PURPOSE

This transmits complete reprint with changes for IRM 4.72.5, Employee Plans Technical Guidance, Top-Heavy Plans.

BACKGROUND

This IRM provides guidance for examiners to determine whether a qualified Retirement plan is top-heavy and, if so, whether the plan meets the requirements for a top-heavy plan under IRC 416.

NATURE OF CHANGES

This transmittal reissues existing procedures in the new IRM format. IRM 4.72.5 replaces IRM 7.71 Chapter 5 using the same catalog number. These procedures have also been updated to include legislative and regulatory changes up to and including the Taxpayer Relief Act of 1997.

INTENDED AUDIENCE

TEGE (Employee Plans)

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4.72.5.1 (07-31-2001)
Overview

(1) These guidelines are provided for EP examiners with regard to whether:

a. a qualified retirement plan is top-heavy and, if so,
b. the plan meets the requirements for a top-heavy plan under IRC 416.

(2) This guideline reflects changes made by the Small Business Job Protection Act of 1996 (SBJPA).

4.72.5.1.1 (07-31-2001)
Technical Overview

(1) The top-heavy rules were added to the Internal Revenue Code by the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), P.L. 97–248, effective for plan years beginning after 12/31/83. To be qualified under IRC 401(a), a plan must contain provisions which meet the requirements of IRC 416 and which will become effective if the plan becomes top-heavy. See IRC 401(a)(10)(B).

4.72.5.1.2 (07-31-2001)
General Requirements

(1) A **defined benefit plan** is top-heavy if, as of the determination date, 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.

(2) A **defined contribution 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.

(3) A top-heavy plan must provide non-key employees with a minimum benefit if it is a defined benefit plan, or a minimum contribution if it is a defined contribution plan. See IRC 416(c).

(4) A top-heavy plan must also provide a special vesting schedule:

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

(5) The IRC 415(e) limitation on benefits and contributions for participants in both a defined benefit plan and a defined contribution plan may have to be adjusted down. See IRC 416(h) prior to its repeal for limitation years beginning after 12/31/99.

(6) Plans covering few employees are more likely to be top-heavy than plans covering a large number of employees. For example,

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

(7) 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 the allocations in the

key employees' accounts (or their benefit accruals) could cause them to have too great a share of the plan assets and result in a top-heavy plan.

(8) A top-heavy plan does not include a simple retirement account under IRC 408(p), for tax years beginning after 12/31/96.

4.72.5.1.3 (07-31-2001)
Examination Steps

(1) How these guidelines are used depends upon whether the plan under examination has received a determination letter and whether the Form 5500 indicates that the plan is top-heavy. A pension plan feature code of "H" on the Form 5500 shows that the plan is top-heavy (refer to Form 5500 instructions).

(2) If the plan received a determination letter, and code H of Form 5500 is not filled in (indicating the plan is not top-heavy), determine whether the plan is top-heavy. See 5.2. If the plan is top-heavy, determine whether the plan satisfies the top-heavy requirements. See 5.3.

(3) If the plan received a determination letter, and code H of Form 5500 is filled in (indicating the plan is top-heavy), refer to 5.3 to determine whether the plan satisfies the top-heavy requirements.

(4) If the plan did not 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, Determination of Qualification of Top-Heavy Requirements. Then follow the instructions at (2) or (3) above, based on whether code H appears on the Form 5500.

4.72.5.2 (07-31-2001)
Determining Top-Heavy Status

(1) Special top-heavy rules apply for Government, Collectively-Bargained and Multiple Employer Plans.

a. Governmental plans, under IRC 414(d), are exempt from the top-heavy rules. See IRC 401(a)(10)(B)(iii) and Reg. 1.416–1, Q. & A. T–38. (Hereinafter, all citations to "Q. & A" in the regulations promulgated under IRC 416 are deleted.)
b. 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. A collective-bargaining agreement is an agreement between employee representatives and one or more employers. See IRC 416(i)(4) and Regs. 1.416–1, T–3 and T–38.
c. A multiple employer plan is subject to the top-heavy rules on an employer by employer basis. If a portion of a multiple employer plan is top-heavy with respect to one employer, the top-heavy rules apply only to the employees of that employer. If the top-heavy rules are not in effect for the employees of that one employer, the entire multiple employer plan can be disqualified. See Reg. 1.416–1, G–2.

