**Chapter 5: Top-Heavy Plans**

**Q. 5.01: What is the definition of a top-heavy plan?**

Code Section 416(g) defines a top-heavy plan as:

1. Any defined benefit plan if, as of the determination date, the present value of the cumulative accrued benefits under the plan for key employees exceeds 60 percent of the present value of the cumulative accrued benefits under the plan for all employees; and
2. Any defined contribution plan if, as of the determination date, the aggregate of the accounts of key employees under the plan exceeds 60 percent of the aggregate of accounts of all employees under such plan.[[1]](#footnote-1)

**Q. 5.02: How often must a plan be tested for top-heavy status?**

A plan must be tested every plan year. A plan year is identified by the year in which the plan year begins.[[2]](#footnote-2)

**Q. 5.03: What is the accrued benefit?**

In a defined benefit plan, the accrued benefit is the portion of the total retirement benefit earned based on years of service or years of participation as of a specific date.

In a defined contribution plan, the accrued benefit is the account balance in a defined contribution plan as of a specific date.

**Q. 5.04: What is the determination date for purposes of top-heavy status?**

The determination date is the last day of the preceding plan year or, in the case of the first plan year, the last day of the first plan year.[[3]](#footnote-3)

If a plan is top-heavy in its first plan year, then the plan is considered top-heavy for the first two years.

**Q. 5.05: What is the present value of the accrued benefit for purposes of top-heavy status?**

The present value of the accrued benefit in a defined benefit plan is the lump sum equivalent equal to the current value of the accrued benefit, assuming it is paid starting at retirement age, considering the time value of money and the life expectancy of the participant.[[4]](#footnote-4)

**Example 1.** Following are data for an employee as of December 31, 2013:

|  |  |
| --- | --- |
| Salary: | $30,000 |
| Date of hire: | January 1, 2003 |
| Date of plan participation: | January 1, 2004 |
| Date of birth: | January 1, 1969 |
| Date of retirement: | January 1, 2034 (age 65) |
| Plan benefit: | 60% of average compensation |

Assuming level compensation to retirement age, this employee’s retirement benefit at age 65 will be $1,500 per month for life ($30,000 × 60% / 12 months). The funding calculations of this plan determine that $206,275 will be needed at age 65 to be able to provide the promised benefit (based on 5 percent interest and individual annuity male mortality). In other words, the plan needs $137.52 at age 65 to fund each dollar of monthly benefit promised ($206,275 / $1,500).

Further assume that benefit accruals are based on participation; therefore, the employee’s accrued benefit would be:

Retirement benefit ×

(years of participation to 12/31/13 ÷ years of participation to 1/1/2034)

$1,500/month × (10 / 30) = $500/month

The lump sum necessary to fund the accrued benefit, i.e., the amount necessary to pay the accrued benefit of $500 per month beginning at age 65, for life, would be $68,760 ($500 per month × $137.52). The next question is how much is necessary as of December 31, 2013, so that if invested at x percent, that amount will grow to $68,760 at the employee’s age 65? A financial calculator will show that the answer is $16,187 (based on 7.5 percent interest), the present value of the participant’s accrued benefit as of December 31, 2013.

The determination of top-heavy status in a defined benefit plan follows the same procedure for each employee.

**Q. 5.06: Who is a key employee for purposes of top-heavy status?**

A key employee is any employee who, at any time during the plan year containing the determination date, is:[[5]](#footnote-5)

1. an officer of the employer having an annual compensation greater than $170,000 (for 2014), adjusted for inflation in $5,000 increments;
2. a 5 percent owner of the employer; or
3. a 1 percent owner of the employer having an annual compensation from the employer of more than $170,000.

When identifying key employees under items 2 and 3, the ownership attribution rules of Code Section 318(a) apply.

**Q. 5.07: Who is an officer for purposes of top-heavy status?**

The determination about whether a key employee is an officer is based on the facts, including the source of the employee’s authority, the term for which the employee is serving in the position, whether elected or appointed, and the nature and extent of the employee’s duties.[[6]](#footnote-6) There is a limit on the number of officers who must be taken into account depending on the number of employees in the group being tested for top-heavy status. Keeping in mind that the term “officer” refers to the facts and circumstances and not the title, entities other than corporations can have officers for purposes of top-heavy status. A partner in a partnership with the authority of an officer would be considered an officer for top-heavy purposes.

**Q. 5.08: What is an aggregation group?**

An aggregation group is a combination of an employer’s qualified retirement plans (both defined benefit and defined contribution plans) for purposes of determining top-heavy status.

