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Top-heavy Plan Basics

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A top-heavy plan is one that primarily benefits officers, owner-employees, shareholder-employees, partners, self-employed persons and other employees who are deemed to be “key employees” (as defined later in this article). When a qualified plan becomes top-heavy, special provisions are activated to ensure that non-key employees receive reasonable benefits under the plan. For example, a minimum contribution is generally required.

Prior to 2007, an accelerated vesting schedule was also required; however, the Pension Protection Act of 2006 (PPA) made the top-heavy accelerated schedule the maximum vesting schedule for all plans. This article explains how to determine when a plan becomes top-heavy and what must be done to comply with the law thereafter.

Defined Contribution Top-heavy Plan Defined

Defined contribution (DC) plans are top-heavy when the aggregate account balances of key employees exceed 60% of the total account balances.

Account Balances

The account balance used for the top-heavy test includes employer contributions, elective deferrals, after-tax contributions, rollover contributions received prior to January 1, 1984, “related” rollovers, investment earnings credited to account balances and forfeitures. The following are excluded from the account balance for top-heavy test purposes: unrelated rollover contributions received on or after January 1, 1984, deemed IRA contributions, and Voluntary Deductible Employee Contributions (VDECs) are excluded from the top-heavy test.



Employer contributions: In profit sharing and 401(k) plans, except for the first year of the plan, employer contributions are included only if contributed on or before the determination date. In money purchase plans, contributions will be included, if contributed by the last day of the plan year or, if later, up to 8 ½ months after the close of the prior plan year (§1.416-1 Q & A T-24).

Example: Garden State Diner, Inc. sponsors both a profit sharing and a money purchase plan. Each plan is on a calendar year basis. To determine top-heavy status for 2011 (using 12/31/10 data), the profit sharing plan will only

include 2010 contributions made on or before December 31, 2010. To determine the top-heavy status for 2011 (using 12/31/10 data), the money purchase plan will use contributions made on or before September 15, 2011 for 2010.

Elective deferrals counted in the account balance include employee voluntary after-tax, pre-tax elective deferrals or mandatory after-tax contributions, but not Deemed IRA or Qualified Voluntary Employee Contributions (QVECs), rollovers received prior to January 1, 1984, but not those received on or after that date, unless from a plan of a *related* employer.

Example 1: Ava, a new employee of Garden State Diner, Inc., rolls in money from her prior employer's plan. Ava was not an owner of her prior employer, which was unrelated to Garden State Diner. This amount is not included in the top-heavy determination.

Example 2: Bob, who owns Garden State Diner, Inc., also owned another company and rolls the funds from the other plan into Garden State Diner's. Because Bob owned both companies, this transaction is a related rollover and would be included in the top-heavy determination.

Investment earnings credited to account balances, forfeitures and distributions made within the one-year period ending on the determination date due to severance of employment, death or disability must be included in the top-heavy test. There is a five-year lookback period for in-service distributions, including excess deferrals, excess contributions, excess aggregate contributions and excess annual additions. In-service distributions also include a terminated plan of the employer if that plan would have, except for the fact that it was terminated, been aggregated for testing.

For example, when performing the top-heavy test as of the December 31, 2010 determination date, in-service and corrective distributions for 2010, 2009, 2008, 2007 and 2006 must be added to the December 31, 2010 balance.

If a plan participant does not have any earned income during the lookback year, his or her balance is excluded from the test.

Example: A participant terminates employment on April 23, 2010 and by September 16, 2010 withdrew his entire balance in the plan. For the 2011 top-heavy test, the determination date balance of December 31, 2010 would be used. Of course, since the participant withdrew everything, his balance would be zero, but any amounts distributed during the one-year lookback period, in this example the amount distributed on September 16, 2010, would be added back into the December 31, 2010 determination date balance.

Example of a DC Top-heavy Plan

Employee	Key or Non-Key	12/31/10 Account Balance
Bob	Key	\$ 473,000
Mom	Key	\$ 358,000
Dad	Key	\$ 45,000
Otto	Non-Key	\$ 135,000
Elle	Non-Key	\$ 127,000
Anna	Non-Key	\$ 81,000
Ava	Non-Key	\$ 69,000
Ada	Non-Key	\$ 102,000
Lil	Non-Key	\$ 18,000
Nan	Non-Key	\$ 31,000
		\$ 1,439,000

This defined contribution plan is top-heavy because as of December 31, 2010, the testing date for the 2011 plan year, the total of the account balances of the key employees was \$876,000 and the total account balance of all employees was \$1,439,000. Since key employees' account balances were 60.876% of the total account balances ($876,000 \div 1,439,000 = 60.876\%$), the plan is top-heavy.

