Top-Heavy Plans

Employee Plans Issue Resource Guide

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I. Background

The top-heavy rules were added to the Internal Revenue Code (IRC 416) by the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), P.L. 97-248, Section 240, effective for plan years beginning after December 31, 1983, and amended by Sections 524 and 713(f) of the Tax Reform Act of 1984 (P.L. 98-369). Generally, to be qualified under IRC 401(a), a plan must contain language which meets the requirements of IRC 416, and which will be effective if the plan becomes top-heavy per IRC 401(a)(10)(B).

II. Acronyms

The table lists acronyms used in this EP Resource Guide and their definitions:

Acronym	Definition
ACP	Actual Contribution Percentage
ADP	Actual Deferral Percentage
CODA	Cash or Deferred Arrangement
DB	Defined Benefit Plan
DC	Defined Contribution
EP	Employee Plans
PPA '06	Pension Protection Act of 2006
PVAB	Present Value of Accrued Benefit
QNEC	Qualified Nonelective Contribution
SIMPLE	Savings Incentive Match Plan for Employees
TEFRA	Tax Equity and Fiscal Responsibility Act of 1982

III. General Requirements

A defined benefit (DB) plan is top-heavy if, as of the determination date (as defined later in this Resource Guide) the present value of the accrued benefits (PVAB) under the plan for the key employees exceeds 60% of the PVAB under the plan for all employees.

A defined contribution (DC) plan is top-heavy if, as of the determination date, the total of the accounts of the key employees under the plan exceeds 60% of the total of the accounts of all employees under the plan.

A top-heavy plan must give non-key employees a minimum benefit if it is a DB plan or a minimum contribution if it is a DC plan. IRC 416(c).

A top-heavy plan must also vest benefits using a special vesting schedule:

- 3-year 100% vesting schedule, or
- 6-year graded vesting schedule. IRC 416(b).

Plans covering few employees are more likely to be top-heavy than plans covering many employees. For example:

- If key employees make up a substantial percentage of the workforce, it is more likely the plan will become top-heavy.
- Plans of larger employers can also be top-heavy where the employer maintains separate plans for its divisions. If the smaller divisions employ many highly paid employees who are key employees, their plans may be top-heavy.

Even if a plan passes the nondiscrimination test of IRC 401(a)(4), it must be examined for top-heaviness. Accrual or allocation rates under a plan can be nondiscriminatory, but the total amount of allocations in the key employees' accounts (or their benefit accruals) could cause the key employees to have too great a share of the plan assets and result in a top-heavy plan.

For plan years beginning on or before December 31, 2023, a top-heavy plan doesn't include a:

- SIMPLE retirement account under IRC 408(p). IRC 416(g)(4)(G).
- Plan for any year that consists solely of a cash or deferred arrangement which meets the "safe-harbor" requirements under IRC 401(k)(12) for minimum contributions for participants and makes matching contributions that meet IRC 401(m)(11). IRC 416(g)(4)(H).
- Plan for any year that consists solely of a cash or deferred arrangement which meets the "safe-harbor" requirements under IRC 401(k)(13) for automatic contribution arrangements and makes matching contributions that meet the requirements of IRC 401(m)(12). IRC 416(g)(4)(H).
- Plan for any year that meets the SIMPLE)plan requirements of IRC 401(k)(11) and doesn't permit contributions other than those required by IRC 401(k)(11). IRC 401(k)(11)(D)(ii).

For plan years beginning after December 31, 2023, a top-heavy plan doesn't include a:

- SIMPLE retirement account under IRC 408(p). IRC 416(g)(4)(G).
- Plan for any year that consists solely of a cash or deferred arrangement which meets the "safe-harbor" requirements under IRC 401(k)(12) for minimum contributions for participants and makes matching contributions that meet IRC 401(m)(11) or 401(m)(13). IRC 416(g)(4)(H).

- Plan for any year that consists solely of a cash or deferred arrangement which meets the "safe-harbor" requirements under IRC 401(k)(13) for automatic contribution arrangements and makes matching contributions that meet the requirements of IRC 401(m)(12) or 401(m)(13). IRC 416(g)(4)(H).

- Starter 401(k) deferral-only arrangement described in IRC 401(k)(16)(B) or a safe harbor deferral-only plan described in IRC 403(b)(16). IRC 416(g)(4)(H).

- Plan for any year that meets the SIMPLE plan requirements of IRC 401(k)(11) and doesn't permit contributions other than those required by IRC 401(k)(11). IRC 401(k)(11)(D)(ii).

The determination of whether the plan is excluded from consideration as a top-heavy plan is determined on a year-by-year basis. Thus, for example, it is possible that in a certain year, the employer might make an employer profit sharing contribution in addition to providing for elective deferrals and matching contributions that satisfy the requirements of IRC 401(k)(12) and 401(m)(11). The plan would be evaluated for top-heavy requirements for that year because it does not meet the requirements of IRC 416(g)(4)(H) since the plan does not solely consist of the elective deferral and matching contributions that meet the applicable requirements of IRC 401(k)(12) and 401(m)(11), and because it also consists of profit sharing contributions.

