. ERISA §§ 201(2), 301(a)(3), 401(a)(1), 29 U.S.C. §§ 1051(2), 1081(a)(3), 1101(a)(1).

may, for example, impose forfeiture conditions that apply for a far longer period than ERISA tolerates; even amendments reducing or eliminating benefits earned by prior service are conceivable.⁸⁴ Moreover, a top hat plan need not grant the employee's spouse any survivorship interest in, nor any say over the disposition of, plan benefits.⁸⁵ And defined benefit top hat plans are not covered by the PBGC's insurance program, which covers most other defined benefit plans.⁸⁶

Top hat plans, however, are not statutorily exempt from ERISA's reporting and disclosure, administration, and enforcement provisions.⁸⁷ Nevertheless, a rule issued in 1975 grants top hat plans relief from the reporting and disclosure obligation if an employer utilizes an alternative compliance option.⁸⁸ Under that option, the employer is not obliged to furnish top hat plan participants with a summary plan description or summary annual reports. Instead, a one-time filing with the Department of Labor reporting the number of top hat plans maintained by the employer and the number of employees covered by each suffices to excuse the program from all information sharing obligations other than a duty to provide plan documents to the Labor Department upon request.⁸⁹

This not only deprives the participant of disclosure rights about the terms of the plan, limits on benefits, and procedures governing dispute resolution, but it also denies policymakers and the public access to significant information about top hat plans. Notably absent, for example, is any requirement to report the type or amount of benefits promised, or the managerial duties or compensation levels of participants. Nor is there even any need to update the filing if the plan is discontinued or there is a substantial change in plan coverage. The data is woefully unenlightening, and what little is reported can quickly turn

84. That is, ERISA's accrued benefit anti-cutback rule does not apply. ERISA §§ 201(2), 204(g), 29 U.S.C. §§ 1051(2), 1054(g) (2018); *Central Laborers' Pension Fund v. Heinz*, 541 U.S. 739 (2004). See Wiedenbeck, *supra* note 82, at 1037–43 (arguing that the anti-cutback rule converts contingent contractual benefit claims into “property” entitlements).

85. See ERISA §§ 201(2), 205, 29 U.S.C. §§ 1051(2), 1055.

86. ERISA § 4021(b)(6), 29 U.S.C. § 1321(b)(6).

87. Consisting of Parts 1 and 5 of ERISA Title I, ERISA §§ 101–11, 501–22, 29 U.S.C. §§ 1021–31, 1131–52.

88. ERISA § 110, 29 U.S.C. § 1030; 29 C.F.R. § 2520.104-23 (2021).

89. 29 C.F.R. § 2520.104-23 (2021).

stale. The resulting absence of systematic reliable data makes it difficult to gauge the degree to which top hat plan participation has expanded over time. Consequently, the magnitude of the threats that such expansion may pose—both to participants' individual retirement finances and more generally to the qualified retirement plan system (by undercutting demand for increased nondiscriminatory benefits)—is currently unknowable. For that reason, the ERISA Advisory Council recommended that the Labor Department replace the alternative method of compliance with a much more robust reporting regime that would be periodically updated.⁹⁰

ERISA's administration and enforcement framework, as applied to top hat plans, is likewise stultified. A top hat plan is an employee benefit plan under ERISA, notwithstanding its exemption from ERISA's funding, vesting and fiduciary requirements. But top hat plans are subject to ERISA's enforcement regime, which includes a provision broadly preempting state law.⁹¹ As a result, a participant claiming benefits under a top hat plan would ordinarily be unable to assert causes of action or pursue remedies provided under state law, notwithstanding that the participant does not enjoy substantive federal protections. This sharply contrasts with the treatment of participants in governmental plans or church plans: those programs are totally exempt from ERISA, hence preemption does not apply, giving their participants recourse to state law and state remedies.⁹² Moreover, because top hat plan participants must rely on ERISA's civil enforcement mechanism, ERISA's procedural limitations, including required exhaustion of administrative remedies and review under the deferential abuse-of-discretion standard,⁹³ apply in

90. EAC TOP HAT PLAN REPORT, *supra* note 29, at 9, 56–61.

91. ERISA §§ 3(3), 514, 29 U.S.C. §§ 1002(3), 1144.

92. ERISA §§ 4(b), 514(a), 29 U.S.C. §§ 1003(b), 1144.

93. The abuse of discretion standard of review of benefit claim denials was an outgrowth (arguably misguided, *see* John Langbein, *The Supreme Court Flunks Trusts*, 1990 SUP. CT. REV. 207 (1991); Wiedenbeck, *supra* note 82, at 1073–74, 1073 n.283) of the Supreme Court's resort to trust law when interpreting ERISA's fiduciary obligations. In contrast to other pension plans, top hat plans are necessarily unfunded and ERISA's fiduciary obligations do not apply. Instead, participant benefit rights are purely a matter of contract. Nevertheless, top hat plan terms are likely to contractually restrict the scope of review of benefit denials because employee benefit law practitioners have learned the importance of such express limitations on judicial oversight. *But see* Sally Lerner Gulati, *The ERISA Hokey-Pokey: You Put*

tandem with ERISA's remedial limitations. In suits challenging benefit denials, federal courts have permitted ERISA plans to include and enforce terms drastically restricting venue and cutting back limitation periods.⁹⁴ Such procedural impediments to benefit claim enforcement presumably apply to top hat plans as well. As one of the authors has observed, top hat plan participants, who have “few protections and diminished judicial remedies[,] . . . are worse off than they would have been had ERISA never been enacted.”⁹⁵ In short, top hat plan participants get the worst of all possible worlds when it comes to pension security: ERISA protections are inapplicable, state law protections are superseded and ERISA's remedial and procedural limitations seriously curtail enforcement of the terms of the plan.

In its declaration of policy underlying the enactment of ERISA, Congress announced the central goal to protect “the interest of participants in private pension plans and their beneficiaries by improving the equitable character and the soundness of such plans” by imposing vesting, minimum-funding and termination insurance requirements.⁹⁶

Your Top Hat In, You Put Your Top Hat Out, 5 NEV. L. R. 587, 606-12 (2005) (arguing that courts should review top-hat plan benefit denials de novo even if plan terms attempt to limit the scope of review).

94. See *In re Becker v. U.S. Dist. Court*, No. 20-72805, 2021 WL 1219745 (9th Cir. Apr. 1, 2021) (restricting venue to a single district court); *Heimeshoff v. Hartford Life & Acc. Ins.*, 581 U.S. 99 (2013) (approving plan-prescribed limitation period). The authors are aware of pension plans that prescribe limitation periods as short as six months, but one court has rejected as unreasonable a 100-day limitations period. *Nelson v. Standard Ins.*, 2014 U.S. Dist. LEXIS 119179 (S.D. Cal. Aug. 26, 2014). Mandatory arbitration provisions and class action waivers are emerging as additional—and hotly contested—procedural hurdles to benefit claim enforcement. See *Munro v. Univ. of S. Cal.*, 896 F.3d 1088 (9th Cir. 2018) (finding that individual employee arbitration agreements did not apply to a defined contribution *plan's* fiduciary breach claims).

95. EAC TOP HAT PLAN REPORT, *supra* note 29, at 16 (quoting statement of Norman Stein, at 4) (Dec. 2020). The Advisory Council states that Stein points out that this treatment stands in stark contrast to the treatment of excess benefit plans, which are pension plans that make up solely for the limits on contributions and accruals under § 415. *Id.* at 16 n.29. Unfunded excess benefit plans are entirely exempt from ERISA, which affords covered participants with access to state law judicial remedies. ERISA §§ 3(36), 4(b)(5), 29 U.S.C. §§ 1002(36), 1003(b)(5).

96. ERISA § 2(c), 29 U.S.C. § 1001(c).

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ERISA's four principal policies—promoting informed financial decision making; preventing mismanagement and abuse of benefit programs; protecting the reliance interests of plan participants and beneficiaries; and preserving substantial employer autonomy with respect to plan sponsorship and design—are directed to eliminating misunderstandings and injustices in the operation of a voluntary system of employer-provided pension and welfare benefits.⁹⁷

The top hat plan exemptions, when viewed through the lens of these objectives, illustrate the tension between ERISA's policies. Top hat plan participants enjoy no statutory safeguards against exploitation (mismanagement, abuse and frustrated reliance), and the prevailing alternative reporting system denies them assured access to information (mandatory disclosure) that would equip them to make balanced career and financial planning decisions. The employer, however, is accorded virtually complete autonomy in setting top hat plan terms. Complete, that is, save for one vital matter: plan membership cannot extend beyond a select group of management or highly compensated employees. Clearly, a functional reading of ERISA would define the scope of the select group with reference to the need for participant protections.

ERISA's labor title only incidentally addressed private pension plan coverage: "That wasn't its focus. Its focus was saying, 'You can promise whatever you want, but if you promise it, you got to deliver it.'"⁹⁸ Title II, containing ERISA's qualified plan provisions, did speak to coverage, however. Although frequently overlooked, several Code amendments took aim at the rapidly escalating exploitation of corporate pension plans as a tax shelter by high-income professionals.⁹⁹ Central to that effort was the enactment of the workforce aggregation rules, which treat all employees of a commonly controlled group of businesses, whether

97. Wiedenbeck, *supra* note 53, at 516. For an overview of ERISA's policies, see PETER J. WIEDENBECK, *ERISA: PRINCIPLES OF EMPLOYEE BENEFIT LAW* 14–19 (2010) [hereinafter *ERISA PRINCIPLES*].

98. Remarks of Daniel I. Halperin, in *Panel 5: Some New Ideas and Some New Bottles: Tax and Minimum Standards in ERISA*, 6 *DREXEL L. REV.* 385, 399–400 (2014).

99. Wiedenbeck, *supra* note 53, at 517–28; S. REP. NO. 93-383, at 119–22, *reprinted in* 1 *ERISA LEGISLATIVE HISTORY*, *supra* note 48, at 1187–90.

or not incorporated, as employed by a single employer in applying the tax law coverage and amount nondiscrimination rules.¹⁰⁰ Prior to ERISA, nondiscrimination requirements could be avoided by strategic segmentation of the workforce: highly paid staff might be employed by a company that sponsors a plan (a parent corporation, for example), while the rank-and-file worked for a legally distinct related company (e.g., a subsidiary) with no plan or a less generous plan. Coverage of the parent corporation's plan tested in isolation—taking into account solely employees of that business entity “employer”—easily passed scrutiny. The plan might make *all* parent corporation employees members, but *only* parent corporation employees. In contrast, treating all employees of the group of related companies as one consolidated workforce restricts preferential tax treatment to those retirement savings programs that provide reasonably consistent contributions or benefits for both rank-and-file and highly paid workers across the entire business enterprise. Hence the workforce aggregation rules, added by ERISA Title II, are essential to implementing the complex tax subsidy redistribution mechanism that the nondiscrimination rules aim to achieve.¹⁰¹ Understanding this aspect of ERISA suggests another metric for defining a select group of management or highly compensated employees. If top hat plan coverage of a group of workers would threaten to materially depress their demand for enhanced qualified plan contributions or benefits—demand that could only be accommodated by increasing savings on behalf of rank-and-file employees—then top hat plan membership would undercut Title II's goal of broad distribution of retirement savings.¹⁰²

D. ERISA Advisory Council Study

The intersection of the protective policy of ERISA Title I and the distributional objectives of ERISA Title II did not escape notice in the 2020 ERISA Advisory Council study of top hat plan participation and reporting.¹⁰³ Based on witness testimony and members' own investigation

100. § 414(b) and (c).

101. See *infra* Part II.

102. This nondiscrimination-avoidance concern is explored in detail *infra* text accompanying notes 116–137 and 182–204.

103. One of the authors (Wiedenbeck) was a member of the 2020 ERISA Advisory Council and had a role in developing the Council's report and recommendations on top hat plans. The other author presented a

and experience, the Council concluded that top hat plan participation substantially expanded in recent decades, and that such broader coverage poses potential threats both to the retirement security of top hat plan participants and to the proper functioning of the qualified retirement plan system. The Council concluded that assessing those threats should be a high priority. It recommended that the Labor Department “proceed quickly” to obtain reliable data on top hat plan membership and characteristics and that it “expeditiously solicit relevant information” on a regulatory definition of eligible top hat plan participants. Because the Council was “convinced the public policy issues are of sufficient import that time is of the essence,” it urged the Department to consult with the Treasury Department’s Office of Tax Policy and move forward with appropriate action.¹⁰⁴

In its investigation the Council learned that the Labor Department’s announced standard—that top hat plan participation should be reserved for individuals who “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”¹⁰⁵—is virtually a dead letter in practice. Advisors uniformly testified that the standard is unused, if not unworkable.¹⁰⁶ Indeed, there was general agreement that, with few exceptions, top hat plans are employer-designed programs offered on a take-it-or-leave-it basis, and in a large corporation there may be only two or three individuals who realistically have the sway to influence plan design or operation.¹⁰⁷

statement and testimony to the Council on this subject. EAC TOP HAT PLAN REPORT, *supra* note 29, at 3, 6.

104. EAC TOP HAT PLAN REPORT, *supra* note 29, at 63 (quotations), 64 (recommending coordination in “evaluating and addressing the impact top hat plans have on qualified plans”).

105. ERISA Adv. Op. 90-14A (May 8, 1990).

106. EAC TOP HAT PLAN REPORT, *supra* note 29, at 29, 30, 36 (observing that the ability to influence design or administration “is not useful and is often not taken into account in determining eligibility”).

107. EAC TOP HAT PLAN REPORT, *supra* note 29, at 36; EAC Hearing of Oct. 23, 2020, Transcript of Testimony of J. Mark Iwry, at 28 (“[I]t turns out that nobody has much bargaining power in the modern corporation as we’ve seen it except for a very, very few.”); *id.*, Transcript of Testimony of Arthur Kohn, at 93–94.

Pointing to the ability to influence plan design or operation communicates a restrictive approach to top hat plan membership.¹⁰⁸ That stance has fallen by the wayside. Top hat plans today often cover a broad swath of the workforce, as determined by the employer’s chosen definition of “highly compensated” or “management” employees, using criteria designed to keep membership under a target percentage of the total workforce deemed “safe.”¹⁰⁹ That’s often 10 or 15%, but sometimes higher.¹¹⁰ Many witnesses testified that sponsors always limit participation to highly compensated employees, but as the Council observed, those assurances may mean only that membership is restricted to employees whose compensation satisfies the qualified plan definition of highly compensated employee.¹¹¹ That definition does not govern ERISA’s usage of

108. EAC TOP HAT PLAN REPORT, *supra* note 29, at 36:

The standard announced in Advisory Opinion 90-14A was apparently intended to communicate a restrictive approach to top hat eligibility focused on the absence of need for the substantive protections of ERISA Title I. That focus is appropriate and, in the Council’s view, depends upon an employee’s access to information and ability to understand and bear the risks associated with top hat plan participation.

109. EAC TOP HAT PLAN REPORT, *supra* note 29, at 63 (“[The Council] heard testimony that suggests a steady downward creep in the universe of employees who are covered by top hat plans.”); EAC Hearing of Sept. 18, 2020, Transcript of Testimony of Norman Stein, at 144 (“There is some evidence that both the number of top hat plans and the reach of their coverage into mid-level employees has substantially increased over the last two decades.”). This expansion may be an outgrowth of administrative neglect. The Council heard testimony indicating that the Labor Department is not inclined to examine top hat plans on audit. EAC Hearing of Oct. 22, 2020, Transcript of Testimony of Barry K. Downey, at 211 (“I’ve heard over and over again from [Department of Labor] auditors that we don’t care about the highly compensated. We’re here to protect the non-highly compensated, or the rank and file.”); *id.* at 227–28; *see also* EAC Hearing of Oct. 23, 2020, Transcript at 237 (remarks of Bridget O’Connor) (“[O]n the whole, the evidence is pretty clear that DOL has just not looked at this at all.”).

110. *See infra* note 114 and accompanying text.

111. EAC TOP HAT PLAN REPORT, *supra* note 29, at 37. *See id.* at 27 (noting similar ambiguity surrounds the uniform assertion that top hat plans do not cover “rank-and-file” employees).

the term—indeed, it was not adopted until 12 years after ERISA became law¹¹²—and is quite inclusive, covering any employee whose total compensation exceeds \$135,000 in 2022.¹¹³ Industry surveys indicate that it is common to make employees earning \$200,000 or less eligible to participate in NQDC plans, and that many plans are available to more than 10% of the sponsoring company’s workforce.¹¹⁴

112. Section 414(q), which establishes an objective, mechanical definition of “highly compensated employee” for purposes of the qualified-plan-coverage-and-amount nondiscrimination rules, was enacted by the Tax Reform Act of 1986. *See generally* JOINT COMM. ON TAX’N, JCS-10-87, GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986, at 703 (1987) [hereinafter JCT 1987 TAX REFORM ACT OF 1986].

113. § 414(q); I.R.S. Notice 2021-61, 2021-47 I.R.B. 738.

114. *See* PLAN SPONSOR COUNCIL OF AMERICA (PSCA), 2018 NON-QUALIFIED PLAN SURVEY 1, 15 (reporting that 66% of 174 employers responding allow 10% or fewer of their total employees to participate in the NQDC plan, but 20.8% of employers grant eligibility to more than 15% of the workforce); Newport Group, *Current Practices in Non-Qualified Deferred Compensation, 2017 Edition*, at 16 <https://www.newportgroup.com/newportgroup/media/documents/newport-group-2017-current-trends-in-nqdc.pdf> [<https://perma.cc/M88Z-DHJ6>] (last visited Sep. 2, 2022) (“Generally, most plan sponsors use a minimum range of \$125,000–\$150,000 as the low end of the total compensation level. In addition, the maximum number of eligible participants in an NQDC plan is typically held at no more than 10%–15%.”); Prudential, *Prudential/PLANSPONSOR 2017 Executive Benefits Survey*, at 5, <https://www.prudential.com/media/managed/documents/rp/Executive-Benefit-Survey-Results-Report.pdf> [<https://perma.cc/39F7-Q55T>] (last visited Sep. 2, 2022) (“38.0% of all respondents cited a minimum base salary requirement between \$115,000 and \$124,999”); Principal Financial Group, *Trends in Nonqualified Deferred Compensation* 8 (Feb. 2020) (survey of sponsors and participants in NQDC plans with recordkeeping by Principal found that 21% of participants reported annual income of less than \$150,000, and 44% had income between \$150,000 and \$300,000); Newport Group, Inc., *Newport/PLANSPONSOR Executive Benefit Survey, 2020 Edition*, at 6, 14 (data gathered from 300 companies show three-quarters of employers imposed minimum compensation level of at least \$150,000 on NQDC plan eligibility, but noting that “some companies use the HCE compensation definition under qualified plan nondiscrimination testing”); *see also* ExecutiveLoyalty.org, *Survey Data — Nonqualified Plans*, EXECUTIVELOYALTY.ORG (Sep. 4, 2022, 8:05 PM) <https://www.executiveloyalty.org/surveys—nonqualified-plans.html> [<https://perma.cc/XM6D-VXP9>] (providing links to multiple survey results).