Each plan in an aggregation group is treated as a top-heavy plan if the group is a top-heavy group.[[7]](#footnote-7)

A required aggregation group includes each plan of the employer in which a key employee is a participant, and each other plan of the employer that enables any other plan to meet the requirements of Code Section 401(a)(4) or Code Section 410(b).[[8]](#footnote-8)

Permissive aggregation means the employer may treat any plan not required to be included in an aggregation group as being part of that group if that group would continue to meet the requirements of Code Section 401(a)(4) and Code Section 410(b) with that plan being taken into account.[[9]](#footnote-9)

**Example 2.** Employer X sponsors Plans A, B, and C. Assume the plans individually satisfy all requirements of Code Section 401(a)(4) and Code Section 410(b) as indicated in previous chapters (see Chapter 4). As of the determination date the value of accrued benefits for each plan is:

|  |  |  |  |
| --- | --- | --- | --- |
|  | ***Plan A*** | ***Plan B*** | ***Plan C*** |
| **Key employee 1** | $125,000 | None | None |
| **Key employee 2** | $ 60,000 | $ 75,000 | None |
| **Key employee 3** | None | $150,000 | None |
| **Total key benefits** | $185,000 | $225,000 | None |
| **Percentage to key employees** | 64.9% | 57.0% | None |
| **Total nonkey employees** | $100,000 | $170,000 | $195,000 |
| **Total plan benefits** | $285,000 | $395,000 | $195,000 |
| **Percentage to nonkey employees** | 0% | 0% | 0% |
| **Employees** | 35.1% | 43.0% | 100.0% |

According to the preceding rules, the combination of Plan A and Plan B is an aggregation group because they both have key employees participating. Plan A standing alone is top-heavy and Plan B standing alone is not top-heavy. When the plans are aggregated, the resulting aggregation group is top-heavy:

([$125,000 + $60,000] + [$75,000 + $150,000]) / ($285,000 + $395,000) = 60.3%

Because all the plans satisfy Code Section 401(a)(4) and Code Section 410(b), Plans A and B can be permissively aggregated with Plan C with the following result:

([$125,000 + $60,000] + [$75,000+$150,000]) / ($285,000 + $395,000 + $195,000) = 46.9%

Now the resulting aggregation group is not top-heavy, so each plan within the group is treated as not top-heavy.

**Practice Point:**  Plans in an aggregation group with different plan years determine the value of accrued benefits individually and aggregate the accrued benefits for the same plan years.[[10]](#footnote-10) For example, plans with the following plan years (plan year is identified by the year in which the plan year begins) for the year 2013 would aggregate the accrued benefits on the following determination dates:

* Plan year: January 1, 2013, to December 31, 2013   
  Determination date: December 31, 2012
* Plan year: April 1, 2013, to March 31, 2014  
  Determination date March 31, 2013
* Plan year: October 1, 2013, to September 30, 2014  
  Determination date: September 30, 2013

**Q. 5.09: Does the accrued benefit for determining top-heavy status include employee-funded benefits or employee account balances?**

Yes. Both employer- and employee-funded accrued benefits (including voluntary after-tax employee contributions and employee 401(k) deferrals) are generally included in the determination of top-heavy plan status.[[11]](#footnote-11)

**Q. 5.10: How do distributions impact the determination of top-heavy status?**

All distributions to terminated participants made during the one-year period ending on the determination date are added back as accrued benefits for the determination of top-heavy status. There is an exception to this rule for in-service distributions to current participants, although the distributions are subject to a five-year look-back ending on the determination date.[[12]](#footnote-12)

**Example 3.**Following is a calendar year plan for the plan year ending December 31, 2013 (the determination date is 12/31/2012):

|  |  |  |
| --- | --- | --- |
|  | ***Key Benefits/Distributions*** | ***Non-Key Benefits/Distributions*** |
| As of 12/31/2012 | $410,000 | $465,000 |
| Distributions: |  |  |
| 12/31/2012 | $450,000 | $ 15,000 |
| Total | $860,000 | $480,000 |
| Top-heavy status: ($860,000) / ($860,000 + $480,000) = 64.2% | | |

For the plan year ending December 31, 2014, here is the same calculation:

|  |  |  |
| --- | --- | --- |
|  | ***Key Benefits/Distributions*** | ***Non-Key Benefits/Distributions*** |
| As of 12/31/13 | $475,000 | $515,000 |
| Distributions: |  |  |
| 12/31/13 | None | $ 5,000 |
| Total | $475,000 | $520,000 |
| Top-heavy status: ($475,000) / ($475,000 + $520,000) = 47.7% | | |

In this case, the distribution to a key employee because of that employee’s retirement caused the plan to continue to be top-heavy for only one year whereas under prior law (for plan years beginning prior to January 1, 2003) the plan would have been top-heavy for four additional years after the distribution. If the benefit due the key employee was due to retirement in 2012 and had not been distributed but retained in the plan, the plan would not be top-heavy for the year ending December 31, 2014, because the employee was not credited with an hour of service in 2013.