Also, if a plan elects to suspend safe-harbor matching contributions for a plan year, pursuant to Treas. Reg. 1.401(m)-3(i), then the plan will have been amended to provide that the plan be required to pass the ACP test for the plan year. Since the matching contributions will no longer be considered to be safe-harbor matches, the plan will not satisfy the requirements of IRC 416(g)(4)(H) for that year and will also be subject to the top heavy requirements under IRC 416.

Finally, it is possible that a safe harbor 401(k) plan, that meets the exceptions under IRC 416(g)(4)(H)(i), would need to be aggregated with one or more plans and be a part of a Required Aggregation group (see Aggregation of Plans; Required Aggregation). Under such a circumstance, contributions to the safe harbor 401(k) plan may be taken into account for the purpose of determining whether any other plan in the aggregation group meets the top-heavy minimum contributions for DC plans under IRC 416(c)(2).

A. Examination Steps

1. Determine if the plan under examination has received a determination letter.

2. If the plan:

- Received a determination letter, determine whether the plan is top-heavy. If the plan is top-heavy, determine whether the plan satisfies the top-heavy requirements.

- Didn't receive a determination letter, determine whether the plan contains the top-heavy provisions which meet the requirements of IRC 416 by completing Form 8385, Worksheet Number 7 - Employee Benefit Plan Top Heavy Requirements.

IV. Determining Top-Heavy Status

- Special top-heavy rules apply for government, collectively bargained, and multiple employer plans.

- Governmental plans, under IRC 414(d), are exempt from the top-heavy rules. IRC 401(a)(10)(B)(iii) and Treas. Reg. 1.416–1, Q&A T–38. (Hereinafter this EP Resource Guide will omit "Q&A" in the cited 416 regulations.)

- The top-heavy minimum benefits rules of IRC 416(c) and the vesting rules of IRC 416(b) do not apply to any employee included in a unit of employees covered by a collective-bargaining agreement in which retirement benefits were the subject of good faith bargaining. However, the plan must be included in the required aggregation group of the employer if it includes a key employee of the employer. A collective-bargaining agreement is an agreement between employee representatives and one or more employers. See IRC 416(i)(4) and Treas. Reg. 1.416-1, T-3 and T-38.

  Note: "Employee representatives" do not include any organization where more than one-half of the members are employees who are owners, officers, or executives of the employer. IRC 7701(a)(46).

- Multiple employer plans are subject to the top-heavy rules on an employer-by-employer basis. If a portion of a multiple employer plan is top-heavy for one employer, the top-heavy rules apply only to the employees of that employer. If that one employer doesn't apply the top-heavy rules, the entire multiple employer plan can be disqualified. Treas. Reg. 1.416–1, G–2.

A. Examination Steps

1. Determine whether the plan is a government plan under IRC 414(d). If yes, the plan is exempt from the top-heavy requirements.

2. Determine whether the plan is a collectively-bargained plan in which retirement benefits were the subject of good faith bargaining. If yes, the plan must still be included in testing if it covers a key employee because it is still part of the required aggregation group.

3. Determine whether the plan is a multiple employer plan. If yes, determine whether the plan is top-heavy on an employer-by-employer basis.

B. Employer

In determining which plans of the employer are top-heavy, the employers who will be treated as a single employer must be identified.

- Apply the aggregation rules under IRC 414(b), (c) and (m) for IRC 416 purposes. Treas. Reg. 1.416–1, T–1(b). Also, see Form 8388, Worksheet Number 10 - Determination of Qualification: Employee Benefit Plan Affiliated Service Groups.

- Treat an employer who receives a leased employee's services per IRC 414(n) as an employer for top-heavy purposes. Thus, contributions made to (or benefits provided by) a qualified plan by a leasing organization are treated as contributions made or benefits provided by the employer receiving the leased employee's services. (see IRC 414(n)(1) thru (4) for additional details). Also see exception to this general rule in IRC 414(n)(5). The exception generally provides that if the leased employees consist of less than 20% of the employer's work force and the leasing organization contributes to a money purchase pension plan that provides for contributions of at least 10% of compensation, full vesting, and immediate participation, then contributions to such a plan are not treated as contributions made by the recipient employer.

1. Examination Steps

a) Determine whether the employer under exam who maintains the plan is a member of a controlled group of corporations; a partnership, sole proprietorship, trade, or business under common control; or a member of an affiliated service group. Identify all aggregated employers.

b) Identify the recipient of services from a leased employee under IRC 414(n).

C. Determination Date

Assess whether a plan is top-heavy for a plan year on the determination date for the plan year. The determination date for a plan year is:

- The last day of the preceding plan year, or
- For a plan's first plan year, the last day of that plan year. IRC 416(g)(4)(C).

Example: An employer maintains Plan A, a defined contribution plan, in which key employees participate. For Plan A's 2020 plan year, (a calendar year), the determination date is December 31, 2019. As of the determination date, the aggregate of the accounts of the key employees under the plan exceeds 60% of the aggregate of the accounts of all employees under the plan. Plan A is top-heavy for the 2020 plan year.

1. Examination Steps

a) Find the plan's determination date. Use this date to determine the value of the benefits of all employees.

