

# Benefit Insights

*Pinnacle*  
Financial Services, Inc.

A 401(k) Third Party Administrator of  
Exceptional Caliber & Experience

A non-technical review of qualified retirement plan legislative and administrative issues

April 2008

## Top Heavy Rules May Impact Plan Design

Retirement plans have been subject to “top heavy” rules for about 25 years. By now you’d think that their application would be fairly straightforward. But lately these provisions have affected some plans in unexpected ways, surprising plan sponsors who thought top heavy was a non-issue for their plan. This is due in part to regulations which exempt some plans from the top heavy requirements but only if certain conditions are met.

What follows is a close-up look at the top heavy rules and what can be done to avoid some unwelcome consequences.

### Top Heavy Defined

A plan is considered top heavy if more than 60% of the benefits under the plan belong to “key employees” as of the applicable determination date. Multiple plans of an employer in which a key employee participates must be aggregated to form a top heavy group. Plans of the same employer not covering a key employee can also be aggregated as part of the top heavy group under certain circumstances.

### Key Employees

The classification of key employee is sometimes confused with “highly compensated employee” (HCE) which is used for nondiscrimination purposes. In fact, the definitions are similar in some respects, and while most key employees are HCEs, many HCEs are not key employees.

A key employee is an employee who at any time during the determination year was:

- An owner of more than 5% of the employer;
- An owner of more than 1% of the employer with annual compensation in excess of \$150,000; and
- An officer of the employer with annual compensation exceeding a specified dollar amount, adjusted for cost-of-living (\$150,000 for 2008).

Stock attribution rules apply in determining ownership for key employee purposes. An employee is considered as owning the stock or interest owned by his spouse, parents, children and grandchildren.

The number of officers who can be considered key employees is limited to the greater of (a) 10% of the total number of employees, to a maximum of 50 officers, or (b) three.

## Top Heavy Determination

The date for determining if an ongoing plan is top heavy is generally the last day of the preceding plan year (determination year). For the initial year of a plan the determination date is the last day of the first plan year.

In defined benefit plans, the present value of accrued benefits is used to calculate if the key employees' share exceeds 60% of the total. In defined contribution plans, the participants' total account balances are used to perform the test. Vesting is not considered in top heavy calculations.

Certain adjustments must be made to the accrued benefits or account balances when performing the top heavy test. The following items must be included:

- Outstanding balances of participant loans;
- Related rollovers, e.g., from another plan previously maintained by the same employer, and unrelated rollovers received prior to 1984;
- Distributions during the determination year to participants who terminated employment that year;
- In-service distributions during the five-year period ending on the determination date to those still employed as of the first day of the determination year;
- The cash surrender value of any whole life insurance policies in the plan; and
- Salary deferrals and required employer contributions for the determination year that are deposited after the determination date. For the first plan year accrued discretionary contributions are also included.

The following items are not included in the top heavy test:

- Benefits of prior year terminatees (those who did not perform an hour of service during the determination year);

- Distributions to prior year terminatees;
- Benefits of former key employees (those who were key employees but are now classified as non-key employees in the determination year). The same holds true for any amounts distributed to former key employees; and
- Unrelated rollovers received after 1983.

## Requirements of Top Heavy Plans

Top heavy plans must provide certain minimum accrued benefits or contributions to non-key employees and meet special vesting requirements. These provisions do not apply to union employees.

### Minimum Benefits or Contributions

The minimum benefit in a defined benefit plan is a life annuity at normal retirement age of 2% of average compensation for each year of service up to a maximum of 10 years (a maximum required benefit of 20% of average compensation). It must be provided to each non-key employee who is credited with at least 1,000 hours of service during the plan year. Frozen defined benefit plans are no longer required to provide top heavy benefits.

For defined contribution plans, the minimum contribution is the lesser of 3% of compensation or the highest contribution rate allocated to a key employee. For example, if the highest contribution rate for a key employee is 2%, then the top heavy minimum contribution is 2%; if the highest contribution rate for a key employee is 5%, then the top heavy minimum contribution is 3%; and if no key employee receives a contribution, then the top heavy contribution is 0%.