Comprehensive or representative data are not available; reliable longitudinal studies in particular are wanting. Yet despite their limitations, industry surveys and practitioner experience unmistakably demonstrate that NQDC plan eligibility and participation has migrated far down the pay scale. Top hat plans today are frequently available to a broad range of well-paid professional and middle-management employees.¹¹⁵

This state of affairs suggests that top hat pension plans respond to retirement savings demands of a substantial body of well-paid workers. For workers earning under about \$300,000 in total compensation, those needs could alternatively be met by increasing contributions or benefits provided under a qualified retirement savings plan.¹¹⁶ That they are not would seem to indicate that some employers find it preferable—presumably because it’s less costly—to supply additional retirement benefits through a top hat plan. The deterrent can’t be the cost of establishing and administering a qualified plan, because virtually all top hat plan sponsors also already maintain a qualified pension, profit-sharing or stock bonus plan.¹¹⁷ Hence, incremental benefit costs are likely the sticking point. But why would benefit costs be less under a top hat plan? NQDC, after all, generally gets less favorable tax treatment than qualified plan savings. The answer apparently lies in the qualified plan non-discrimination rules, which would require that benefit enhancements for highly-paid middle management be accompanied by comparable increases on behalf of rank-and-file employees.¹¹⁸ If those lower-paid workers don’t desire greater retirement savings, then the nondiscrimination imperative may require increasing the total compensation of rank-and-file employees: they will not accept a dollar-for-dollar substitution of inaccessible qualified retirement savings for much needed current

115. See authorities cited at note 114, *supra*. See EAC TOP HAT PLAN REPORT, *supra* note 29, at 37, 63.

116. § 401(a)(17) caps the amount of compensation that may be taken into account (including as the basis for determining contributions or benefits earned in any year) under a qualified retirement plan and is an essential component of the nondiscrimination rules. ERISA PRINCIPLES, *supra* note 97, at 344; Wiedenbeck, *supra* note 53, at 529. In 2022, the inflation-adjusted cap stands at \$305,000. IRS Notice 2021-61, 2021-47 I.R.B. 738.

117. See *supra* note 31 and accompanying text.

118. See *infra* Part II.

take-home pay.¹¹⁹ Top hat plans, like NQDC in general, are not subject to the nondiscrimination rules, which means that additional retirement savings can be delivered selectively to those workers who most want it—such as those highly-paid employees who volunteer to pay for it themselves by authorizing an equivalent reduction in their current compensation.¹²⁰

The Council heard from practitioners that so-called “spillover” or “mirror 401(k) plans” have become a popular top hat plan design.¹²¹ These programs can offer a nearly seamless extension of the employer’s qualified 401(k) plan, with the same rate of employer matching contributions, same menu of investment options, etc., but without certain limits on highly compensated employee (HCE) deferrals imposed by the qualified plan anti-discrimination norm. Most notably, the annual limit

119. Qualified plan savings are generally inaccessible prior to separation from service. In-service distributions from profit-sharing or stock bonus plans are in principle allowable after a fixed number of years. Treas. Reg. § 1.401-1(b)(1)(ii), (iii), but they are deterred by a 10-percent additional tax on early withdrawals. § 72(t). Moreover, salary reduction contributions under a 401(k) plan cannot be distributed merely because of completion of a stated period of participation or passage of a fixed number of years. Instead, distributions are ordinarily available only upon attaining age 59.5, in the event of death, disability or separation from service, or upon a showing of hardship. *Id.* at § 401(k)(2)(B), (k)(14); Treas. Reg. § 1.401(k)-1(d)(3). Indirect access is blocked by ERISA’s anti-alienation rule, which prevents the sale or other transfer of accrued benefits. *See* ERISA § 206(d)(1), 29 U.S.C. § 1056(d)(1); § 401(a)(13).

120. Indeed, if NQDC is tax-advantaged relative to current compensation, highly-paid employees might accept a somewhat greater reduction in current compensation than the amount they are credited under the top hat plan. *See infra* text accompanying notes 152–156. As explained later, NQDC is currently accorded preferential tax treatment relative to current compensation. *See infra* text accompanying note 196.

121. EAC TOP HAT PLAN REPORT, *supra* note 29, at 32–33. The *Prudential/PLANSPPONSOR 2017 Executive Benefits Survey*, *supra* note 114, at 4, reports that 66% of reporting NQDC plans were voluntary deferred compensation programs (meaning, apparently, funded by employee voluntary elective deferrals) and 22.3% were 401(k) mirror plans. Similarly, the PCSA 2018 Non-Qualified Plan Survey, *supra* note 114, at 18 & Q.15, reports that the most common type of employer contribution to NQDC plans is a “restoration match,” defined as a contribution that “[m]akes up for missed [employer] match in qualified plans due to testing/compensation limits.”

on employee elective deferrals does not apply, leaving the mirror 401(k) plan participant free to contribute as much current compensation as she desires.¹²² Many mid to late career employees earning \$200,000 or more might naturally feel they need to save more than \$20,500 or \$27,000 annually to accumulate a nest egg sufficient to maintain their standard of living in retirement. But it's a mistake to jump to the conclusion that their retirement savings goals cannot be met by a qualified plan. In 2022 as much as \$61,000 (\$67,500 for those 50 and over) can be contributed to a participant's account under a qualified defined contribution plan.¹²³ That much higher savings level cannot be attained exclusively by elective deferrals, such as 401(k) plan salary-reduction contributions.¹²⁴ Employer matching or nonelective contributions, however, are permitted up to the \$61,000 cap. Hence, the popularity of mirror 401(k) plans suggests that many employers are unwilling to put more employer money—contributions not subject to the elective deferral limit—into the company's underlying qualified 401(k) plan. Apparently, many companies instead choose to make highly-paid workers cure the inadequacy of their qualified retirement plan saving themselves, by making additional salary reduction contributions under a mirror 401(k) top hat plan. That stratagem shields the employer from the nondiscrimination-based obligation to increase company contributions on behalf of rank-and-file

122. §§ 402(g), 414(v). In addition to the annual limit on elective deferrals, mirror 401(k) plans can be designed to accept HCE contributions forbidden by the 401(k) actual deferral percentage test (the quantitative 401(k) plan nondiscrimination rule) and section 401(k)(3), as well as contributions based on compensation in excess of the limit on annual compensation that may be taken into account under a section 401(a)(17) qualified plan, which stands at \$305,000 in 2022. IRS Notice 2021-61, 2021-47 I.R.B. 738.

123. §§ 415(c), 414(v)(3)(A); I.R.S. Notice 2021-61, *supra* note 122.

124. Historically, the “lower elective deferral limit reflected the view that cash-or-deferred arrangements should serve as supplementary programs offering workers the option to save more than the amount provided under a nonelective employer-funded qualified retirement plan (traditionally a defined benefit plan).” ERISA PRINCIPLES, *supra* note 97, at 347. In 2002 the elective deferral limit more than doubled, and that “dramatic increase in the elective deferral limit reflects (and reinforces) the trend toward 401(k) plans becoming the primary or sole retirement savings programs for many employers. Rather than supplementing other programs, today, 401(k) plans frequently substitute for other qualified retirement plans.” *Id.*

employees under the baseline qualified 401(k) plan,¹²⁵ although it exposes participants to the risk of loss in the event of employer insolvency.

Mirror 401(k) plans, in other words, may be symptomatic of employer resistance to increasing benefits under qualified retirement plans. Saving more for highly paid workers while sidestepping the obligation to set aside comparable amounts for the rank-and-file undermines nondiscrimination policy, which seeks to increase lower-paid workers' retirement savings in spite of their preference for current compensation.¹²⁶ That possible relationship led the ERISA Advisory Council to recommend that revised top hat plan reporting requirements obtain information on plan designs that allow elective deferrals or provide deferred compensation "under a formula used for determining benefits in a qualified plan of the employer but applied without regard to one or more limits applicable to qualified plans under the Code."¹²⁷

Top hat plans that permit voluntary deferrals of compensation raise questions about sidestepping limits applicable to 401(k) plans. These plans may provide relief from the actual deferral percentage test and reflect a "make up" matching contribution. In the absence of a top hat plan of this sort, it may be that mid-level employees would pressure the employer to offer greater contributions under the qualified plan. A so-called "mirror 401(k)" top hat plan may allow participants to make salary reduction contributions in excess of the

125. This explanation also appears consistent with the increasing prevalence of safe-harbor 401(k) plan designs, under which minimum matching or nonelective-employer contributions to accounts of eligible rank-and-file employees automatically satisfy the actual deferral percentage test (the 401(k) plan amount nondiscrimination requirement) for elective contributions, even if the average percentage of pay deferred by highly compensated employees is actually far greater than the average percentage set aside by non-highly compensated employees. *See* § 401(k)(11)–(13). The 401(k) nondiscrimination safe harbors demand only low levels of employer matching or nonelective contributions and have been likened to selling indulgences for discrimination. ERISA PRINCIPLES, *supra* note 97, at 342–43. The trend toward safe-harbor plans may be symptomatic of a practice of minimizing deferred compensation outlays on behalf of lower-paid employees.

126. *See infra* Part II.

127. EAC TOP HAT PLAN REPORT, *supra* note 29, at 9.

limit on elective deferrals of Code section 402(g) (\$20,500 in 2022); absent that outlet, the employer would likely face pressure to increase matching or non-elective employer contributions to its qualified 401(k) plan. Similarly, the Council recommends identifying plans that are designed to coordinate with—or function as a seamless extension of—a qualified plan of the employer.¹²⁸

Two Council witnesses expressed concern that broad access by highly paid middle-management and professional employees to top hat plan saving blunts the redistributive force of the nondiscrimination rules. One of the authors testified that top hat plans would be preferred over qualified plans “in situations where the employer can design the plan to limit coverage to those employees who most value the tax benefits of deferred compensation and thus not waste coverage on those employees who would prefer cash compensation.”¹²⁹

A more elastic definition [of allowable top hat plan participants] permits a business to design a plan that covers a larger percentage of the employees who value deferred compensation, thus decreasing the incentives for the employer to sponsor a qualified plan (or at least a generous qualified plan) covering more reluctant savers, who will not value the employer’s contribution at 100 cents on the dollar.¹³⁰

Similarly, Mark Iwry, former Treasury Deputy Assistant Secretary for Retirement and Health Policy, testified that “the real issue in defining the top hat exemption ought to be, what’s the impact on a qualified plan system.”¹³¹ That system is built on the “constructive tension” created by the nondiscrimination rules: “the eager savers, those of us in the high tax brackets, . . . encourage the reluctant savers through the

128. *Id.* at 59–60.

129. Stein, *supra* note 95, at 5.

130. *Id.*

131. EAC Hearing of Oct. 23, 2020, Transcript of Testimony of J. Mark Iwry, at 29.

non-discrimination regime”.¹³² Broad top hat plan participation, he opined, has not reduced the number of qualified plans but may be limiting the generosity of their benefits: it “[h]as to have an impact” on qualified retirement savings.¹³³

Following extensive discussion and deliberation, the ERISA Advisory Council concluded that broad top hat plan participation is problematic in two ways: it jeopardizes the security of plan participants’ retirement savings, and it might, to an unknown extent, undercut the proper functioning of the national retirement system.¹³⁴ The Council’s report highlighted the potential systemic threat to the distributional objectives of the qualified plan regime,¹³⁵ stressed the urgency of the matter,¹³⁶ and issued an unprecedented recommendation that the Department of Labor work together with the Treasury Department

132. EAC Hearing of Oct. 23, 2020, Transcript of Testimony of J. Mark Iwry, at 39. “There isn’t much constructive tension in the system when it is as easy as it is to provide non-qualified deferred executive comp as a substitute for qualified plan compensation.” *Id.* at 18

133. EAC Hearing of Oct. 23, 2020, Transcript of Testimony of J. Mark Iwry, at 31, 33, 43. While acknowledging that there “aren’t good data to determine whether an employer would be providing more qualified plan benefits if the non-qualified option had not expanded as it has to the upper middle management and even middle middle management,” Mr. Iwry nevertheless observed that “[i]t is obvious that the non-qualified world has a tremendous impact on the qualified. That they’re closely interrelated.” *Id.* at 12, 36.

134. EAC TOP HAT PLAN REPORT, *supra* note 29, at 61, observes:

[T]he Council believes it is possible that the lack of guidance on top hat eligibility is inviting broader coverage than Congress intended. Broad availability of top hat plan participation may be putting employees inappropriately at risk and undermining the qualified plan system. The former goes to the heart of the exemption (ERISA’s protective policy) and the latter raises a matter vital to retirement policy.

135. EAC TOP HAT PLAN REPORT, *supra* note 29, at 34–35, 61–62. “In the absence of hard data, it is possible that top hat plans are materially undermining the qualified plan system. We view this issue as the central public policy question underlying this topic.” *Id.* at 35.

136. See *supra* note 104 and accompanying text.

(specifically the Office of Tax Policy) to determine the magnitude of the threat and respond appropriately.¹³⁷

II. NONDISCRIMINATION AND ITS LIMITS¹³⁸

ERISA erected a “comprehensive and reticulated”¹³⁹ structure of pension regulation, including both conduct and content controls, upon a foundation laid by the Internal Revenue Code’s preexisting (albeit embryonic) criteria for granting favorable tax treatment to qualified pension, profit-sharing, stock bonus and annuity plans.¹⁴⁰ Indeed, that favorable tax treatment was largely responsible for the rapid growth of the private pension system in the mid-twentieth century, and many of the problems that ERISA addressed had emerged because of the rudimentary nature of prior tax law requirements. Aside from the PBGC termination insurance system, Congress replicated all of ERISA’s pension content controls in the Code, imposing them as additional conditions on attaining qualified plan status.¹⁴¹ This duplication supplements ERISA’s

137. EAC TOP HAT PLAN REPORT, *supra* note 29, at 10, 61–62, 63–64.

138. The discussion in Part II is largely taken from ERISA Principles, *supra* note 97, at 303–11, and is used with the permission of the copyright owner, Cambridge University Press.

139. *Nachman Corp. v. PBGC*, 446 U.S. 359, 361 (1980).

140. With respect to conduct controls, ERISA’s fiduciary duties have antecedents in the requirement that the assets of a qualified pension, profit-sharing or stock bonus plan be held “for the exclusive benefit of [the employer’s] employees or their beneficiaries.” § 401(a)(2). That qualification condition, together with the longstanding requirement that a qualified plan be a definite written program or arrangement which is communicated to employees, indirectly afforded plan participants some protection under state contract law. *See* Treas. Reg. § 1.401–2(a)(2) (as amended in 1976). With respect to content controls, before ERISA the IRS sometimes insisted that qualified plans provide pre-retirement vesting to prevent a higher rate of turnover among rank-and-file employees from causing forfeitures that would skew the amount of deferred compensation actually paid so as to discriminate in favor of highly compensated employees. S. REP. NO. 93-383, at 44–45 (1973), *reprinted in* 1 ERISA LEGISLATIVE HISTORY, *supra* note 48, at 1069, 1112–13; *see* Rev. Rul. 68-302, 1968-1 C.B. 163; Rev. Rul. 73-299, 1973-2 C.B. 137.

141. Specifically, the pension content controls imposed by parts 2 and 3 of subtitle B of ERISA Title I (including the participation, benefit-accrual, vesting, anti-alienation, spousal protection and minimum funding

enforcement regime, bolstering it with a powerful tax-based incentive to comply that is backed by regular expert monitoring (IRS audits).¹⁴²

The special tax treatment accorded qualified deferred compensation implicates traditional tax policy concerns about equity, efficiency and administrability, and those norms have far-reaching implications that extend well beyond ERISA Title I. Consequently, the Code imposes tax controls on qualified plans that are distinct from and apply in addition to those qualification criteria that reiterate ERISA's pension content controls. The favorable tax treatment of qualified plans provides an inducement to saving, and the tax controls seek to structure the incentive so that it induces retirement savings that would not otherwise occur. The tax controls, in other words, are an effort to properly target and control the tax subsidy.

This part of the article examines the standard treatment of deferred compensation (so-called "nonqualified" deferred compensation) under the federal income tax, and compares that approach with

standards) were also incorporated in the qualified plan provisions by ERISA Title II. In addition, the prohibited transaction rules of ERISA sections 406–408, 29 U.S.C. §§ 1104–1108, were reproduced in section 4975 of the Code. The addition of worker protections as conditions on favorable tax treatment can be understood as establishing the principle that only plans providing secure retirement savings deserve public subsidy. Treasury took that stance as early as 1942, when it proposed preretirement vesting as a condition on tax qualification, although at the time Congress was not receptive. 1 *Revenue Revision of 1942: Hearings Before the House Comm. on Ways and Means*, 77th Cong. 80, 87 (Mar. 3, 1942) (statement of Randolph Paul, Special Tax Advisor to the Secretary of the Treasury).

142. Historically, overlapping labor and tax law jurisdictions are more accurately ascribed to political considerations than to the functional advantage of increased compliance through tax enforcement. In a colossal political miscalculation, the Senate Finance Committee derailed comprehensive pension legislation in 1972 at the behest of business groups and the Nixon Administration. The resulting public outcry gave momentum to the reform movement and assured the cooperation of the tax-writing committees in the 93rd Congress. Michael S. Gordon, *Overview: Why Was ERISA Enacted?* in S. SPEC. COMM. ON AGING, 98TH CONG., THE EMPLOYEE RETIREMENT INCOME SECURITY ACT OF 1974: THE FIRST DECADE 1, 23–25 (Comm. Print 1984). Parallel consideration by congressional committees (competing for political credit) led to replication of worker protections in the Code, which spawned overlapping administrative agency oversight by the Labor Department and IRS.

the taxation of amounts deferred under qualified pension, profit-sharing, stock-bonus and annuity plans (“qualified” deferred compensation). The study then takes up the qualified-plan rules that have no ERISA counterparts—in the terminology used here, these are the “tax controls.” Centrally important are the nondiscrimination rules—the mechanism for channeling public assistance into additional savings. Their efficacy, it will be shown, is highly sensitive to workforce composition, income tax rates and the availability of other tax-sheltered savings opportunities.

A. Targeting the Tax Subsidy

The favorable tax treatment of qualified plans provides an inducement to saving. That favorable tax treatment is granted only if the plan satisfies certain tax law conditions designed to structure the incentive so that it induces retirement savings that would not otherwise occur. These tax controls, in other words, are an effort to properly target the tax subsidy and confine its magnitude. The tax controls fall into four broad categories: nondiscrimination rules, caps on qualified plan savings, advance funding limits, and distribution timing constraints. This section explores nondiscrimination in depth. The remaining tax controls operate in combination to limit the amount of the tax subsidy or to direct it toward retirement rather than to other saving.

Before focusing on the nondiscrimination rules, however, it is useful to examine overall objectives with some care. Why do we want to encourage savings? Savings for what purpose(s)? Savings by whom? Answers to these questions will illuminate the function of the tax controls, and disagreement on these matters goes far toward explaining the contradictions and instability of the pension tax rules.

