The Top-Heavy Test: Easy to Fail, Easy to Fix

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Angela and Samuel own Click & Go, Inc., a small tech company in sunny California. After five years of successfully running the business, they decided to hire three employees. Samuel, who is the Plan Administrator, informed his TPA of the employees' hire dates so they could be enrolled in the Click & Go, Inc. Defined Contribution Plan (the "Plan"). The TPA explained that with the introduction of the new employees, it was important to ensure that all activities of the Plan are nondiscriminatory. The TPA further explained that, because the new employees earn and likely will contribute substantially less money than Angela and Samuel, the Plan will probably fail the top-heavy test. Samuel, being the meticulous person that he is, wants to know everything about the importance of top-heavy testing, why his Plan will probably fail the top-heavy test, the adverse consequences of the failure, and how to avoid such adverse consequences in the future. The TPA is thrilled to work with a Plan Administrator who is proactive in maintaining the Plan's qualified status and is happy to tell him everything he needs to know about top-heavy testing. What all does Samuel need to know?

What does it mean for a defined contribution plan to be top-heavy? Under Section 416(g)(1) of the Internal Revenue Code ("IRC"), a defined contribution plan is top-heavy for a plan year if, as of the determination date, the total accounts in the plan for the key employees exceeds 60% of the total of the all accounts for all employees in the plan.

What is a determination date? The determination date for a plan year is the last day of the preceding plan year OR, if it is the very first plan year, the last day of that plan year.

What is a key employee? A key employee is any employee who, at any time during the plan year containing the determination date, is:

- an owner of more than 5% of the business (called, misleadingly enough, a "5% owner" in the law);
- an owner of more than 1% of the employer (yes, a "1% owner") whose compensation exceeds $150,000 for the plan year ending on the determination date; or
- an officer whose compensation is greater than $185,000 for 2020 ($180,000 for 2019, $175,000 for 2018).

All other employees are non-key employees. (If someone was a key employee at one time and ceases to be a key employee, he or she is a “former key employee” and is excluded from the top-heavy testing. Former keys are non-key employees for all other reasons.)

What happens if a defined contribution plan fails top-heavy testing? The point of having a top-heavy test is to ensure that the lower-paid employees receive a minimum benefit. Thus, providing that minimum benefit is the cure for a failed test. The minimum contribution that must be provided to all non-key and former key participants in a defined contribution plan who are employed on the last day of the plan year is the lesser of (a) 3% of compensation; or (b) the highest contribution received by any key employee for the plan year (including, for this purpose, the employee’s salary deferrals).

What Being Top-Heavy Actually Looks Like

Samuel and Angela are both 5% owners of Click & Go, Inc. They’ve each elected to have salary deferrals of $19,500 deposited in the company’s 401(k) Plan – the maximum allowed for the year 2020. Their three new employees each make between $40,000 and $55,000 annually and are contributing 4% of their annual salaries into the Plan.

As of the determination date before the new employees enter, all of the money in the Plan belongs to Samuel and Angela. Therefore, the Plan is top-heavy for that year (and will likely be top-heavy for a long time to come, until their employees’ accounts exceed 40% of the Plan). Now that Samuel knows that the Plan is top-heavy, he needs to make sure that the company contributes sufficiently to provide the minimum amount for the employees. For purposes of determining the rate of contribution received by the key employees, *their own salary deferrals* count as employer contributions. Samuel and Angela each earn $285,000 per year. Their $19,500 apiece of salary deferrals equals 6.84% of compensation; therefore, the top-heavy minimum contribution is 3%. The company must contribute an amount equal to no less than 3% to the three non-key employees: Sara, Jessica, and Parker. (Note that, even though the key employees’ salary deferrals count as employer contributions for purposes of determining the rate of top-heavy contribution needed for the employees, the non-key employees’ salary deferrals *do not* count as part of the minimum contribution the company must provide.)

Is There a Way for Click & Go, Inc. to Avoid the Top-Heavy Test Altogether?

If Samuel and Angela continue running a small business like this and continue to contribute on their own behalf, they will likely fail the top-heavy test every plan year. This means they will need to contribute at least 3% of pay for the employees each year. Furthermore, they will need to pass the nondiscrimination testing for the salary deferrals (called the “ADP test”) and for any other contributions they make.