**Q. 5.11: How do rollovers and transfers impact the determination of top-heavy status?**

The rules for handling rollovers and transfers depend upon whether they are *unrelated* or *related*:[[13]](#footnote-13)

* An *unrelated* rollover or transfer is initiated by the employee and made from a plan maintained by one employer to a plan maintained by another nonrelated employer.
* A *related* rollover or transfer is either not initiated by the employee or made to a plan maintained by the same employer.
* All employers aggregated under Code Sections 414(b), 414(c), or 414(m) are treated as related employers for purposes of determining top-heavy status.

A rollover or transfer of an employee’s benefits from a prior employer does not count towards top-heavy status, assuming the prior employer is an *unrelated* employer. For the prior employer, this rollover or transfer does count.

Rollovers with the same employer or a *related* employer, generally count in the determination of top-heavy status. This may occur when a single employer has two plans (e.g., a defined benefit and 401(k) plan) and terminates one of them, giving employees the option of rolling over their benefits to the remaining plan.

**Practice Point:** If an employer terminates one of two plans, the key employees should roll their benefits over to an IRA (individual retirement account) rollover account so the value of the rollover is no longer part of the top-heavy calculation after one year. If the benefits are rolled over to the other plan, the value will continue to be included in the top-heavy calculation for a longer period.

**Q. 5.12: What happens if a plan is determined to be top-heavy?**

If a plan becomes top-heavy, then it must satisfy the following requirements:[[14]](#footnote-14)

1. special vesting provisions and
2. minimum benefit rules.

**Q. 5.13: How does top-heavy status change vesting provisions?**

If a plan becomes top-heavy, then it must satisfy the following vesting requirements:[[15]](#footnote-15)

1. An employee who has completed at least three years of service with the employer must have a nonforfeitable right to 100 percent of his or her accrued benefit, or
2. The employee must have a nonforfeitable right to a percentage of his or her accrued benefit under the following table.

|  |  |
| --- | --- |
| Years of Service Vesting Schedule | |
| ***Years of Service*** | ***Nonforfeitable Percentage*** |
| 2 | 20% |
| 3 | 40% |
| 4 | 60% |
| 5 | 80% |
| 6 | 100% |

In a year in which the plan is not top-heavy, the vesting schedule may revert to the nontop-heavy vesting schedule as provided in the plan. When the vesting schedule changes for the nontop-heavy year, the nonforfeitable percentage of the accrued benefit for the employee may not be reduced below the prior year’s nonforfeitable percentage. In addition, any employee with three or more years of service must be given the option of remaining with the top-heavy vesting schedule.[[16]](#footnote-16)

**Example 4.** The plan’s top-heavy vesting schedule was a six-year graded schedule as shown in the previous table, but the plan’s non-top-heavy vesting schedule was a five-year-cliff vesting schedule (zero vesting for the first four years and then 100 percent in the fifth year). An employee who was 20 percent vested after two years (the six-year schedule) could not be reduced to zero vesting but would continue to be 20 percent vested when the plan went back to the five-year-cliff vesting in the third year, when the plan was not top-heavy.

**Q. 5.14: What are the minimum benefit rules for a top-heavy defined benefit plan?**

The plan must provide minimum benefits to nonkey employees equal to the lesser of 2 percent multiplied by the number of years of service (excluding service when the plan was not top-heavy) but not more than 20 percent of the employee’s average compensation (averaged over the highest five or fewer consecutive years of service as provided in the plan) payable for life beginning at the retirement age as provided in the plan.[[17]](#footnote-17)

Any eligible employee in a defined benefit plan who has at least 1,000 hours of service must accrue the top-heavy minimum benefit.[[18]](#footnote-18)

