United Retirement Plan Consultants

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Top-Heavy Retirement Plans

Federal tax law requires that plans be tested for top-heavy status each year. If a plan is top-heavy, the company may be required to make a minimum required contribution to the plan, and those contributions must vest according to minimum vesting schedules specified by law. Plans are top-heavy if more than 60% of the plan is for the benefit of key employees.

Who are Key Employees?

A key employee is any employee who meets one of the following criteria at any time during the plan year:

- An officer of the company making over $175,000 (for 2017);
- A 5% owner of the business (a 5% owner is someone who owns more than 5% of the business; or
- An employee owning more than 1% of the business and making over $150,000 for the plan year.

When determining an employee's ownership interest in the company, the rules treat any individual who is a spouse, child, grandparent or parent of someone who is a 5% owner, or who, together with that individual, would own more than 5% of a company's stock as a 5% owner. This means that children working in a business owned by one or both of their parents are considered key employees, even if they do not own stock directly.

Top-heavy Minimum Contributions

Top-heavy plans must satisfy minimum contribution requirements for non-key employees. In defined contribution plans, the minimum contribution is the lesser of:

- 3% of compensation or
- The highest percentage contribution made for a key employee (including their own 401(k) salary deferral contributions).

Top-heavy minimum contribution requirements affect the various types of plans differently:

401(k) Plans

401(k) plans are the most adversely affected by top-heavy requirements.

Example: XYZ Company, owned by Mr. and Mrs. Smith, has a top-heavy pension plan. The Smiths are getting ready to retire, and their son and daughter are taking over the company. The company will be funding the Smiths' buyout over the next several years, so they decide to freeze the pension plan. To allow employees to continue saving for retirement, XYZ sets up a 401(k) plan and allows employees to contribute from their wages to the plan, while XYZ plans on making no contribution to the 401(k). However, the Smiths' son, earning $60,000 a year, contributes $2,400, or 4% of his pay to the 401(k) plan. At the end of the plan year, the Smiths discover that their 401(k) plan is top-heavy as it must be combined with the pension plan for this purpose. Because their son contributed in excess of 3% of his pay, XYZ must now make a minimum contribution of 3% of pay. If their non-key employee payroll is $1 million, the son's $2,400 contribution cost the company $30,000. The non-key employees' own contributions do not count in satisfying this minimum contribution; it must come entirely from the company. Because the top-heavy minimum contribution is the lesser of 3%

or the highest key employee contribution, this required contribution could be avoided entirely if none of the key employees contributed to the plan for the year.

Profit Sharing Plans

Profit sharing plans must meet the top-heavy minimum required contribution, but this will only apply if the company is already planning to make a contribution. In any year where the company does not make a contribution, since the key employees' contribution rate is zero, the top-heavy required minimum contribution is zero for non-key employees. The only significant effect of the top-heavy contribution requirement is for plans that have different contribution rates for different employees. The first 3% of the contribution is allocated as an equal percentage to all.

Money Purchase Plans

Money purchase plans are similar to profit sharing plans in that the top-heavy minimum contribution is applicable only where a contribution is already being made to the plan. Most money purchase plan contribution formulas automatically satisfy top-heavy requirements. If a money purchase plan is frozen, then the top-heavy minimum contribution goes to zero as no key employees receive a contribution.

Defined Benefit Plans

Defined benefit plans can meet the top-heavy requirements by providing a minimum pension benefit payable at the plan's normal retirement age equal to 2% of pay per year of plan participation, up to 10 years maximum. So, if a participant works for 10 years, their minimum benefit would be 20% payable for their lifetime. Like money purchase plans, defined benefit plan formulas usually satisfy this requirement automatically. Also, if the plan is frozen, additional minimum benefits are not required as the key employees are not getting additional benefits either.

Top-heavy Vesting

Company contributions in top-heavy plans are subject to vesting schedules:

Years of Service	Alternative 1	Alternative 2
0-1	0%	0%
2	20%	0%
3	40%	100%
4	60%	100%
5	80%	100%
6	100%	100%

Special Rules

1. A retirement plan is top-heavy when, as of the last day of the prior plan year, the total value of the plan accounts of key employees is more than 60% of the total value of the plan assets.

2. When determining top-heavy status, all qualified retirement plans sponsored by the company must be considered, including plans terminated and distributed in the prior plan year. If, when aggregated together, the plans are top-heavy, then all plans are considered top-heavy and must meet the minimum vesting requirement. The minimum contribution requirements must be met by at least one plan.

3. When determining top-heavy status, distributions made during the year must be included. Distributions made to participants who are still employed at the time of distribution must be counted for the current and 4 preceding plan years.

4. Rollovers (transfers) from plans of unrelated employers are generally not counted in determining top-heavy status. Rollovers from plans of the same or related employers are usually counted in determining top-heavy status.

5. If one of the company's plans is an ongoing defined

benefit pension plan, the minimum can be met by making a defined contribution minimum contribution of 5% percent, instead of the normal 3% percent.

6. In 401(k) plans the company matching contributions can be counted toward satisfying the top-heavy minimum required contribution.

7. Certain safe-harbor 401(k) plans that provide for only salary deferral and safe harbor contributions are not subject to the top-heavy rules.

Conclusion

401(k) plans frequently become top-heavy due to the existence of another retirement plan or a terminated or transferred defined benefit plan. If a 401(k) plan is top-heavy and key employees make elective salary deferral contributions to the plan, the company must make the top-heavy minimum contribution, usually 3% of compensation for non-key employees. This contribution is over and above the non-key employees' own salary deferral contributions. Failure to make this contribution will cause the plan to lose it tax-qualified status.

The 3% minimum contribution can be avoided if no contributions, including employee 401(k) contributions, are made on behalf of key employees.

If the top-heavy minimum contribution will be made, it can serve a dual purpose: it satisfies the top-heavy rules and it may also be considered a qualified non-elective contribution (QNEC) or "fail-safe" contribution to help the plan pass its ADP test.

Alternatively, it can serve a dual purpose by providing a base contribution to all employees in a profit sharing contribution allocation. The 3% contribution can be made as a profit sharing contribution, and the key employees may also receive a 3% contribution. If integrated, employees earning over the FICA wage base may be eligible to receive an additional contribution of 3% of their compensation over the wage base. If the plan provides for a tiered profit sharing allocation, the 3% top-heavy minimum contribution can support additional profit sharing contributions to highly compensated employees within the requirements of IRS nondiscrimination testing.