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# Giving Nonqualified Deferred Compensation Plans their Due Diligence in M&As: Part II—Top-Hat and FICA Fitness

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*Last issue we described how Internal Revenue Code (IRC) Section 409A[1] compliance presented perhaps the most challenging question for sponsors of nonqualified deferred compensation plans (NDCPs) during a merger and acquisition (M&A) due diligence test. However, even if all the NDCPs pass this potential problem, there are still other challenges to solve before this critical examination is completed. Two such questions are "fit" related: (1) will the NDCPs still fit within the top-hat exemption post-merger; and (2) have the NDCPs Federal Insurance Contributions Act (FICA) taxes been properly applied to the benefits? This article prepares NDCP sponsors to answer these two important topics and alert them to any trick questions they may pose.*

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## WILL THE TOP-HAT EXEMPTION STILL "FIT" POST-MERGER/ACQUISITION?

NDCP sponsors must be careful to restrict participation in their NDCPs so that they remain "primarily for the purpose of providing deferred compensation for a select group of management or highly compensated employees"[2] (*i.e.*, a "top-hat group"). Maintaining this restriction is necessary in order for the NDCPs to continue to be exempt from coverage under the qualified plan rules of the Employee Retirement Income Security Act of 1974 (ERISA) governing participation, vesting, funding, and fiduciary requirements.[3] Since NDCPs are typically designed and administered in a manner that would not satisfy these ERISA requirements, losing the top-hat exemption would result in a myriad of adverse consequences, including exposing the plan and sponsor to the severe penalties that result from ERISA noncompliance. The key question in this analysis is always where can sponsors safely draw the participation line? That is, identifying the right rung on the corporate ladder that sufficiently secures the NDCP's top-hat footing so as to prevent an inadvertent free fall into ERISA coverage?

Presently there is no formal bright-line definition of what constitutes a "select group of management or highly compensated employees" or, in other words, which employees may be covered under a top-hat plan. While the IRC has defined "highly compensated employee"[4] (generally earning at least $120,000 [2018 limit] as indexed) for qualified retirement plan purposes, an NDCP sponsor that uses this mark as its plan's eligibility cut-off will not be guaranteed that its covered group is "top hat." The Department of Labor (DOL) has the authority to impose ERISA penalties and, thus, it is the DOL definition that tends to govern. Generally, the IRC's definition is much less restrictive and nuanced than what the DOL has in mind for these plans. The DOL wants sponsors to focus on a more restrictive group of employees who are in a position to negotiate their own plan provisions and, thus, not be in need of the protections offered under ERISA.[5] The DOL, however, has never issued regulations formalizing its position on this matter.

In the absence of DOL regulatory guidance on this issue, this eligibility determination process has often been viewed as more of an art than a science, with sponsors and their advisors left to construe their own definitions versus the dated DOL advisory opinion[6] versus various court rulings that have limited precedential value outside of their jursdictions. Over the years, without citing the specific case law, some courts' benchmarks have included:

1. Those individuals with significant managerial duties;

2. A group representing 5 percent or less of the employee population (though there have been some court cases where higher percentages have been deemed to meet the exemption); and

3. The average compensation of the covered group is three times the average of the noncovered group.

As recently as May 28, 2015,[7] the DOL reiterated its staunch belief that true "bargaining power" be a prerequisite to participation in NDCPs. The DOL filed a lengthy amicus brief in a case challenging a top-hat group in an attempt to see this view supported by a favorable ruling; however, the court did not concur in the case.[8] While a comprehensive review of the legal landscape surrounding this topic is beyond the scope of this article, an analysis of recent court decisions can be found in the prior edition of the *Benefits Law Journal*,[9] which raises an issue regarding the geographical split that has emerged between the various circuits, one that is particularly relevant in the M&A context: "an identical employees benefits plan, covering an identical amount and type of employees, could be subject to the requirements of ERISA if used by an employer in Cincinnati but completely exempt when used by a Philadelphia employer."[10] Accordingly, unless future rulings resolve this rift, employers engaged in M&As that unite companies from regions covered by separate circuit courts may need to assess the individual applicable rulings when reviewing their respective NDCP's top-hat groups in order to ascertain whether they are likely to withstand a future challenge.