Note: The value of the benefits on the determination date can be based on a calculation done on the plan's valuation date.

b) Check whether the plan complied with the top-heavy vesting and allocation rules in the following plan year (same plan year, if the first year of the plan).

D. Key Employee

There are several terms for the definition of "key employee," e.g., officer, 5% and 1% owner. IRC 416(i).

A key employee is any employee who at any time during the plan year containing the determination date (the determination date year) is an officer who meets a compensation threshold, a 5% owner of the employer, or a 1% owner of the employer who meets a compensation threshold. IRC 416(i). Use the following definition of compensation and the amount from all aggregated employers:

Definition	Amount
Definition in IRC 414(q)(4) and 415(c)(3) includes: • Elective deferrals under a qualified cash or deferred arrangement (CODA) • Other elective deferrals under IRC 402(g)(3) • Any amount the employer contributed or deferred at the employee's election, and which is not includible in the employee's gross income by reason of IRC 125, 132(f)(4), or 457 • See IRC 416(i)(1)(D) and Treas. Reg. 1.415(c)-2.	The compensation received from each employer is aggregated under IRC 414(b), (c), and (m) to determine who is a key employee. See Treas. Reg. 1.416–1, T–20.

1. Officer

An officer of the employer having annual compensation greater than $130,000 (as adjusted under IRC 416(i)(1) for plan years beginning after December 31, 2002) for the determination date year is a key employee. IRC 416(i)(1)(A) and Treas. Reg. 1.416–1, T–12.

An officer is determined based on the source of the officer's authority, the term for which elected or appointed, and the nature and extent of the duties. If an employee has the title of an officer but not the authority, that employee is not an officer for purposes of determining who is a key employee. An employee who does not have the title of an officer but who has the authority of an officer is an officer for key employee purposes. Treas. Reg. 1.416–1, T–13.

Officers are in:

- Corporations
- Sole proprietorships
- Partnerships
- Trusts
- Labor organizations
- Associations

Treas. Reg. 1.416–1, T–15

No more than 50 employees (or if fewer, the greater of 3 or 10 percent of the employees) shall be treated as officers. If 10% of the number of employees is not an integer, the maximum number of individuals to be treated as key employees by reason of being officers shall be increased to the next integer. If there are more than 50 officers who meet these requirements, select the 50 officers who had the largest annual compensation during the year of the determination date. Treas. Reg. 1.416-1, T-14.

For purposes of determining the number of officers taken into account, employees described in IRC 414(q)(5) shall be excluded. IRC 416(i)(1)(A).

For the purpose of determining the number of officers taken into account, IRC 414(q)(5) and Treas. Reg. 1.414(q)-1T, 9(b) provide for the exclusion of the following employees:

- Employees who have not completed 6 months of service
- Employees who normally work less than 17 ½ hours per week
- Employees who normally work during not more than 6 months during any year
- Employees who have not attained age 21
- Employees covered by a collective bargaining agreement between employee representatives and the employer, if at least 90 percent of the employees of the employer are covered under collective bargained agreements and the plan being tested covers only employees who are not covered under such agreements
- Nonresident aliens who received no earned income from sources within the United States.

The term "officer" does not include any officer or employee of an entity referred to in IRC 414(d) relating to governmental plans. IRC 416(i)(1)(A).

2. Five Percent Owner

An employee who is a 5% owner of the employer at any time during the determination date year is a key employee.

- A 5% owner of a corporation is any person who owns more than 5% of the outstanding stock of a corporation or stock possessing more than 5% of the total combined voting power of all stock of the corporation.
- Use the constructive ownership rules of IRC 318.
- In determining who is a 5% owner, do not aggregate employers under IRC 414(b), (c), or (m). IRC 416(i)(1)(B)(i).

3. One Percent Owner

An employee who is a 1% owner of the employer at any time during the determination year and whose compensation exceeds $150,000 for the determination date year is a key employee. IRC 416(i)(1)(A)(iii).

Note: This $150,000 dollar threshold is not indexed for inflation.

Use the constructive ownership rules of IRC 318 to help determine whether an employee is a 1% owner. In determining who is a 1% owner, determine ownership without aggregating employers under IRC 414(b), (c), or (m).

4. Examination Steps

a) Identify all the key employees of the employer to determine whether the plan is top-heavy and whether it must be aggregated with the employer's other plans to test for top-heaviness.

b) Identify all key employees of the employer, including those in the plan under examination and any other plans the employer (as aggregated) has.

- Determine the 5% and 1% owners of the employer.
- Determine, as necessary, whether any employees who don't have the title of an officer have the authority of an officer.
- Determine whether any employees make elective deferrals under a CODA of the employer and any other elective deferrals under IRC 402(g)(3), as well as any amount which the employer contributed or deferred at the employee's election and which is not includible in the employee's gross income by reason of IRC 125, 132(f)(4), or 457. Make sure the employer included these deferrals in compensation to identify the key employees.
- Request information to determine the employer's key employees.

E. Aggregation of Plans

You must aggregate certain other employer plans to determine whether the plan you are examining is top-heavy. Plans that are required to be aggregated are part of a "required aggregation group." Under certain circumstances, an employer may use "permissive aggregation" to aggregate plans that are not part of a required aggregation group. IRC 416(g)(2).