Note: If the key employee account balances exceed 60%, the plan is top-heavy.

There is no *de minimis* amount applicable to the key employee account balances. One of our clients had a multi-million dollar retirement plan become top-heavy by approximately \$200. Neither the Internal Revenue Code nor the regulations provide any leeway where the 60% is exceeded by even the smallest amount. It is a pure mathematical calculation that draws a line at the 60% amount. Thus, it is important to alert a client when the plan reaches a level approaching 60% so that the client may advise its key employees to cut back on contributions.

Example: On December 31, 2010, the key employees have a balance of \$433,050 and the total plan balance is \$720,900. This plan has 60.07% of the balance in the key employees' accounts and thus, the plan is top-heavy. To show how little can make the difference, if the key employees had \$575 less and the plan balance had been the same, the plan would have not been top-heavy with a ratio of 59.997%.

The determination date for the top-heavy test is the last day of the plan year preceding the plan year for which the rules will be applied. For example, to determine if a calendar year plan is top-heavy for 2011 and, thus, to see if a top-heavy allocation is required for 2011, the determination date of December 31, 2010 is utilized. Therefore,

the December 31, 2010 account balance for any individual who was a key employee at any time in 2010 is used to determine if the plan is top-heavy for 2011. Keep in mind that the key employee had to have rendered personal service and received compensation during the 2010 year.

If the plan requires an allocation to only non-key employees, then once the determination date of December 31, 2010 shows that the plan is top-heavy for 2011, the non-keys who are employed on December 31, 2011 will receive a top-heavy allocation, assuming that any key employee received an allocation—which for top-heavy purposes includes making an elective deferral contribution.

Defined Benefit Top-heavy Plan Defined

Defined benefit (DB) plans are top-heavy when the present value of accrued benefits of key employees exceeds 60% of the present value of total accrued benefits.

The present value of accrued benefits must be based on reasonable actuarial assumptions. The rules for including previously distributed amounts in a defined benefit plan's top-heavy determination are the same as with defined contribution plans. Distributions within one year of the determination date are added back. There is a five-year look-back for in-service distributions.

Example of a Defined Benefit Plan that is Not Top-heavy

Employee	Key or Non-Key	Age	Accrued Benefit	Present Value of Accrued Benefit
Jack	Key	55	\$ 6,000/mo.	\$ 305,819
Jill	Non-Key	50	\$ 5,300/mo.	\$ 183,853
Karen	Non-Key	40	\$ 3,200/mo.	\$ 51,417
Tom	Non-Key	35	\$ 2,400/mo.	\$ 26,245
Tracey	Non-Key	25	\$ 1,600/mo.	\$ 8,104
Steve	Non-Key	25	\$ 1,000/mo.	\$ 5,065
				\$ 580,503

Unlike the defined contribution plan example, this plan is not top-heavy. The present value of accrued benefits for the key employee is \$305,819, while the total present value of all accrued benefits is \$580,503. The key employee benefits represent 52.68% of the total. Thus, the top-heavy rules below will not be applicable to this plan during the next plan year.

Aggregated Plans

All plans of the same employer covering a key employee must be aggregated for top-heavy testing. Two or more plans must be aggregated where one plan covers a key employee and is dependent on the other(s) in order to meet the coverage [Code §410(b)] and nondiscrimination tests [Code §401(a)(4) and 401(k) and (m)] for qualification.

Two or more plans of a controlled group may be aggregated where one covers a key employee and aggregation may make the plans, when tested together, not top-heavy, provided the plans are nondiscriminatory when considered as a unit.

Once aggregated, all plans that must be aggregated are either top-heavy or not top-heavy as a group.

Determination Date

The determination date for measuring whether a plan is top-heavy for a given year is the last day of the preceding plan year. For a calendar year plan, to determine top-heavy for 2011, the test would be done using the December 31, 2010 balances. For first year plans, the determination date is the last day

of the first plan year. Thus, for a plan that was established in 2010, December 31, 2010 is the determination date for 2010 and 2011.

For defined contribution plans, the account balances are determined as of the most recent valuation date in the 12-month period ending on the determination date plus an adjustment for contributions due as of the determination date.