So, what are the potential challenges to an NDCPs top-hat status? While the most obvious would be a DOL audit of the plan, the far more common threat comes from disgruntled participants who are adversely affected by one of the plan's "non-ERISA" plan provisions or by one of the limitations of NDCPs. Examples of the former would be a vesting schedule longer than the minimum years permitted under ERISA or perhaps a vesting schedule with a noncompete attached to it. The most prevalent illustration of the latter would be the requirement that benefits owed participants remain "unfunded" (*i.e.*, subject to the creditors of the plan sponsor in the event of its insolvency). In this scenario, the negatively affected participants seek recovery of the benefits they lost in the bankruptcy based on the argument that such benefits should have been protected by an ERISA trust because the plan includes participants who are not "top-hat" employees.

Because the prospect of a disgruntled participant poses such a danger to a borderline top-hat NDCP, vetting such plan's eligible group during the due diligence process is crucial, considering the fact that the M&A itself may increase the odds of some participants becoming upset (especially in cases where the acquired executives may be terminated). Even if the NDCPs of each company involved in the deal independently met the top-hat group requirements for their respective plan sponsors, this may not be the case post-merger. For example, assume that a large company acquires a smaller company along with the smaller company's executives and the NDCP in which they participate. All of the executives of the smaller company may have fallen well within the top-hat standard based on the facts and circumstances of their employment with the smaller company; however, their position in the combined company may no longer justify top-hat status. If this is the case, they may very well also fall into that "disgruntled participant" status by virtue of their diminished status in the new company, thereby increasing the potential for a top-hat legal challenge.

Some potential solutions for this situation include freezing the questionable NDCPs, terminating and liquidating them, or, in an asset sale transaction, not accepting the NDCP. Each of these options has its limitations and may not be feasible depending on various circumstances (*e.g.*, most notably timing issues and the applicability of the IRC Section 409A rules).

## HAVE ALL REQUIRED TOP-HAT FILINGS BEEN MADE?

Even if the acquired NDCPs and their participants will still meet the top-hat exemption post-merger, the surviving company could be at risk if the acquired company failed to file the one-time top-hat statement[11] for each plan with the DOL. This filing is required in order for the NDCP to be exempt from the qualified plan reporting and disclosure requirements (most importantly the annual Form 5500 filings) and the severe penalties assessed for failing to timely make these filings:

- IRS penalties of $25 per day up to $15,000,[12] and
- Maximum DOL penalties of $2,097 per day with no limit.[13]

The good news is that even if the acquired company failed to timely file its top-hat statement, there is an amnesty program available through the DOL. Failures to file can be easily and electronically corrected by:

- Submitting the required DOL filing;
- Completing a submission under the DOL's Delinquent Filer Voluntary Compliance Program (DFVCP); and

- paying the penalty (*i.e.*, $750 regardless of the number of plans maintained by the sponsor or the degree of lateness).[14]

It is also important to note that even if a previous filing *was made* by the acquired company, a new filing may be required because:

- An employer may become a sponsor of NDCPs through acquisitions of organizations that sponsored such programs.

- A subsidiary that is spun off from a parent or sold may become the direct sponsor of the portion of the NDCP that applies to the subsidiary's employees that was previously covered under the parent's DOL filing but which is not covered by a DOL filing after the spinoff or sale.