The overall personal saving rate in the United States, as a percentage of disposable income, underwent a fairly steady decline from about 10% in the early 1980s to about 2.2% in 2005, and has since rebounded to about 8%.¹⁴³ Because personal savings are the principal

143. Federal Reserve Bank of St. Louis, *Federal Reserve Economic Data (FRED), Personal Savings Rate*, ECONOMIC RESEARCH (Sep. 4, 2022, 8:55 PM) <https://fred.stlouisfed.org/series/PSAVERT> [<https://perma.cc/4F5Q-KR7D>] (graph of monthly personal saving as a percentage of disposable personal income, 1959-present, as reported by Bureau of Economic Analysis, U.S. Department of Commerce, National Income and Product Accounts Table 2.1: Personal Income and Its Disposition).

source of investment capital, which fuels higher productivity and real wages, a low saving rate signals danger for long-term economic growth. For that reason, many analysts and politicians advocate measures to encourage savings generally, particularly measures that would move the federal tax system from a realized income tax toward a consumption tax. This macroeconomic concern has seen expression in recent years in a relaxation of various limits on tax-subsidized retirement savings, in the emergence of tax-favored educational savings (such as 529 plans), and in calls for all-purpose Roth-IRA-like tax-advantaged savings accounts.¹⁴⁴

Instead of encouraging savings generally, the traditional and still dominant justification for the special tax treatment accorded qualified plans is to induce greater *retirement* savings. Social Security old-age benefits provide a baseline level of retirement income, but for a large majority of retirees, Social Security alone is inadequate to maintain their pre-retirement standard of living. Most workers need to supplement

144. Tax recommendations repeatedly put forward by President George W. Bush would have expanded Roth-style tax-free savings opportunities in individual accounts of two types. A proposed Retirement Savings Account (RSA) would allow contributions of up to \$5,000 per year regardless of income or coverage under a qualified retirement plan. As with a Roth IRA, RSA contributions would be nondeductible (after-tax), but earnings would accumulate tax-free, and qualified distributions would be excluded from gross income. As proposed, the RSA would have substituted for all current forms of IRAs, other than rollover IRAs created solely to receive qualified plan distributions. In addition, it was proposed that individuals be allowed to contribute up to \$2,000 annually to a Lifetime Savings Account (LSA), another Roth-style personal account that could be used to save for any purpose. Hence the LSA would not be limited to saving for retirement, health care, or education (for which tax-favored accounts are currently available), but could also be used to save for the purchase of a car or a home or for precautionary purposes. LSA contributions would be allowed whether or not the contributor had earned income and regardless of his total income. The annual contribution limit would apply to all accounts held in a particular individual's name, rather than to the contributor, so that an affluent middle-aged couple could put \$4,000 (total) into their own LSAs and also contribute \$2,000 to accounts for each of their children (or grandchildren, etc.). U.S. DEP'T OF THE TREASURY, GENERAL EXPLANATIONS OF THE ADMINISTRATION'S FISCAL YEAR 2009 REVENUE PROPOSALS 9–10 (2008), at <https://home.treasury.gov/system/files/131/General-Explanations-FY2009.pdf> [<https://perma.cc/898S-HV4C>].

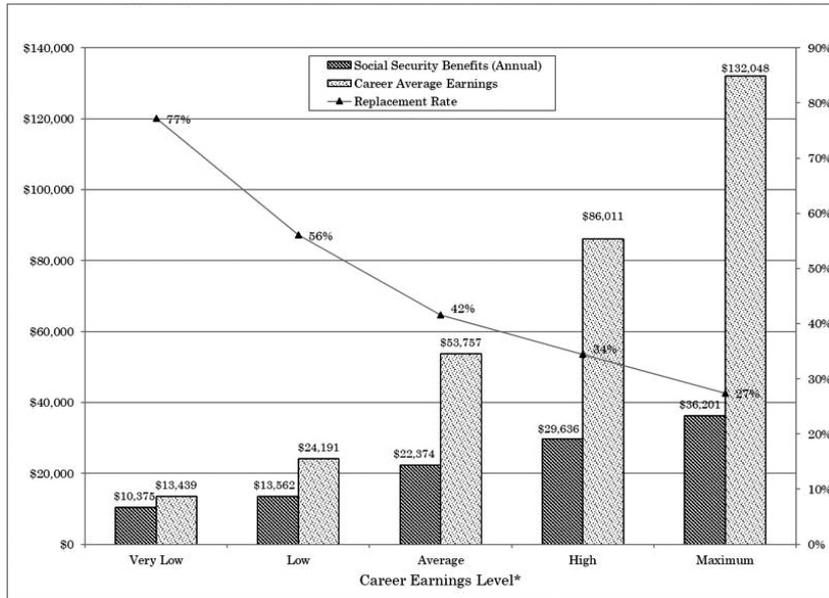
Social Security with pensions or private savings to avoid painful cut-backs in their personal budgets and cramped lifestyles in retirement. Without another source of support, even low-wage workers, who receive Social Security benefits that constitute a larger share of their pre-retirement wages than other workers, will experience a significant drop in their standard of living upon retirement. Most experts estimate that retirees typically need to replace about 70 to 80% of their pre-retirement earnings to maintain their standard of living.¹⁴⁵

As Figure 1 illustrates, Social Security alone cannot fill the bill. The “Low” earnings level depicted in the figure is roughly comparable to a career of full-time minimum-wage work; the “Very Low” earnings level corresponds to a low-paid worker with substantial gaps in labor force participation. These workers get relatively more from Social Security because the program contains a redistributive component (the benefit schedule is progressive or bottom-weighted), but the low earner still falls far short of the 80% benchmark. Moreover, the replacement rates shown are computed as a proportion of career average compensation, which arguably overstates Social Security’s importance to workers in the upper half of the earnings distribution. Because real wages of skilled workers tend to increase with age and experience, Social Security replacement rates would be lower if computed with reference to immediate pre-retirement earnings (such as average compensation over the final five years of work). Presumably, retirees’ sense of whether they have experienced a drop in living standards upon retirement is formed with reference to their immediate pre-retirement earnings.

Retirees at virtually every income level need to supplement Social Security to preserve their accustomed lifestyles, but why do they

145. The measure of pre-retirement earnings used to compute replacement rates (the denominator of the fraction) is not standardized. Depending on the purpose of the computation, some measure of final pre-retirement earnings or of career average earnings may be used, and such differences can yield dramatic variations in numerical results. See Andrew G. Biggs & Glenn R. Stringstead, *Alternate Measures of Replacement Rates for Social Security Benefits and Retirement Income*, 68 SOC. SEC. BULL. 1 (2008); Johannes Binswanger & Daniel Schunk, *What is an Adequate Standard of Living During Retirement?* 11 J. PENS. ECON. 203 (2018) (finding in a survey of prospective preferred levels of old-age spending that adequate levels of retirement spending exceed 80% of working life spending for a majority of respondents, and that minimum acceptable replacement rates depend strongly on income).

Figure 1*: Social Security Benefits and Replacement Rates (Retirement at Age 66 (NRA) in 2020)



* Career earnings levels represent 25%, 45%, 100%, and 160% of average wage; maximum reflects annual earnings equal to the taxable wage base. Source: MICHAEL CLINGMAN ET AL., SOCIAL SECURITY ADMINISTRATION, OFFICE OF THE CHIEF ACTUARY, REPLACEMENT RATES FOR HYPOTHETICAL RETIRED WORKERS, Actuarial Note No. 2020.9, Table C (April 2020).

need *public* assistance (the tax subsidy) to do so? Rather than relying on individuals to supplement Social Security with private savings (or suffer the consequences of their failure to do so), the tax law encourages accumulation through qualified plans which, by virtue of their preferential tax treatment, represent public-private hybrid saving. This elaborate hybrid (or semi-private) retirement savings system is best understood as an effort to counteract a bias in favor of current consumption.

As an incentive, the qualified plan tax subsidy can be justified if it induces retirement savings that would not otherwise occur.¹⁴⁶ To the

146. The current federal tax system is not a pure income tax, as it fails to capture all accretions (accessions) to wealth as they occur. It is a hybrid system containing elements of a consumption tax base. William D. Andrews, *A Consumption-Type or Cash Flow Personal Income Tax*, 87 HARV. L. REV. 1113, 1128–40 (1974). The tax treatment of qualified retirement savings is consistent with a consumption tax (which would exclude all

extent that the subsidy benefits people who would save adequately on their own, the subsidy amounts to wasted forgone revenue. Low- and moderate-income workers are less able to save on their own (lower disposable income). In addition, they are less likely to prioritize retirement saving because access to those savings is more restricted, often rendering those funds unavailable for more urgent objectives like saving for education, home ownership, or to build a reserve against illness or unemployment (so-called precautionary saving). Rank-and-file workers are not only less able to save and less focused on retirement; they are less likely to be induced to save by the prospect of tax relief. Recall that the qualified plan subsidy is cast in the form of tax deferral (or equivalently, tax exemption of the investment return). At present, however, the bottom 40% of U.S. households (by income) pay virtually zero federal income tax.¹⁴⁷ In contrast, high-income individuals have the ability to save on their own, and because they are subject to high marginal tax rates, they receive the greatest benefit from a tax allowance that grants deferral (or exemption of investment returns) based on individual savings decisions. This is the challenge to which the tax controls, and particularly the nondiscrimination rules, are addressed: granting tax deferral for retirement savings on an individual basis would do very little to increase saving by low- and middle-income workers, but it would give a windfall to the highly paid, who would simply shift their other savings into the tax-advantaged form. Giving all taxpayers, regardless of income, access to IRAs, for example, is likely to induce: (1) minimal additional savings by low-income taxpayers; (2) portfolio rearrangement by high-income savers to take advantage of the tax reduction (such behavior is known as tax arbitrage); and (3) a modest amount of new

investment returns from the base until such time as resources are applied to consumption) and is a prominent compromise feature of the existing hybrid system. *See, e.g., id* at 1128; EDWARD A. ZELINSKY, *THE ORIGINS OF THE OWNERSHIP SOCIETY* 119–25 (2007).

147. When the U.S. population is ranked by an expanded definition of cash income, the lowest and second-lowest quintiles have average effective federal individual income tax rates of -5.6% and -1.3%, respectively. Urban-Brookings Tax Policy Center, *T20-0037, Effective Federal Tax Rates—All Tax Units, By Expanded Cash Income Percentile, 2019*, TAX POLICY CENTER (Sep. 4, 2022, 8:57 PM) <https://www.taxpolicycenter.org/model-estimates/baseline-share-federal-taxes-february-2020/t20-0037-average-effective-federal-tax> [<https://perma.cc/Y25D-SU2Z>]. The negative effective tax rates are due to the earned income tax credit and the refundable portion of the child tax credit.

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savings by middle-income individuals for whom the tax benefit increases their return enough to make saving more attractive than otherwise-preferred consumption alternatives.

B. Nondiscrimination and Redistribution

These considerations indicate that deferred taxation of amounts devoted to retirement saving, if extended on the basis of individual savings decisions, would generate a wasteful—even perverse—distribution of public assistance. The qualified plan nondiscrimination rules, first enacted in 1942, seek to avoid that result by conditioning favorable tax treatment of deferred compensation on the dual requirements that (1) the program’s coverage does not unduly favor highly compensated employees, and (2) the “contributions or benefits provided under the plan [expressed as a proportion of compensation] do not discriminate in favor of highly compensated employees.”¹⁴⁸ A leading Treasury tax policy official told Congress that the qualified plan nondiscrimination rules mean that the “reduction in taxes is designed to induce high-income taxpayers to save for retirement in such a manner that there will also be benefits for rank-and-file employees who are not only less able to save, but also less likely to be induced to do so by reason of tax relief.”¹⁴⁹ Professors Fischel and Langbein explained:

Despite the strongly voluntary or consensual basis of the private pension system, various features of pension regulation are designed to interfere with individual autonomy in pension saving. For example, the anti-discrimination norm—the bedrock principle of pension taxation—conditions access to tax advantaged pension saving for a firm’s better paid workers upon extensive participation of the firm’s lower paid workers. The rationale is to create incentives for management to induce lower paid workers to engage in higher levels of pension saving than they would if allowed unfettered

148. §§ 401(a)(3)–(5), 410(b) (quotation from § 401(a)(4)).

149. *National Pension Policies: Private Pension Plans: Hearings Before the Subcomm. on Retirement Income and Employment of the House Select Comm. on Aging*, 95th Cong. 228, 229 (1978) (statement of Daniel I. Halperin, Tax Legislative Counsel, U.S. Department of the Treasury).

choice. Whether this strategy is very successful is open to question, but it exemplifies the idea that some employees should be protected against their inclination to save too little for retirement.¹⁵⁰

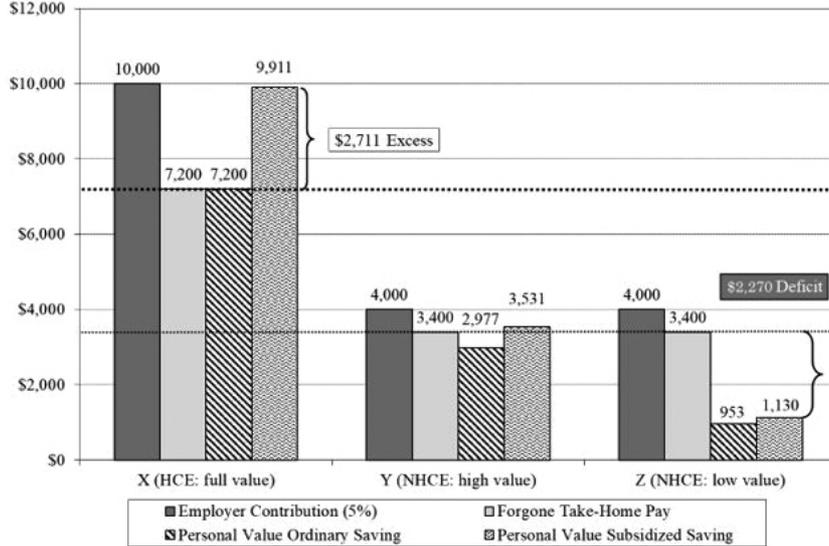
The mechanism inducing lower paid workers to increase their pension saving is complex.¹⁵¹ To understand the operation and assess the effectiveness of the nondiscrimination rules, it is helpful to illustrate their application to a simple fact pattern. Assume that a hypothetical employer's workforce is composed of three employees, X, Y and Z, and that each is 45 years old. X, an executive, is a highly compensated employee (HCE) who earns a salary of \$200,000 and is subject to the 28%-marginal income tax rate; Y and Z are non-highly compensated employees (NHCEs), each of whom earns \$80,000 and is taxed at the 15% rate. Suppose that instead of a raise, the employer allows each employee to independently elect whether the employer will contribute an amount equal to five percent of the employee's salary to a retirement account (to be invested and the accumulated balance distributed to the employee at age 65) or pay the five percent to the employee currently as additional cash compensation. Finally, assume that X, the executive, already saves a substantial portion of her after-tax income for retirement, but Y and Z do not: Y would save if he could get a somewhat higher return on his money than the market now offers, while Z confronts urgent immediate consumption needs (such as family medical and educational expenses) and so strongly dis-prefers saving. Figure 2 illustrates how these workers are likely to exercise their choice between retirement saving and additional salary.

For each worker, the first column represents the employer's current outlay (5% of salary), whether contributed to a retirement account or paid in cash. The second column is the after-tax value of the employer's payment, and so reflects the amount of consumption the worker would forgo (lesser take-home pay) in selecting a retirement account

150. Daniel Fischel & John H. Langbein, *ERISA's Fundamental Contradiction: The Exclusive Benefit Rule*, 55 U. CHI. L. REV. 1105, 1122-23 (1988).

151. See generally Bruce Wolk, *Discrimination Rules for Qualified Retirement Plans: Good Intentions Confront Economic Reality*, 70 VA. L. REV. 419 (1984); Michael W. Melton, *Making the Nondiscrimination Rules of Tax-Qualified Retirement Plans More Effective*, 71 B.U. L. REV. 47 (1991).

Figure 2*: Nondiscrimination and Redistribution



* Assumptions: (1) all amounts saved, whether individually or in an employer-sponsored retirement fund, earn 6.0% compound annual return for 20 years; (2) each employee’s tax rate remains constant for the 20-year duration of the retirement account; (3) X would save more than 5% of her compensation in investments that do not receive preferential income tax treatment (hence X’s personal discount rate is her after-tax rate of return, 72% of 6.0%); (4) Y values deferred compensation by applying a personal (internal) discount rate that is 5.8%; (5) Z values deferred compensation by applying a personal (internal) discount rate of 12.0%.

contribution. The third column, labeled “Personal Value Ordinary Saving,” shows each employee’s individual assessment (personal valuation) of the saving alternative under the normal income tax rules. By assumption, X would save at least this amount of her after-tax income on her own, and so for X, the present value of the savings option is equal to her forgone take-home pay (in other words, X’s personal discount rate is just equal to her after-tax rate of return, 72% of 6%, or 4.32%). By comparison, Y slightly prefers current consumption, and Z strongly favors immediate needs, as reflected in their lower personal valuations of saving compared to additional take-home pay (assumed personal discount rates of 5.8% and 12.0%, respectively). The final column, labeled “Personal Value Subsidized Saving,” displays the value of tax-deferred saving (as under traditional IRA treatment) for each employee, which is higher than for ordinary saving because of the additional accumulation that tax deferral facilitates.¹⁵²

152. The amount shown is each employee’s individual assessment of the present after-tax value of tax-preferred saving. It is computed by taking

The results shown in Figure 2 confirm the qualitative predictions made earlier. If the tax-advantaged savings opportunity is made available on an individual basis, then the highly compensated employee, who would have saved anyway, obtains a large benefit by deferring a substantial tax obligation (high marginal rate) for an extended period. X can get \$2,711 more after taxes just by rearranging her investments to make use of the tax-deferred savings vehicle. Rather than increasing savings, that arbitrage opportunity might actually *reduce* goal-oriented savings by X and other high-income individuals who have the wherewithal to save because, thanks to the tax concession, they need to put less aside to meet future goals. Z, the middle-income worker with pressing obligations, will not be persuaded to save by tax deferral alone because at his tax rate the incremental return to saving is just too small to make a difference. Y, however, would be moved to save by the tax allowance because it increases his return enough to counteract his impatience and make it worthwhile to postpone consumption.

Figure 2 also demonstrates the logic of the nondiscrimination rules. Instead of granting tax deferral on an individual basis, consider a system that conditions the benefit for the highly compensated employee on proportional saving by the rank-and-file workers. Z's personal circumstances are such that he will not consent to reducing his current consumption by \$3,400 in favor of savings that are worth only \$1,130 to him. But observe that the tax advantage to X is large enough that it would be worthwhile for X to bribe Z to participate in order to satisfy the nondiscrimination condition. Moreover, because qualified retirement plans are employer-mediated programs, X does not have to take the step of personally making a side payment to induce Z's acquiescence. Instead, the employer can accomplish the transfer by reducing X's current compensation by more than the \$10,000 retirement contribution made on behalf of X, while at the same time contributing \$4,000 for Z without reducing Z's current compensation by the full amount. On the facts illustrated, Z will accept the \$4,000 retirement contribution if his salary is reduced

the future value of the account (using a compound six-percent tax-free rate of return), reducing that amount by the tax due on distribution, and discounting that after-tax accumulation by the employee's personal discount rate. For X, that discount rate is simply her after-tax rate of return on savings, 4.32% (= 6.0% × 72%); the personal discount rate of Y and Z (assumed to be 5.8% and 12.0%, respectively) exceeds each taxpayer's 5.1% (= 6.0% × 85%) after-tax rate of return.