An aggregation group is top-heavy if, as of the determination date, the sum of the present value of accrued benefits (as defined later in this Resource Guide) for key employees and the account balances of key employees in all of the plans in the aggregation group exceeds 60% of the same amounts determined for all participants in all plans included in the aggregation group.

1. Required Aggregation Group

The "required aggregation group" is defined in IRC 416(g)(2)(A)(i). It is made up of:

- Each plan of the employer in which a key employee participates during the determination date year (or participated in during any of the four preceding years), and
- Any other of the employer's plans which, during this period, is aggregated with a plan in which a key employee participates to meet the nondiscrimination requirements of IRC 401(a)(4) or IRC 410.

If the required aggregation group is top-heavy, each plan in the required aggregation group is top-heavy, even if it would not be top-heavy if tested independently, or if it doesn't even cover key employees. Similarly, if the required aggregation group is not top-heavy, no plan in the required aggregation group is top-heavy.

All plans in a required aggregation group that are top-heavy must satisfy the vesting requirements of IRC 416(b) and the minimum benefits requirements of IRC 416(c). Treas. Reg. 1.416–1, T–10.

- Only one DC plan needs to satisfy the minimum contribution requirements for any non-key employee who participates in more than one DC plan in the required aggregation group. Treas. Reg. 1.416–1, M–8 and T–10.
- Only one DB plan must satisfy the minimum accrual requirements for any non-key employee who participates in more than one DB plan in the required aggregation group. Treas. Reg. 1.416–1, T–10.

2. Permissive Aggregation Group

An employer may also aggregate plans that are not part of a required aggregation group with the plans in a required aggregation group to create a permissive aggregation group, as long as the permissive aggregation group satisfies IRC 401(a)(4) and 410. IRC 416(g)(2)(A)(ii).

If a permissive aggregation group is not top-heavy, none of the plans are top-heavy. If a permissive aggregation group is top-heavy, then the top-heavy requirements apply only to those plans in the required aggregation group. IRC 416(g)(2) and Treas. Reg. 1.416–1, T-1(b) and (c), T-6, T-7, and T-9–11.

Example: Employer has Plan A which covers key employees and other employees and independently satisfies the requirements of IRC 401(a)(4) and 410. Plan A is top-heavy when tested on its own. Employer also has Plan B, which doesn't have any key employees and is not top-heavy. The employer may permissively aggregate these plans to test for top-heaviness if the permissive aggregation group satisfies IRC 401(a)(4) and 410.

3. Examination Steps

a) List all plans of the employer that contain key employees in the determination date year.

b) List all plans that permit any of these plans to satisfy IRC 401(a)(4) or 410 (the required aggregation group). Determine whether this required aggregation group is top-heavy.

c) List all plans that are not part of the required aggregation group that are permissively aggregated. Make sure that this permissive aggregation group satisfies IRC 401(a)(4) and 410. Determine whether this permissive aggregation group is top-heavy.

F. Calculating Top-Heavy Ratio

A defined contribution plan is top-heavy for a plan year if, as of the determination date, the aggregate of the accounts of the key employees under the plan exceeds 60% of the aggregate of the accounts of all employees under the plan. IRC 416(g)(1).

A defined benefit plan is top-heavy for a plan year if, as of the determination date, the present value of the cumulative accrued benefits (PVAB) under the plan for key employees exceeds 60% of the PVAB of all plan employees.

- If all an employer's defined benefit plans accrue benefits under the same method, determine the accrued benefits of employees using that accrual method.
- If the employer's plans use different methods for accruing benefits, determine the accrued benefits of non-key employees by using the slowest permitted rate under the fractional accrual rule of IRC 411(b)(1)(C). IRC 416(g)(4)(F).

  Note: Although IRC 416(g)(4)(F) provides that this method for calculating the accrued benefit only applies to non-key employees, the Conference Agreement found in House Conference Report 99-841, regarding changes made by P.L. 99-514 (the Tax Reform Act of 1986) doesn't distinguish between calculating accrued benefits for key and non-key employees and says the above method applies for the calculation of the accrued benefit of "the participants in each plan."

1. Calculating Present Value (PVAB)

In a defined contribution plan, calculate the account balances as of the determination date. Add the account balances as of the most recent valuation date within the 12-month period ending on the determination date and add in contributions due as of the determination date. In the first plan year, also add in contributions made after the determination date that are allocated during that year. Treas. Reg. 1.416–1, T–24.

In a defined benefit plan, calculate the PVAB as of the determination date by using the most recent valuation date within the 12-month period ending on the determination date.

- The valuation date must be the same valuation date the plan uses to compute plan costs for minimum funding purposes.
- The actuarial assumptions used to determine the PVAB must be reasonable.
- Withdrawal assumptions may not be used.
- Present values should be based on a benefit payable at normal retirement age and shouldn't consider pre-retirement death and disability benefits and post-retirement medical benefits.
- The assumptions don't have to be the same as the assumptions used for minimum funding or for actuarial equivalence of optional benefits.