The DOL guidance letter on this topic states as follows:

> Where one of the participating employers is the plan administrator, the plan administrator could identify the employer that serves as the plan administrator by name, employer identification number (EIN), and address. If a participating employer is an authorized person from whom the Department may request plan documents under 29 C.F.R. Section 2520.104-23(b)(2), including documents regarding the other participating employers, the statement could identify that authorized employer as the "employer." In cases where only one participating employer is identified as the "employer," the registration statement should include some general identifying information regarding the group of participating employers that maintain the plan. The addition or removal of individual participating employers from the group would not necessitate the filing of an updated registration statement as long as the employer identified in the original registration statement continues to be an employer of employees covered by the plan and continues to be an authorized person from whom the Department could request documents regarding the plan.[15]

## ASSESSING FICA FITNESS

If an employee receives compensation that qualifies as "wages" under IRC Section 3121, such pay is generally subject to FICA tax when it is "paid or otherwise made available" to the employee.[16] There, however, are separate provisions for NDCPs that provide that amounts deferred under such plans are subject to both a "special timing" rule and a "nonduplication" rule.[17]

The special timing rule enables NDCP sponsors to apply FICA taxes at the later of the performance of services or the lapse of any substantial risk of forfeiture (*i.e.*, when vesting occurs) instead of waiting until the time the amounts are actually distributed from the plan.[18] This special timing rule generally yields favorable results for NDCP participants because most or all of them will already exceed the FICA wage base (*e.g.*, $128,400 for 2018[19]) for imposition of the 6.2 percent Social Security tax in the year of performing services due to their regular wages. Consequently, such participants' NDCP amounts would therefore not be subject to the 6.2 percent Social Security tax, and only the 1.45 percent Medicare tax would apply in the year of deferral. In addition, thanks to the nonduplication rule, any subsequent earnings on the deferred amounts that were FICA taxed in accordance with the special timing rule would never be subject to FICA taxes. In contrast, had the special timing rule not been used, FICA taxes would apply years later when the NDCP distributions actually occur. This alternative would potentially result in two negative outcomes for the participants: (1) the FICA tax would be applied to the total distribution (*i.e.*, the sum of the allocations plus any earnings); and (2) the application the FICA tax would occur postemployment when the participants may not have regular wages in excess of the FICA wage base, thereby exposing the entire distribution to full FICA taxation.

While employers, with the assistance of their payroll system administrators (whether internal or external), typically have little trouble correctly calculating, withholding and paying the federal employment taxes that are due on the *current* compensation that they pay their employees each year, the same is not always true when it comes to the more complex rules applicable to the calculation and payment of FICA taxes on some amounts deferred under their NDCPs. "Some" is the operative word here because NDCP *employee* deferrals, whether from base pay or bonuses, are normally not a problem; just like 401(k) deferrals, such amounts are 100-percent vested when made and, thus, they are simply run through a payroll system, which already contains a built-in mechanism for withholding and paying FICA on amounts of this type.

NDCP sponsors and their payroll providers, however, may struggle in determining the timing of NDCP *employer* allocations. If the NDCP is a defined contribution plan, such amounts could be subject to FICA taxation under the special timing rule when they become vested. This is fairly simple when a cliff vesting (*i.e.*, full vesting occurs after a specified number of years of service are completed) schedule is used. For example, assume a participant receives an employer annual allocation of $10,000 a year for five years under an NDCP with a five-year cliff vesting schedule. The participant remains employed by the sponsor for the entire vesting period and, at the date upon which 100-percent vesting occurs, the account balance is $52,600 (*i.e.*, the sum of the five allocations of $10,000 plus $2,600 in earnings). If the special timing rule is used, the $52,600 will be subject to FICA taxation in the year of vesting—but since such taxation occurs while the participant is still receiving a full salary, odds are that only the 1.45-percent Medicare tax would apply, since the participant's salary will most likely be over the FICA wage base. Assuming that the same allocations are made each year and the employer continues to apply the special timing rule, going forward, the participant will only owe FICA tax on the $10,000 allocated each year, and future investment earnings on such amounts, as well as on the existing, already-taxed $52,600, will escape FICA taxation.