(2) Collectively-bargained plans should be tested for top-heaviness. A collectively-bargained plan may become top-heavy either on its own or

because it is part of a required aggregation group. If so, the plan will have to adjust (downward) the IRC 415(e) limits as required by IRC 416(h).

- "Employee representatives" do not include an organization more than half of the members of which are employees who are owners, officers, or executives of the employer. See IRC 7701(a)(46).

4.72.5.2.1 (07-31-2001)
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. Refer to the applicable question on Form 5500 to determine if this is a collectively-bargained plan. If yes, the plan must still be tested for top-heaviness because of the special rules under IRC 416(h) regarding the downward adjustment of the IRC 415(e) limits.

(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.

4.72.5.2.2 (07-31-2001)
Employer

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

a. The aggregation rules under IRC 414(b), (c) and (m) apply for IRC 416 purposes. See Reg. 1.416–1, T–1(b). Also, see Form 8388, Worksheet 10 on Affiliated Service Groups.
b. The recipient of the services of a leased employee within the meaning of IRC 414(n) is treated as an employer for top-heavy purposes.

4.72.5.2.2.1 (07-31-2001)
Examination Steps

(1) Determine whether the employer maintaining the plan under examination is a member of a controlled group of corporations; a partnership, proprietorship, trade or business under common control; or a member of an affiliated service group. Identify all of these aggregated employers.

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

4.72.5.2.3 (07-31-2001)
Determination Date

(1) Assessing whether a plan is top-heavy for a plan year is made as of the determination date for the plan year. The determination date for a plan year is—

a. the last day of the preceding plan year, or
b. in the case of a plan's first plan year, the last day of that plan year. See IRC 416(g)(4)(C).

(2) A plan (other than a plan in its first year) which becomes top-heavy will not have to satisfy the top-heavy rules in operation until the next plan year.

Example: An employer maintains Plan A, a defined contribution plan, in which key employees participate. For Plan A's plan year, a calendar year starting in 1994, the determination date is 12/31/93. 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 1994 calendar year.

4.72.5.2.3.1 (07-31-2001)

Examination Steps

(1) Find the plan's determination date. Use this date to determine the key employees and 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. See 4.72.5.2.6, Calculating the Top-Heavy Ratio.

(2) Check whether the plan complied with the top-heavy vesting and allocation rules in the following plan year.

4.72.5.2.4 (07-31-2001)

Key Employee

(1) There are a number of terms which comprise the definition of "key employee", e.g., officer, top ten owner, 10%, 5% or 1% owner. See IRC 416(i) and Reg. 1.416–1.

(2) The general rules which apply to a key employee are as follows:

a. Any employee who at any time during the plan year containing the determination date (the determination date year) or the four preceding years is an officer who meets a compensation threshold, one of the 10 largest owners of the employer who meets a compensation threshold, a 5% owner of the employer, or a 1% owner of the employer who meets a compensation threshold. See IRC 416(i).
b. Compensation includes elective deferrals under a qualified cash or deferred arrangement (CODA). See IRC 416(i)(1)(D).
c. The compensation received from each employer is aggregated under IRC 414(b), (c) and (m) to determine who is a key employee. See Reg. 1.416–1, T–20.

Example: You are examining a plan for the 1994 calendar year to determine whether it is top-heavy. The determination date for the 1994 plan year is 12/31/93. Individual A, an officer of the employer whose compensation exceeded the threshold limit, separated from service in 1989. Even though Individual A is no longer an employee of the employer, Individual A is treated as a key employee for purposes of determining whether this plan is top-heavy for the 1994 plan year. However, for purposes of determining whether the plan is top-heavy for the 1995 plan year, Individual A is not treated as a key

employee because five years have elapsed since Individual A performed any services for the employer.

4.72.5.2.4.1 (07-31-2001)
Officer

(1) An officer of the employer whose annual compensation, at any time during the determination date year or the four preceding plan years, is greater than 50% of the dollar limit on annual benefits under a defined benefit plan, at IRC 415(b)(1)(A), is a key employee. See IRC 416(i)(1)(A) and Reg. 1.416–1, T–12.