Consider subsidized early retirement benefits and subsidized benefit options only if they are nonproportional subsidies, i.e., available to a group of employees that doesn't satisfy the coverage requirements of IRC 410(b). A benefit that is a nonproportional subsidy is valued as if it commenced at the age at which it is the most valuable. See Treas. Regs. 1.416–1, T–25, 26 and 27.

Accrued benefits include benefits attributable to employee contributions, other than deductible employee contributions. See Treas. Reg. 1.416-1, T-28.

2. Required or Permissive Aggregation Group

If there are two or more plans in an aggregation group, calculate the value of the benefits separately for each plan as of each plan's determination date and add them when the plan years are the same. When plan years aren't the same, aggregate the values for each plan year as of the determination dates for those plans that fall within the same calendar year. Treas. Reg. 1.416–1, T–23.

Example: Employer X maintains Plan A, a defined contribution plan, and Plan B, a defined benefit plan. Key employees participate in both plans. Plans A and B are a required aggregation group and are calendar year plans.

Plan A (DC)		Plan B (DB)	
Key Employees	**Accounts**	**Key Employees**	**PVAB**
A	170,000	A	940,000
B	120,000	B	660,000
Non-Key Employees			
C	40,000	C	50,000
D	70,000	D	30,000
E	65,000	E	95,000
F	70,000	F	0
G	20,000	G	0
290,000 / 555,000 = 52%		1.6 million / 1.775 million = 90%	

Note: Plan A + Plan B: 1.89 million ÷ 2.33 million = 81%. Both Plans are top-heavy.

The key employees' accounts in the DC plan are 52% of the value of all the employees' accounts under the plan. The key employees' accrued benefits in the DB plan are 90% of the value of the accrued benefits of all employees under the plan. The plans are aggregated by adding together the results for each plan. The sum of the accrued benefits and account balances of the key employees under both plans is 81% of the accrued benefits and account balances for all employees under both plans. Thus, both plans are top-heavy.

3. Amounts Added or Excluded

Add back distributions the plan made within the 1-year period (5-year period for in-service distributions, i.e., any distribution made for a reason other than severance from employment, death or disability) ending on the plan's determination date to determine the participants' accrued benefits or account balances, IRC 416(g)(3). If the plan distributed an annuity contract, the amount distributed is the current actuarial value of the contract determined on the distribution date plus any prior distribution within the applicable period.

If a key employee becomes a non-key employee, exclude his accrued benefit or account balance to determine whether the plan is top-heavy. This person is referred to as a former key employee, IRC 416(g)(4)(B) and Treas. Reg. 1.416–1, T–1(d).

Exclude an individual (key or non-key) who hasn't performed services for the employer with the plan at any time during the 1-year period ending on the determination date. Exclude the accrued benefit or account balance of that employee to determine whether the plan is top-heavy. See IRC 416(g)(4)(E) and Treas. Reg. 1.416–1, T–1(d).

Treat amounts participants rolled over or transferred between plans as part of their accrued benefit or account balance in the plan making the rollover or transfer, or in the plan accepting the rollover or transfer, depending on whether the rollover or transfer is unrelated or related. Treas. Reg. 1.416-1, T-32.

Example: You're examining a plan for the 2020 calendar year to determine whether it is top-heavy. The determination date for the 2020 plan year is December 31, 2019. Individual A, an officer of the employer whose compensation exceeded the threshold limit, separated from service in 2019. Even though A is no longer an employee of the employer, you'd treat A as a key employee to determine if the plan is top-heavy for the 2020 plan year. However, for purposes of determining whether the plan is top-heavy for the 2021 plan year, you wouldn't count A's benefits under the plan because A didn't perform services for the employer during 2020.

4. Related and Unrelated Rollovers

A "related rollover" is a rollover or transfer of plan assets into a plan maintained by the same employer group, or a rollover/transfer not initiated by the employee.

- Treat a related rollover as part of the accrued benefit or account balance in the plan accepting the rollover.
- Don't treat the related rollover as a distribution from the plan making the rollover and likewise don't count it as part of the accrued benefit or account balance in that plan to determine if it's top-heavy.
- Generally, don't treat a rollover or transfer made pursuant to the division of one plan into two, or the merger of two or more plans into one, as employee initiated. See IRC 416(g)(4)(A) and Treas. Reg. 1.416–1, T–32.

The rollover or transfer of an employee's account balance when the employee moves to an unrelated employer is an "unrelated rollover."

- Count an unrelated rollover or transfer as a distribution under the plan making the rollover in testing for top-heaviness.
- Don't treat the unrelated rollover/transfer as part of an accrued benefit or account in the plan accepting the rollover when you test whether it is top-heavy.

5. Terminated and Frozen Plans

For a terminated or frozen plan, determine whether it's top-heavy in the same way as active plans.. Treas. Reg. 1.416–1, T–4 and T–5.

For IRC 416 purposes, a terminated plan is a plan that has been formally terminated, no longer credits service for benefit accruals and vesting, and distributed or is distributing all plan assets as soon as administratively feasible (generally within one year). Rev. Rul. 89–87, 1989–2 C.B. 81.