This calculation becomes much more complicated in cases where the NDCP utilizes a graded vesting schedule in lieu of the above-described cliff vesting schedule. In addition, there are separate rules for determining the timing of FICA taxation for NDCP defined benefit plans. A complete analysis of these rules is beyond the scope of this article; however, to summarize, they add another date to the mix with respect to the latest date that FICA taxation must be applied. Instead of just the later of the performance of services or the lapse of any substantial risk of forfeiture (*i.e.*, when vesting occurs), defined benefit plans can wait until the date on which the amounts become "readily ascertainable."[20] This provision is primarily intended to address those NDCPs that provide benefits that are linked to a qualified defined benefit plan. Since the ultimate NDCP benefit is not really ascertainable until the qualified plan benefit becomes fixed, the rule allows NDCP defined benefit plan sponsors to have the option of delaying FICA taxation until such time or applying it sooner under an early inclusion rule and then truing up the tax later once the amount becomes readily ascertainable.

In any event, whether an NDCP sponsor elects to apply the special timing rule, or the sponsor and its payroll provider are just not aware of the rule, failure to use the rule does not result in a violation of tax law because the FICA taxes would then be applied at the time of distribution. Nevertheless, this is still an area that should be examined during the M&A due diligence process so that the companies involved in the deal can assess the respective FICA situations of each other's NDCPs and know what, if any, action may be needed in the future should they assume sponsorship of these plans (*i.e.*, has the FICA tax already been withheld or must it be withheld upon distribution?). In addition, if the decision reached in a recent court case is any indication of future verdicts, a thorough review of this issue could serve to protect the surviving company from being named in a future suit and perhaps having to pay damages to participants.

In the case of *Davidson v. Henkel Corp.*,[21] current and former employees who were participants of the plan sponsor's NDCP filed a class action lawsuit against the sponsor and the plan when the sponsor withheld required FICA tax payments from their NDCP distributions. The court found that the employer's failure to apply the special timing rule under its top-hat plan violated the plan's terms and thereby created an impermissible reduction of the participant's benefits. The NDCP under review contained the following provision:

> ***Taxes***. For each Plan Year in which a Deferral is being withheld or a Match is credited to a Participant's Account, the company shall ratably withhold from that portion of the Participant's compensation that is not being deferred the Participant's share of all applicable Federal, state or local taxes. If necessary, the Committee may reduce a Participant's Deferral in order to comply with this Section."[22]

According to the court's ruling, the above provision required the employer "to properly withhold the [p]articipants' taxes" when the NDCP contributions were credited. Two important factors to remember in this case, and which may distinguish it from future results, are two actions taken by the NDCP that significantly hampered it ability to defend the claim against it:

1. The NDCP sponsor was effectively its own "whistle blower" by sending letters to the participants admitting that FICA taxes had "not been properly withheld."

2. Even though the use of the special timing rule may be optional under the FICA regulations, the fact that the use of such rule was hard coded into the document made it a plan provision that the sponsor was thereby contractually bound to follow.

This ruling creates an even more pressing need for companies in a possible M&A transaction to conduct a thorough review of their respective NDCP documents and administrative procedures in order to ascertain whether FICA tax withholding was addressed. It is quite possible that future plaintiffs may argue that, even without the inclusion of specific language in the NDCP document, the *Henkel* ruling creates a de facto obligation on NDCP sponsors to administer their plans in accordance with the special timing rule so as to best protect NDCP participants from the adverse tax consequences of failing to do so. Accordingly, at the very least, if there are any NDCPs that have language similar to the language found in the plan in the *Henkel* case (*i.e.*, committing to the use of the special timing rule) and FICA taxes have not been withheld on a timely basis, that fact pattern should create a red flag to be discussed during the M&A negotiations. Some companies may choose to be even more proactive and insist on the use of the special timing rule as the best defensive administrative practice.