**Example 5.** An employer sponsors a defined benefit plan with a plan year ending on December 31, 2013:

|  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| Table 5-1. Determination of Top-Heavy Benefits in a Defined Benefit Plan | | | | | | | | | |
| Retirement benefit formula | | | | | 50% of compensation | | | | |
| Benefit accruals: | | | | | Based on total years of participation | | | | |
|  | | | | | | | | | |
| **Name** | **Date of Partic-ipation** | **Age** | **Officer/**  **Owner** | **Monthly Salary** | | **Monthly Retirement Benefit** | **Plan Accrued Benefit** | **Top- Heavy Minimum Benefit** | **Present Value of Accrued Benefit\*** |
|  |  |  |  |  | |  |  |  |  |
| John | 1/1/2013 | 50 | Pres/50% | $10,000 | | $ 5,000 | $ 333 |  | $ 15,492 |
| Samuel | 1/1/2013 | 39 | VP/50% | $ 7,500 | | $ 3,750 | $ 144 |  | $ 3,026 |
|  |  |  |  |  | |  |  |  | $ 18,518 |
| **Top-Heavy Percentage** | | | | | | | | **64.62%** | |
| Mark | 1/1/2013 | 27 |  | $ 2,500 | | $ 1,250 | $ 33 | $ 50 | $ 440 |
| Howard | 1/1/2013 | 32 |  | $ 3,200 | | $ 1,600 | $ 48 | $ 64 | $ 809 |
| Scott | 1/1/2013 | 49 |  | $ 5,000 | | $ 2,500 | $156 | $100 | $ 6,755 |
| Michael | 1/1/2013 | 38 |  | $ 2,000 | | $ 1,000 | $ 37 | $ 40 | $ 781 |
| David | 1/1/2013 | 40 |  | $ 3,000 | | $ 1,500 | $ 60 | $ 60 | $ 1,353 |
|  |  |  |  |  | |  |  |  | $ 10,138 |
| \*Assuming no increase in salary | | | | | | | | | |

The present value of the accrued benefit is based on the higher of the plan accrued benefit or the top-heavy minimum accrued benefit (the “determination date” for the first and second plan years is the last day of the first plan year). Because this is the first plan year, the determination that the plan is top-heavy will carry over to the year ending December 31, 2014 (the status of the first plan year is based on the last day of the first plan year, which is the same date that top-heavy status is determined for the second plan year).

Mark’s benefit is $1,250 per month at age 65 (salary of $2,500 per month times the benefit formula of 50 percent of compensation). His accrued benefit, which is based on years of plan participation, is $33 per month beginning at age 65, and his top-heavy minimum benefit is $50 per month beginning at age 65.

|  |  |
| --- | --- |
| Salary: | $2,500 per month |
| Benefit formula: | 50% |
| Retirement benefit: | $1,250 per month |
| Years of participation to end of plan year 1: | (1/1/13 to 12/31/13) |
| Total years of participation to retirement: | 38 (1/1/13 to 12/31/50) |
| (Mark is 27 as of 12/31/13 after one year of participation. He will have to participate an additional 37 years to reach the retirement age of 65 for total years of participation of 38.) | |
| Top-heavy minimum accrued benefit: | $50 per month (2% of $2,500) |

Accrued benefit calculation:

* Monthly salary × benefit percentage × participation to plan year-end / participation to retirement
* As of 12/31/13 ( 2,500 × 50% × 1 ) / 38 = $33 per month
* As of 12/31/14 ( 2,500 × 50% × 2 ) / 38 = $66 per month

Because Mark’s accrued benefit of $33 per month is less than the required top-heavy minimum benefit of $50 per month, he must accrue the higher top-heavy minimum benefit. In accordance with the top-heavy minimums required in defined benefit plans, the top-heavy accrued benefit is capped at 20 percent of compensation, i.e., 2 percent per year of top-heavy service for up to a maximum of ten years.

Consider the same accrued benefit calculation in years 10, 11, 15, and 16, again assuming salary stays constant.

|  |  |  |  |
| --- | --- | --- | --- |
| Year 10 | As of 12/31/22  For top-heavy | ($2,500 × 50% × 10) / 38  ($2,500 × 2% × 10) | = $329 per month  = $500 per month |
| Year 11 | As of 12/31/23  For top-heavy | ($2,500 × 50% × 11) / 38  ($2,500 × 2% × 10) | = $362 per month  = $500 per month |
| Year 15 | As of 12/31/27  For top-heavy | ($2,500 × 50% × 15) / 38  ($2,500 × 2% × 10) | = $493 per month  = $500 per month |
| Year 16 | As of 12/31/28  For top-heavy | ($2,500 × 50% × 16) / 38  ($2,500 × 2% × 10) | = $526 per month  = $500 per month |

In year 10, Mark reaches the maximum required accrued benefit in a top-heavy defined benefit plan, 20 percent of compensation ($2,500 × 20%), so in year 11 his accrued benefit for top-heavy purposes does not increase. In year 15, his accrued benefit based on the plan provisions approaches his top-heavy accrued benefit, and in year 16 the plan’s accrued benefit surpasses his top-heavy accrued benefit. In the event that Mark terminated employment and was paid out, he would receive a distribution based on the higher of the top-heavy accrued benefit or the plan’s accrued benefit.