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by no more than \$1,329 (equivalent to \$1,130 of foregone consumption at Z's 15% rate), which means that the employer would have to increase Z's total compensation by \$2,671 (\$2,270 after tax) to satisfy the non-discrimination requirement. The employer recoups this added cost from X, who should be willing to trade any amount less than \$13,765 of her (pre-tax) salary for the \$10,000 retirement contribution. The \$3,765 compensation savings that can be extracted from X (equivalent to \$2,711 after tax at X's 28% rate) is of course more than sufficient to fund the \$2,671 compensation increase necessary to bribe Z to participate. The exact disposition of this extra tax subsidy, together with a small amount of compensation that could be extracted from Y (who would trade \$4,154 in salary for the \$4,000 qualified plan contribution), is indeterminate. Presumably, relative bargaining power will determine its division between the employer and the employees (X, in particular), and some amount will have to be captured by the employer to compensate it for the additional costs it will incur in administering the plan.

By conditioning favorable tax treatment on broad participation, the nondiscrimination rules can, in the right circumstances, effect a hidden transfer (or covert redistribution, if you will) of the tax subsidy from high-income, high-preference employees to lower-paid workers who are reluctant savers. Nondiscrimination tends to redirect public monies from windfall tax savings by highly paid workers into retirement savings that would not otherwise occur, and so operates to better target the tax subsidy. Yet the complex system that has evolved is riddled with defects and limitations. For although the nondiscrimination rules are the central mechanism for channeling public assistance into additional retirement savings, their efficacy is highly sensitive to employee preferences, workforce composition, elasticity of labor supply in the relevant markets, income tax rates and the availability of other tax-sheltered savings opportunities. Many of these limitations are apparent upon further consideration of Figure 2. First consider employee preferences: if Y were in financial straits nearly as tight as Z's (high personal discount rate due to current consumption needs), then the compensation savings that could be extracted from X (\$3,765 maximum) would be insufficient to fund the compensation increases necessary to persuade both Y and Z to participate.¹⁵³ Therefore, the nondiscrimination condition could not be satisfied without increasing employer costs.

153. Financial education might be a low-cost strategy to increase the savings inclination on the part of moderate and lower-income workers. We

Assuming that the employer operates in a competitive industry where that is not feasible, it will not sponsor a plan, and the rank-and-file workers will not have retirement savings.

Workforce composition—meaning the number, pay levels, and ages of employees—is another crucial set of factors. Hiring a third person at a salary of \$80,000 would sink the plan if that new worker's propensity to save were closer to Z's than Y's. On the other hand, the addition of a second HCE saver like X would generate a great deal of additional tax savings that would not have to be redistributed to satisfy the nondiscrimination rules if Y and Z remain the only NHCEs; and in that case, the tax subsidy would entail a lot of wasted revenue (shared, in some fashion, between the HCEs and the company). Similarly, the original three-person workforce would be awash in wasted subsidy if X were instead paid \$240,000 and taxed in the 33% bracket.¹⁵⁴ Tax savings available for redistribution depend not only on the HCE-saver's contribution and tax rate, but also on the duration of saving. The facts on which Figure 2 is based assume that the amount contributed for each employee would remain in the account for 20 years until distribution. If, instead, X is only eight years away from retirement, the tax advantage in qualified plan savings would not be sufficient to cover the additional compensation cost required to secure Z's participation.

Because the amount of subsidy is based on the value of tax deferral, legislative income tax rate changes can dramatically affect the attractiveness of qualified plan saving. This underappreciated link can sometimes cause tax and pension policies to work at cross purposes. Consider the Tax Reform Act of 1986, which broadened the base of the individual income tax and in return drastically lowered income tax rates, with the top bracket rate falling from 50% to 28%. That statute made the coverage and amount nondiscrimination rules more demanding and tightened the vesting rules, which generally increased the cost of maintaining a qualified plan by forcing more benefits to be provided to low-paid, low-preference employees. Yet at the same time that Congress insisted on greater redistribution, it drastically reduced the tax rate and

are unaware of any empirical work testing the viability of educational efforts as a means to increase the savings propensity of such employees.

154. Assuming the same facts on which Figure 2 is based (except for X's higher salary and tax rate), the \$12,000 contribution (5% of \$240,000) would be worth \$17,497 in salary to X—\$5,497 more than the employer contribution. Of that excess, only \$2,671 is needed to buy Z's cooperation.

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the value of deferral for high-income savers, thereby cutting the subsidy available to meet those increased costs. The largely unforeseen but predictable result was a marked decline in the attractiveness of instituting or expanding qualified retirement savings programs. For any particular employer, the exact impact of tax rate reductions depends, of course, on the factors described above, namely individual savings preferences and workforce composition (number, pay levels and ages of employees). As seen above, a workforce that includes a lot of highly paid savers can generate much more tax subsidy than needed to satisfy the nondiscrimination rules; any subsidy in excess of the amount that must be shifted to low-paid, reluctant savers either benefits high-paid workers who would save on their own or is captured by the employer (through reduced compensation). From the perspective of nondiscrimination policy, this excess subsidy is wasted revenue, and in this instance, lowering tax rates reduces waste and improves the effectiveness of redistribution. Another employer whose workforce includes few highly paid savers and is composed predominantly of low-paid workers with urgent consumption needs (non-savers) may find that a tax rate reduction makes qualified plan sponsorship uneconomic, because the reduced subsidy means that the potential compensation cost savings that might be extracted from high-paid workers is now insufficient to induce enough participation from low-paid workers to satisfy the nondiscrimination rules.¹⁵⁵ In this case, the post-tax cut subsidy may simply be too small to pay the compensation increases needed to bribe enough low-paid workers into the plan.¹⁵⁶

155. If some employers in a particular labor market offer plans and other do not, some sorting of employees among employers might occur, reducing redistributive costs for those employers that offer plans. See William J. Carrington et al., *Nondiscrimination Rules and the Distribution of Fringe Benefits*, 20 J. LAB. ECON. S5, at S10 (2002).

156. See generally Daniel I. Halperin, *Special Tax Treatment for Employer-Based Retirement Programs: Is It "Still" Viable as a Means of Increasing Retirement Income?*, 49 TAX L. REV. 1 (1993); Peter J. Brady, *Pension Nondiscrimination Rules and the Incentive to Cross Subsidize Employees*, 6 J. PEN. ECON. & FIN. 127, 142 (2007) (using a simulation analysis to model the impact of nondiscrimination rules on 401(k) plans, and finding that only firms with a relatively low ratio of NHCEs to HCEs (less than about 4 to 6) would have an economic incentive to sponsor a plan). See also Olivia S. Mitchell et al., *Better Plans for the Better Paid: Determinants and Effects of 401(k) Plan Design*, in RESTRUCTURING RETIREMENT RISKS (David Blitzstein

The upshot of all this is that enriching the subsidy by increasing tax rates, while it will make plan sponsorship more attractive across the board and induce some employers to institute a plan who previously could not afford to offer one, will not necessarily trigger additional redistribution under preexisting plans. Instead of being shifted to low-income non-savers, the additional subsidy associated with established programs—programs that met nondiscrimination standards under the stingier prior regime—might just be pocketed by the employer or its highly paid workers. Conversely, curtailing the subsidy by reducing tax rates might reduce wasted revenue and increase the efficiency of redistribution in some cases, but under a system of voluntary sponsorship, that step might cause some employers to discontinue existing programs and deter other employers from instituting new plans. Despite their maddening complexity, the nondiscrimination rules accomplish only haphazard and imperfect redistribution—in part due to various strategies that sophisticated plan advisors use to reduce their redistributive force.¹⁵⁷

et al. eds. 2006) (concluding, based on an empirical study of plan feature and employee characteristics in 507 401(k) plans for the 2001 plan year, that “401(k) plan design is strongly motivated by a desire to satisfy higher-paid employees’ demand for tax-advantaged compensation” and that federal tax policy regarding nondiscrimination testing tends to create inequities based on workforce characteristics and in particular favors “firms with better-paid and longer-tenured workforces”).

157. Numerous strategies are available to plan sponsors to manipulate or sidestep the full force of the nondiscrimination rules. Some common strategies are: (1) the use of “cross-testing” and new comparability plans, see Peter Orszag & Norman Stein, *Cross-Tested Defined Contribution Plans: A Response to Professor Zelinsky*, 49 *BUFF. L. REV.* 629 (2001); (2) exploiting the flexibility of the definition of highly compensated employee, see Amber Waddell, *Who Are Highly Compensated Employees (and Why Do We Care)?* (2016), <https://www.linkedin.com/pulse/who-highly-compensated-employees-why-do-we-care-amber-waddell> [<https://perma.cc/LYK2-TX96>] (explaining how to use flexibility in the definition of “highly compensated employee” to increase discrimination in favor of highly compensated employees in law firm settings); (3) integrating qualified plan benefits with Social Security benefits, see, e.g., The American Retirement Plan Company, LLC, *Why Permitted Disparity Matters* (Jul. 30, 2019) <https://www.trpcweb.com/why-permitted-disparity-matters/> [<https://perma.cc/C7KV-3ZPG>]; Nancy J. Altman, *Rethinking Retirement Income Policies: Nondiscrimination, Integration, and the Quest for Worker Security*, 42 *TAX L. REV.* 433 (1987) (presenting a classic critique of Social Security integration under earlier law); (4) hiring part-time workers,

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Nor do they apply universally: governmental plans are now entirely exempt from the antidiscrimination imperative, and the coverage non-discrimination standard is relaxed for church plans.¹⁵⁸

III. INTERACTIONS

Two common themes of ERISA's top hat plan exemptions and the Code's framework for taxing deferred compensation offer windows into the dangers posed by expanding top hat plan participation. Each of those

see Carrington, supra note 155 (hiring projected short-tenure employees who are unlikely to vest in their benefits). In 1984 Professor Wolk argued that use of the non-discrimination norm will always be an inefficient means of expanding retirement savings among reluctant savers and advocated a mandatory universal pension in its place, which had been proposed by the Treasury Department under President Carter. Wolk, *supra* note 151, at 463–71. The political feasibility of a mandatory universal pension seems no stronger today than it did when Professor Wolk wrote his paper. Thus, we believe that retirement plan coverage of lower- and moderate-income workers will continue to rely on the nondiscrimination rules, despite their high tax cost relative to the social product they purchase.

158. I.R.C. §§ 401(a)(5)(G), 414(d)–(e), 410(c). The nondiscrimination exemption covers plans of federal, state and local governments and their agencies and instrumentalities. It also covers plans maintained by an Indian tribal government or an agency or instrumentality thereof for employees performing noncommercial essential governmental functions. The complete exemption of state and local governmental plans from nondiscrimination obligations was enacted in 1997 (previously, governmental plans were subject to the relaxed pre-ERISA requirements applied to church plans), and the legislation also retroactively excused prior discrimination by such plans. Taxpayer Relief Act of 1997, Pub. L. No. 105-34, § 1505(a)(1), (d)(2), 111 Stat. 788, 1063–64. The only explanation Congress offered was an unelaborated nod to “the unique circumstances [of] governmental plans and the complexity of compliance.” STAFF OF THE JOINT COMM. ON TAX’N, JCS-23-97, GENERAL EXPLANATION OF TAX LEGISLATION ENACTED IN 1997, at 436 (1997). Nondiscrimination is not the only tax qualification condition that does not apply, or that is applied with reduced force, to governmental and church plans. Governmental and church plans are entirely excluded from ERISA's labor law requirements. ERISA § 4(b), 29 U.S.C. § 1003(b). Correspondingly, such plans are generally exempt from the tax qualification rules that parallel ERISA Title I requirements, including the vesting, benefit-accrual, anti-alienation and spousal-protection rules. §§ 401(a), 410(c), 411(e), 414(d), (e).

themes—which focus on funding and compensation level—actually imports different concerns in the two contexts. Interrogating that dissonance exposes the dark side of the interface between executive deferred compensation and qualified retirement savings.

A. Divergent Functions of “Unfunded” Benefits

From one perspective, the requirement that top hat plans be unfunded is an artifact of the original expectation that pension reforms would be directed at qualified plans. Senator Jacob Javits’s wide-ranging 1967 pension overhaul bill, from which the language of the top hat plan exception is derived, applied solely to qualified plans.¹⁵⁹ Even in the 93rd Congress, Senate versions of the legislation—including the Senate version of H.R. 2 considered by the conference committee—took aim at qualified plans, which are necessarily advance funded to some degree.¹⁶⁰

159. See *supra* note 49. The exception required express disclaimer of preferential tax treatment. Its language provided that “such plan is unfunded and is established by an employer primarily for the purpose of providing deferred compensation for a select group of management employees and is declared by the employer as not intended to meet the requirements of section 401 (a) of the Internal Revenue Code.” S. 1103, 90th Cong. §101(b)(6). Moreover, the bill conditioned preferential tax treatment upon compliance with its mandate that a plan register with a new centralized agency, the U.S. Pension Commission. *Id.* § 111. The bill also exempted plans covering not more than 25 employees, *id.* § 101(b)(4), so it apparently contemplated a sizeable “select group of management employees . . .”. *Id.* § 101(b)(6). With respect to funding, Senator Javits observed in an explanatory statement that “[o]nly one section of the Act in any way affects an employee benefit plan without a fund, and that is section 504, which permits suits by private parties for breach of an agreement relating to an employee benefit plan.” 113 CONG. REC. 4659 (1967).

160. See Retirement Income Security for Employees Act, S. 4, 93d Cong. § 104(b)(4) (as introduced, Jan. 4, 1973) (expressing exemption with language taken verbatim from Sen. Javits’ 1967 bill, *supra* note 159), *reprinted in* 1 ERISA LEGISLATIVE HISTORY, *supra* note 48, at 93, 113. Subsequent Senate consideration in the 93rd Congress led to a tax-based reform bill that did not contain such an exemption, presumably because qualified plans are necessarily funded. The bill’s vesting and funding requirements were accompanied by a prohibition against maintenance of nonqualified plans. H.R. 2, 93d Cong. §§ 222(a), 262 (as passed by the Senate, Mar. 4, 1974), *reprinted in* 3 ERISA LEGISLATIVE HISTORY, *supra* note 48, at 3599, 3635–36, 3666–68. The fiduciary

The House version of H.R. 2, however, cut the link to qualification, yet to designate exempt plans it adopted the verbal formula traceable to the 1967 Javits bill that the program be “unfunded and is established or maintained by an employer primarily for the purpose of providing deferred compensation for a select group of management employees.”¹⁶¹ In that context, absence of advance funding cannot serve, as it had in earlier Senate bills, as shorthand for “these reforms apply to all plans that are funded to any extent and all such plans must be qualified.”¹⁶²

The general extension of participant safeguards and Labor Department oversight to plans not receiving preferential tax treatment might betoken a protectionist policy imperative, such that “unfunded” in the context of ERISA Title I ought to be accorded the narrowest plausible reading.¹⁶³ That didn’t happen. When faced with the choice, the Labor Department acquiesced in a tax-based interpretation of “unfunded” that expanded the scope of ERISA’s top hat exemption.

standards of the bill were imposed as amendments to the WPPDA and, like Senator Javits’s 1967 bill, applied only with respect to employee benefit funds. *Id.* § 502(a) (adding paragraphs (13) and (25) to WPPDA section 3, defining “employee benefit fund” and “fiduciary,” respectively), *reprinted in* 3 ERISA LEGISLATIVE HISTORY, *supra* note 48, at 3742, 3744, 3747; *Id.* § 511 (adding WPPDA section 15, imposing fiduciary standards with respect to every employee benefit fund), *reprinted in* 3 ERISA LEGISLATIVE HISTORY, *supra* note 48, at 3772–81. The bill imposed excise taxes on prohibited transactions, but here too a fiduciary was defined solely in terms of actions or authority affecting money or other property of a qualified plan. *Id.* § 522(b) (adding the section 4974 excise tax and accompanying definition of fiduciary), *reprinted in* 3 ERISA LEGISLATIVE HISTORY, *supra* note 48, at 3786, 3796.

161. Employee Benefit Security Act of 1974, H.R. 2, 93d Cong. § 101(b)(5), 201(b)(5), 301(b)(5) (as passed by the House Feb. 28, 1974), *reprinted in* 3 ERISA LEGISLATIVE HISTORY, *supra* note 48, at 3898, 3918-19, 3971, 3996. The House bill, unlike the Senate version, defined fiduciary and fiduciary obligations broadly, encompassing actions or authority with respect to the management or administration of a plan, without required nexus to money or property. *Id.* §§ 3(21)(A), 111(b)(1), *reprinted in* 3 ERISA LEGISLATIVE HISTORY, *supra* note 48, at 3898, 3910, 3950.

162. *See supra* notes 159–160.

163. Alternatively, labor law duplication of participant protections could be discounted as a political side-show, as members of congressional labor and tax-writing committees clamored for electoral credit. *See supra* note 53.

Funding is relevant to the timing of taxation of NQDC. Specifically, an employee using the cash receipts and disbursements method of accounting may be required to include “funded” NQDC in gross income well before actually receiving payments.¹⁶⁴ In contrast, ordinarily an employee is not subject to current taxation upon earning an unfunded right to future payment, even if the right is unconditional and the promisor is financially robust (i.e., faces no significant risk of insolvency).¹⁶⁵ Instead, the cash method taxpayer reports unfunded deferred compensation upon distribution, which may occur after retirement when her marginal tax rate may be lower. For this purpose, NQDC is funded insofar as the employee obtains “a beneficial interest in assets (including money) which are transferred or set aside from the claims of creditors of the transferor, for example, in a trust or escrow account.”¹⁶⁶ That formulation focuses on whether the deferred compensation is insulated from the claims of general creditors of the employer. An employer may segregate certain assets, investing them to accumulate

164. If assets are set aside in trust for the benefit of employees and the trust is not exempt from tax as part of a qualified plan, an employee-beneficiary of such funded NQDC is taxed on the value of her interest in the trust as of the earliest date on which the interest becomes transferrable or not subject to a substantial risk of forfeiture. §§ 402(b)(1), 83(a). Section 83, which prescribes the general rules governing the taxation of in-kind compensation, was enacted by the Tax Reform Act of 1969. Previously, inclusion of in-kind compensation in advance of receipt was governed by the economic benefit doctrine. *See* Rev. Rul. 60-31, 1960-1 C.B. 174; *Pulsifer v. Comm’r*, 64 T.C. 245, 246 (1975); *Sproull v. Comm’r*, 16 T.C. 244, 247-48 (1951), *aff’d*, 194 F.2d 541 (6th Cir. 1952). Indeed, the regulatory definition of property for purposes of section 83 can be viewed as an expanded and liberalized successor to the economic benefit doctrine. Under the economic benefit doctrine, the timing of inclusion and deduction of NQDC depends upon whether the employee’s interest in property is nonforfeitable, which incorporates concerns about both insulation from the employer’s creditors and freedom from risk of loss due to forfeiture conditions. *See* Treas. Reg. §§ 1.402(b)-1(d)(2), 1.404(a)-12(c).