## WHY IS IT SO CRUCIAL TO FIX OR AT LEAST FOCUS ON FICA BEFORE CLOSING THE DEAL?

The *Henkel* case highlights one of the worst-case scenarios of an NDCP sponsor's failure to follow FICA withholding rules. There are several reasons as to why this issue should be fully examined and, if needed, corrected during the due diligence period:

1. Whether it is self-induced turnover as the result of pre-merger rumors that lead employees to seek other employment for fear of not having a position postmerger or actual postmerger layoffs, human resource and payroll staff may very well be considered redundant and thus not survive the merger. Depending on whether the company adequately documented its administrative practices, these individuals may be the only reliable sources on how FICA withholding was handled prior to closing. Accordingly, there will be a much better chance of retrieving the necessary information while this staff is still accessible.

2. There will be sufficient time to assess if there is an underwithholding problem and, if so, how much.

3. If there is an underwithholding problem, the cost of correction will only grow as more time passes (*i.e.*, if not discovered until later, the surviving entity may face future underwithholding penalties and/or lawsuits from participants).

4. Obtaining this knowledge in advance may influence decisions to be made regarding the affected NDCP.

## MAINTAINING TOP-HAT AND FICA FITNESS A MUST IN M&AS

As discussed last issue in Part I of this article, IRC Section 409A compliance deservedly garners the lion's share of attention when bringing NDCPs into the M&A due diligence den. When reviewing existing NDCPs prior to closing a deal, the analysis, however, cannot be limited solely to IRC Section 409A. In order to ensure that the NCDPs' all-important ERISA exemptions remain intact, the respective plan populations must be reviewed to determine whether any relevant NDCPs will still fit into the top-hat exemption group postmerger. The results of such review may influence which plans survive the merger and may even affect the negotiations of the deal itself. Efforts must also be taken to ensure that all NDCP required filings are complete and whether any corrective action (under the DOL amnesty program) or new filings (due to a postmerger change in the NDCP sponsor) will be needed. Furthermore, there is a time-sensitive need to ascertain if and how the NDCP documents and administrative practices have addressed payroll tax withholding regarding the NDCPs, because companies forgetting FICA withholding requirements could also find themselves facing future financial exposure, especially given the potentially far-reaching *Henkel* decision. As a result, in order to fully give NDCPs their due diligence in M&As, plan sponsors should work with their employee benefit advisors and legal counsel to establish a complete compliance regimen that will ensure that the surviving company emerges in not only fine IRC Section 409A shape but also top-hat and FICA-withholding fit.

## NOTES

1. IRC § 409A and Treas. Reg. § 1.409A-1 through 6.

2. 29 U.S.C. §§ 1101(a), 1051(2), 1081(a)(3).

3. *Id.*

4. IRC §414(q).

5. DOL Advisory Opinion 90-14A (May 8, 1990).

6. *Id.*

7. Amicus brief filed by the DOL re: Bond v. Marriott International, Inc., 637 Fed. Appx. 726, 61 EBC 1005 (4th Cir. 2016).

8. *Id.*

9. "The Top-Hat Exemption After *Sikora*", Elizabeth Rowe and J. Christian Nemeth, *Benefits Law Journal,* Vol. 31, No. 3, Autumn 2018.

10. *Id.*

11. 29 CFR § 2520.104-23(a)-(d).

12. IRC §§ 6652(d), 6652(e) and 6692

13. Fed. Reg., Vol. 83, No. 1, 30 CFR, Part 100.

14. *https://www.dol.gov/sites/default/files/ebsa/about-ebsa/our-activities/resource-center/fact-sheets/dfvcp.pdf.*

15. December 19, 2008, DOL Memorandum, 2008-08A, ERISA § 104.

16. Treas. Reg. § 31.2121(v)(2)-1(a)(1).

17. Treas. Reg. § 31.2121(v)(2)-1(a)(2).

18. *Id*.

19. *https://www.ssa.gov/news/press/factsheets/colafacts2018.pdf*.

20. Treas. Reg. § 31.2121(v)(2)-1(c)(2)(iii).

21. *Davidson v. Henkel Corp.*, E.D. Mich. No. 12-CV-14103, 2015 U.S. Dist. LEXIS 722.

22. *Id*.



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