**Q. 5.15: What are the minimum benefit rules for a top-heavy 401(k) plan or other defined contribution plan?**

The plan must provide a minimum contribution equal to 3 percent of the employee’s compensation or, if less, the highest percentage contribution made for any key employee.[[19]](#footnote-19)

1. The minimum contribution may not include investment earnings or employee elective deferrals under Code Section 402(g) in a 401(k) plan (although elective deferrals of key employees are included in the determination of the highest percentage contribution made for any key employee).[[20]](#footnote-20)
2. Qualified nonelective contributions (QNECs) in a 401(k) plan, as described in Code Section 401(m)(4)(C), may be treated as employer contributions for purposes of top-heavy minimum contributions.[[21]](#footnote-21)
3. Matching contributions, as described in Code Section 401(m)(4)(A), can be counted towards the minimum top-heavy contribution requirement.[[22]](#footnote-22)
4. Participants in a defined contribution plan employed on the last day of the plan year must receive a contribution regardless of whether they have 1,000 hours of service or not during that plan year.[[23]](#footnote-23)

**Example 6.** Following are the top-heavy considerations if the employer discussed in Table 5-1 (see Q. 5.14) sponsors a traditional 401(k) plan instead (see Chapter 6). The plan year-end in this case is still December 31, 2013.

The ADP test, which includes the 100 percent vested match, is satisfied. The highly compensated employees’ average percentage is 14.25 percent and the nonhighly compensated employees’ average percentage is 12.20 percent.

|  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- |
| Table 5-2. Determination of Top-Heavy Contributions in a 401(k) Plan | | | | | | | | |
| Matching formula: 100% of the first 3-percent deferral | | | | | | | | |
| ***Name*** | ***Date of Partici-pation*** | ***Age*** | ***Officer/***  ***Owner*** | ***Monthly Salary*** | ***Employee Deferral*** | ***Employee Match*** | ***Top- Heavy Minimum Deposit*** | ***Account Balance\**** |
| John | 1/1/2013 | 50 | Pres/50% | $120,000 | $15,000 | $3,600 |  | $18,600 |
| Samuel | 1/1/2013 | 39 | VP/50% | $ 90,000 | $ 9,000 | $2,700 |  | 11,700 |
|  |  |  |  |  |  |  |  | $30,300 |
| **Top-Heavy Percentage** | | | | | | | | **61.71%** |
| Mark | 1/1/2013 | 27 |  | $ 30,000 | $ 4,450 | $ 900 | $ 900 | $ 5,350 |
| Howard | 1/1/2013 | 32 |  | $ 38,400 | $ 4,350 | $1,152 | $1,152 | $ 5,502 |
| Scott | 1/1/2013 | 49 |  | $ 60,000 | $ 0 | $ 0 | $1,800 | 0 |
| Michael | 1/1/2013 | 38 |  | $ 24,000 | $ 4,150 | $ 720 | $ 720 | $ 4,870 |
| David | 1/1/2013 | 40 |  | $ 36,000 | $ 2,000 | $1,080 | $1,080 | $ 3,080 |
|  |  |  |  |  |  |  |  | $18,802 |
| \*The account balance does not include the top-heavy minimum deposit. | | | | | | | | |

The accrued benefit would be measured by each participant’s account balance. For ease of discussion, assume no investment earnings on the contributions, so the account balance would equal the contributions made for the year. As of the end of the first plan year, 12/31/13, the account balances of the key employees equal 61.71 percent of the total, making the plan top-heavy for the 2013 plan year. For the 2014 plan year, the prior year’s top-heavy minimum deposit is part of the account balances and changes the result as illustrated in Table 5-3:

|  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- |
| Table 5-3. Effects of Top-Heavy Contribution on Following Year Top-Heavy Determination | | | | | | | | |
| ***Name*** | ***Date of Partici-pation*** | ***Age*** | ***Officer/***  ***Owner*** | ***Annual Salary*** | ***Employee Deferral*** | ***Employee Match*** | ***Top- Heavy Minimum Deposit*** | ***Account Balance\**** |
|  |  |  |  |  |  |  |  |  |
| John | 1/1/2013 | 50 | Pres/50% | $120,000 | $15,000 | $3,600 |  | $18,600 |
| Samuel | 1/1/2013 | 39 | VP/50% | $ 90,000 | $ 9,000 | $2,700 |  | $11,700 |
|  |  |  |  |  |  |  |  | $30,300 |
| **Top-Heavy Percentage** | | | | | | | | **55.34%** |
| Mark | 1/1/2013 | 27 |  | $ 30,000 | $ 4,450 | $ 900 | $ 900 | $ 6,250 |
| Howard | 1/1/2013 | 32 |  | $ 38,400 | $ 4,350 | $1,152 | $1,152 | $ 6,654 |
| Scott | 1/1/2013 | 49 |  | $ 60,000 | $ - | $ - | $1,800 | $ 1,800 |
| Michael | 1/1/2013 | 38 |  | $ 24,000 | $ 4,150 | $ 720 | $ 720 | $ 5,590 |
| David | 1/1/2013 | 40 |  | $ 36,000 | $ 2,000 | $1,080 | $1,080 | $ 4,160 |
|  |  |  |  |  |  |  |  | $24,454 |

