Top Heavy Plans

A top heavy plan means that you have a very successful plan for your key employees — but it may come at a price

NOBLE-DAVIS CONSULTING, INC.

30275 Bainbridge Road
Building B
Solon, OH 44139

Phone: 440-498-8408
Fax: 440-498-9566
E-mail:
contactus@noblepension.com

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A retirement plan becomes top heavy when the account balances of key employees account for 60% or more of the total plan assets. Generally, key employees are those employees with more than 5% ownership, employees with more than 1% ownership and compensation in excess of $150,000 or officers with over $160,000 in compensation. While this means that your plan design has worked in benefitting your key employees to the extent that they now hold over 60% of the plan assets, it also comes with a price tag. Top-heavy plans are required to make a minimum contribution of at least 3% to all non-key employees eligible to participate in the plan. This can be an unexpected and unwelcome expense for many plans. Further complicating issues is the fact that this test cannot be performed until the account balances for the year are determined. For example, for a 2011 calendar year plan, the testing relies on the account balances as of 12/31/10. These balances may not be determined until well into the 2011 plan year, so it can make for a surprising result. And while the testing sounds like a basic ratio percentage calculation, there are many different aspects to the top heavy test, such as excluding unrelated rollovers and balances of terminated employees, that can dramatically affect the results off the testing.

What should you do if your plan becomes top-heavy?

The top heavy rules were written way back in 1982, which is long before 401(k) plan were even created. The thinking behind the top heavy rules was to encourage plan sponsors to create plans that benefitted all employees and not just the owners. Generally, qualified retirement plans must be designed to not discriminate in the favor of key employees (officers or owners of the plan sponsor). However, with the popularity of the 401(k) plan, the top heavy rules no longer make a lot of sense. If you think about a 401(k) plan, every participant in the plan has a right to make a deferral. If the owners aggressively defer into the plan and the non-owners choose not to defer, the plan will become top-heavy and require a mandatory 3% contribution to the very employees who are not interested in saving for their own retirement. It doesn't make a lot of sense to punish the owners who want to save, but it is the reality of the law. Unfortunately, plans that cover a smaller number of employees are much more likely to become top heavy, and the burden of a required contribution is often greater for a smaller company.

The 3% required contribution rule is actually a little more complicated than it may seem. The law actually says that the plan must make a contribution equal to the lesser of the highest contribution percentage or any key employee or 3%. That means, you can avoid the top heavy 3% minimum contribution to the non-key employees by restricting the contributions to the key employees. Unfortunately, in a 401(k) plan, the deferrals are included in the computation of the key employee contribution amount, so this means that your key employees would need to stop their 401(k) deferral contributions in order to comply with this rule. Not allowing any key employee contributions is probably not a desirable plan design.

Another solution to a top-heavy plan might be to adopt 401(k) safe harbor provisions. Adding 401(k) safe harbor provisions allows you to bypass the top heavy rules and deferral non-discrimination testing. Safe harbor contributions can either be a 3% contribution given to all participants (similar to a top heavy contribution) or it may be a match (100% on the first 3% deferred and 50% on the next 2 % deferred). If your plan is top heavy, it may be that the reason it is top heavy is that many of the non-key employees choose not to defer. In this case, a safe harbor match contribution may allow maximum deferral contributions for the owners at a cost far below the 3% top-heavy required contribution.

Advanced planning can help ease the burden of top-heavy contributions and good plan design can further insulate the plan from mandatory top-heavy contributions. We understand that no plan sponsor wants an unexpected required contribution. We monitor the top-heavy status of the plan each year and will communicate with your about your alternatives.