For defined benefit plans, the present value of accrued benefits is determined as of the most recent actuarial valuation in the 12-month period ending on the determination date.

Additional Qualification Requirements

Minimum Allocation or Benefit Accrual for Top-heavy Plans

In defined contribution plans the minimum allocation for each non-key employee in a plan that is top-heavy is the lesser of 3% of compensation, or the highest actual percentage allocated to any key employee. For this purpose, employer contributions include elective deferrals, employer match, employer discretionary or required contributions and forfeitures.

Example 1: Bob, the key employee of Garden State Diner, Inc., receives a 2% allocation in the profit sharing plan. All eligible, non-key participants must receive an allocation of at least 2%.

Example 2: Bob, the key employee of Garden State Diner, Inc., receives a 10% allocation in the profit sharing plan. All eligible, non-key participants must receive an allocation of at least 3%.

Example 3: Bob, the key employee of Garden State Diner, Inc., defers 6% to his 401(k) plan. This amount is considered an accrual of benefit and triggers the requirement for a 3% contribution to the non-key employees.

Note: The top-heavy minimum contributions must be made for all non-key employees. Legally, the top-heavy contribution does not have to be made to key employees. Whether the employer will want to permit its key employees to receive such contributions will depend on considerations such as costs, demographics and whether providing more allocations to key employees is making it more difficult to no longer be top-heavy. Selecting the appropriate plan provision can eliminate the top-heavy contribution to key employees.

Last Day Requirement Rule

All non-key participants who are active employees on the last day of the plan year must receive the defined contribution minimum regardless of the actual number of hours of service performed.

Example 1: The profit sharing plan allocation of contribution requires the completion of 1,000 hours of service and employment on the last

Where the employer maintains a defined contribution and a defined benefit plan, either can provide the top-heavy minimum for both by providing an increased formula amount.

day of the plan year. Elle, a non-key employee, is an eligible plan participant employed at year-end. However, she only has 750 hours of service. Although she is not eligible for the profit sharing contribution, she must receive the 3% top-heavy minimum required contribution.

Example 2: Jack became eligible to participate in the plan in the year 1997. Since then Jack worked about 2,040 hours in every year and received a top-heavy allocation as a non-key employee. Jack decided to terminate service as of December 22, 2010. Although Jack had worked more than 2,000 hours in 2010, he is not eligible for a top-heavy allocation because he is not employed on the last day of the 2010 plan year.

No 1,000-hour Requirement

There is no 1,000-hour requirement in a defined contribution plan for a top-heavy allocation.

An eligible participant who works as little as one hour during the year and who is employed on the last day of the plan year has met the service requirement for a top-heavy allocation in a defined contribution plan. A 1,000 hours of service requirement may not be imposed even if the plan requires 1,000 hours of service for an allocation of matching or non-elective contributions.

Example: An eligible participant makes deferrals and only worked 800 hours during the year but was still employed on the last day of the year. In the employer's plan, 1,000 hours of service is required to receive the matching contribution and to receive a profit-sharing contribution. Thus, this participant is neither entitled to the matching contribution nor the profit-sharing contribution. However, this participant is entitled to the top-heavy contribution.

Defined Benefit Top-heavy Allocation Rules

The defined benefit plan top-heavy rules are different and may require the completion of a year of service to be entitled to a top-heavy benefit accrual. In addition, defined benefit top-heavy rules do not require the participant to be there on the last day to accrue a top-heavy benefit. In defined benefit plans the minimum benefit accrued for each non-key employee in a plan that is top-heavy is two percent of compensation for each year of service until the accrued benefit equals 20% of compensation. After the top-heavy minimum is accrued, the participant's benefit is determined in accordance with the normal benefit formula in the plan. All non-key participants who have at least 1,000 hours of service for a benefit computation period must accrue a minimum benefit even if they are not employed at year-end. Although a frozen defined benefit plan may be

top-heavy based on the value of accrued benefits, frozen plans are not subject to top-heavy minimum contributions. Frozen plans are, however, subject to vesting and aggregation requirements.

Determining Contributions and Benefits When a Plan is Top-heavy

Compensation

The Code Section 415 definition of compensation must be used for determining required top-heavy minimum contributions. This type of compensation includes all earnings for services rendered to the employer. It is gross compensation (deferrals are not netted out) and is for the full year of employment, even if the employee was not a plan participant for the entire year.