In this case, the plan is not top-heavy for 2014. For this year there is no top-heavy minimum deposit required. Because the plan is not top-heavy for 2014, the plan’s non-top-heavy vesting schedule can be used for any participant who has less than three years of service (see Years of Service Vesting Schedule, Q 5.13.) The top-heavy rules would not apply if this were a safe harbor 401(k) plan as long as the required safe harbor contribution of 3 percent for all eligible employees or the safe harbor matching contribution was provided.

This type of 401(k) plan and other forms of 401(k) plans are covered in detail in Chapter 6.

**Q. 5.16: Should an employer always avoid top-heavy status?**

Not necessarily. Generally, when a plan is top-heavy, it means the benefits are going to the key employees, which in some cases include the owner(s) of the employer sponsoring the plan. This is frequently the goal for a qualified plan in a closely held company.

**Q. 5.17: What issues arise with minimum top-heavy contributions for a 401(k) plan?**

Several complex issues arise for 401(k) plans including the following:

* For many employers 401(k) plans have become the plan of choice. Unfortunately, in small plans this becomes a trap. On the one hand, the employer wants to offer a 401(k) plan to its employees; on the other hand, it cannot afford the added cost of top-heavy minimum contributions.
* QNECs, which count toward top-heavy minimum contributions, can also be made by the employer to all eligible employees to satisfy a failed nondiscrimination test.[[24]](#footnote-24)
* Matching contributions can be counted toward the minimum top-heavy contribution requirement, but this does not relieve the plan from providing the top-heavy minimums to those participants that do not make salary deferrals and therefore do not receive a matching contribution.[[25]](#footnote-25)
* As an incentive to establish a 401(k) plan, the top-heavy rules provide that a plan will not be considered top-heavy if it provides only for safe harbor contributions (see Chapter 6). The plan could not allow for profit sharing contributions in addition to the safe harbor employee deferrals and safe harbor employer contribution.[[26]](#footnote-26)

**Practice Point:** If a client is considering a 401(k) plan, a pre-adoption survey should be conducted to determine whether the plan is likely to be top-heavy, particularly if the client is on a tight budget.

**Q. 5.18: Do the minimum benefit and contribution rules apply to each plan in an aggregation group?**

No. If the aggregation group is top-heavy, the employer is not required to provide a top-heavy minimum benefit in each plan.[[27]](#footnote-27)

**Q. 5.19: What are the minimum benefit rules for a top-heavy aggregation group of dissimilar plans?**

If one of the plans in the aggregation group is a defined benefit plan and another plan is a defined contribution plan, then any one of the following four safe harbor rules can be used to satisfy the top-heavy minimum benefits for nonkey employees:[[28]](#footnote-28)

1. The employer may provide the defined benefit minimum of 2 percent of compensation multiplied by the years of top-heavy service.
2. In an offset approach, the defined benefit minimum is provided, offset by the value of the benefit provided in the defined contribution plan. In this case, the defined contribution minimum is projected to retirement age, with investment earnings, and converted to a retirement benefit. If the benefit is more than the defined benefit minimum required, no benefit is required in the defined benefit plan. If the converted benefit in the defined contribution plan is less than the defined benefit minimum required, the difference, or shortfall, is provided in the defined benefit plan.
3. The employer may show that the combined benefits provided in the defined benefit plan and defined contribution plan, for any nonkey employee, are at least equal to the defined benefit minimum benefit.
4. The employer may allocate 5 percent of compensation in the defined contribution plan for each nonkey employee, including employer contributions and forfeitures.

**Practice Point:** When an employer sponsors two dissimilar plans, the defined benefit minimum and defined contribution minimum should be analyzed to determine which is less costly. This analysis should be done as part of the plan design process prior to preparing the plan document because the plan document must set forth the method of satisfying the top-heavy minimum and, once chosen, that method cannot later be changed without plan amendment.[[29]](#footnote-29) Take into consideration current employee census information and potential future changes.

**Example 7.** This example is a review of top-heavy status if the defined benefit plan in Example 5 and the 401(k) plan in Example 6 were aggregated.

