Conjure up extra plan benefits

When your business is thriving and you're in the prime of life, you should try to salt away as much money in your qualified retirement plans as you possibly can. But the tax law imposes annual limits on contributions that may hinder your efforts.

Strategy: Set up a "top-hat" plan. Despite the name, it involves no sleight of hand, but the results can be quite magical.

Presto! This way your company can provide extra benefits to higher-ups like yourself without bumping up against the usual restraints for qualified retirement plans.

Here's the whole story: A top-hat retirement plan is a nonqualified deferred compensation plan covered under the landmark Employee Retirement Income Security Act (ERISA) of 1974. ERISA imposes a wide range of funding, participation, vesting and other fiduciary requirements on benefit plans providing retirement income or deferred compensation to employees. But favorable exceptions may apply to a select group of employees (i.e., the top-hat group).

Top-hat plans have generated more interest among higher-ups in recent years due to the restrictions on qualified retirement plans, especially as they relate to high wage-earners. For example, the maximum annual compensation that may be taken into account for retirement plan purposes in 2019 is $280,000 (up from $275,000 in 2018).

As a result, an employer may want to use a nonqualified top-hat plan to reward long-standing employees or to attract or retain other valuable performers without being restricted by such limitations.

Be aware that a top-hat plan comes at a tax price. Under rules instituted after 2004, amounts that are deferred under a nonqualified plan must be included in taxable income unless there is a substantial forfeiture risk. Thus, the plan should be carefully drafted with the tax aspects in mind.

Also, top-hat plans must meet special reporting and disclosure rules under ERISA. For example, a plan description must be filed with the U.S. Department of Labor (DOL) within 120 days of inception. Plus, an employer may have to provide plan documentation if the DOL requests it. If the one-time filing requirement isn't met, the full reporting and disclosure rules of ERISA may be imposed.

Which employees may be covered under a top-hat plan? This is somewhat of a gray area, but here are some general guidelines:

- A top-hat plan can't extend coverage beyond a select group of managers or highly-compensated employees.
- The group must be small in comparison to the total workforce.
- The average income of the plan participants must be higher than the average income of the other employees.
- The participants must be in a position to affect or substantially influence the design and operation of the plan. Example: In a typical small business, a top-hat plan might cover only the company's owner, officers

7600 Leesburg Pike, Suite 300, Falls Church, VA 22043-2004 (800) 543-2002

and leading salespeople. Similarly, a plan might be set up to benefit physicians in a medical practice.

Tip: This type of plan is complex, and implementation is best left to the professionals. Consult with a benefits specialist.

What's at stake?

If you're a business owner pulling down a hefty salary, the compensation limit for deductible contributions to tax-favored retirement plans could cost you thousands in contributions.

Example: Your company has a profit-sharing plan that expects to provide retirement plan contributions to employees equal to 10% of salary. You project that your salary for 2019 will be $400,000. Normally, that would mean the company contributes $40,000 to your account (10% of $400,000).

However, the maximum amount of compensation that may be taken into account for plan purposes in 2019 is $280,000. Thus, your contribution is limited to $28,000 (10% of $280,000). In effect, you lose $12,000 this year.

7600 Leesburg Pike, Suite 300, Falls Church, VA 22043-2004 (800) 543-2002