

Top-Heavy Retirement Plan

What is a Top-Heavy Plan?

Many employers have a 401(k) plan or some other form of defined contribution plan that needs to meet what are called “top-heavy plan rules.” The top-heavy rules are designed to ensure that lower paid employees receive at least a minimum benefit in plans where most of the assets are owned by higher paid employees (referred to as “key employees” and defined below). When a plan is top-heavy, certain minimum vesting and allocation requirements must be satisfied. Plans with fewer than 100 participants are the most likely to become top-heavy and thus affected by the top-heavy rules.

A **key employee** key employee is an employee, who at any time during the plan year containing the determination date (the last day of the preceding plan year) is:

- A more than 5% owner of the employer (family attribution rules apply);
- A more than 1% owner of the employer with annual compensation greater than \$150,000 (family attribution rules apply); or
- An officer with annual compensation greater than a dollar amount as determined by the IRS annually.

A defined contribution plan is top-heavy when, as of the last day of the preceding plan year (the determination date), the aggregate value of the plan accounts of key employees exceeds 60% of the aggregate value of the plan accounts of all employees under the plan. For top-heavy purposes, aggregate - not yearly - contributions and earnings are counted to ensure the top paid group does not benefit disproportionately. Note: It’s even possible for a plan to become top-heavy after a year in which no contributions are made.

What happens if my plan is Top-Heavy?

- 1) 3% of each non-key employee’s compensation for the entire year.
 - All employer contributions, including match, profit sharing, forfeitures and QNECs are all considered and count toward the minimum contribution. Elective deferrals are not included.
 - The 3% minimum contribution requirement is reduced if the largest percentage contribution made on behalf of a key employee for the plan year is less than 3 percent.

or

- 2) The highest contribution percent of any key employee (for example a key employee defers 2%, the top-heavy minimum is 2%).

A top-heavy plan must also satisfy one of two minimum vesting schedules: the “three-year cliff” or “six-year graded” vesting schedule. A plan must state the vesting rules that will apply if the plan is top-heavy, even if the plan isn’t currently top-heavy. Under three-year cliff vesting, employees must be 100% vested once they have three years of service. Prior to completing the third year of service, the employee’s vesting percentage may be any percentage, including zero. Under six-year graded vesting, employees must be 100% vested once they have six years of service with certain minimum requirements for the interim periods.

To properly comply with the top-heavy rules, employers must test their plans every year to determine their status. If the plan is top-heavy for a given year, the minimum benefits and vesting must be given for that year. The failure to properly follow the top-heavy rules can cause the plan to lose its qualified status.

How can a plan avoid top-heavy contributions?

Certain safe harbor plans are exempt from the top-heavy rules. A plan that consists solely of elective deferrals and safe harbor contributions (matching or QNEC) are not required to make top-heavy minimum contributions. However, if a safe harbor plan reallocates forfeitures, makes a discretionary match or profit-sharing contribution, the top-heavy minimum rules will apply. A safe harbor plan must also have the same eligibility requirements for all sources of money to qualify for the exemption. If all key employees do not have any contributions, no top-heavy minimum is required.

Who is eligible to receive the top-heavy contribution?

Any participant who is eligible to defer into the plan, regardless if such participant actually elects to defer, is eligible to receive the top-heavy minimum. If a non-key participant is employed at the end of the plan year, an hour requirement may not be imposed, such as 1,000 hours. However, the plan may require participants are employed on the last day of the plan year to receive the top-heavy minimum.

Does this affect the other retirement plans we sponsor from this company?

A non-key employee who participates in both a top-heavy defined contribution plan and a top-heavy defined benefit plan maintained by the same employer need not receive both a defined contribution and defined benefit minimum, but should receive more than just a 3% contribution to the defined contribution plan. A plan may use one of the following alternative safe harbor methods to provide top-heavy minimums. The plan must specify the method selected. Only the defined benefit plan must provide the minimum benefit.

- 1) A floor offset arrangement under which the defined benefit plan minimums can be offset by the defined contribution plan benefits.
- 2) Both the defined contribution plan and the defined benefit plan together, using comparability analysis, provide benefits at least equal to the defined benefit plan minimum.
- 3) A safe harbor defined contribution minimum of contributions and forfeitures equal to 5% of the compensation of each non-key employee.

When is my Top-Heavy contribution due?

In order to satisfy the top heavy rules, the contribution must be deposited no later than the last day of the year following the year for which it is required; however, in order to deduct the contribution, it must be deposited by the due date of the tax return for the year for which it will be deducted.

Planning Ahead

If your plan isn't top-heavy yet, but getting close, here are a few items to consider that may put your plan in top-heavy status. If any of these situations will occur soon, it is important you discuss with your administrator as soon as possible:

- If an owner or key employee will terminate employment or retire soon
- If your plan has low participation or small account balances and a participant takes a large distribution
- Hiring a new family member
- Your employee count has a significant increase or decrease