(2) 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. See Reg. 1.416–1, T–13.

(3) Officers (see Reg. 1.416–1, T–15) are in:

a. Corporations
b. Sole proprietorships
c. Partnerships
d. Trusts
e. Labor organizations

(4) An officer does not include an employee who meets any of the following requirements. See the flush language of IRC 416(i)(1)(A) and IRC 414(q)(5).

- Has not completed 6 months of service,
- Normally works less than 17 1/2 hours per week,
- Normally does not work more than 6 months in a year,
- Is less than age 21,
- Most employees covered by a collective bargaining agreement.

(5) There is no minimum number of officers that may be taken into account. The maximum number of employees who can be treated as officers for purposes of counting as key employees is 50, or, if lesser, the greater of 3, or 10% of the employees. 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 and the four preceding years. See IRC 416(i)(1) and Reg. 1.416–1, T–14.

4.72.5.2.4.2 (07-31-2001)
Top 10 Owner

(1) An employee who is one of the 10 largest owners of the employer, and whose compensation exceeds the IRC 415(c)(1)(A) dollar limit on annual additions to a participant's account in a defined contribution plan ($30,000 in 1994) at any time during the determination date year or the preceding four plan years is a key employee. See IRC 416(i)(1)(A)(ii).

a. If two employees own the same interest in the employer, treat the employee with the greater compensation as having a larger interest.

In this manner, the 10 largest owners in a company that is owned equally by more than 10 employees can be selected.

b. Use the constructive ownership rules of IRC 318 to help determine the 10 largest owners (and a 5% or 1% owner). In determining who is a top-10 owner (or a 5% or 1% owner), ownership is determined without aggregating any employers under IRC 414(b), (c) or (m).

4.72.5.2.4.3 (07-31-2001)
Five Percent Owner

(1) An employee who is a 5% owner of the employer at any time during the determination date year or the preceding four plan years 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. See IRC 416(i)(1)(B)(i).

4.72.5.2.4.4 (07-31-2001)
One Percent Owner

(1) An employee who is a 1% owner of the employer and whose compensation exceeds $150,000 at any time during the determination date year or the preceding four plan years is a key employee. (See IRC 416(i)(1)(A)(iv).

4.72.5.2.4.5 (07-31-2001)
Examination Steps

(1) Identifying all the key employees of the employer is necessary in determining whether the plan being examined is top-heavy and whether the plan must be aggregated with other plans of the employer in testing for top-heaviness. See 5.2.2. Identify all key employees of the employer, including those in the plan under examination and any other plans of the employer (as aggregated).

a. Determine the 5% and 1% owners of the employer.
b. Determine, as necessary, whether any employees who do not have the title of an officer have the authority of an officer.
c. Identify the 10 largest owners of the employer.
d. Determine whether any employees make elective deferrals under a CODA of the employer. Make sure the employer included these deferrals in compensation for purposes of identifying the key employees.
e. Request information to determine who the key employees of the employer were during the four preceding years.

4.72.5.2.5 (07-31-2001)
Aggregation of Plans

(1) To determine whether a plan is top-heavy, it must be aggregated with certain other plans of the employer. This type of aggregation is known as the “required aggregation group”. Under certain circumstances, an employer may use “permissive aggregation” to aggregate plans not part of a required aggregation group. See IRC 416(g)(2).

4.72.5.2.5.1 (07-31-2001)
Required Aggregation Group

(1) The "required aggregation group" is defined in IRC 416(g)(2)(A). It consists 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 plan of the employer which, during this period, is aggregated with a plan in which a key employee participates to meet the nondiscrimination regulations of IRC 401(a)(4) or IRC 410.

- Refer to the applicable question on Form 5500 to determine whether the employer aggregates plans for purposes of IRC 401(a)(4) or 410, other than for purposes of computing the average benefit percentage. Plans that are included in a testing group for purposes of running the average benefit percentage test for a particular plan are not members of that plan's top-heavy aggregation group.

