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Top Heavy Impact on 401(k) Plans

There are many reasons for the wide popularity of 401(k) plans, one of which is that they shift the funding burden from employers to employees. But this advantage may be diminished for plans classified as "top heavy" where special contribution rules kick in that plan sponsors may not be aware of. What follows is a detailed look at the impact of the top heavy rules on 401(k) plans and some strategies for minimizing the cost to employers.

What is a Top Heavy Plan?

A defined contribution plan is considered top heavy when more than 60% of the account balances are attributable to "key employees." A key employee is an employee who meets any of the following criteria during the determination year:

- Owns more than 5% of the employer;
- Owns more than 1% of the employer and had compensation in excess of $150,000; or
- Is an officer of the employer with compensation in excess of a specified dollar amount ($165,000 for 2012), with certain limits on the maximum number in this category.

In determining ownership, family attribution rules apply, meaning that an employee is deemed to own the stock or interest owned by his or her spouse, parents, children and grandchildren. It's important for employers to keep their third party administrators abreast of any changes in the ownership or officer status of the company so that the top heavy tests can be performed accurately.

The term "key employee" is sometimes confused with "highly compensated employee" (HCE) which is used for nondiscrimination testing. The main difference is that HCEs include all employees earning more than a certain dollar amount in the prior year ($115,000 in 2012), whereas such employees would not be considered key employees unless they meet the ownership or officer criteria.

Most large 401(k) plans are not top heavy due to the high number of non-key employees participating.

How is Top Heavy Calculated?

For ongoing plans, the top heavy determination date is the last day of the preceding plan year (determination year). For new plans, the determination date is the last day of the first plan year. As of the determination date, the account balances, including loans, of the key employees are compared to the total account balances of all participants, without regard to the plan's vesting schedule. Certain adjustments must be made to the account balances when performing these calculations. The following amounts must be added: distributions to recent terminees; in-service distributions over the past five years; and the cash surrender values of whole life insurance policies.

The following amounts must be subtracted: unrelated rollovers, i.e., those not coming from another plan sponsored by the same employer (related rollovers should not be deducted); and account balances of participants who terminated prior to the determination year. Account balances and distributions to former key employees are not included.

Here is an example of a top heavy plan calculation: Thomas owns 100% of ABC Company which sponsors a profit sharing plan. He and his wife both work for the company as does their 25 year old son. All three are considered key employees due to stock ownership and attribution rules. The account balances under the plan are as follows:

Employee	12/31/11 Balance	Unrelated Rollovers	Distributions to 2011 Terminees	Total
Thomas	$500,000			
Cindy	100,000			
Thomas, Jr.	50,000	($25,000)		
Total Key	$650,000	($25,000)		$625,000
Non-Key	450,000	(100,000)	$25,000	375,000
Plan Totals	$1,100,000	($125,000)	$25,000	$1,000,000
			Key Percentage:	62.50%

Since the adjusted account balances of the key employees exceed 60% of the adjusted account balances of the entire plan as of December 31, 2011, the plan is top heavy for 2012.

Generally, if the employer sponsors multiple plans covering the same key employee(s), they are required to be aggregated for top heavy purposes.

Consequences of Being Top Heavy

A defined contribution plan that is top heavy must provide a minimum contribution to non-key employees equal to the highest contribution rate allocated to any key employee up to a maximum of 3% of compensation. For example, if a top heavy profit sharing plan has one key employee who received a contribution of 2% of his compensation, then all non-key employees would be entitled to a 2% contribution. If the key employee receives a 4% contribution under the plan formula, then the non-key employees must receive at least a 3% contribution.

Forfeiture allocations, as well as matching contributions in a 401(k) plan, are included and provide a dollar-for-dollar offset of the required top heavy contribution. When an employer sponsors multiple plans, the top heavy benefits need only be provided by one of the plans; however, there are special rules and potentially higher contributions that may apply when an employer sponsors both a defined benefit and defined contribution plan.

Impact on 401(k) Plans

The top heavy regulations provide that salary deferrals made by key employees are considered employer contributions but deferrals by non-key employees are considered employee contributions. In other words, deferrals by a key employee can trigger the top heavy contribution requirement, yet deferrals by a non-key employee cannot be used to satisfy the requirement.