- Aggregate the terminated plan with the employer's other plans if it was maintained within the last 5 years ending on the determination date of the plan under examination, and it would, if not terminated, be part of a required aggregation group.
- Add back distributions from the terminated plan during the 1-year period (5-year period for in-service distributions, i.e., any distribution made for a reason other than severance from employment, death, or disability) ending on the determination date to determine whether the required aggregation group is top-heavy. If the required aggregation group is top-heavy, no additional contributions, benefit accruals, or vesting is required for participants in the terminated plan, but the ongoing plans must satisfy the top-heavy rules. IRC 416(g)(3) and Treas. Reg. 1.416–1, T–4.

A frozen plan is one in which benefit accruals have stopped, but the plan has not distributed all the assets. If a frozen plan is top-heavy, it must provide top-heavy minimum contributions, benefit accruals, and vesting. However, in a DC plan, no top-heavy minimum contribution is required if no key employee receives a contribution. See Treas. Reg. 1.416–1, T–5 and IRC 416(c)(2)(B).

6. Simplified Top-Heavy Ratio Method

An employer can use simplified methods to compute a plan's top-heavy ratio. These methods permit using imprecise data to show the plan isn't top-heavy. Using these methods computes a top-heavy ratio that's higher than if precise data had been used. So, if the simplified method results in a top-heavy ratio less than 60%, an employer can demonstrate that the plan is not top-heavy. Treas. Reg. 1.416–1, T–39.

Method	Method explanation - the employer:
1	Overestimates key employees' benefits and underestimate the non-key employees' benefits. (Estimated fraction will be higher than exact fraction.)
2	Considers only some non-key employees. (Adding more non-key employees would only further decrease the ratio.)
3	Uses imprecise data to determine the key employees' accounts, resulting in an overstatement of their benefits. (Worst case scenario.)
4	Uses imprecise withdrawal assumptions to compute the top-heavy ratio resulting in an overstatement of key employees' benefits. (Worst case scenario.)

7. Examination Steps

a) To do a preliminary test of the top-heavy ratio, calculate the key and non-key employees' aggregate account balances and/or accrued benefits:

$$\frac{\text{Sum of Key Employee Balances}}{\text{Sum of Total Employee Balances}} = \text{Top-Heavy Ratio}$$

b) If the top-heavy ratio is considerably greater than 60%, the plan is most likely top-heavy. If the top-heavy ratio is near 60%:

- Add in all distributions the plan made to employees during the 1-year period (5-year period for in-service distributions, i.e., distributions made for a reason other than severance from employment, death, or disability), ending on the determination date.
- Exclude former key employees' account balances, accrued benefits and distributions.
- Exclude the account balances, accrued benefits, and distributions of employees who have not performed services for the employer at any time during the 1-year period ending on the determination date.

V. Top-Heavy Allocations

Those non-key employees who are participants in a top-heavy defined contribution (DC) plan who have not separated from service by the end of the plan year must receive the DC contribution minimum.

Non-key employees who have become participants but who subsequently fail to complete 1,000 hours of service (or the equivalent) for an accrual computation period must receive the DC minimum.

A non-key employee may not fail to receive a defined contribution minimum because either (1) the employee is excluded from participation (or accrues no benefit) merely because the employee's compensation is less than a stated amount, or (2) the employee is excluded from participation (or accrues no benefit) merely because of a failure to make mandatory employee contributions, or in the case of a cash or deferred arrangement, elective contributions. Treas. Reg. 1.416-1, M-10.

For plan years beginning after December 31, 2023, DC plans may exclude non-key employees from receiving the top-heavy minimum contribution if minimum age and service requirements in IRC 410(a)(1) are not met. IRC 416(c)(2)(C).

A. Top-Heavy Minimum Contributions

If a DC plan is top-heavy, the employer must contribute to each non-key employee's account who is a plan participant of at least 3% of the participant's compensation.

- You can consider forfeitures allocated to a participant's account for the 3% minimum contribution, but not elective contributions. You can count matching contributions under IRC 401(m)(4)(A) for years after December 31, 2001.
- The 3% minimum contribution requirement is reduced if the largest percentage contribution made on behalf of a key employee for the plan year is less than 3%.
- The minimum contribution can't be reduced due to social security contributions.

If the required aggregation group includes a DC and a DB plan aggregated to meet the requirements of IRC 401(a)(4) or 410, then a 3% minimum contribution is generally required in the defined contribution plan, even if the highest contribution rate for a key employee is less than 3%. IRC 416(c)(2) and Treas. Reg. 1.416–1, M–7.

Example: Plan A is a top-heavy plan. The largest percentage contribution made on behalf of a key employee during the 2015 plan year is to Employee M. Employee M's compensation is $269,000. The employer contributes $10,600 to Employee M. Because Employee M's compensation is limited to $265,000 in 2015 for contribution purposes by IRC 401(a)(17), the percentage contribution made on behalf of Employee M is 4% (10,600 ÷ 265,000 = 4%). Each non-key employee must receive a top-heavy minimum contribution equal to 3% of compensation.