(2) 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 covered no key employees. Similarly, if the required aggregation group is not top-heavy, no plan in the required aggregation group is top-heavy.

(3) 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). See Reg. 1.416–1, T–10.

a. Only one defined contribution plan need satisfy the minimum contributions requirement for any non-key employee who participates in more than one defined contribution plan in the required aggregation group. See Reg. 1.416–1, M–8 and T–10.
b. Only one defined benefit plan must satisfy the minimum accrual requirements for any non-key employee who participates in more than one defined benefit plan in a required aggregation group. See Reg. 1.416–1, T–10.

4.72.5.2.5.2 (07-31-2001)
Permissive Aggregation Group

(1) 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. Refer to the applicable question on Form 5500 to determine whether the employer permissively aggregates plans for purposes of IRC 401(a)(4) and 410. See IRC 416(g)(2)(A)(ii).

Example: An employer maintains Plan A which covers key employees as well as other employees and independently satisfies the requirements of IRC 401(a)(4) and 410. Assume that Plan A is top-heavy when tested on its own. The employer may permissively aggregate these plans in testing for top-heaviness, as long as the permissive aggregation group satisifes IRC 401(a)(4) and 410.
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. See IRC 416(g)(2) and Regs. 1.416–1, T-1(b) and (c), T-6, T-7, and T-9–11.

4.72.5.2.5.3 (07-31-2001)
Examination Steps

(1) Look at the applicable question on Form 5500 to determine whether the employer aggregates plans to satisfy IRC 401(a)(4) or 410.

(2) List all plans of the employer that contain key employees in the determination date year or any of the 4 preceding years.

(3) 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.

(4) 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.

4.72.5.2.6 (07-31-2001)
Calculating Top-Heavy Ratio

(1) 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 the employees under the plan. See IRC 416(g)(1).

(2) 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 under the plan for the key employees exceeds 60% of the PVAB under the plan for all employees.

a. If all defined benefit plans of the employer accrue benefits under the same method, determine the accrued benefits of employees using that accrual method.
b. If the plans of the employer 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). See IRC 416(g)(4)(F).

$$\text{Top-Heavy Plan} = \frac{\text{Accounts or Accrued Benefits of Key Employees}}{\text{Total of All Accounts or Accrued Benefits Under the Plan of All Employees}} > 60\%$$

4.72.5.2.6.1 (07-31-2001)
Calculating Present Value (PVAB)

(1) In a defined contribution plan, calculate the PVAB on the determination date. Add up 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 such year. See Reg. 1.416–1, T–24. Such contributions should also be taken into account for the second plan year.

(2) In a defined benefit plan, calculate the PVAB on the determination date by using the most recent valuation date within the 12 month period ending on the determination date.

a. The valuation date must be the same valuation date used for computing plan costs for minimum funding purposes.
b. The actuarial assumptions used for determining the present value of accrued benefits (PVAB) must be reasonable.
c. Withdrawal assumptions may not be used.
d. Present values should be based on a benefit payable at normal retirement age, and should not take into account pre-retirement death and disability benefits and post-retirement medical benefits.
e. The assumptions do not have to be the same as the assumptions used for minimum funding or for actuarial equivalence of optional benefits.
f. Any assumptions which reflect a reasonable mortality experience and an interest rate not less than 5% or greater than 6% will be considered as reasonable. Plans are not required to use an interest rate in this range.

(3) Subsidized early retirement benefits and subsidized benefit options are taken into account only if they are nonproportional subsidies, i.e., available to a group of employees that does not 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 Regs. 1.416–1, T–25, 26 and 27.

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

4.72.5.2.6.2 (07-31-2001)

Required or Permissive Aggregation Group

(1) 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 the plan years are not the same, aggregate the values for each plan year as of the determination dates for such plans that fall within the same calendar year. See 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. The two plans are a required aggregation group and are calendar year plans.

Plan A (DCP)		Plan B (DBP)	
Key Eees	**Accounts**	**Key Eees**	**Pres.Val. Acc. Ben.**
A	170,000	A	940,000
B	120,000	B	660,000

Non-Key Eee			
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
290000 ÷ 555999 = 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 accounts of the key employees in the defined contribution plan are 52% of the value of all the employees' accounts under the plan. The accrued benefits of the key employees in the defined benefit 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.