Since they will need to contribute 3% of compensation for their employees under the top-heavy rules, they should consider amending the Plan to be a 401(k) Safe Harbor plan. Safe Harbor plans that provide a flat 3% contribution to all eligible employees are exempt from ADP testing. This allows the 3% contribution that the company was making anyway to do “double duty” for Click & Go, Inc. – meeting the top-heavy minimum requirement *and* avoiding the ADP testing. (As an alternative to the 3% contribution, the Plan can be set up to provide a matching contribution of 100% of salary deferrals up to 3% of compensation, plus 50% of compensation between 3% and 5%. While this has the potential of requiring a larger contribution for an employee who defers more than the 3% he or she would get in the 3% flat contribution style plan (called a “nonelective contribution”), it also encourages the employees to contribute on their own behalf in the Plan. This is called a “safe harbor matching plan.”)

Thanks to the Setting Every Community Up for Retirement Enhancement ("SECURE") Act, it is easier to set up Safe Harbor 401(k) plans after December 31, 2019, that use the nonelective contribution style. While safe harbor matching plans need to provide notice to participants at least 30 days before the plan year, no such notice is required for nonelective contribution plans. Furthermore, while safe harbor matching plans must be adopted before the year begins, nonelective plans can be adopted by plan amendment up to the 30th day before the plan year ends OR, if the nonelective contribution is increased for the first year to 4%, during the year following the year for which they are effective.

But I Don't Want to Contribute for My Employees at All!

Now, some of you employers may be thinking, "I don't want to have to make nonelective contributions to the plan. Can't I just have the plan return money to the key employees so that their aggregated accounts don't exceed 60% of the aggregated accounts of all the employees?" The answer, my frugal friend, is <u>no</u>. Once your money is contributed into the plan, it stays in the plan unless a distributable event occurs. Taking the money out of the plan absent a distributable event will only cause you even more expensive problems; the worst of which is that your plan can lose its tax status as a qualified plan. You can, of course, avoid making key employee contributions in the future; however, that makes it harder for the owners to save money for their own retirement. All in all, if you are in this situation, it's time to talk to your TPA to determine the best course of action.

Other Testing Rules (Money Added or Excluded, Rollovers, and Terminated and Frozen Plans)

IRC Section 416(g) fine-tunes the rules for determining whether a plan is top-heavy. Not all account balances are included in the plan, and some funds that are distributed must be added back to determine the top-heavy fraction for a time. Here are some of those details:

- Distributions made to terminated employees within the one-year period ending on the plan's determination date are added back into the fraction. In-service distributions to working employees (such as hardship distributions and COVID-related distributions) are added back for five years.
- If an employee, whether key or non-key, has not performed services for the employer at any time during the one-year period ending on the determination date, that employee's account must be excluded. (This would apply for someone who has terminated employment but has not taken his or her account as a distribution.)
- If an employee, whether key or non-key, has worked at least one hour of service during the one-year period ending on the determination date, that employee's account must be included.
- Rollover contributions to the plan from an unrelated plan are not taken into account with respect to the recipient plan for purposes of determining whether the plan is top-heavy. So, when an employee joins the company and rolls over his or her balance from the prior employer's plan, that balance is ignored for top-heavy determinations. Rollovers from related plans, however (such as when the employer terminates a plan and its employees roll over their balances to the new replacement plan), are included in the top-heavy testing.
- Because terminated or frozen defined contribution plans have no contributions for the key employees, they generally do not need to provide top-heavy minimum contributions.

Top-Heavy Testing for Multiple Plans: All that Aggregation

When a single employer has more than one plan, the accounts of all the plans may need to be aggregated (that is, added together and treated like one big plan) for testing purposes. For this purpose, "employer" includes controlled groups and affiliated service groups under IRC sections 414(b), (c), and (m). These are companies that have sufficient common ownership and/or provide services commonly to the same clients or to each other that the law treats them like they were one company.

In general, all plans that have key employee participants must be added together for the top-heavy test. If the total accounts for all key employees added together equals more than 60% of the total of all aggregated plan accounts, the whole group of plans is top-heavy. Other plans without key employees *may* be aggregated with these plans if they help the key accounts fall under the 60% threshold (in which case, none of the plans is treated as top-heavy). This can get a little complex, so it is good to chat with your TPA about this.

IRS Correction Programs

If a plan fails to provide the top-heavy minimum contribution when it is supposed to, that problem is easy to correct. If the error was made within the past two plan years, the employer can self-correct by contributing the top-heavy minimum and lost earnings. If the error was made more than two years ago, the employer should consider full correction through the IRS's Voluntary Correction Program. If the problem is found when the IRS audits the plan, it may still be corrected using the IRS's Audit Closing Agreement Program, but there will be a sanction required to retain the plan's tax-qualification.

One More Thing …

If you have a defined benefit plan, the rules about how top-heavy minimum amounts are provided and how the top-heavy status of the plan is determined are very different. If you have both a defined benefit plan and a defined contribution plan, it's even more interesting. Check with your TPA to make sure the top-heavy contributions are being handled correctly.

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