Example: The facts are the same as in the Example above, except that the employer contributes $5,300 to Employee M in 2015. The percentage contribution made on behalf of Employee M is 2% (5,300 ÷ 265,000 = 2%). Each non-key employee must receive a top-heavy minimum contribution equal to 2% of compensation.

If the employer maintains only one defined contribution plan, each non-key employee covered by the plan must receive the defined contribution minimum. If the employer maintains more than one defined contribution plan, and a non-key employee participates in more than one, then only one defined contribution plan has to provide a minimum contribution for the employee. Treas. Regs. Treas. Reg. 1.416–1, T–10, M–8 and M–12.

1. CODA Rules

Elective deferrals by non-key employees cannot be treated as contributions for purposes of the minimum contribution requirement in a top-heavy defined contribution plan. But elective deferrals are considered in determining the contribution percentage of a key employee. Treas. Reg. Treas. Reg. 1.416-1, M-20.

A qualified nonelective contribution (QNEC) is treated as a contribution for purposes of the minimum contribution requirement. (A QNEC is an employer contribution which can be used to satisfy the actual deferral percentage (ADP) or average contribution percentage (ACP) tests, but is not a matching contribution.) Treas. Reg. 1.416-1, M-18.

Note that matching contributions to non-key employees are counted towards satisfying the minimum contribution requirement. IRC 416(c)(2)(A).

IRC 415(c)(3)(D) defines compensation as including an elective deferral under IRC 402(g)(3) and any amount which is contributed or deferred by the employer at the election of the employee and which is not includible in the gross income of the employee by reason of IRC 125, 132(f)(4), or 457.

Example: For elective contributions under an IRC 401(k) plan, the required minimum contribution is based on an employee's compensation, including the elective deferral.

2. SECURE Act Changes

Section 112 of the SECURE Act amends IRC 410(a) by adding a new maximum service requirement for certain long-term part-time employees.

The new maximum service requirement that a plan can impose for purposes of making elective deferrals to a 401(k) plan is the completion of 3 consecutive 12-month periods during which the employee completed at least 500 hours of service.

Section 112 of the SECURE Act further provides that an employer may elect to exclude all employees who are eligible, solely because of the completion of the above eligibility requirements, from being subject to the top-heavy vesting requirements of IRC 416(b). In addition, the employer may elect to exclude these employees from receiving top-heavy minimum contributions required under IRC 416(c).

3. SECURE 2.0 Act Changes

Section 125 of the SECURE 2.0 Act reduced the 3 consecutive 12-month periods described above to 2 years, effective for plan years beginning after December 31, 2024. Section 125 also provides that pre-2021 service is disregarded for vesting purposes.

Section 125 also provides that a 401(k) plan which permits entry for long-term part-time employees who are not eligible for safe harbor contributions remains exempt from top-heavy testing. This clarification is effective as if included in Section 112 of the SECURE Act.

Section 310 of the Act enables a top-heavy 401(k) plan that covers otherwise excludible employees (employees who have not met the minimum participation standards of IRC 410(a)) to disaggregate those employees for top-heavy testing purposes, effective for years beginning after December 31, 2023.

4. Examination Steps

a) When examining a plan determined to be top-heavy, make sure the top-heavy minimum required contributions (or benefits) and vesting rules are met in operation.

b) Check whether the employer has made a minimum contribution to the non-key employees in a top-heavy DC plan. If there is more than one DC plan in the required aggregation group, look at all the plans to determine whether any key employee receives contributions equal to or greater than 3% of compensation.

c) Make sure non-key employees, who meet the plan's eligibility requirements, and who have not separated from service at the end of the plan year, receive a minimum contribution, even if they have less than 1000 hours of service.

d) Check that the minimum contribution is properly computed. Check to make sure elective deferrals that non-key employees made were not counted as minimum contributions.

e) Make sure minimum contributions for non-key employees are made even if the only contributions on behalf of key employees are elective deferrals.

B. Top-Heavy Minimum Accrued Benefits

A top-heavy DB plan must give each non-key employee who is a plan participant a minimum accrued benefit that, when expressed as a single life annuity (with no ancillary benefits) beginning at normal retirement age, equals the participant's highest aggregate compensation for a period of consecutive years up to five (called the testing period) multiplied by the lesser of 2% times years of service, or 20% (the applicable percentage), IRC 416(c)(1).

Example: Employee M, a non-key employee, has been a participant in Plan A for five years, during which time, it was top-heavy. Employee M's average annual compensation during those five years was $30,000. Employee M's minimum pension must be $3,000 ($30,000 x (2% x 5 years of plan service).

The DB plan minimum isn't met if a plan gives a normal retirement benefit equal to the greater of the plan's projected formula or the projected minimum benefit, and if the benefits accrue under the fractional accrual rule at IRC 411(b)(1)(C). Treas. Reg. 1.416–1, M–5.

Example: Employee N, a non-key employee, becomes a participant at age 25 in Plan X, a top-heavy DB plan. The plan's normal retirement benefit is the greater of the plan's projected formula or the projected minimum benefit. The plan accrues benefits under the fractional accrual rule. Employee N's projected minimum benefit is greater than the plan's projected formula. At age 35 under the fractional accrual rule, Employee N's accrued benefit will equal 5% (20% x 10 ÷ 40). This benefit does not satisfy the top-heavy minimum benefit of 20%.