4.72.5.2.6.3 (07-31-2001)

Amounts Added or Excluded

(1) Distributions made within the 5-year period ending on the plan's determination date are added back in determining the accrued benefits or account balances of plan participants. See IRC 416(g)(3). If an annuity contract is distributed, the amount distributed is the current actuarial value of the contract determined on the distribution date plus any prior distribution within the 5-year period.

(2) If a key employee becomes a non-key employee, exclude the accrued benefit or account balance of that employee in determining whether the plan is top-heavy. This individual is referred to as a former key employee. See IRC 416(g)(4)(B) and Reg. 1.416–1, T–1(d).

(3) If an individual (key or non-key) has not performed services for the employer maintaining the plan at any time during the 5 year period ending on the determination date, exclude the accrued benefit or account balance of that employee in determining whether the plan is top-heavy. See IRC 416(g)(4)(E) and Reg. 1.416–1, T–1(d).

(4) Treat amounts rolled over or transferred between plans as part of the accrued benefit or account balance in the plan making the rollover or transfer, or in the plan accepting the rollover or transfer, in accordance with whether the rollover or transfer is unrelated or related.

4.72.5.2.6.3.1 (07-31-2001)
Related and Unrelated Rollovers

(1) 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.

a. This amount is treated as part of the accrued benefit or account balance in the plan accepting the rollover.
b. The amount is not treated as a distribution under the plan making the rollover and therefore is not counted as part of the accrued benefit or account balance in that plan for purposes of determining whether it is top-heavy.
c. A rollover or transfer made pursuant to the division of one plan into two, or the merger of two or more plans into one, is not treated as initiated by the employee. Refer to the applicable question on Form 5500 to determine whether plan assets were merged or whether plan assets were transferred to another plan. See IRC 416(g)(4)(A) and Reg. 1.416–1, T–32.

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

a. An unrelated rollover or transfer counts as a distribution under the plan making the rollover in testing for top-heaviness.
b. The unrelated rollover/transfer is not treated as part of an accrued benefit or account in the plan accepting the rollover in testing whether it is top-heavy.

4.72.5.2.6.4 (07-31-2001)
Terminated and Frozen Plans

(1) The determination of whether a terminated or frozen plan is top-heavy is the same as for any other plan. See Reg. 1.416–1, T–4 and T–5.

(2) 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). See Rev Rul. 89–87, 1989–2 C.B. 81.

a. The plan must be aggregated with other plans of the employer if it was maintained within the last 5 years ending on the determination date of the plan under examination, and would, but for the fact that it terminated, be part of a required aggregation group.
b. Distributions from the terminated plan which have taken place within the 5 years ending on the determination date are added back in determining 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. See IRC 416(g)(3) and Reg. 1.416–1, T–4. Refer to the applicable question on Form 5500 which indicates whether the plan was terminated in the current year or in a prior year.

(3) 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, even if no other accruals occur. However, no top-heavy minimum contribution is required if no key employee receives a contribution. See Reg. 1.416–1, T–5 and IRC 416(c)(2)(B).

4.72.5.2.6.5 (07-31-2001)
Simplified Top-Heavy Ratio Method

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

a. The employer overestimates the value of benefits for key employees and underestimates the value of benefits for non-key employees.
b. The employer considers only some non-key employees.
c. The employer uses imprecise data to determine the accounts of key employees.
d. The employer uses imprecise withdrawal assumptions in computing the top-heavy ratio.

4.72.5.2.7 (07-31-2001)
Examination Steps

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

(2) $\frac{\text{Key Employee Aggregate Balance}}{\text{Total Employee Aggregate Balance}} = \text{Top-Heavy Ratio}$

(3) If the top-heavy ratio is considerably greater than 60%, the plan is top-heavy. If the top-heavy ratio is near 60%:

a. Add in all distributions made to employees within the 5 year period ending on the determination date.
b. Exclude the account balances, accrued benefits and distributions of former key employees.
c. Exclude the account balances, accrued benefits and distributions of employees who have not performed services for the employer at any time during the 5 year period ending on the determination date.