Example: Anna is employed for all of 2010 and earns \$30,000. However, she entered the plan on July 1, 2010 and had earnings of \$15,000 between July 1 and December 31. The top-heavy benefit is based on the \$30,000 salary [if she deferred to a 401(k) that amount is not subtracted].

Compensation is limited to \$200,000 adjusted for cost-of-living. The limit for 2007 is \$225,000, for 2008 is \$230,000, for 2009 is \$245,000, for 2010 is \$245,000 and for 2011 is \$245,000.

When More Than One Plan Exists

If an employer maintains more than one qualified plan, the top-heavy allocation or benefit accrual limitations that apply are as follows:

Multiple Defined Contribution Plans

When an employer maintains two DC plans, the top-heavy minimum can be satisfied by either plan. However, appropriate language must be included in each plan to stipulate which plan(s) will receive the top-heavy minimum; otherwise, each plan will be required to satisfy the top-heavy minimum. Typically the money purchase plan is selected because the contribution is already mandated by the terms of the plan.

Dual Eligibility

Beware of DC plans with dual eligibility. If an employee is eligible for any portion of the plan, that employee is considered a participant and is eligible for top-heavy contributions.

Example: Garden State Diner, Inc. maintains a 401(k) that has immediate eligibility for elective deferrals but a one-year of service requirement for matching and nonelective employer contributions. Those participants eligible to defer are entitled to a top-heavy contribution, even if not yet eligible for the other contribution sources under the plan.

Defined Contribution and a Defined Benefit Plan

Where the employer maintains a defined contribution and a defined benefit plan, either can provide the top-heavy minimum for both by providing an increased formula amount.

If the top-heavy minimum for both the DC and DB is covered by the defined contribution plan, the minimum contribution percentage is increased to 5% from 3%.

If the top-heavy minimum for both is covered by the defined benefit plan, the accrual percentage is increased to 3% from 2%.

Contributions That Are Not Counted Towards a Top-heavy Minimum

Contributions that are not counted towards a top-heavy minimum include:

- Employee after-tax contributions and accrued benefits attributable to them may not be considered for purposes of the top-heavy contribution;
- Employer contributions to the OASDI program cannot be counted; and
- Employer contributions representing employee elective deferrals cannot be considered.

Note: Effective for plan years beginning on or after January 1, 2002, matching contributions may be counted towards satisfying top-heavy accruals even if they are used in testing.

Vesting Requirements Under Top-heavy Plans

Full vesting after two years of service must be used if the plan has an eligibility requirement that is two years. A “year of service” for this eligibility standard is deemed to be a maximum of 1,000 hours in a 12-consecutive month period. If the employer uses a one-year or less eligibility requirement, the plan may utilize either of the following vesting schedules when the plan is top-heavy:

2/20 Graded Vesting

Years of Service	% Vested
2	20%
3	40%
4	60%
5	80%
6	100%

Three Year Cliff Vesting

Years of Service	% Vested
0 - 2	0%
3	100%

The Change from Five Year Cliff and Seven Year Graded Vesting Schedules

The change to top-heavy vesting occurred in two stages. Effective in 2002, all plans with matching contributions must use a top-heavy vesting schedule with regard to such contributions. Effective for plan year 2007, all new employer contributions may not be on a schedule that is longer than a top-heavy vesting schedule.

Most plan documents contained provisions that will automatically change the vesting schedule if the plan becomes top-heavy. Thus no plan amendment was required. However, the vesting schedule did not revert to a non-top-heavy schedule if the plan subsequently was determined to be not top-heavy. In this case an amendment was required.

Top-heavy Exemption for Certain Safe Harbor 401(k) Plans

EGTRRA included a change for plans that meet the ADP/ACP safe harbor with the non-elective contribution (NEC) or the matching contribution and offer no contributions other than deferrals and a safe harbor contribution. These plans are deemed to satisfy top-heavy minimum allocation requirements. Revenue Ruling 2004-13 covers the exemption from top-heavy testing afforded some safe harbor 401(k) plans. A safe harbor 401(k) plan that consists solely of elective deferrals and employer contributions that satisfy the safe harbor requirements as set forth in §401(k)(12) and 401(m)(11) of the Internal Revenue Code is exempt from top-heavy. The key clarification is to what the term “solely” that is used in the law refers.

The revenue ruling consists of four specific examples, which clarify the IRS interpretation of the law.

Scenario One: The contributions allowable under the plan are the elective deferrals, safe harbor match and discretionary non-elective. The plan chooses not to fund the discretionary nonelective piece for a year. Even though there might be prior dollars in the plan from this source, since it is not being used currently then the plan is exempt from top-heavy for the year.