165. An unfunded promise to pay is not “property” that would trigger taxation under section 83, Treas. Reg. § 1.83-3(e), and an employee using the cash receipts and disbursements method of accounting who has earned a right to future payment ordinarily does not include the amount in income until it becomes payable. To assure that result, the right to future payment should be non-transferrable (to avoid application of the cash equivalence doctrine) and the arrangement must comply with the requirements of § 409A.

166. Treas. Reg. § 1.83-3(e).

resources that can be drawn upon to pay NQDC. Despite such segregation—which can be viewed as practical or informal funding—so long as the assets remain subject to creditor claims in the event of the sponsor’s bankruptcy or insolvency the arrangement is treated as unfunded for tax purposes, and plan participants do not risk taxation in advance of actual distribution.¹⁶⁷

The employer is correspondingly not entitled to deduct NQDC until it is includible in the employee’s income.¹⁶⁸ Where employer and employee tax rates are comparable, that matching of inclusion and deduction achieves neutrality in the taxation of current and NQDC.¹⁶⁹ But if, as is often the case, the employee’s marginal tax rate will be lower upon payment of the deferred amounts (after retirement, for example), then NQDC reduces the tax burden.¹⁷⁰ Potential rate reduction, combined with the difficulty that liquidity-constrained employees may face if

167. See, e.g., IRS Priv. Ltr. Rul. 92-28-026 (Apr. 13, 1992); Rev. Proc. 92-64, 1992-2 C.B. 422 (IRS model rabbi trust). A “rabbi trust” is a device designed to alleviate the risk that the employer will choose not to pay NQDC because of an employment dispute or a change in control of the employer. It ensures that benefits will be paid according to the terms of the plan, provided that the employer does not become insolvent. In a number of corporate bankruptcies executives have asserted, without success, that rabbi trust assets backing their top hat plan benefits are not reachable by general creditors. See, e.g., *In re Lehman Brothers Holdings Inc.*, 792 F. App’x 16 (2d Cir. 2019); *In re IT Grp., Inc.*, 448 F.3d 661, 669 (3d Cir. 2006). The name “rabbi trust” comes from the initial private ruling concerning such an arrangement, which involved a trust established by a religious congregation for the benefit of its rabbi. Priv. Ltr. Rul. 81-13-107 (Dec. 31, 1980). See generally, Ridgeley A. Scott, *Rabbis and Other Top Hats: The Great Escape*, 43 CATHOLIC U. L. REV. 1 (1994).

168. § 404(a)(5); *Albertson’s Inc. v. Comm’r*, 42 F.3d 537 (9th Cir. 1994).

169. Doran, *supra* note 10, at 185–87.

170. This use of NQDC for self-help lifetime income averaging has drawn fire in the past. The House version of the Tax Reform Act of 1969—the legislation that added section 83—also included a provision to combat the use of NQDC to defer income to a year when the employee’s tax rate would be lower. Finding it “anomalous that the tax treatment of deferred compensation should depend on whether the amount to be deferred is placed in a trust or whether it is merely accumulated as a reserve on the books of the employer corporation”, the Ways and Means Committee recommended imposing a minimum tax on unfunded deferred compensation when received. H.R. Rep.

obliged to pay tax before getting money, creates strong pressure to delay inclusion of NQDC in workers' income, notwithstanding suspension of the employer's deduction.¹⁷¹ For these reasons, NQDC plans are invariably structured as unfunded plans, meaning that they represent unsecured promises by the employer to pay compensation in the future.¹⁷²

Tax concerns inducing ongoing exposure of NQDC to the employer's general creditors—that benefits be “unfunded” in the tax sense—need not have tied the hands of the Labor Department in construing “unfunded” in ERISA's top hat plan exceptions. Funding, after all, seems more naturally to refer to accumulation of assets than to protection from creditors.¹⁷³ Despite the distinct concerns of ERISA Title I and the income tax, the Labor Department conformed its position to the IRS reading:

The Department of Labor has advised that whether a “top hat” or excess benefit plan is funded or unfunded

No. 91-413, at 90 (1969). The provision, which was quite complex, was not included in the legislation. H.R. Rep. No. 91-782, at 305 (1969) (Conf. Rep.).

171. Reduction of state tax on retirement income provides an additional incentive to defer. Pursuant to 4 U.S.C. section 114(a), states are precluded from taxing retirement income of nonresidents, and that bar extends to NQDC that supplements a qualified retirement plan. Consequently, the state in which deferred compensation was earned cannot reach distributions made after the participant retires and relocates to another state. Doran, *supra* note 10, at 203–05. Prior to 2018, delayed taxation of NQDC was important for another reason. The \$1 million limit on deductible compensation of certain officers of publicly traded corporations did not apply to compensation deferred past termination of employment. See JOINT COMM. ON TAX'N, JCS-1-18, GENERAL EXPLANATION OF PUBLIC LAW 115–97, 257, 259 (2018); Doran, *supra* note 10, at 200-03. § 162(m)(3)(C) ended that exemption.

172. Ordinarily, funded NQDC arrangements are encountered only when a program intended to be a qualified retirement plan (for which advance funding is required) becomes disqualified.

173. Indeed, the tax timing issue technically turns upon whether NQDC is “an unfunded and unsecured promise to pay money or property in the future.” Treas. Reg. § 1.83–3(e) (as amended in 2014). In a practical sense, NQDC backed by a rabbi trust is funded but not secured from the employer's creditors. See *supra* note 167 and accompanying text. The IRS's conclusion that a plan participant's interest in a rabbi trust is not “property” taxable in advance of distribution prioritizes protection from the employer's creditors and arguably equates “unfunded” with “unsecured.”

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depends upon all of the facts and circumstances. However, it is the DOL's view that such plans will not fail to be "unfunded" for purposes of sections 4(b)(5), 201(2), 301(a)(3) and 401(a)(1) of ERISA solely because there is maintained in connection with such a plan a trust which conforms to the model [rabbi] trust described in . . . this revenue procedure.¹⁷⁴

A contrary position would have extended vesting, funding, spousal rights, and fiduciary obligations, among other protections, to participants in the many NQDC plans that use a rabbi trust to prevent the employer

174. Rev. Proc. 92-64, 1992-2 C.B. 422, 423. A letter from Elliot I. Daniel, Assistant Administrator for Regulations and Interpretations, Pension and Welfare Benefits Administration, to Richard H. Manfreda, Chief, Individual Income Branch, Internal Revenue Service (Dec. 13, 1985) (available on Bloomberg Law, Labor and Employment Practice Center, Department of Labor, EBSA Information Letters) concluded that:

[i]n the absence of pertinent legislative history defining "unfunded" for purposes of Title I of ERISA, the Department believes that in the case of "top hat" plans (as well as excess benefit plans) the positions adopted by the Service regarding the tax consequences to trust beneficiaries of the creation of, or contributions to, a "rabbi trust" should be accorded significant weight under Title I.

In connection with development of the model rabbi trust, the IRS again consulted the Labor Department. *Id.* In response, the Director of Regulations and Interpretations called attention to certain provisions of the model rabbi trust that would obligate the employer, upon a change in control, "to make an irrevocable contribution to the trust in an amount sufficient to provide for the future payment to each plan participant or beneficiary the benefits they would be entitled to receive under the terms of the plan(s)." Nevertheless, "[t]he inclusion of the mandatory contribution provisions described in the subject model trust [did] not change the Department's view" that the associated NQDC plan should be treated as unfunded for purposes of ERISA Adv. Op. 91-16A (April 5, 1991). See also Letter from Bette J. Briggs, Chief, Division of Fiduciary Interpretations, Office of Regulations and Interpretations, to Robert J. Musick, Jr. (Oct. 20, 1992) ("calling attention to established principles under ERISA," namely, that maintenance of a rabbi trust does not cause the associated plan to be funded for purposes of Title I).

from renegeing on its promise to pay.¹⁷⁵ Those protections would have entailed some cost (and forfeiture of a tax arbitrage opportunity¹⁷⁶), causing many top hat plan sponsors to reconsider the decision to reinforce their contractual commitment to pay in the future. Those companies choosing to dispense with rabbi trust (and resulting ERISA) protections for NQDC would notoriously subject their prized workers to materially enhanced risk, dampening their appetite for NQDC and increasing their demand for greater qualified plan benefits. That dynamic would force greater retirement savings on behalf of rank-and-file workers—the non-elite more vulnerable component of the labor force—as explained in the next section.

B. Divergent Functions of “Highly Compensated”

Top hat plans must cover a select group of highly compensated employees,¹⁷⁷ qualified plans may not discriminate in favor of highly compensated employees.¹⁷⁸ Despite identical wording, the phrase serves different functions in these contexts. Attention to that difference demands a much narrower interpretation of permissible top hat plan participation. As explained below, it should be restricted to a small subset of the class of workers who cannot be favored under a qualified retirement plan.

The qualified plan definition of highly compensated employee (QP-HCE), enacted 12 years after ERISA, is broad and mechanical, potentially including all workers whose total compensation exceeds \$135,000 in 2022.¹⁷⁹ Industry surveys suggest that the creeping expansion of top hat plan coverage has gone so far that some companies equate the

175. See PSCA, *supra* note 114, at 21 (80% of all NQDC plans responding to a 2018 survey used a rabbi trust as an investment vehicle).

176. Application of ERISA Title I would trigger the anti-inurement rule, immunizing plan assets from the employer’s creditors. ERISA § 403(c)(1), 29 U.S.C. § 1103(c)(1). That immunity would cause participants’ interests in the rabbi trust to be “funded” for tax purposes and classified as “property” subject to taxation in advance of distribution under section 83. See ERISA PRINCIPLES, *supra* note 97, at 293–94.

177. ERISA §§ 201(2), 301(a)(3), 401(a)(1), 29 U.S.C. §§ 1051(2), 1081(a)(3), 1101(a)(1).

178. §§ 401(a)(4), 410(b).

179. See *supra* notes 112–113 and accompanying text.

categories.¹⁸⁰ The Treasury Department, in explaining its temporary regulation defining QP-HCE, warned against such conflation. Stating that it “would like to clarify its understanding that Section 414(q) [of the Internal Revenue Code] is not determinative with respect to provisions of Title I of ERISA, other than those provisions that explicitly incorporate such section by reference (e.g., section 408(b)(1)(B) of ERISA),”¹⁸¹ it announced:

The Departments of Treasury and Labor concur in the view that a broad extension of section 414(q) to determinations under [the top hat plans rules of] sections 201(2), 301(a)(3), and 401(a)(1) of ERISA would be inconsistent with the tax and retirement policy objectives of encouraging employers to maintain tax-qualified plans that provide meaningful benefits to rank-and-file employees.¹⁸²

Top hat plans are not required to provide meaningful—or any—benefits to rank-and-file employees because they are unencumbered by the coverage and amount nondiscrimination rules applicable to qualified retirement plans. NQDC comes without the tax advantages accorded qualified plan savings, but when the nondiscrimination rules operate correctly, those tax advantages should not substantially benefit the employer or its QP-HCE savers. Instead, they are redistributed in the form of retirement savings for rank-and-file employees.¹⁸³ Accordingly, the lesser tax benefits associated with top hat plan savings, which can be split between the employer and its savings-motivated high-income employees, can sometimes be a more cost-effective means of delivering deferred compensation. Those who want it will pay a premium for it, and their concession can be captured by the company rather than shared with low-paid reluctant savers.¹⁸⁴

180. See PLAN SPONSOR COUNCIL OF AMERICA, *supra* note 114. It appears, however, that the dominant practice remains to draw the line for top hat plan membership significantly higher than the QP-HCE cutoff. *Id.* at 15.

181. Preamble, Definition of Highly Compensated Employee and Compensation, 53 Fed. Reg. 4965, 4967 (Feb. 19, 1988).

182. *Id.*

183. See *supra* text accompanying notes 148–158.

184. Employees who desire supplemental retirement savings often finance their top hat pensions by salary reduction, and as a result of

Top hat plans supplement qualified plan savings, but the benefits they deliver usually could be provided under a qualified plan. Many NQDC plans take the place of—indeed, they are often designed to substitute for—deferred compensation that the employee cannot accrue in a qualified plan due to the operation of one or more applicable legal limits.¹⁸⁵ Consider two common examples. First, a voluntary deferral NQDC plan may permit employees who are prevented from making larger elective deferrals under a qualified 401(k) plan (such as by application of the limit on elective deferrals, or the nondiscrimination tests applicable to elective deferrals) to instead contribute the larger amount to the NQDC plan.¹⁸⁶ Those larger elective deferrals, however, would be unnecessary if the employer made or increased company *nonelective* contributions under the 401(k) or some other qualified plan. Another example is presented by NQDC plans that “make up” for matching contributions or nonelective employer contributions under a defined contribution plan (or accruals under a defined benefit plan) which would otherwise have been earned under the qualified plan but for the limit on compensation that may be taken into account in determining contributions or benefits.¹⁸⁷ Instead of instituting a top hat plan to provide contributions or benefits based on such excess compensation, however, the underlying qualified plan could be amended to increase the rate of contribution or benefit accrual applied to compensation falling below the limit. In each of these cases, of course, the alternative qualified

employees’ revelation of their preferences (opting into plan participation) the employer may be able to indirectly extract a larger concession, by moderating plan participants’ future compensation increases.

185. See Doran, *supra* note 10, at 192–93 (observing that “it is commonplace among public corporations to use nonqualified plans to supplement the benefits provided under tax qualified plans” and “a nonqualified defined contribution plan may supplement a corporation’s tax-qualified defined contribution plan, restoring the benefits lost by reason of the limitations under §§ 415, 401(a)(17), 402(g), 401(a)(4), 401(k)(3), and 401(m)”).

186. §§ 402(g), 401(k)(3), (m).

187. § 401(a)(17). Until the contribution and benefit accrual limits under qualified plans were increased substantially in 2001, it was also common for nonqualified plans to substitute for benefits lost to those limits. See § 415(b), (c). Providing contributions or benefits beyond the limits of section 415 makes a NQDC program an excess benefit plan to that extent. Unfunded excess benefit plans are wholly exempt from ERISA. See ERISA §§ 3(36), 4(b)(5), 29 U.S.C. §§ 1002, 1003.

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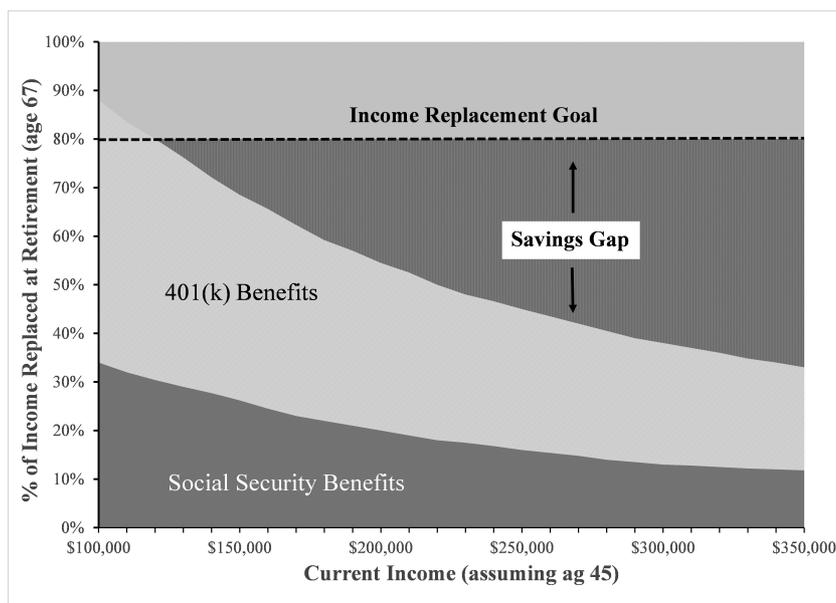
plan solution would have to be extended to all participants to satisfy the nondiscrimination rules. Hence, these top hat plan designs *selectively* (i.e., discriminatorily) supplement qualified retirement plan savings. And the ubiquity of those designs serves to indicate a widely held objective to avoid increasing benefits for the rank-and-file. The suggestion that undue restrictions on qualified retirement plan savings drive top hat plan popularity largely lacks merit.

Figure 3, a graph that was submitted to the ERISA Advisory Council, illustrates that top hat plans respond to a rational desire by highly-paid workers to supplement qualified plan savings.¹⁸⁸ The assumptions underlying the graph reveal that their supplementation demand derives from the employer's self-imposed limits on the underlying qualified plan.¹⁸⁹ In particular, the estimates assume that 401(k) plan contributions consist exclusively of elective deferrals, with no employer matching or nonelective contributions. Accordingly, such highly-paid employees would find their contributions limited throughout most of their career by the section 402(g) annual cap on elective deferrals rather

188. 2020 ADVISORY COUNCIL ON EMPLOYEE WELFARE AND PENSION BENEFIT PLANS EXAMINING TOP HAT PLAN PARTICIPATION AND REPORTING WITNESS TESTIMONY: TRISHA MORRISON 3 (Oct. 22, 2020), <https://www.dol.gov/sites/dolgov/files/EBSA/about-ebsa/about-us/erisa-advisory-council/2020-examining-top-hat-plan-participation-and-reporting-morrison-written-statement-10-22.pdf> [<https://perma.cc/Y27U-QBFW>] [hereinafter TRISHA MORRISON STATEMENT]. The Pangburn Group did not contribute to the development of this article and should not be understood as endorsing its conclusions.

189. Figure 3 was derived from computations incorporating the following assumptions: Current income and projections in 2019 dollars; retirement at age 67 in 2041; Social Security benefits estimated by the Social Security Administration's Social Security Quick Calculator, <https://www.ssa.gov/OACT/quickcalc/index.html> [<https://perma.cc/C6E4-Y7ZG>], using calculator's assumed earnings history and projected earnings; same earnings assumptions used to estimate 401(k) plan contributions, which contributions consist only of elective deferrals; elective deferrals began at age 25 at 1% of compensation, increased 1 percentage point per year until reaching 20% and remained level thereafter, each year taking into account contribution limits and catchup contributions where applicable; age 67 401(k) plan account balance computed using historical market indices to 2019 and projected 5% annual growth thereafter; final account balance annuitized as single life annuity using 3% growth rate. Correspondence between Trisha Morrison and Peter Wiedenbeck (Feb. 10, 17, 2021) (on file with author).