4.72.5.3 (07-31-2001)
Top-Heavy Allocations

(1) A minimum contribution (in a defined contribution plan) or minimum benefit (in a defined benefit plan) must be allocated to the account of a non-key employee who is a participant in a top-heavy plan, in accordance with the top-heavy rules.

(2) If non-key employees have been excluded from the plan because compensation is less than a stated dollar amount, they must accrue a minimum benefit.

4.72.5.3.1 (07-31-2001)
Top-Heavy Minimum Contributions

(1) If a defined contribution plan is top-heavy, the employer must make a contribution to each non-key employees' account who is a plan participant equal to at least 3% of the participant's compensation.

a. Forfeitures allocated to a participant's account are included in determining whether a 3% minimum contribution has been made, but elective contributions are not.
b. 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%.
c. The minimum contribution cannot be reduced due to social security contributions.

(2) If the required aggregation group includes a defined contribution plan and a defined benefit 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%. See IRC 416(c)(2) and Reg. 1.416–1, M–7.

Example 1: Plan A is a top-heavy plan. The largest percentage contribution made on behalf of a key employee during the 1994 plan year is to Employee M. Employee M's compensation is $269,000. The employer makes a contribution of $6,000 to Employee M. Because Employee M's compensation is limited to $150,000 for contribution purposes by IRC 401(a)(17), the percentage contribution made on behalf of Employee M is 4% (6,000 ÷ 150,000 = 4%). Each non-key employee must receive a contribution equal to 3 % of compensation.

Example 2: The facts are the same as the Example above, except that the employer makes a contribution of $3,000 to Employee M in 1994. The percentage contribution made on behalf of Employee M is 2% (3,000 + 150,0000 = 2%). Each non-key employee must receive a contribution equal to 2% of compensation.

(3) 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. See Regs. 1.416–1, T–10, M–8 and M–12.

4.72.5.3.1.1 (07-31-2001)
Benefits for Non-Key Employees

(1) A top-heavy defined contribution plan **must** provide a minimum contribution to each non-key employee who has not separated from service at the end of the plan year. See Reg. 1.416–1, M–10. This includes non-key employees who—

a. are participants but fail to complete 1000 hours of service for an accrual computation period.
b. have satisfied the plan's eligibility requirements even if the employees have not received any contributions for several years.

c. were excluded from plan participation because the—(i) employees' compensation was below a stated amount; (ii) employee made no elective deferrals to a IRC 401(k) plan; or (iii) employee made no mandatory employee contributions.

(2) Thus, top-heavy minimums may have to be provided to part-time employees.

4.72.5.3.1.2 (07-31-2001)
CODA Rules

(1) 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 taken into account in determining the contribution percentage of a key employee.** See Reg. 1.416-1, M-20.

(2) A qualified nonelective contribution (QNC) is treated as a contribution for purposes of the minimum contribution requirement. (A QNC 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.) See Reg. 1.416-1, M-18.

(3) Matching contributions allocated to key employees are treated as employer contributions for purposes of determining the contribution percentage of a key employee. A plan can use matching contributions to non-key employees to satisfy the minimum contribution requirement, but if used to satisfy the top-heavy minimums they cannot be used in the ADP or ACP test. See Reg. 1.416-1, M-19.

(4) For years beginning before 1-1-98, Reg. 1.415-2(d) defines compensation as excluding amounts contributed to a defined contribution plan. In the case of elective contributions under an IRC 401(k) plan, the required minimum contribution is based on an employee's compensation excluding the elective deferral. See Reg. 1.416-1, T-21. For years beginning after 12-31-97, IRC 415(c)(3)(D) defines compensation as including an elective deferral under IRC 402(g)(3). Therefore, in the case of elective contributions under an IRC 401(k) plan, the required minimum contributions is based on an employee's compensation including the elective deferral.

4.72.5.3.1.3 (07-31-2001)
Examination Steps

(1) In 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.

(2) Check whether the employer has made a minimum contribution to the non-key employees in a top-heavy defined contribution plan. If there is more than one defined contribution 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.

(3) Make sure non-key employees 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.

