ASCENSION
CAPITAL

BEYOND THE 401(K)

A Retirement Plan Option for Highly-Compensated Executives

The 401(k) contribution limit is $22,500 in 2023, which rises to $30,000 for workers over the age of 50[i].

From the standpoint of using retirement savings to replace income later in life, $30,000 a year works reasonably well for most Americans.

But not for highly-compensated employees and executives.

If you're an executive earning a salary of $2,000,000 a year, for instance, $30,000 a year means you're only able to save 0.015% of your income each year into a 401(k). The income tax deduction from your retirement contribution would be equally as small.

In order to maintain standard of living in retirement, highly-compensated employees and executives may need to look beyond the company's 401(k) plan.

We think "Top Hat" plans offer an attractive solution.

What are "Top Hat" Deferred Compensation Plans?

A "Top Hat Plan" is a type of retirement savings plan designed to give key executives and highly compensated employees of a company the opportunity to accumulate enough savings to replace a significant portion of their pre-retirement income.

Current tax law allows executives to defer up to 100% of their compensation without paying income tax on that money until it is withdrawn, generally in retirement. Much like money in a 401(k) plan, the assets can benefit from tax-free growth[ii].

NO LIMITS

From a regulatory standpoint, there are no caps on how much an executive can contribute to a Top Hat plan (though companies can impose limits).

$14.6 MILLION

The average Top Hat balance for CEOs of S&P 500 companies, according to Institute for Policy Studies.

$169 MILLION

The Top Hat retirement account balance of Walmart CEO Doug McMillion, as of 2023 and according to the Institute for Policy Studies[iii].

Here are some other key features of Top Hat Plans to be aware of:

Limited Eligibility

The plans are only available to a "select group of management or highly compensated employees." Here's how the IRS expands on this definition:

"It generally means a small percentage of the employee population who:

- *are key management employees, or*
- *earn a salary substantially higher than that of other employees.*

Over the years, the courts and the Department of Labor have looked at one or more factors:

- *total employees versus the number of employees covered under the plan*
- *the average salaries of the select group versus the average salaries of other employees,*
- *the average salaries of the select group versus the average salary of all management or highly compensated employees,*
- *range of salaries of employees in the select group, and*
- *the extent to which the select group can negotiate salary and compensation packages.*[iv]*"*
- *Investment Options and Vesting Schedules*

Participants typically have a range of investment options to choose from within a Top Hat plan, similar to a 401(k) plan. The investment earnings also grow tax-deferred until distribution.

Companies may also implement vesting schedules to ensure that participants remain with the company for a certain period before they are fully entitled to the deferred compensation and its earnings.

Nonqualified

Top Hat Plans are nonqualified, meaning they are exempt from certain ERISA (Employee Retirement Income Security Act) requirement, such as the participation, vesting, and fiduciary responsibility provisions. The theory is that executives have the power to negotiate their own compensation, which precludes the need for ERISA protections[v].

But there is one key risk with this plan setup - the assets in the plan are considered company assets until the executive withdraws the money. That means if the company declares bankruptcy, executives could lose some or all of their savings (by contrast, money in 401(k) plans is protected in a bankruptcy)[vi].

Distribution Options

Participants can usually choose when and how they want to receive their deferred compensation, which could be in a lump sum, over a set number of years, or as annuity payments.

Lack of Portability

Unlike 401(k) plans, Top Hat Plans generally do not allow participants to roll over their balances to another employer's plan.

The Bottom Line

Top Hat plans provide executives with a viable option for saving for retirement, and the plans also allow for sizable income tax deductions–with some plans allowing 100% of income to be deferred. That makes the plans attractive options for executives and highly-compensated employees, in our view.

Sources:

[i] *Source: IRS (https://www.irs.gov/newsroom/401k-limit-increases-to-22500-for-2023-ira-limit-rises-to-6500)*
[ii] *Source: "For Executives Only, CEOs Amass Billions in Savings with 'Top Hat' Plans," The Wall Street Journal, May 18, 2023.*
[iii] *Source: "For Executives Only, CEOs Amass Billions in Savings with 'Top Hat' Plans," The Wall Street Journal, May 18, 2023.*
[iv] *Source: IRS (https://www.irs.gov/retirement-plans/non-governmental-457b-deferred-compensation-plans)*
[v] *Source: Thomson Reuters Practical Law, "Top Hat Plans."*
[vi] *Source: "For Executives Only, CEOs Amass Billions in Savings with 'Top Hat' Plans," The Wall Street Journal, May 18, 2023.*