The top heavy contribution must be given to each eligible non-key employee who is employed on the last day of the plan year, regardless of the number of hours worked. An allocation of forfeitures, derived from the accounts of participants who terminated employment without full vesting, is counted towards satisfaction of the minimum

top heavy contribution. The deadline for making the contribution is the last day of the following plan year.

Where an employer sponsors multiple plans, only one plan has to provide the top heavy benefit. Special rules apply where an employer sponsors both a defined benefit and a defined contribution plan.

### Minimum Vesting

Top heavy plans must have a vesting schedule no less restrictive than one of the following two schedules:

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

Under the Pension Protection Act of 2006, all defined contribution plans are required to use a vesting schedule no less restrictive than one of the top heavy schedules as of 2007. Only certain defined benefit plans can still use a non-top heavy schedule (7-year graded or 5-year cliff).

### 401(k) Plans

Salary deferrals under a 401(k) plan are treated differently than other types of contributions for top heavy purposes. Deferrals made by key employees are considered employer contributions for purposes of determining the minimum top heavy contributions owed to non-key employees.

However, deferrals made by non-key employees do **not** count towards satisfaction of the required contribution. For example, if any key employee defers 3% or more of his compensation, the employer must make a 3% contribution for all eligible non-key employees.

Matching contributions in a 401(k) plan can be used towards satisfaction of the top heavy contri-

bution. But such contributions may not cover the required minimum for those who deferred, and those who didn't defer would be entitled to a full top heavy contribution.

### Top Heavy Exemption

A safe harbor 401(k) plan is a plan that elects to eliminate the annual average deferral percentage (ADP) and average contribution percentage (ACP) nondiscrimination testing. It does so by providing either a 3% nonelective contribution for all eligible employees or matching contributions of at least 100% of the first 3% of compensation deferred, plus 50% of the next 2% of compensation deferred. An annual safe harbor notice must also be provided.

Safe harbor 401(k) plans are automatically deemed to be not top heavy if the only contributions to the plan are salary deferrals and either the 3% safe harbor nonelective contribution or the safe harbor match contribution. Additional match contributions can also be made as long as they meet the ACP safe harbor requirements.

Beginning in 2008, the same exemption applies to a Qualified Automatic Contribution Arrangement (QACA), which is a type of safe harbor 401(k) plan that utilizes an automatic enrollment feature.

The top heavy exemption provides an added incentive for some employers to elect safe harbor status.

Although a safe harbor 401(k) plan may be exempt from the top heavy rules, it can still be part of an aggregated top heavy group. In that case, employer contributions under the 401(k) plan can be used towards the contribution requirements of the top heavy group.

### Impact of Additional Contributions

Safe harbor plans that provide additional contributions from those mentioned above (including

forfeiture allocations) are not exempt from the top heavy rules. This can create some surprising results.

A plan that would be top heavy if not for the exemption would lose its exemption by making even a small profit sharing contribution. But this contribution, together with other employer contributions under the plan (such as the safe harbor match), may not be sufficient to meet the top heavy requirements. As a result, the employer might be obligated to contribute thousands of dollars more than it originally intended.

A similar situation can occur when forfeitures are allocated resulting in the elimination of the top heavy exemption. For this reason, it is wise to design a safe harbor 401(k) plan so that forfeitures are used to offset future contributions or pay administrative expenses.

Keep in mind that in a straight profit sharing plan without salary deferrals, the top heavy contribu-

tion requirement can be met simply by allocating the contributions and forfeitures proportionately by compensation. Then every participant would receive the same allocation rate as the key employees. The scenario changes in 401(k) plans due to the treatment of key employee deferrals.

## Conclusion

The increased popularity of 401(k) plans has limited the number of retirement plans considered to be top heavy. When a plan is top heavy it must provide certain minimum benefits or contributions, and defined benefit plans must use one of the accelerated vesting schedules.

Some safe harbor plans are exempt from the top heavy requirements, but additional contributions or forfeiture allocations to those plans can eliminate the exemption and create further contribution obligations. Advanced planning can help prevent some unexpected consequences and keep plans in compliance with the top heavy rules.

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