(4) Check that the minimum contribution is properly computed. Test check to make sure elective deferrals by non-key employees were not counted as minimum contributions.

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

4.72.5.3.2 (07-31-2001)

Top-Heavy Minimum Accrued Benefits

(1) A top-heavy defined benefit 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 5 (called the testing period) multiplied by the lesser of 2% times years of service, or 20% (the applicable percentage). See IRC 416(c)(1).

Example: Employee M, a non-key employee, has been a participant in Plan A for 5 years, during which time it was top-heavy. Employee M's average annual compenstion 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 participation)).

(2) The defined benefit plan minimum is not satisfied if a plan provides 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). See 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 defined benefit plan. The plan provides that the normal retirement benefit is equal to the greater of the plan's projected formula or the project minimum benefit. The plan provides for the accrual or 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%.

(3) In determining the applicable percentage, a defined benefit plan may disregard a year of service—

a. that ends in a plan year beginning before 1/1/84;
b. if the plan was not top-heavy for any plan year ending in that year of service. See IRC 416(c)(1)(C)(ii).

(4) For purposes of determining the years in the testing period, a plan can disregard a year of service—

a. that ends in a plan year beginning before 1/1/84;
b. in which the employee did not participate in the plan; or

c. that begins after the close of the last year in which the plan was top-heavy. See IRC 416(c)(1)(D)(iii). But if a plan is top-heavy in year 1, not top-heavy in year 2, and top-heavy in year 3, the compensation earned in the intervening year is included in the testing period.

(5) If a non-key employee in a plan has accrued benefits due to employer contributions in non-top-heavy years, these accruals count in determining whether the minimum accruals were received in a top-heavy year. See Reg. 1.416–1, M–2(e).

4.72.5.3.2.1 (07-31-2001)
Benefits for Non-Key Employees

(1) Each participant in a top-heavy defined benefit plan with at least 1000 hours of service in a plan year **must** receive a minimum benefit. See Reg. 1.416–1, M–4.

(2) A non-key employee must receive a minimum benefit even if the employee—

a. was not employed on a specific date; or
b. is excluded from participation because the employee did not make mandatory employee contributions <>

Example: Employer M maintains Plan X, a defined benefit plan. Plan X requires employees to contribute at least 3% of compensation in order to participate. Employee A does not make any contributions to Plan X in the 1995 plan year, and consequently is not a participant. Employee A has more than 1000 hours of service with Employer M in 1995. Plan X is top-heavy in 1995. Employee A must receive a top-heavy in 1995. Employee A must receive a top-heavy minimum accured benefit for 1995 because Employee A has more than 1000 hours of service for Employer M in 1995.

4.72.5.3.2.2 (07-31-2001)
Examination Steps

(1) Test check to make sure that non-key employees in a top-heavy defined benefit plan who had 1000 hours of service or more received the minimum benefit.

(2) Remember a plan may compute the minimum benefit based on a non-key employee's years of participation in the plan, rather than years of service with the employer.

(3) Test check to determine whether non-key employees in a top-heavy defined benefit plan who did not participate because they did not make mandatory employee contributions receive the minimum benefit.

4.72.5.4 (07-31-2001)
Additional Allocation Rules

(1) Special top-heavy rules apply when an employer maintains, and employees participate in, both a defined contribution plan and a defined benefit plan, which are top-heavy. Safe harbor rules for calculating top-heavy minimums and IRC 415 limits are available.

4.72.5.4.1 (07-31-2001)
Safe Harbor Top-Heavy Minimums

(1) A non-key employee who participates in **both** a top-heavy defined contribution plan and a top-heavy defined benefit plan maintained by the same employer need not receive both a defined contribution and defined benefit minimum, but should receive more than just a 3% contribution to the defined contribution plan. See IRC 416(f).

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

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

4.72.5.4.2 (07-31-2001)
IRC 415 Rules

(1) In general, IRC 416(h)(1) provides, for limitation years beginning before 1/1/2000, an adjustment to the IRC 415(e) limits for any employee who participates in a defined benefit plan and a defined contribution plan maintained by the same employer that are top-heavy. See IRC 416(h)(2). Section 416(h) has been repealed for limitation years beginning after 12/31/99.

a. The dollar limits in the denominators of the defined benefit plan fraction and the defined contribution plan fraction are computed by substituting 1.0 for 1.25, thereby reducing the maximum contributions.
b. However, if the plan is not “super top-heavy,” the 1.25 factor in the denominator of the IRC 415(e) fraction can be used if the plans provide an extra minimum benefit or contribution.