Scenario Two: The facts are the same as Scenario One above, except that the nonelective portion of the plan receives a contribution for the year. The top-heavy exemption is not applicable for this year.

Scenario Three: The facts are the same as Scenario One above, except that allocations are made from prior year forfeitures in the same manner as the nonelective contribution. The top-heavy exemption is not applicable for this year.

Scenario Four: The facts are the same as Scenario One above, except the eligibility requirements for the deferral portion of the plan is immediate and the eligibility for the safe harbor matching contribution is one year of service with the employer. The top-heavy exemption is not applicable for this year. Since all eligible non-highly compensated employees under the plan do not receive the safe harbor contribution, the matching requirements do not meet the conditions of the ADP safe harbor.

The final 401(k) regulations made clear that the safe harbor 401(k) exemption from top-heavy testing is a year-by-year determination.

At the October 2006 ASPPA Annual Conference, the IRS stated that in order for a safe harbor NEC plan to be exempt from the top-heavy test, the compensation must be based on full year compensation and not compensation only while a participant. In addition, the IRS stated that for the safe harbor match plan to be exempt from the top-heavy rules, only the safe harbor match and elective deferrals may be made to the plan. If any other contributions or forfeitures are made, the plan would not be exempt from the top-heavy rules. We await written IRS guidance on these statements.

Key Employee Defined

Key employees are used only for the purpose of top-heavy testing. Prior to 2002, the rules were different than the rules shown below, which are effective currently.

A key employee is any employee who, during the plan year containing the determination date for the year being tested, falls into any one of the following three categories:

1. An Officer:
 - Earning in excess of \$145,000 for 2007, \$150,000 for 2008, \$160,000 for 2009, \$160,000 for 2010 and \$160,000 for 2011.
 - Limit on number of officers; employers with:
 - more than 500 employees—no more than 50 officers must be counted
 - 30 - 500 employees—no more than 10% of all employees must be counted as officers
 - fewer than 30 employees—no more than three officers must be counted as key employees
 - If only some officers need be counted, they must be determined in order of compensation from the top down.

2. A 5% Owner:

- An employee who owns more than 5% of the employer.
- Stock attribution rules apply as set forth in Code §318. Thus, interests owned by parents, spouse, children and grandchildren regardless of ages will be deemed to be owned by any and all others listed.

3. A 1% Owner with compensation of more than \$150,000.

- An employee who owns more than 1% of the employer and earns more than \$150,000.
- Family attribution rules apply for the 1%.
- The \$150,000 is not adjusted for COLA.

Compensation for Key Employee Determination

All rules are applied on the basis of total compensation actually paid to an employee during the applicable year, including amounts which were deferred under 401(k), cafeteria and tax-sheltered annuity [403(b)] plans. Compensation should not be annualized for this calculation.

The determination of a key employee is made based on the information for the plan year that contains the determination date. For example, for a 2011 top-heavy test for a calendar year plan, the determination date would be December 31, 2010; therefore, the determination of key employees would be based on the 2010 plan year (in this case, calendar year) data. If the participant is a key employee at any time during the look-back year, the person was a key employee for the entire year.

Example: Donald owned 51% of his company for many years. Donald sells his interest in the company but stays on as an employee working one day a week as of August 2, 2010. Donald continues to work only one day a week. When does Donald stop being a key employee for testing purposes?

As of the December 31, 2010 determination date (for the 2011 top-heavy test), Donald is still classified as a key employee because he had key employee status during part of the 2010 year. As of the December 31, 2011 determination date (for the 2012 top-heavy test), Donald is no longer considered a key employee since he had no ownership during any period of 2011.

Donald is then a former key employee and a former key employee's balance is excluded from the top-heavy test.


Other Issues

Corrections

What is the required correction for a plan that does not provide the minimum top-heavy benefit? Appendix A of EPCRS Rev. Proc. 2008-50 requires that an employer who fails to provide the minimum top-heavy benefit under §416 must contribute the proper amount as required under the terms of the plan.

Note: Key employees may not have their deferrals returned to avoid the required top-heavy contribution (such action would not be a permitted distributable event).

Exemptions

The following plans are exempt from top-heavy rules: SIMPLE IRAs, SIMPLE 401(k), 403(b) plans, 457(b) plans and Safe Harbor 401(k)—including QACAs that meet the requirements above for being exempt. 



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