



LEVY & ASSOCIATES

Qualified Retirement Plan Consulting and Administration

The 401(k) Plan Top-Heavy Conundrum 2020 - 2021

Generally, a qualified retirement plan becomes “Top-Heavy” when the benefits of certain executives (called “Key Employees”) account for more than 60 percent of the plan’s benefits. When a plan is Top-Heavy and any Key Employee receives a contribution allocation of 3% or more the employer must make a minimum three percent of pay contribution to the accounts of all “Non-Key” eligible Employees (and sometimes Key Employees also) employed at year end. This is true even for 401(k) plans where there is no employer match or profit sharing allocation. A deferral by any Key Employee will require the employer to make a Top-Heavy contribution of up to 3% of eligible pay. For example, if any Key Employee defers 1%, 2% or 3% (or more) of eligible compensation the employer would be required to contribute 1%, 2% or 3% of eligible compensation (the cap is 3%) to eligible employees. Eligible employees not employed on the last day of the plan year are not allocated a Top-Heavy contribution. Safe Harbor 401(k) plans are deemed to satisfy the Top-Heavy requirements where there are no profit sharing accruals.

For the first year of a new Plan the Top-Heavy status is determined on the “Determination Date” which is the last day of the Plan Year. For ongoing plans the Top-Heavy status is determined on the “Determination Date” which is the last day of the preceding Plan Year. With plan data collected after year end the Top-Heavy status is not determined until some time during the plan year. Here is the issue; at the start of a given plan year the plan sponsor (the employer) does not know if their Plan is Top-Heavy. If any Key Employee defers compensation to the plan and it is determined the Plan is Top-Heavy it would be too late to avoid the required Top-Heavy contribution.

Conclusion

For traditional 401(k) plans to avoid an unexpected required Top-Heavy contribution do not allow Key Employees to defer until the Top-Heavy status is determined. Safe Harbor 401(k) plans with no profit sharing allocations are deemed to satisfy the Top-Heavy requirements and the ADP/ACP tests.

Key Employee Defined

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 (\$185,000 – 2021; \$185,000 – 2020).

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.

60% Determination

For a defined contribution plan to be Top-Heavy, the aggregate account balances of Key Employees must exceed 60% of total account balances. Account balance Includes:

- Employer contributions,
- Employee voluntary or mandatory contributions but not deductible (IRA type) employee contributions,
- Rollovers received prior to January 1, 1984, but not those received on or after that date, unless from a plan of a related employer, (Note: A related rollover is a rollover from a plan of the same employer. For example, if an employer terminates a money purchase plan and a participant decides to roll the money purchase funds into the employer’s profit sharing plan).
- Investment earnings credited to account balances,
- Forfeitures,
- Distributions within one-year of the determination date. There is a five-year look back for in-service distributions, including excess deferrals, excess contributions, excess aggregate contributions and excess annual additions.

**Note: In Profit-Sharing and 401(k) Plans, except for the first year of the plan, employer contributions are included only if contributed on or before the determination date, i.e. a “cash basis.”*