

Administering a Top Heavy Plan



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One of the many reasons that employers decide to establish a qualified retirement plan is to maximize owner retirement contributions. A qualified plan is a great tool to accumulate wealth and prepare financially for life after retirement. However, before business owners decide how much to contribute to their personal accounts, it is important to understand the top heavy rules.

What does it mean for a plan to be “top heavy”?

Qualified retirement plans are subject to numerous annual nondiscrimination tests, including the Internal Revenue Code §416 test to determine whether or not a plan is top heavy for the following plan year. A plan is top heavy if the total of the account balances for the Key Employees is greater than 60% of the total plan assets. The top heavy ratio is determined at the end of each plan year for the upcoming year, except for the initial plan year. This test is designed to ensure that lower paid employees receive at least a minimum benefit, since top heavy plans primarily favor the owners of a business.

Who is considered to be a Key Employee for top heavy determination?

The Internal Revenue Service (IRS) updates a list of limitations annually for qualified plans. This list includes the qualifications for a participant to be considered a Key Employee. For the 2014 plan year, an employee who meets one of the following qualifications at any time during the plan year is considered a Key Employee:

- An officer making over \$170,000
- A more than 1% owner, making over \$150,000
- A more than 5% owner, regardless of pay level

Related family members are considered when determining owners, and there is a limit on the number of employees who can be considered as “officers.”

How does the top heavy test work?

The top heavy test is a ratio of Key Employee assets to total plan assets. However, there are several adjustments that must be made before determining the ratio. Rollover amounts from unrelated plans, catch-up contribution amounts, and account balances for terminated employees

who were not employed during the plan year are all subtracted from the balances. Certain in-service distributions made within the five-year period ending on the determination date as well as certain termination distributions made during the plan year must be added back to the balances. Balances for employees who were Key Employees but have become non-Key Employees are removed from the plan totals. The account balances used for the determination are based on cash basis accounting.

What happens if a plan is top heavy?

If it is determined that the top heavy ratio is over 60%, a minimum contribution must be allocated to the non-Key employees equal to the lesser of 3% of compensation *or* the highest percentage of compensation received by any Key employee for the plan year. **Employee deferrals made by a Key employee are included in determining the percentage of compensation received.** This means that for a top heavy plan, if any Key employee contributes to his 401(k) account, the top heavy required minimum contribution will be triggered for that plan year. Several employer contribution sources can be used to satisfy the required top heavy minimum contribution including profit sharing or matching contributions, reallocated forfeitures, qualified nonelective contributions (QNECs), qualified matching contributions (QMACs), and safe harbor contributions. If non-Key participants have already received a contribution greater than or equal to the top heavy requirement, no additional contribution is needed. The required minimum contribution only has to be allocated to participants that are still employed on the last day of the plan year and must be allocated regardless of how many hours the participant worked during the year. If a non-Key employee has met the eligibility requirement for salary deferrals but not for employer contributions, he must still receive the required minimum contribution.

Are there any exceptions to the top heavy rules?

An exception to the top heavy rules is granted to safe harbor 401(k) plans. If a safe harbor contribution has been given to the participants, then generally the plan will automatically be deemed to have met top heavy requirements. This makes sense in regards to a 3% safe harbor nonelective contribution which equals the 3% top heavy contribution. However, this exception also applies to safe harbor matching contributions, where only employees who elect to make salary deferrals to the plan will be entitled to receive an employer contribution. However, if the employer makes an employer contribution in addition to the safe harbor matching contribution, or if forfeitures are reallocated in addition to the safe harbor matching contribution, then the top heavy exception does not apply and a required minimum contribution must be given to all non-Key employees as noted in the previous question.



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There are many factors to take into consideration when making the top heavy determination and the consequences of performing the test incorrectly can be costly. Consult with your TPA if you think your plan has the potential to be top heavy or with any questions regarding these complex regulations.



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