Figure 3*: Social Security and 401(k) Plan Contributions to Retirement Saving Goal



*. Figure 3 presents the same data as the original chart submitted by Trisha Morrison, *id.* at 3, in a slightly reformatted version.

than the much higher section 415(c) limit on annual additions under defined contribution plans. (In 2022 those limits are \$21,000 (increased to \$27,500 for participants over age 50) versus \$61,000.)¹⁹⁰ As a rough approximation, if the 401(k) plan offered a dollar-for-dollar match of the assumed employee elective deferrals then the 401(k) plan contribution to the retirement income goals would more than double for employees earning less than about \$280,000.¹⁹¹ That commitment of employer

190. I.R.S. Notice 2021-61, 2021-47 I.R.B. 738.

191. This approximation is based on the observation that the elective deferral limit for workers over age 50 is somewhat less than half of the section 415(c) defined contribution plan limit. Hence doubling contributions to the plan each year would be permissible and, with the compounding of larger annual investment returns, would yield an account balance on retirement more than twice as large as illustrated in Figure 3. At \$280,000 in compensation Social Security provides about a 14% replacement rate and the plan as illustrated contributes about another 29%. TRISH MORRISON STATEMENT, *supra* note 188, at 3.

money would eliminate the savings gap for these workers and drastically reduce it for those earning more than \$280,000.

The lesson here is that qualified plan limits impose no serious obstacle to accumulating sufficient retirement resources for employees earning up to about \$500,000 in mid-career.¹⁹² The obstacle lies in employer resistance to increasing qualified plan benefits. That resistance is apparently founded on cost: it seems that many workers, particularly rank-and-file employees, prefer \$X of current compensation over the additional retirement benefits that \$X invested in a qualified plan would produce. Under those circumstances, the reluctant savers will oppose increased qualified plan saving if they must bear the full cost (\$X reduction in current compensation) and a nondiscriminatory increase in qualified plan benefits can be achieved only by imposing some lesser charge (call it \$Y).

The function of the nondiscrimination rules, as explained in Part II above, is to incentivize plan sponsors to supply the difference: provide \$X of benefits to reluctant savers, reduce other components of those workers' compensation by \$Y, thereby increasing their total compensation by \$X-\$Y. Assuming competitive labor markets, the employer won't bear the burden of that increase. Instead it is funded by QP-HCE savers, who are willing to pay a premium to access the financial advantages of qualified plan saving. By accepting a greater reduction in current compensation than the amount of benefits QP-HCE savers earn under the qualified plan, the employer obtains compensation savings that can be deployed to increase compensation of reluctant savers and satisfy the nondiscrimination rules. The Code's definition of QP-HCE should perhaps be framed to maximize this redistribution, but since 1987 it has been set at a specified pay level nationwide, untethered to the location or composition of any particular workforce.¹⁹³ The objective bright-line classification provides certainty, facilitates planning, limits plan administration expenses, promotes sponsorship and induces widespread reliance, which makes fundamental reworking of the QP-HCE definition most unlikely.

192. The maximum annual defined contribution plan contribution (assuming the section 415(c) limit increases two percent annually) made each year for 40 years and invested at a five percent rate of return would produce an account balance of about \$9.3 million, which translates into a life annuity (using three percent internal rate of return) paying about 70% of final compensation.

193. See JCT 1987 TAX REFORM ACT OF 1986, *supra* note 112, at 703.

Compare the compensation equilibrium under top hat plans. In some cases the participant's nest egg may be less secure,¹⁹⁴ which mars its value to some degree, but under the prevailing relationship between corporate and individual income tax rates it offers some financial advantage over individual savings, albeit generally less than a qualified plan would provide. If the risk of nonpayment is not too large, one should expect high income savers to be willing to pay a premium for top hat plan benefits, accepting a greater reduction in current compensation than the amount of benefits earned under the top hat plan. The premium should be less than under a qualified plan because the tax subsidy is not generally as substantial, but the employer can pocket any such premium. Favorable taxation is not conditioned on nondiscrimination, so there is no imperative to transfer any premium to rank-and-file employees to offset their disinclination to save. It may be that the greater premium associated with qualified plan savings would be sufficient to satisfy nondiscrimination tests, but from the employer's perspective that redistribution is an unnecessary cost. Why forgo tax benefits the employer could capture and retain by meeting high-income savers' demands for retirement resources through a top hat plan?

This analysis suggests that broad eligibility to participate in top hat plans blunts the force of the nondiscrimination regime, which seeks to translate qualified plan tax preferences into increased savings on behalf of those low-paid workers who would not otherwise adequately prepare for retirement (i.e., without benefit of the cross subsidy). Maybe the cost that leads employers to resist increasing qualified plan benefits is loss of the tax advantages the company could otherwise extract from top hat plan participants. At the extreme, perhaps rank-and-file employees are getting only the qualified plan benefits that they are willing to pay for in full, by a dollar-for-dollar offset to current compensation. If the redistributive force of nondiscrimination were to become a dead letter, no persuasive justification would remain for the preferential tax treatment of qualified retirement plans.¹⁹⁵ Clearly, creeping top hat plan

194. See *supra* text accompanying notes 82–95. In the case of a financially robust plan sponsor that backs up its commitment with a rabbi trust, however, the risk of nonpayment of NQDC is virtually zero.

195. Some politicians might still prefer the qualified plan system on the view that it functions as a central pillar of a series of measures tending to transform the federal tax system from an income tax into a consumption tax. Given the cost and complexity of subchapter D (titled “Deferred

proliferation seems to threaten the core value of the qualified plan regime.

Recognition of that threat counsels a restrictive approach to permissible top hat plan membership. The definition of select group of highly compensated employees under ERISA Title I (hereinafter TH-HCE) should exclude many valuable highly-paid workers who want to save. If the demands of a substantial body of the company's prized managerial, professional, and technical talent cannot be met by top hat pensions, increasing benefits under qualified plans will often be the next most cost-effective solution. The employer may prefer qualified plan enhancement to the magnitude of pay raises required to fund adequate after-tax savings by that group. Increasing the risks associated with top hat plans, which would reduce their value to participants and decrease the premium the employer could extract, would likewise intensify demand for qualified plan savings.¹⁹⁶

Some prevalent features of contemporary top hat plans are consistent with this explanation and likewise tend to support a narrow definition of TH-HCE. Top hat plans designed to coordinate with an underlying qualified plan have become commonplace, particularly spillover or mirror 401(k) plans that operate as a near-seamless extension of the employer's generally available cash-or-deferred program.¹⁹⁷ Four revelatory aspects of this development deserve comment. First, the mirror 401(k) top hat plan is financed predominately or exclusively via participants' elective salary reduction contributions. Allowing eligible highly-paid employees (TH-HCEs) who strongly prefer current compensation to opt out minimizes cost. Although the program superficially involves dollar-for-dollar substitution of NQDC for current pay, participants reveal their high valuation of deferred compensation, allowing the

Compensation, Etc." and comprising sections 401 to 436), including economic distortions, that position would seem to betray a judgment that forthright substitution of a consumption tax base is politically unachievable.

196. As discussed previously, if a NQDC plan backed by a rabbi trust were treated as funded for purposes of ERISA Title I, then benefit protections would apply, which would in turn trigger accelerated taxation under section 83. See *supra* notes 175–176 and accompanying text. Accelerated taxation would likely cause employers to discontinue maintenance of rabbi trusts, materially increasing the risk of nonpayment, thereby decreasing the attractiveness of the remaining exempt top hat plans.

197. See *supra* notes 121–128 and accompanying text.

sponsor to extract from them a hidden higher price, as through reduced future compensation increases. And if the top hat plan includes a company match, the employer obtains direct savings from eligible participants who opt out.

Second, mirror plans foster the impression that federal tax law prevents the employer from increasing qualified plan savings. The top hat plan offers a workaround for the Code's cap on elective deferrals or the special nondiscrimination tests applicable to baseline 401(k) plan, but as has been shown, those limits do not bar the provision of greater benefits through nonelective employer contributions or increased nondiscriminatory matching contributions.¹⁹⁸ By blaming the IRS—every businessperson's favorite whipping boy—for meager qualified retirement plan benefits, employers can minimize pressure for qualified plan benefit increases that would redound to the mutual benefit of the rank-and-file and the mission-critical elite.

Third, meticulous mimicry of the underlying qualified plan obscures differences between NQDC and qualified retirement savings. The mirror 401(k) plan, for example, may be structured to allow the same contribution rate (shorn of the constraints set by elective deferral or compensation caps) as under the 401(k) plan, offer the same nominal array of investment options,¹⁹⁹ and use the same recordkeeper to provide periodic consolidated reporting of accrued benefits under both plans. Downplaying differences by giving the top hat plan the same look and feel as the underlying qualified plan induces participants to accord top hat plan savings comparable trust.²⁰⁰ Maximizing valuation of top hat plan savings increases the compensation premium that the employer can exact from participants.²⁰¹

Fourth, where a top hat plan purports to offer the same investment options as the qualified plan, the sponsor may well be compelled to credit the participant's account with the same periodic investment

198. See *supra* text accompanying notes 185–193.

199. Recall that because top hat plans are unfunded, they have no actual investments, but plans often credit participants' accounts with notional earnings based upon the performance of designated investment assets or indices. See *supra* note 42 and accompanying text.

200. Transcript of EAC Hearing of Dec. 4, 2020, at 46-47, 136-37 (remarks of Peter Wiedenbeck noting reduced salience of differences in risk between top hat plan and qualified plan with which it is aligned).

201. See *supra* text accompanying notes 195–196.

return despite the disparate tax treatment of NQDC. Income earned by top hat plan investments is taxed currently at the employer's rate, whereas qualified plan earnings are tax-exempt. Nevertheless, the sponsor may credit a pre-tax rate of investment return to heighten the impression that the top hat plan is an equally valuable extension of the qualified plan.²⁰² That tax gross-up will ordinarily cost the employer,²⁰³ and to the extent it does so that cost detracts from the benefit of substituting top hat plan benefits for qualified plan benefits. Observe, however, that the sponsor's willingness to incur that cost offers strong evidence that: (1) participants put a premium on top hat plan savings; and (2) it is more advantageous for the employer to share that premium with its top hat plan participants than to share a larger qualified plan tax subsidy with rank-and-file reluctant savers.

Passing a top hat plan off as an unremarkable extension of an associated qualified plan comes with another pathology. Independently of the tax law nondiscrimination imperative, fostering the comparability impression is objectionable from a labor law protective policy perspective. The employer's interest in getting participants to highly value top hat plan benefits provides impetus for sponsors to reduce some risks of loss. Mimicking the 401(k) plan, for example, might lead the sponsor to incorporate plan terms that grant full and immediate vesting of elective contributions (and any employer match), provide spousal rights, and bolster reliability by adopting a rabbi trust to prevent recalcitrance in the event of an employment dispute or change of control.²⁰⁴ Still, the risk of loss of NQDC in the event of bankruptcy or insolvency, while often negligible, is irreducible, and the employer seeking maximum benefit from sponsoring a top hat plan has strong reason to downplay that risk.²⁰⁵

202. See EAC TOP HAT PLAN REPORT, *supra* note 29, at 61 ("Witnesses indicated that top hat plans are often structured to replicate qualified plans, for example, by crediting pre-tax earnings on deferrals with no adjustment for the tax cost to the employer.").

203. *But see* Doran, *supra* note 10, at 198 (observing that many NQDC sponsors face a zero effective tax rate in many years due to net operating loss deductions).

204. Promissory barriers such as these could be cosmetic and for the time being only, however, unless the sponsor also forswears any reduction in accrued benefits. And because at present top hat plan terms need not be disclosed to participants, the situation is rife with opportunity for dissembling reassurances.

205. Transcript of EAC Hearing of Dec. 4, 2020, at 137-38 (remarks of Peter Wiedenbeck) (noting "the more the top hat plan[] shares the . . . same

Taking protection of top hat plan participants—as opposed to nonparticipant rank-and-file employees—as the polestar, ready access to information on the employer’s financial health, and the ability to appreciate its implications, would seem to be a key element (with others discussed below²⁰⁶) of any functional definition of workers eligible to participate. The ERISA Advisory Council recommended that the Labor Department “[r]equire that top hat plan sponsors notify eligible participants of the risks associated with the absence of ERISA’s substantive protections, including the risk of nonpayment in the event of insolvency and, if applicable, any risks of forfeiture or repudiation.”²⁰⁷ Warning may be ineffective in light of mixed messages, however. After all, these highly-paid workers are told that they qualify for special benefits as members of a select group. The status or prestige associated with top hat plan membership may be important to some eligible employees, desensitizing them to vulnerabilities.

The merits of disclosure, both as a means to enhance security of retirement saving and as a restraint on expansion of top hat plan coverage, are surveyed in Part V. First, however, an exploration of the third pernicious byproduct of top hat plans—their hidden revenue cost—is in order.

IV. THE UNINTENDED NQDC TAX EXPENDITURE

NQDC offers tax savings if the employee-participant will be subject to a lower income tax rate on distribution than when the compensation is earned, or if the employer is subject to a lower rate of tax than the employee during the deferral period.²⁰⁸ In the former case the employee can use NQDC to shift compensation income from a year when she is

look and feel as an underlying qualified plan, participants are going to more and more be prone to overlook the differences between those two savings vehicles, and in particular the very substantial differences in terms of the risks that they face”). *But see id.* at 136 (Witness testimony indicated that participants are routinely informed of insolvency risk upon initial enrollment, and many employers apparently remind them with some regularity).

206. See the discussion of risk disclosure, *infra* Part V.A.

207. EAC TOP HAT PLAN REPORT, *supra* note 29, at 9, 55–57.

208. *General Tax Reform: Panel Discussions Before the H. Comm. on Ways and Means*, 93d Cong. 1125 (1973) [hereinafter *General Tax Reform*] (statement of Daniel Halperin) (observing that “unless the employee is in the higher bracket than the employer or if the employee expects to be in a lower

subject to a high marginal rate to a later year when she faces a lower rate, either because her income has declined or due to legislated rate reductions. Frequently, income declines substantially upon retirement, and so NQDC often presents an opportunity for self-help income averaging. Even if the employee faces a constant tax rate throughout the deferral period, NQDC is advantageous if the employer's tax rate is lower. That's because income produced by investment of the deferred compensation is taxed to the employer, rather than the employee.²⁰⁹ In effect, the employer is taxed on growth of the fund in substitution (as proxy) for the employee throughout the accumulation phase. Consequently, the fund will grow faster if the lower-rate employer invests on the employee's behalf.²¹⁰

From another perspective, observe that if employer and employee face a common constant rate throughout the deferral period existing law produces tax neutrality between current and nonqualified deferred compensation. Equal tax-paid resources will be available to the employee whether he takes current compensation and invests the after-tax amount himself, or instead opts for employer investment (for the same duration) and delayed payment of the proceeds. In this instance NQDC entails no tax advantage and poses no threat to the revenue. Tax neutrality, however, is a special case.

Episodically, one or another element of potential NQDC tax saving (i.e., lower employee rate on payout and earnings compounding at a lower employer rate) has garnered attention and been addressed by policymakers. But those efforts (described below) have been piecemeal and

bracket than he is today, there is not much of a tax advantage to nonqualified deferred compensation"); *id.* at 1138.

209. Halperin & Warren, *supra* note 10, at 327–30.

210. How the aggregate tax savings affects overall compensation levels of participants in top hat plans is complex. If the top hat plan credits participants with pre-tax investment earnings, the firm will incur a cost because it is paying tax (at its tax rate) on the investment income. An employer could shift this cost to participants by crediting them only with its after-tax investment return or by reducing other components of compensation to recoup the firm's tax costs. Reducing returns to participants by the employer's tax burden appears an uncommon response. (For mirror 401(k) plans offering the same investment menu as an underlying qualified plan the difference in returns would defeat the illusion that the top hat plan offers comparable value.) The extent to which employers transfer tax cost to participants through adjustments to other elements of compensation is unknown.

incomplete. Importantly, NQDC has never been labeled a tax expenditure, and to this day no official revenue loss estimate exists. Lack of quantification and neglect may have been reasonable under rate relationships prevalent in earlier eras, but contemporary circumstances render the delinquency pernicious.

From its first appearance in 1968, the Treasury's systematic tabulation of tax expenditures has included the special tax treatment accorded qualified retirement plans but omitted NQDC.²¹¹ Accounting methods were categorized "not as variations from the generally accepted measure of net income or as tax preference but as a part of the structure of an income tax system".²¹² Seen as inherent structural elements of an income tax, generally applicable income inclusion and deduction timing rules became accepted components of the "normative income tax," the central theoretical construct deployed to identify deviations as tax expenditures.²¹³ Even today both the Treasury and the Joint Committee on Taxation list qualified retirement savings arrangements, including IRAs, as tax expenditures, but do not so designate NQDC.²¹⁴ While consistently

211. ANNUAL REPORT OF THE SECRETARY OF THE TREASURY ON THE STATE OF THE FINANCES FOR THE FISCAL YEAR ENDED JUNE 30, 1968 at 335, 340 (1969), https://fraser.stlouisfed.org/files/docs/publications/treasar/AR_TREASURY_1968.pdf [<https://perma.cc/8JJ9-9V2L>].

212. *Id.* at 329. *Accord id.* at 327 (referring to the baseline defined by "widely accepted definitions of income and standards of business accounting and from the generally accepted structure of an income tax").

213. STANLEY S. SURREY, *PATHWAYS TO TAX REFORM* 7, 23 (1973) ("Treasury analysis views the coexistence of the cash receipts and accrual accounting methods as part of the structure of an income tax system."); *id.* at 303 n.40 (observing that, while deferred compensation arrangements are not listed as tax expenditures, "their present favorable treatment is considered by some as an improper application of the tax rules"); *see also Tax Reform Act of 1969: Hearings Before the S. Finance Comm. on H.R. 13270*, 91st Cong. 3404, 3413-14 (Sept. 25, 1969) (written statement of Stanley Surrey) (observing that 1969 House proposal to limit the rate reduction benefit of NQDC was among the measures "directed at remedying mistakes in tax structure, that is mistakes in which there was no intention deliberately to confer a tax benefit for incentive or other reasons but rather matters in which the technical tax structure just didn't work correctly").

214. JOINT COMM. ON TAX'N, JCX-23-20, *ESTIMATES OF FEDERAL TAX EXPENDITURES FOR FISCAL YEARS 2020-2024* at 4, 15, 34 (2020) [hereinafter JCT 2020 TAX EXPENDITURE ESTIMATES] (noting that cash method accounting used by certain businesses is treated as a tax expenditure by the Joint

accepted as part of the normative income tax, the cash receipts and disbursements method of accounting is notorious for its susceptibility to manipulation, particularly the ability to delay taxation by arranging deferred payment.²¹⁵ Nevertheless, cash basis accounting is tolerated for its understandability and ease of application by individual taxpayers.²¹⁶

Preferential taxation of NQDC usually flies under the radar. In part that's because it's contingent on rate relationships (employee now versus later, employee versus employer) that sometimes yield an advantage and sometimes do not. But it hasn't always escaped notice. Most people expect lower taxable income post-retirement, which typically translates into a lower marginal rate. In connection with its study of tax avoidance by high-income individuals, the 1969 the Ways and Means Committee adopted a provision aimed at NQDC. Observing "that the possibility of shifting income to taxable years after retirement when the marginal tax bracket is expected to be lower should not be available to employees who are in a position to bargain for deferred compensation arrangements and to rely on the unsecured obligation of their

Committee but not by the Treasury Department); OFFICE OF MANAGEMENT AND BUDGET, ANALYTICAL PERSPECTIVES, BUDGET OF THE U.S. GOVERNMENT, FISCAL YEAR 2022 at 106, 123, 142 (2021).