* The benefits in both plans are aggregated as either key or nonkey benefits, and the result determines the top-heavy status of both plans. If an employer maintains two plans and individually one is top-heavy and the other is not, when aggregated, if the result is top-heavy, they are both top-heavy.
* The result of the aggregation would be:

($18,518 [key defined benefit plan] + $30,300 [key 401(k) plan])

Divided by

($18,518 + $30,300 + $18,802 [nonkey 401(k) plan] + $10,139 [nonkey defined benefit plan])

= 62.78 percent 🡪 which makes both plans top-heavy.

In Example 5 in the second plan year, ending December 31, 2014, the 401(k) plan was shown to be not top-heavy. Even so, as a result of the aggregation, if the sum of key employee benefits were more than 60 percent of the total, the 401(k) plan and the defined benefit plan would be top-heavy.

If the aggregation group is top-heavy, the employer is not required to provide a top-heavy minimum benefit in both plans. If the two plans are dissimilar, any one of the four safe harbor rules listed previously can be used to satisfy the top-heavy minimum benefits.

Safe harbor option 1 was illustrated previously in Q 5.14. In that case, the two plans would provide only the minimum benefit accrual in the defined benefit plan and no top-heavy minimum deposit in the defined contribution (401(k)) plan. Safe harbor option 4 could be used if the employer did not want to increase the accrued benefits in the defined benefit plan for the employees who were below the top-heavy minimum, i.e., Mark, Howard, and Michael (see Table 5.1).

Safe harbor options 2 and 3 are illustrated in the following examples, using the benefits listed for Mark and Michael in Table 5-4. Option 2, the offset approach of the safe harbor rules, can be illustrated using the information from the defined benefit plan in Table 5-1.

|  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- |
| Table 5-4. Satisfying the Top-Heavy Minimums with an Offset Approach | | | | | | | | |
| ***Name*** | ***Date of Partici-pation*** | ***Age*** | ***Officer/***  ***Owner*** | ***Monthly Salary*** | ***Monthly Retire-ment Benefit*** | ***Plan Accrued Benefit*** | ***Top- Heavy Minimum Deposit*** | ***Present Value of Accrued Benefit\**** |
|  |  |  |  |  |  |  |  |  |
| John | 1/1/2013 | 50 | Pres/50% | $10,000 | $5,000 | $333 |  | $15,492 |
| Samuel | 1/1/2013 | 39 | VP/50% | $ 7,000 | $3,750 | $144 |  | $ 3,026 |
|  |  |  |  |  |  |  |  | $18,518 |
| **Top-Heavy Percentage** | | | | | | | | **64.62%** |
| Mark | 1/1/2013 | 27 |  | $ 2,500 | $1,250 | $ 33 | $ 50 | $ 440 |
| Howard | 1/1/2013 | 32 |  | $ 3,200 | $1,600 | $ 48 | $ 64 | $ 809 |
| Scott | 1/1/2013 | 49 |  | $ 5,000 | $2,500 | $156 | $100 | $ 6,755 |
| Michael | 1/1/2013 | 38 |  | $ 2,000 | $1,000 | $ 37 | $ 40 | $ 781 |
| David | 1/1/2013 | 40 |  | $ 3,000 | $1,500 | $ 60 | $ 60 | $ 1,353 |
|  |  |  |  |  |  |  |  | $10,138 |
| \*Based on 1983 individual annuity male mortality rate at 5 percent. | | | | | | | | |

Mark’s top-heavy minimum benefit is $50 per month. Assume that the 401(k) plan in Table 5-2 also provides a profit sharing contribution to all eligible employees of 3 percent of annual pay; for Mark that would be $900.

The first step in the offset approach would be to calculate the future value of a single deposit of $900 with interest to Mark’s retirement age of 65 and convert that value to an annuity. The result of that calculation would be a lump sum at age 65 of $14,053 (using 7.5 percent interest), which would convert to a monthly annuity of $102.19 (based on 5 percent interest and 1983 individual annuity male mortality), well in excess of the required top-heavy minimum of $50 per month. In Mark’s case the defined benefit plan would not have to fund the additional $17 per month benefit to bring his accrual to the top-heavy minimum amount because it is offset by the converted value of the contribution in the 401(k) plan.

In Michael’s case the lump-sum value at age 65 for his contribution of $720 (3 percent of annual pay) would be $5,074 (using 7.5 percent interest), which would convert to a monthly annuity of $37 (based on 5 percent interest and 1983 individual annuity male mortality), by chance equal to the actual accrual in the defined benefit plan. In his case the defined benefit plan would have to fund the accrued benefit shortfall of $3 per month. If the value of Michael’s defined contribution deposit converted to a monthly annuity of $38 per month, the defined benefit plan would still have to provide the remaining $2 per month because his top-heavy minimum is $40 per month.