For example, if the plan is top heavy and one key employee defers 4%, the 3% minimum contribution requirement will apply to all non-key employees who have met the plan's eligibility requirements, even those who have elected not to make deferrals. It is important to note that for plans with multiple eligibility schedules, i.e., immediate eligibility for 401(k) deferrals and a one-year wait for company contributions, any non-key employee who is eligible for any component of the plan and is still employed on the last day of the plan year is entitled to the top heavy minimum contribution.

How to Avoid Top Heavy Contributions in a 401(k) Plan

Here are a couple of strategies that can be utilized to avoid the top heavy contribution requirement in a 401(k) plan.

Key employees can choose not to participate if the plan is top heavy. If no key employee receives a contribution or forfeiture allocation, then top heavy contributions are not required. This strategy not only serves to eliminate the contribution requirement but also is likely to reduce the key employee top heavy percentage over the years, assuming that non-key employees continue to contribute (investment results and employee terminations also play a factor).

It's possible that after a few years of not participating, the key employee percentage will drop below 60%, resulting in the plan not being top heavy for one or more years and allowing key employees to resume participation.

Another strategy is for one or more key employees to take an in-service distribution from the plan, if allowed under the terms of the plan. This option is less effective since in-service distributions over the last five years must be added back when calculating the top heavy ratio. But after five years, such distributions are ignored, potentially resulting in the plan falling out of top heavy status for many years.

Keep in mind that in-service distributions may be unnecessary where the key employees choose not to participate because after five years of not contributing the plan may no longer be top heavy even without such distributions.

The Safe Harbor Alternative

Certain salary deferral plans that provide minimum contributions and meet an annual notice requirement are exempt from the top heavy rules and are automatically deemed to pass the annual ADP (actual deferral percentage) and ACP (actual contribution percentage) nondiscrimination tests. This only applies if additional employer contributions above the safe harbor limits are not made to the plan. Such plans may actually require the employer to contribute less than the top heavy minimum. They include:

SIMPLE 401(k) Plan

This is a good compromise for many employers with 100 or fewer employees. The employer must contribute 2% of compensation to all participants earning at least $5,000 or make a matching contribution of 100% of deferrals up to a maximum of 3% of compensation. No other contributions are allowed and all contributions must be fully vested. Participants of this plan may not receive any contributions or benefit accruals under any other plans of the employer.

SIMPLE 401(k) plans have lower contribution limits. Instead of the current $17,000 deferral limit, plus $5,500 catch-up limit for those age 50 and over, participants in a SIMPLE 401(k) plan can defer up to $11,500 plus $2,500 as a catch-up ($14,000 total).

The 2% contribution requirement is less than the 3% top heavy contribution. In plans where the employer is already making some matching contribution this might not represent a big increase. And the reduced deferral limit may actually be higher than what HCEs could defer under the ADP test. This alternative works very well for some employers.

Safe Harbor 401(k) Plan

This plan allows the same deferral limit as a regular 401(k) plan ($17,000 plus $5,500 catch-up), but requires slightly higher employer contributions than the SIMPLE 401(k) plan. The employer must make either a 3% contribution for all participants or a matching contribution of 100% of the first 3% of compensation deferred, plus 50% of the next 2% of compensation deferred (maximum match of 4% of compensation).

There are some differences between a 3% top heavy and a 3% safe harbor contribution which should be considered. For example, the top heavy contribution is required for non-key employees still employed at the end of the year whereas the safe harbor contribution is required for non-HCEs who were eligible at any time during the year (although HCEs are often included). Safe harbor contributions must always be fully vested but top heavy contributions can be subject to a vesting schedule.

Qualified Automatic Contribution Arrangements (QACA)

Salary deferral plans that provide a minimum matching contribution in conjunction with an automatic enrollment feature can also be exempt from the top heavy rules and ADP/ACP testing. Participants are automatically enrolled in the plan unless they elect not to participate. The default contribution rate escalates each year. Deferrals are matched at a rate of 100% of the first 1% of compensation deferred, plus 50% of the next 5% of compensation deferred (maximum match of 3.5% of compensation).

As an alternative to the matching contribution, a QACA can provide a 3% employer contribution similar to the safe harbor 401(k) requirement. Safe harbor contributions under a QACA must be 100% vested after the completion of two years of service.

Conclusion

The top heavy provisions can have surprising consequences for 401(k) plans, particularly in smaller companies, resulting in the liability for additional employer contributions. Certain strategies can help avoid such contributions and take the plan out of top heavy status.

The safe harbor alternative also requires minimum contributions but lets the plan eliminate ADP/ACP nondiscrimination testing. Accurate employee information is important for proper top heavy determinations.

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