In determining the applicable percentage, a DB plan may disregard a year of service:

- That ends in a plan year beginning before January 1, 1984.
- If the plan was not top-heavy for any plan year ending in that year of service. IRC 416(c)(1)(C)(ii).
- To the extent that this service occurs during a plan year in which no key employee or former employee benefits under the plan. IRC 416(c)(1)(C)(iii).

1. Benefits for Non-Key Employees

Each non-key employee who is a participant in a top-heavy DB plan with at least 1,000 hours of service in a plan year must receive a minimum benefit accrual for that year. Treas. Reg. 1.416–1, M–4.

A non-key employee must receive a minimum benefit even if the employee:

- Was not employed on a specific date; or
- Is excluded from participation because the employee didn't make mandatory employee contributions or because the employee's compensation is less than a stated amount.

Example: Employer M maintains Plan X, a DB plan. Plan X requires employees to contribute at least 3% of compensation in order to participate. Employee A doesn't contribute to Plan X in the 2020 plan year, and consequently is not a participant. Employee A has more than 1,000 hours of service with Employer M in 2020. Plan X is top-heavy in 2020. Employee A must receive a top-heavy minimum accrued benefit for 2020 because Employee A has more than 1,000 hours of service for Employer M in 2020.

If a non-key employee in a plan has accrued benefits due to employer contributions in non-top-heavy years, these accruals may be counted for the purpose of satisfying the top-heavy minimums. Thus, if a non-key employee had already accrued a benefit of 20% of final average pay at the time the plan became top-heavy, no additional minimum accruals are required (although the accrued benefit would increase as final average pay increases). Treas. Reg. 1.416–1, M–2(e).

2. Examination Steps

a) Verify that non-key employees in a top-heavy DB plan who had 1,000 hours of service or more received the minimum benefit.

b) Verify that non-key employees in a top-heavy DB plan who didn't participate because they didn't make mandatory employee contributions received the minimum benefit.

VI. Additional Allocation

Special top-heavy rules apply when an employer maintains, and employees participate in, both a DC and DB plan, which are top-heavy. Safe harbor rules for calculating top-heavy minimums are available.

A. Safe Harbor Top-Heavy Minimums

A non-key employee who participates in both a top-heavy DC and a top-heavy DB plan maintained by the same employer doesn't have to receive both a DC and DB minimum but should receive more than just a 3% contribution to the DC plan. IRC 416(f) and Treas. Reg. 1.416-1, M-12.

A plan may use one of four alternative safe harbor methods to provide top-heavy minimums. The plan must specify the method selected. Treas. Reg. 1.416–1, M–12 and M–15.

Safe Harbor Method	Safe Harbor Explanation
1	Only the DB plan must provide the minimum benefit.
2	A floor offset arrangement under which the DB plan minimums can be offset by the DC plan benefits.
3	Both the DC plan and the DB plan together, using comparability analysis, provide benefits at least equal to the DB plan minimum.
4	A safe harbor DC minimum of contributions and forfeitures equal to 5% of the compensation of each non-key employee.

VII. Top-Heavy Vesting

IRC 416(b) requires that a top-heavy plan provide one of two alternative vesting schedules: 100% vesting after three years of service, or a six-year graded vesting schedule. IRC 416(b)(1)(A) and (B).

Top-heavy vesting applies to all amounts contributed or accrued in a plan, even though accrued before the plan becoming top-heavy. The rules:

- Apply to each employee who has at least one hour of service after the plan becomes top-heavy.
- Don't apply to an employee who doesn't have service after the plan becomes top-heavy.

Example: Plan X has a plan year beginning on July 1 and maintains a 5–year vesting schedule. The plan has a 3–year vesting schedule in a year in which it is top-heavy. Plan X became top-heavy in the plan year beginning July 1, 2020. Employee A became a plan participant on August 1, 2017, and terminated service on August 15, 2020, with 240 hours of service during the top-heavy plan year. Employee A becomes 100% vested in her accrued benefit under the top-heavy vesting schedule because Employee A had at least one hour of service in the plan year in which the plan became top-heavy.

When a top-heavy plan ceases to be top-heavy, the vesting schedule can be changed to one that would otherwise be permitted., but see Treas. Reg. 1.416–1, V–7 and IRC 411(a)(10).

- The employee's vested percentage under the top-heavy vesting schedule as applied to benefits accrued before and after the plan ceases to be top-heavy can't be reduced.
- Any employee with three or more years of service must be given the option to remain under the top-heavy vesting schedule.

A. Examination Steps

1. Make sure employees who have hours of service, in the year a plan is top-heavy, vest under one of the top-heavy vesting schedules.

2. Check whether benefits accrued, or contributions made before the plan became top-heavy, are subject to the top-heavy vesting once the plan is top-heavy.

3. If a plan that was top-heavy ceases to be top-heavy and changes back to a normal vesting schedule, check that amounts vested under the top-heavy vesting schedule are not reduced, and that employees with three or more years of service are given the option to remain under the top-heavy vesting schedule.