**Example 8.**The comparability approach with the benefits provided to Michael can be illustrated using Table 5-4. In the defined benefit plan, Michael’s accrued benefit according to the plan provisions is $37 per month. If, in addition, the 401(k) plan made a 3-percent-of-pay contribution of $720, the value of that contribution when converted to an annuity was $37 per month. The sum of the two benefits of $74 per month is more than the required $50 per month top-heavy minimum benefit, so no additional accruals in the defined benefit plan or contributions in the 401(k) plan are required.

**Q. 5.20: What are the minimum benefit rules for a top-heavy aggregation group of defined contribution plans?**

If both plans in the aggregation group are defined contribution plans, then the combined contribution for each nonkey employee must be greater than or equal to the top-heavy minimum contribution. It is also possible for either plan to provide the top-heavy minimum contribution. That would typically occur in a money purchase/profit sharing plan combination. In any case, the plan documents must specify which plan will be responsible for the top-heavy minimum contribution.[[30]](#footnote-30)

**Practice Point:**  In this combination the top-heavy minimum contribution should be provided in the money purchase plan because it has a required contribution. If the top-heavy minimum is provided in the profit sharing plan, it too now has a required contribution of 3 percent and is no longer discretionary.

If the profit sharing plan is a 401(k) plan allowing deferrals immediately or after six months and the money purchase plan requires one year of service to participate, the 401(k) plan is forced to make top-heavy minimum contributions for those employees who are not yet eligible for the money purchase plan.

Fortunately this problem can also be solved with the adoption of the new

safe harbor 401(k) plan (see Chapter 6).

1. IRC Sec. 416(g). [↑](#footnote-ref-1)
2. IRC Sec. 416(a). [↑](#footnote-ref-2)
3. IRC Sec. 416(g)(4)(C); Treas. Reg. § 1.416-1, T-22. [↑](#footnote-ref-3)
4. Treas. Reg. §§ 1.416-1, T-25; 1.416-1, T-26. [↑](#footnote-ref-4)
5. IRC Sec. 416(i). [↑](#footnote-ref-5)
6. Treas. Reg. §§ 1.416-1, T-13; 1.416-1, T-14. [↑](#footnote-ref-6)
7. Treas. Reg. § 1.416-1, T-9. [↑](#footnote-ref-7)
8. Treas. Reg. § 1.416-1, T-6. For nondiscrimination and coverage, see Chapter 4. [↑](#footnote-ref-8)
9. IRC Sec. 416(g)(2)(A)(ii); Treas. Reg. §§ 1.416-1, T-7; 1.416-1, T-11. [↑](#footnote-ref-9)
10. IRC Sec. 416(g)(2). [↑](#footnote-ref-10)
11. Treas. Reg. § 1.416-1, T-28. [↑](#footnote-ref-11)
12. IRC Sec. 416(g)(3); Treas. Reg. §§ 1.416-1, T-30; 1.416-1, T-31. [↑](#footnote-ref-12)
13. IRC Sec. 416(g)(4)(A); Treas. Reg. § 1.416-1, T-32. [↑](#footnote-ref-13)
14. IRC Sec. 416(a). [↑](#footnote-ref-14)
15. IRC Sec. 416(b); Treas. Reg. § 1.416-1, V-2; IRC Sec. 411(a)(4). [↑](#footnote-ref-15)
16. IRC Sec. 411(a)(10). [↑](#footnote-ref-16)
17. IRC Sec. 416(c)(1); Treas. Reg. § 1.416-1, M-2. [↑](#footnote-ref-17)
18. Treas. Reg. § 1.416-1, M-4. [↑](#footnote-ref-18)
19. IRC Sec. 416(c)(2). [↑](#footnote-ref-19)
20. Treas. Reg. § 1.416-1, M-20. [↑](#footnote-ref-20)
21. Treas. Reg. § 1.416-1, M-18. [↑](#footnote-ref-21)
22. Treas. Reg. § 1.416-1, M-19. [↑](#footnote-ref-22)
23. Treas. Reg. § 1.416-1, M-10. [↑](#footnote-ref-23)
24. Treas. Reg. § 1.416-1, M-18. [↑](#footnote-ref-24)
25. Treas. Reg. § 1.416-1, M-19. [↑](#footnote-ref-25)
26. IRC Sec. 416(g)(4)(H); 401(k)(12). [↑](#footnote-ref-26)
27. Treas. Reg. § 1.416-1, M-12. [↑](#footnote-ref-27)
28. IRC Sec. 416(g)(2)(A)(ii); Treas. Reg. § 1.416-1, M-12. [↑](#footnote-ref-28)
29. Treas. Reg. § 1.416-1, M-15. [↑](#footnote-ref-29)
30. Treas. Reg. §§ 1.416-1, T-12; 1.416-1, T-15. [↑](#footnote-ref-30)