215. See Michael Doran, *Deferred Compensation Unbound*, 167 TAX NOTES FED. 1589, 1596 (Jun. 18, 2020):

[a]ccrual-based taxation closely aligns includable income with economic income, but it presents administrative difficulties. Permitting individuals and small businesses to determine their tax liabilities on the basis of cash receipts and cash payments has always been a concession to those difficulties, and it is harmless enough in many cases. But use of the cash method for deferred compensation now allows executives and corporations to leverage this administrative concession into a substantial tax subsidy.

JCT 1987 TAX REFORM ACT OF 1986, *supra* note 112 at 474-75 (observing that cash method accounting "frequently fails to reflect accurately the economic result of a taxpayer's trade or business over a taxable year" but "simplicity justifies its continued use for certain types of taxpayers" including individuals and small businesses).

216. See STANLEY S. SURREY & PAUL R. MCDANIEL, TAX EXPENDITURES 189-90 (1986) (stating that normative tax accounting is tempered by "practical concerns of tax collection and tax administration").

employers, when such benefits are not available to other employees,” the House bill would have imposed a special tax rate on NQDC distributions determined by reference to the employee’s marginal rate in the years when the compensation was earned.²¹⁷ Citing administrative difficulties, the Finance Committee dropped the provision pending completion of a comprehensive Treasury Department study of both qualified and nonqualified employee benefit plans.²¹⁸ At the same time the issue became less urgent: the Tax Reform Act of 1969 set a maximum 50% rate on earned income (the top individual rate then being 70%), which limited the rate reduction potential of NQDC, particularly because the 50% rate cap did not apply to NQDC *distributions*.²¹⁹

By the early 1970s, experts understood that abuse of the qualified plan rules demanded urgent attention. Pension plans had become a notorious tax shelter deployed by high income professionals. Nondiscrimination rules were then easily side-stepped, and there was no real limit on the amount of tax-favored savings for any individual employee.²²⁰ Professor Daniel Halperin, who worked with Stanley Surrey at the Treasury during the 1960s, outlined the defects of the qualified plan regime in 1973.²²¹ ERISA imposed workforce aggregation rules and capped the maximum permissible contribution or benefit under a qualified plan, reining in the worst outrages.²²² At the time the top corporate rate was 48%;²²³ because the individual rate on earned income was capped at 50%, revenue loss from NQDC was insignificant.

When tax expenditure analysis was becoming accepted and institutionalized in the late 1960s and early 1970s,²²⁴ the value of pure

217. H.R. REP. NO. 91-413, Part I, at 89, 90 (1969); *id.* Part II, at 65-67.

218. S. REP. NO. 91-552, at 306-07 (1969).

219. § 1348(b)(1) (amended 1976, repealed 1981); see John P. Kelsey & Joseph M. Buckheit, *The Impact of the Tax Reform Act of 1969 on Executive Compensation*, 4 IND. LEGAL F. 246, 266-67 (1970); *General Tax Reform*, *supra* note 209, at 1138-39.

220. See generally Wiedenbeck, *supra* note 53, at 517-28.

221. See *General Tax Reform*, *supra* note 209, at 1121-24, 1126-34.

222. §§ 414(b), (c), 415.

223. TAX POLICY CENTER, HISTORICAL CORPORATE INCOME MARGINAL TAX RATES, 1942-2020 at 1, <https://www.taxpolicycenter.org/statistics/marginal-corporate-tax-rates> [<https://perma.cc/S572-JZXX>].

224. See SURREY, *supra* note 214, at 4-5. Annual preparation of a tax expenditure budget was mandated by the Congressional Budget Act of 1974, Pub. L. No. 93-344, §§ 3(3), 601, 88 Stat. 297, 299, 323.

tax deferral was well understood.²²⁵ In contrast, the financial consequences of shifting investment income from the employee to the employer was not yet widely appreciated. Income shifting during the accumulation phase—what Professors Halperin and Warren call “counterparty deferral” to distinguish it from pure deferral²²⁶—was often overlooked due to the mistaken notion that delaying the employer’s deduction until such time as the employee includes the deferred compensation eliminates any tax advantage.²²⁷ Until recently, such matching of NQDC deduction and inclusion (which has been required since 1954²²⁸) was often said to eliminate the benefit of deferring the employee’s inclusion of NQDC.²²⁹

Nor did visibility of rate shifting via counterparty deferral matter much until recently. As noted, the top rates on corporate income and individual earned income differed little in the 1970s (48% v. 50%); they remained comparable through 1986 (46% v. 50%); and from 1988

225. While pure deferral was commonly conceptualized as an interest-free loan of the taxes that would otherwise be due, it appears that in the early 1970s many tax experts did not fully appreciate the financial equivalence of deferral to exemption of the yield produced by investment of untaxed income. William D. Andrews, *A Consumption-Type or Cash Flow Personal Income Tax*, 87 HARV. L. REV. 1113, 1126–28, 1127 n.22 (1974), emphasized the equivalence of immediate deduction and yield exemption, and seems to have brought the matter to the attention of a broad group of tax law scholars and policy makers. See Halperin, *supra* note 10, at 519 n.47 (crediting Professor Andrews’s article as inspiring the analysis).

226. Halperin & Warren, *supra* note 10, at 324.

227. Halperin, *supra* note 10, at 520 n.49 (citing an observation in his own 1976 article evaluating ERISA as an example of the mistake).

228. § 404(a)(5); *Albertson’s Inc. v. Comm’r*, 42 F.3d 537 (9th Cir. 1994). The matching rule dates to 1954. See H.R. REP. NO. 83-1337, at A151. Previously (from the inception of the qualified plan nondiscrimination requirements in 1942) NQDC was deductible by the employer in the year of contribution if the employee had nonforfeitable rights under the plan, but if the employee’s rights were forfeitable the employer never received a deduction. *Id.* at 43–44.

229. Halperin & Warren, *supra* note 10, at 317, 327–29. *But see* DAVID F. BRADFORD & U.S. TREASURY TAX POLICY STAFF, BLUEPRINTS FOR BASIC TAX REFORM 52–53 (2d ed. 1984) (The original study, published in 1977, relies upon equivalence of accrual-based taxation of deferred compensation and current taxation of fund earnings combined with full taxation of benefits upon distribution.).

through 1992 rates disfavored NQDC (34% v. 28% or 31% for individuals).²³⁰ Adding the net investment income tax effectively increased the top individual rate to 43.4% between 2013 and 2017, during which period the top corporate rate was 35%.²³¹ That 8.4% point gap looks serious, but a careful study of the available evidence, including industry surveys, proxy statement disclosures, and interviews with experts, concluded that the “joint tax consequences of nonqualified deferred compensation do not appear to be of first order importance in the decision to adopt these plans.”²³² More granular analysis showed that, while potential joint tax savings differ according to participants’ notional investments and the employer’s informal funding decision, investment selection was unresponsive to those differences, suggesting that employer “financial accounting and participant diversification concerns often trump joint tax-minimization.”²³³ A 2017 revenue estimate for a proposal to tax NQDC upon vesting found gains of \$1 billion to \$2 billion annually, while the annual revenue loss from qualified plans is in the vicinity of \$300 billion.²³⁴ Professor Walker observed, “it seems doubtful to me that, pre-TCJA, nonqualified deferred compensation arrangements in aggregate represented a significant drain on the public fisc.”²³⁵

Things are different now. Since 2018 corporations have faced a flat rate tax of 21%, while the top individual rate on ordinary income stands at 37%. Taking into account the 3.8% net investment income tax, the spread has increased to 19.8 percentage points, nearly cutting in half the burden of taxes on investment income during the period of accumulation when saving via NQDC. By effectively rendering top hat plans semi-tax-qualified, this rate disparity strongly induces—perhaps supercharges—NQDC, greatly

230. Compare TAX POLICY CENTER, *supra* note 224, with TAX POLICY CENTER, HISTORICAL HIGHEST MARGINAL INCOME TAX RATES, at 1, <https://www.taxpolicycenter.org/statistics/historical-highest-marginal-income-tax-rates> [<https://perma.cc/UV7H-NMGW>].

231. *Id.*; § 1411.

232. Walker, *supra* note 23, at 2072.

233. *Id.*

234. Compare JOINT COMM. ON TAX’N, JCX-46-17, ESTIMATED REVENUE EFFECTS OF H.R. 1, THE “TAX CUTS AND JOBS ACT” 5 (2017) with JCT 2020 TAX EXPENDITURE ESTIMATES, *supra* note 215, at 34.

235. Walker, *supra* note 23, at 2112.

magnifying the tax expenditure.²³⁶ No comprehensive authoritative measure of aggregate NQDC accumulations (outstanding benefit promises) is available, but in 2020 the Government Accountability Office estimated that the accumulated NQDC benefits due to the top five executives in each of the 500 largest U.S. public companies total about \$13 billion.²³⁷ Top hat plans, of course, are sponsored by tens of thousands of other employers (public, private and nonprofit), and today participation extends far beyond the highest echelon of the company pay scale. Formerly, many analysts concluded that NQDC principally presented a challenge for corporate governance.²³⁸ Today, revenue losses from NQDC can no longer be ignored as *de minimis*.²³⁹

236. See generally Doran, *supra* note 216, at 1590–91; *id.* at 1590 (observing that rate disparity “sets up the largest tax payoff for [nonqualified] deferred compensation in more than a generation”).

237. U.S. GOV’T ACCOUNTABILITY OFF., PRIVATE PENSIONS: IRS AND DOL SHOULD STRENGTHEN OVERSIGHT OF EXECUTIVE RETIREMENT PLANS 14, 60–61 (2020). Focusing only on the \$13 billion, if one assumes a 10% return (as ordinary income), forgone revenue from that tiny slice of the NQDC universe would exceed \$250 million annually (i.e., $19.8\% \times 10\% \times \$13 \text{ billion} = \$257.4 \text{ million}$).

238. See, e.g., Walker, *supra* note 23, at 2126–27 (noting that “returns that match those available under qualified plans are not considered above-market returns for the purposes of [SEC public company] disclosures, even if plan sponsors incur greater costs in delivering these returns on nonqualified accounts”); *id.* at 2130; Doran, *supra* note 10, at 218–19; see also *General Tax Reform*, *supra* note 209, at 1138–39 (stating Professor Halperin’s view that NQDC “provides an unseen benefit to the employee which will not be reported in proxy material . . . and may be hidden from the scrutiny of shareholders”); Michael Doran, *Executive Compensation Reform and the Limits of Tax Policy* 11–14 (Tax Policy Center, Disc. Paper No. 18, 2004), <https://www.taxpolicycenter.org/publications/executive-compensation-reform-and-limits-tax-policy> [<https://perma.cc/7EVG-CJHZ>](critiquing § 409A penalty for noncompliant NQDC as actually likely to harm shareholders). See generally LUCIAN BEBCHUK & JESSE FRIED, *PAY WITHOUT PERFORMANCE* 95–107, 135–36 (2004).

239. The staff of the Joint Committee on Taxation uses a \$50 million threshold for reporting tax expenditures. JCT 2020 TAX EXPENDITURE ESTIMATES, *supra* note 215, at 23. Using a conservative guess that aggregate accumulated top hat plan benefits, taking into account all sponsors and all participants, probably exceed the GAO’s estimate by a factor of 100 or more, the associated tax expenditure would be on the order of \$25 billion annually. That’s about eight to ten percent of the qualified plan tax expenditure. *Id.* at 34.

V. SOLUTIONS

Preceding parts of the article exposed three glaring top hat plan pathologies, namely: (1) the insecurity of top hat plan benefits; (2) the risk that top hat plan participation impedes enhancement of qualified retirement plan benefits; and (3) unintended revenue loss (an unwarranted tax subsidy). Several measures could be harnessed to alleviate or eliminate these flaws. This part will survey three such measures: (1) requiring plan sponsors to periodically warn top hat participants with specificity of all risks of loss of their accrued benefits under the plan; (2) substantially restricting eligibility to participate in a top hat plan; and (3) ending preferential tax treatment of top hat plan savings by requiring accrual-based taxation of NQDC or taxing investment earnings in the plan at a proxy tax rate at least equivalent to the employee's rate. The first two approaches lie within existing rulemaking authority of the Department of Labor,²⁴⁰ although they could also be accomplished through legislation. The last option, which would provide a complete and permanent solution, would require legislative action.

A. Disclosing Risks to Top Hat Plan Benefits

One readily available (albeit indirect) mechanism to protect top hat plan participants from loss of their anticipated pension benefits is to give them enough information to protect themselves. Periodic understandable disclosure of the risk of loss in the event of employer insolvency or repudiation, or due to the participant's failure to satisfy any required vesting conditions, might dissuade some vulnerable workers from putting their compensation at risk. Although top hat plans are not statutorily exempt from ERISA's reporting and disclosure regime, required information sharing with top hat plan participants was eliminated by rule.²⁴¹ The ERISA Advisory Council highlighted and criticized the resulting potential for loss and recommended requiring top hat plan sponsor to periodically "notify

240. ERISA § 505, 29 U.S.C. § 1135. The Labor Department may, "by regulation or otherwise," prescribe alternative methods of compliance with reporting and disclosure obligations for any class of pension plans, including top hat pension plans. ERISA § 110, 29 U.S.C. § 1030.

241. See *supra* notes 87–90 and accompanying text.

eligible participants of the risks associated with the absence of ERISA's substantive protections"²⁴².

Risk awareness would also tend to mitigate substitution of top hat pensions for increased qualified plan benefits. To the extent that risk disclosure would cause some highly-paid savers to decline participation, the sponsor would face agitation for increased qualified plan benefits. Moreover, those eligible workers who continue participation would more realistically assess the value of their top hat pensions, reducing any compensation concession captured by the employer.²⁴³

Still, mandatory disclosure is no panacea. It is at best a stop-gap half measure. In part that's because strong forces work against disclosure's effectiveness. The greater the value participants assign their top hat pensions, the greater the benefit the employer derives from sponsorship. Demanding balanced understandable risk disclosure by the sponsor—the employer whose financial incentive is to tout the plan and downplay its deficiencies—assures that mixed motives will shape the information release. Imposing liability for inadequate disclosure would create an intractable optimization problem, akin to the dilemma employers face in drafting the summary plan description, which must be both “calculated to be understood by the average plan participant” and “sufficiently accurate and comprehensive to reasonably apprise” participants and beneficiaries of their rights and obligations under the plan.²⁴⁴

Disclosure would likely have disparate impacts on publicly traded and closely held companies. Large financially robust employers would still be in a position to pitch their programs as low-risk substitutes for qualified plan savings. These companies can contractually replicate qualified plan protections (such as rapid vesting, spousal rights, etc.), employ a rabbi trust to bar repudiation, and point to their financial statements and credit market assessments to reassure participants that the inherent risk of insolvency is minuscule. By doing so these firms would assuage the protective policy concerns of ERISA, but at the same time they could continue to charge a premium for top hat plan

242. See *supra* note 208 and accompanying text.

243. See *supra* text accompanying note 197.

244. ERISA § 102(a), 29 U.S.C. § 1022(a). See generally Peter J. Wiedenbeck, *Unbelievable: ERISA's Broken Promise* (Washington University in St. Louis, School of Law, Paper No. 21-08-01 2021), <https://ssrn.com/abstract=3900735> [<https://perma.cc/MEX6-A97M>].

participation and profit by sidestepping qualified plan nondiscrimination obligations.

In contrast, private companies would resist sharing financial information with employees. Without that data their eligible employees couldn't evaluate the security of proffered top hat plan savings. That uncertainty, in turn, would detract from eligible employees' valuation of the opportunity to participate.²⁴⁵ The consequence might be lower participation and greater pressure for enhanced qualified plan benefits. That outcome, while normatively preferable, would impair the utility of top hat plans as a tool for small businesses to recruit and retain talent—a handicap that their larger competitors would not face.²⁴⁶

B. Restricting Top Hat Plan Eligibility

At best, disclosure empowers self-protection and rebalances the top hat-versus-qualified plan comparison at the margin. Broad eligibility combined with disclosure effectively conditions participation on willingness to take risks. That's a far cry from ability to understand risks and absorb losses, functional indicators that statutory protections are unnecessary.²⁴⁷ And insofar as the goal of increasing qualified retirement plan benefits guides interpretation, then a "select group of management or highly compensated employees" should exclude many highly paid savings-oriented employees, so that their demands cannot be met by top hat plans.

A number of approaches are available to the Labor Department. Treating rabbi trusts as "funded" for purposes of ERISA Title I is one candidate. As indicated earlier, this expedient depresses the value of the top hat plans that remain exempt (those not backed by a rabbi trust),

245. Some privately-held companies might include in the plan document terms obligating the employer to annually provide top hat plan participants a copy of audited financial statements, if such statements are prepared for the use of owners, creditors or government regulators. *See* EAC TOP HAT PLAN REPORT, *supra* note 29, at 50, 56. Many companies would be unable or unwilling to do so.

246. *See id.* at 27 ("[Compensation] consultants cautioned against overly restrictive guidance that might hamper smaller companies' ability to compete with large companies in recruiting and retaining talent.").

247. *See id.* at 47, 49, 50 (suggesting that financial sophistication and risk-bearing capacity guide discretionary determinations of top hat plan eligibility).

increasing the relative attractiveness of qualified plan enhancement.²⁴⁸ Standing alone, this reform fails to accord greater protection to the benefits of participants in those top hat plans that remain.²⁴⁹ The definition of the “select group of management or highly compensated employees” must be narrowed to accomplish that.

An approach that would prioritize protection of the qualified plan system might restrict the definition of the select group to those few employees who have accrued the maximum permissible contributions or benefits under the company’s qualified plans.²⁵⁰ Federal tax law (not simply the existing terms of the employer’s plan²⁵¹) prohibits these employees from obtaining additional saving through qualified retirement plans. Consequently, barring them from earning top hat plan benefits cannot encourage extension of nondiscriminatory benefits to rank-and-file employees. Restricting top hat plan membership to this elite group would create functional symmetry between the qualified plan system and ERISA-exempt top hat plans and would be consistent with legislators’ original expectation that virtually all employer-sponsored retirement savings programs would be qualified plans.²⁵² Nevertheless, this approach collides with a weighty objection: in effect it equates top

248. See *supra* text accompanying notes 173–176.

249. The responses to this expanded definition of funding by sponsors that currently back their top hat plan with a rabbi trust cannot be predicted in advance and would not necessarily yield greater security to participants going forward. Accelerated taxation triggered by application of ERISA Title I makes continuation of a program of funded NQDC unattractive. See *supra* note 176 and accompanying text. The affected plan might just be terminated, or termination might be accompanied by substitution of a replacement (wholly unfunded) top hat plan, or by benefit enhancements under a qualified plan.

250. § 415. In 2022 the maximum annual addition under defined contribution plans is \$61,000 and the maximum annual benefit under defined benefit plans is \$245,000. Notice 2021-61, 2021-47 I.R.B. 738. Before its repeal in 1999, section 415(e) barred double dipping by imposing a coordinated limit applicable to individuals who participated in defined contribution and defined benefit plans of the same employer. Hence the only employees currently barred by law from earning greater qualified plan savings are those who simultaneously actively participate in defined contribution and defined benefit plans of the employer and who are earning the maximum from each.

251. See *supra* text accompanying notes 185–193.

252. See *supra* notes 159–162 and accompanying text.

hat plans with excess benefit plans, which have their own independent exemptions from ERISA.²⁵³ The presumption against statutory surplusage would likely persuade a reviewing court to set aside a Labor Department rule adopting this tax-centric view. Accordingly, it appears that some account must be taken of the need for participant protections (the concern of ERISA Title I) in drawing lines around the select group.

Ambiguity enabled top hat plan participation to trickle down the pay scale. Reversing that drift calls for an invigorated standard that is

253. ERISA section 3(36), 29 U.S.C. § 1002(36), sets forth the definition of excess benefit plan. Unfunded excess benefit plans are wholly exempt from ERISA Title I. ERISA § 4(b)(5), 29 U.S.C. § 1003(b)(5). Funded excess benefit plans are exempt from ERISA's vesting and funding rules. ERISA §§ 201(7), 301(a)(9), 29 U.S.C. §§ 1051(a)(7), 1081(a)(9). All excess benefit plans, whether or not funded, are exempt from the PBGC termination insurance program of ERISA Title IV. ERISA § 4021(b)(8), 29 U.S.C. § 1321(b)(8).

Almost no illuminating legislative history of ERISA's excess benefit plan exceptions exists. The House version of H.R. 2 included the section 415 limits on qualified plan contributions and benefits, but the labor provisions of the bill contained no corresponding exemptions. Employee Benefit Security Act of 1974, H.R. 2, 93d Cong. § 2003 (as passed by the House, Feb. 28, 1974), *reprinted in* 3 ERISA LEGISLATIVE HISTORY, *supra* note 48, at 4218; Private Pension Reform Legislation, 93d Congress, March 1974—Comparison of Senate-Passed and House-Passed Versions of H.R. 2, *reprinted in* 3 ERISA LEGISLATIVE HISTORY, *supra* note 48, at 4268, 4270. The vesting and funding rules (but not the fiduciary rules) of the labor provisions did, however, include exceptions for “supplementary plans,” defined as plans covering only employees covered under another plan providing a life annuity commencing not later than age 65 and providing an annual benefit of not less than two percent of final average compensation times years of covered service. H.R. 2, *supra*, §§ 3(37), 201(b)(4), 301(b)(4), *reprinted in* 3 ERISA LEGISLATIVE HISTORY, *supra* note 48, at 3898, 3915–16, 3971, 3996. With respect to such exempt supplementary plans the Committee on Education and Labor commented that:

the Secretary will have to exercise the utmost care to avoid jeopardizing the overall retirement security of the participants. The Committee expects that he will issue regulations which will protect against this possibility and he may choose to require funding [of the primary plan] in excess of the minimum requirements contained in Part 3, as a condition of receiving the exemption of coverage accorded the supplementary plan.

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more restrictive and unmistakable. Bright line compensation-based cut-offs could serve as simple objective indicators of “highly compensated employee” status under the top hat plan exemptions. Yet a nationally uniform numerical compensation level trigger for TH-HCE status seems unsuitable. Although the qualified plan nondiscrimination regime follows that tack,²⁵⁴ such a binary test fails to respond to the heterogeneity of workforce skill sets and compensation levels in the private sector. The ERISA Advisory Council hypothesized a more nuanced approach, suggesting that regulations could set two bright-line compensation-based tests. These thresholds would specify a minimum compensation level below which an employee would not be allowed to participate in a top hat plan (marking off a prohibited zone or “unsafe harbor”) and a much higher level that would classify all employees earning compensation in excess of that amount as per se highly compensated (establishing a participation safe harbor). Between those bounds eligibility to participate would turn upon workforce-specific facts; the regulation envisioned would “set forth a set of criteria tending to show that top hat plan membership is either compatible or at odds with the accomplishment of ERISA’s policies.”²⁵⁵ The criteria would presumably incorporate factors such as the employee’s ability to understand risks associated with NQDC, investment sophistication, access to employer financial information and capacity to absorb losses.²⁵⁶ Such a context-specific multifactor analysis offers employers some flexibility but admittedly no assurance.

Employee Benefit Security Act of 1974: Material Explaining H.R. 12906 Together with Supplemental Views, 120 Cong. Rec. 3977, 3982 (Feb. 25 1974), *reprinted in* 3 ERISA LEGISLATIVE HISTORY, *supra* note 48, at 3293, 3307. Excess benefit plans constitute a subset of such supplementary plans, but the substitute exceptions in the enacted version of ERISA Title I were merely mentioned—not explained—by the conference committee. H.R. Rep. No. 93-1280, at 261, 292, 296 (1974) (Conf. Rep.) (“Supplemental unfunded plans which provide benefits in excess of limitation on contributions and benefits under the Internal Revenue Code and plans which are for the highly paid to be excluded from the new funding standard.”), *reprinted in* 3 ERISA LEGISLATIVE HISTORY, *supra* note 48, at 4277, 4528, 4559, 4563.

254. § 414(q).

255. EAC TOP HAT PLAN REPORT, *supra* note 29, at 48. Other approaches to restricting top hat plan eligibility are possible, and the Council’s report surveyed a number of alternatives. *Id.* at 41–51.

256. *See id.* at 50 (suggesting that the regulation “specify factors tending to support (or undercut) the existence of financial sophistication and

Nevertheless, the Council observed that “If numerous examples accompanied the specification of criteria, the Department could provide considerable certainty to plan sponsors by addressing common practices and could provide guideposts for the courts.”²⁵⁷

Quantitative boundaries on top hat plan membership yield certain results at the ends of the compensation spectrum. The broader the range of the intermediate (discretionary) zone, the greater would be the planning and administrative costs of this approach. From the pension policy perspective, a high set point for the prohibited zone boundary is crucially important. Only if many highly-paid savings-oriented employees cannot participate in a top hat plan will the employer face substantial pressure to sponsor reasonably generous qualified retirement plan(s).²⁵⁸ Meeting that demand ensures that low and moderate income employees will receive comparable levels of contributions or benefits.²⁵⁹

Substantial restriction of top hat plan membership relative to lax current practice would induce plan sponsors to respond, and not necessarily by qualified plan improvements. Certain evasive reactions can be anticipated. Some companies may continue to offer NQDC to current top hat plan participants, but seek to avoid pension classification under ERISA by altering plan terms to call for in-service distribution. Savings arrangements that do not provide retirement income or defer income to the termination of covered employment are not employee benefit plans subject to ERISA,²⁶⁰ but would be taxed like top hat plan savings. For example, a program might allow participants to elect to take

risk-bearing capacity” and conceding that this approach calls for a discretionary determination that is “more of a standard than a rule”).

257. *Id.* at 48–49.

258. *Id.* at 45 (“[F]rom the standpoint of the Code’s nondiscrimination policy, it is important that a significant cohort of employees earning compensation above the QP HCE limit fall below the top hat floor, so that their employer may not evade the carefully constructed tensions within the qualified plan system that favor reasonably generous qualified retirement plan(s) for low-to-moderate income employees.”).

259. To illustrate the framework, the Council posited setting the unsafe harbor at 150% of the Code’s definition of QP-HCE (\$135,000 in 2022, or a cutoff of \$202,500) and the safe harbor at 150% of the maximum compensation that may be taken into account under a qualified plan (\$305,000 in 2022, or a cutoff of \$457,500). *Id.* at 49.

260. ERISA § 3(2)(A), 29 U.S.C. § 1002(2)(A).

distributions while still employed, require complete distribution of any remaining balance at age 62, and call for forfeiture on separation from service at a younger age. By forcing in-service payout, pension plan classification is apparently avoided. Yet ERISA still applies if “as a result of surrounding circumstances” a plan provides retirement income or results in deferral to the termination of covered employment or beyond.²⁶¹ The Labor Department could assert that plans providing late-career in-service distributions, and plans inducing elective distributions shortly before voluntary separation from service, are pension plans as a result of surrounding circumstances,²⁶² but combatting this tactic might require commitment of considerable audit resources. Other employers might move their current top hat plan participants into another type of non-pension NQDC by providing stock-based compensation (stock options, restricted stock plans, stock appreciation rights, etc.). If benefits become nonforfeitable and are distributed after a specified period of service (say, five or ten years), then ERISA typically would not apply. Such substitution of stock-based medium-term deferred compensation for top hat pensions would increase employees’ risk of loss of their deferred compensation: without becoming insolvent the employer’s stock price could drop dramatically and unpredictably.

261. *Id.*

262. It is the longstanding position of the Labor Department that the manner in which a deferred compensation arrangement is administered or represented to participants can constitute “surrounding circumstances” that might cause a bonus or savings program to be categorized as a pension plan, even if the terms of the plan call for in-service distributions or short-term deferral. *See, e.g.*, ERISA Adv. Op. 81-16A (Jan. 23, 1981) (suggesting that if employees selected to participate in a public drilling fund estimated to last for 10 years are likely to retire or terminate employment within that time the discretionary bonus program could be a pension plan); ERISA Adv. Op. 81-18A (Feb. 2, 1981) (stating that an employee stock purchase plan that did not restrict the resale of stock might be a pension plan if communicated to participants in a way that discouraged them from requesting distribution of their shares and selling the stock). Whether or under what circumstances in-service distribution opportunities preclude classification of a deferred compensation program as a pension plan if amounts can be deferred to the termination of employment remains an unsettled question. *Compare* *Wilson v. Safelite Group, Inc.*, 930 F.3d 429, 436–38 (6th Cir. 2019), *with* *Emmenegger v. Bull Moose Tube Co.*, 197 F.3d 929, 933 (8th Cir. 1999).

C. Mandating Accrual-Based Taxation

The Labor Department's toolbox contains both warnings and restrictive definitions of the select group, but in a way those are only palliatives. The real problem lies in motivations. Deferred compensation under a top hat plan is more valuable than an equivalent amount of taxable current compensation to many high-income employees, and unlike qualified plan saving, the employer can extract some of that premium value without being obliged to share any amount with rank-and-file employees. Eliminate the premium value of NQDC and the problems attending resort to risky top hat plan benefits to avoid across-the-board increases in qualified plan saving disappear.

The added value of top hat pensions comes from their income tax treatment, in the form of rate reduction. Under current law, benefit accruals and investment earnings accumulate at the employer's corporate tax rate, which is now much lower than the marginal rates many highly-paid employees face (21% vs. 32, 35 or 37%),²⁶³ and deferred inclusion in gross income shifts the compensation to a later year when the employee's rate may be lower. The tax timing rules that generate these rate reductions follow from the cash receipts and disbursements method of accounting. If instead workers were required to report top hat compensation under the accrual method—including the value of their right to future payment as soon as all events had occurred fixing their right to receive it—then the compensation would generally be

263. The extent of tax savings obtained through NQDC depends upon the character of plan earnings (investment income). In particular, because corporate capital gains are taxed at 21%, while individual long-term gains qualify for reduced rates (maximum 20% under § 1(h) plus the 3.8% net investment income tax of § 1411), the advantage of investing NQDC for appreciation is quite modest compared to investments producing ordinary income (such as interest or rents). See Doran, *supra* note 10, at 196–200 (comparing pre-2018 rate disparities). Savvy high-income executives (or their financial advisers) likely take this factor into account in managing their portfolios, primarily pursuing ordinary income in the NQDC plan and allocating more of their direct holdings (taxable accounts) toward capital appreciation. Despite the preceding qualification, it's important to recognize that the tax advantage accorded NQDC is scheduled to *increase* under current law. The 21% corporate tax rate is not subject to a sunset rule, while individual rates are currently set to expire, returning to their pre-2018 levels in 2026 (raising the top rate from 37% to 39.6%). Compare § 1(j)(1), with *id.* § 11(b).

taxed at the *employee's* current marginal rate, and so would annual investment earnings on amounts deferred.²⁶⁴ Rate arbitrage between employer and employee, or between the employee now and in the future (e.g., post-retirement) would end. Many policy experts have recommended accrual-based taxation of NQDC as a solution to the distortions caused by the current system.²⁶⁵

Accrual-based taxation of NQDC would require congressional action. Yet it would yield two signal advantages. First, it is a permanent solution: it's not subject to the vagaries of periodic individual and corporate income tax rate fluctuations, which can dramatically increase or reduce the tax advantages NQDC obtains under the current system. Second, it would justify repeal of a set of complex, ill-considered rules Congress enacted in 2004 in response to perceived abuses of cash method accounting for NQDC.²⁶⁶

An alternative approach to eliminating the tax subsidy for top hat plans would be to tax accumulating value to the plan sponsor, but at the employee's marginal tax rate or the highest marginal tax rate imposed on individuals.²⁶⁷ In situations where the trust rate exceeds the taxpayer's marginal rate on accumulations, this could fairly be characterized as a tax penalty on top hat plan compensation. It would also, in our view, entail more complexity than a current accrual approach. But these are questions that can be explored if there is the political will to ensure that nonqualified deferred compensation does not enjoy a tax subsidy.

CONCLUSION

When ERISA was enacted in 1974, what is now referred to as the "top hat" exemption was more an afterthought than a key provision in the

264. If the deferred compensation remains subject to a continuing substantial risk of forfeiture then inclusion would be required upon substantial vesting (as under section 83(a) in the case of in-kind compensation). Vesting (favorable resolution of forfeiture conditions) may occur in a later tax year than the year in which the employee performed the services. Treas. Reg. § 1.402(b)-1(d)(2) (definition of nonforfeitable prior to the effective date of the Tax Reform Act of 1969).

265. See Doran, *supra* note 10, at 230, 233-42; Doran, *supra* note 239.

266. § 409A; see generally Doran, *supra* note 239.

267. See Ethan Yale & Gregg D. Polsky, *Reforming the Taxation of Deferred Compensation*, 85 N.C. L. REV. 571 (2007), for a discussion of these approaches.

statute, apparently included so as not to apply federal worker protections to bespoke deferred compensation contracts negotiated by firms with their senior executives. As far as we have been able to ascertain, non-qualified retirement arrangements of the time did not generally cover middle management employees nor more than a tiny percentage of the workforce. Nor were they perceived as offering participants in such arrangements substantial tax advantages.

Although the exemption's language has never been altered, its significance to retirement and tax policy has expanded due to three important developments. The first development, fostered by the inherent ambiguity of the top hat exemption's language, has been the increase in the use of unfunded nonqualified deferred compensation plans for employees who are well paid but do not enjoy executive-suite levels of compensation. These middle management, professional and technical employees, who are offered supplemental deferred compensation on a take-it-or-leave-it basis, have little to no ability to protect themselves from the risks ERISA was designed to guard against. Indeed, employees in top hat plans occupy a singularly vulnerable legal position: they are neither protected by ERISA's substantive pension rights (vesting, funding, benefit accrual, spousal rights, anti-alienation, etc.), nor protected by state law, yet when a plan fails to pay promised benefits they must contend with ERISA's procedural obstacles and remedial limitations.

The second development has been the spread of 401(k) plan designs that provide minimal employer contributions beyond workers' own elective deferrals. This confines annual retirement savings to the elective deferral limit (currently \$20,500), plus the employer's minimal matching or nonelective contribution, usually no more than three percent of compensation. As a result, contributions under these plans fall far short of the maximum permitted annual addition to defined contribution plans, now \$61,000. Many well-paid savings-minded managerial, professional, and technical employees want to stockpile more.

The employer could accommodate those workers by increasing its matching or nonelective contributions to the 401(k) plan, but this imposes costs in the form of additional contributions for rank-and-file plan participants required by the nondiscrimination rules. The employer has an alternative, however: establishing a top hat plan, and especially an elective contribution top hat plan, covering only highly paid employees—a group that includes those who want to defer compensation beyond what the qualified 401(k) plan permits. This use of top hat plans to satisfy savings demands of highly-paid employees who are not in

senior management ranks undermines the redistributive goal of the qualified plan system, namely, fostering retirement savings for low- and moderate-income employees who would otherwise not save adequately for retirement.²⁶⁸ This cost-containment (nondiscrimination avoidance) strategy is made possible by the ambiguity that continues to enshroud permissible top hat membership.

This brings us to the third development, the recent substantial increase in the tax benefits associated with nonqualified deferred compensation. (In the period of ERISA's gestation these potential tax benefits seem not to have been widely understood.) ERISA itself had provisions that were designed to limit the tax subsidy for qualified plans, reducing it for the most highly paid employees. It is difficult to believe that the 1974 Congress would have tolerated special deferred compensation programs for executives if those arrangements conferred material tax savings.

Yet nonqualified deferred compensation can yield tax savings, to the extent the marginal tax rate of the plan participant exceeds the marginal tax rate of the employer. Since 2018, corporate profits have been taxed at a flat rate of 21%, while high-income employees are subject to marginal tax rates that can reach 40.8%. And some corporations, because of net operating losses, pay an effective tax rate of 0. The tax subsidy embedded in nonqualified retirement plans is thus significant today in a way that it never was before, reducing the employer-employee aggregate tax burden on nonqualified deferred compensation. In doing

268. A parallel development occurred in 1989, when section 401(a)(17) was added to the Code, capping the compensation a qualified plan could consider in its benefit formula. *See supra* notes 116, 122, 186–188, and accompanying text. In 1988, when the section 415(c) limit on additions to defined contribution plans was \$30,000, a plan would provide the maximum for an employee with compensation of \$400,000 if the employer contribution was 7.5% of compensation. In 1989, when section 401(a)(17) limited includible compensation to \$200,000, the plan could provide a \$30,000 addition for such employee only by increasing the employer's contribution to 15%. Under the nondiscrimination rules, however, that increased contribution rate would have to be applied across-the-board, doubling contributions made on behalf of rank-and-file employees. The alternative, of which many plan sponsors availed themselves, was to set up a top hat plan for the employees whose compensation exceeded the (a)(17) cap. And when the compensation limit was lowered to \$150,000 in 1994, the membership in such top hat plans once again would have expanded.

so, it has changed the cost calculus of retirement saving, increasing the attractiveness of using a top hat plan to satisfy the savings objectives of middle management employees relative to increasing qualified plan benefits.

The approaches to address these developments and their consequences suggested here are not novel. They have been presented repeatedly over the last quarter century, in varying degrees of detail and nuance. Adopting such changes, whether through regulation or legislation, would be a heavy lift, both technically and politically.²⁶⁹ This paper does not aspire to definitively resolve the underlying policy issues presented by top hat plans in the 21st century. Instead, our goal is to identify those issues, and by underscoring their importance we hope to persuade policymakers to begin the hard work of resolving them.²⁷⁰

269. A study quantifying the tax subsidy associated with top hat plans could be undertaken without generating much controversy, however. The controversy would occur only if the study indicates that the costs are substantial.

270. At a 2022 meeting of the ERISA Advisory Council, Acting Assistant Secretary of Labor Ali Khawar was asked whether the Employee Benefits Security Administration contemplated acting on the 2020 top hat plan report. Secretary Khawar indicated that the Council's work on top hat plans increased the agency's knowledge of prevailing practices, but observed that "I don't view [top hat plans] as a front burner problem for the system." EAC Hearing of July 20, 2022, Transcript of Statement of Ali Khawar, at 26 (on file with the authors).