4.72.5.4.3 (07-31-2001)
Extra Top-Heavy Minimums

(1) In a defined benefit plan, the extra minimum benefit for non-key employees increases the applicable percentage from 2% of compensation per year to 3% a year. The overall cap on the minimum accrued benefit is increased from 20% of compensation to 20% of compensation plus one percent for each year of service with the employer (up to 10 years).

(2) In a defined contribution plan, the extra minimum contribution for non-key employees increases the employer’s contribution from 3% of compensation to 4%.

(3) A plan is super top-heavy if the sum of the PVAB for key employees under the defined benefit plans and/or the sum of the account balances of the key employees under the defined contribution plans are greater than 90% of the amount for all plan participants.

Example: Employer N maintains Plan A, a top-heavy defined benefit plan, and Plan B, a top-heavy defined contribution plan. These plans are not super top-heavy. Both plans use the 1.25 factor to compute the dollar limits for the defined benefit and defined contribution plan fractions. Plan A and Plan B provide extra minimum contributions and benefits to non-key employees. Employee M, a non-key employee, has been a participant in Plan A for 5 years. Employee M's average annual compensation for those 5 years was $30,000. Employee M's minimum pension must be $4,500 ($30,000 x (3% x 5 years of participation)).

4.72.5.4.4 (07-31-2001)

Safe Harbor Extra Top-Heavy Minimums

(1) A top-heavy plan which retains the 1.25 factor in the denominator of the IRC 415(e) fraction must provide extra top-heavy minimums. A non-key employee who participates in both a top-heavy defined contribution plan and a top-heavy defined benefit plan maintained by the same employer need not receive both defined contribution and defined benefit extra minimums. Instead, Reg. 1.416–1, M–14 provides alternative safe harbor methods providing extra top-heavy minimums to non-key employees who participate in both plans. (These are adjustments to the methods described at Reg. 1.416–1, M–12).

(2) The four alternative safe harbor methods for IRC 415 purposes are as follows:

1. Only the defined benefit plan provides the minimum benefit, which is increased to 3% for each year of the employee's service (up to 10 years).
2. A floor offset arrangement under which the above defined benefit minimum is offset by the benefits under a defined contribution plan.
3. A comparability analysis under which the defined contribution and defined benefit plans together provide a benefit at least equal to the above defined benefit minimum.
4. A defined contribution plan that provides contributions and forfeitures equal to 71/2% of the non-key employee's compensation.

4.72.5.4.5 (07-31-2001)

1.25 Factor

(1) A plan can continue to use the 1.25 factor in the denominator of the IRC 415(e) fraction for a participant even if the plan is super top-heavy or does not provide the extra top-heavy contributions or benefits, as long as there are no further employer contributions or forfeitures to a defined contribution plan, or accruals under a defined benefit plan for that individual. See IRC 416(h)(3).

(2) Accruals may resume for an employee covered by both types of plans when the IRC 415(e) fraction for the employee is less than 1.0, using the 1.0 factor in the denominators instead of 1.25. See Reg. 1.416–1, T–33.

Example: Employer M maintains Plan A, a defined contribution plan, and Plan B, a defined benefit plan. Both plans are top-heavy. Employee N is a participant in Plan A and Plan B. The plans use the 1.25 factor in the denominators of the IRC 415(e) fraction and provide for extra

minimum contributions and benefit accruals for non-key employees. The plans became super top-heavy in the 1994 plan year and retained the 1.25 factor. Employee N's aggregate accrued benefits and annual contributions under Plan A and Plan B exceed 1.0 where the 1.0 factor is used in the denominator of the IRC 415(e) fraction. No further accruals or annual additions under the plans are permitted for Employee N until the IRC 415(e) fraction for Employee N is less than 1.0, using the 1.0 factor in the denominators instead of 1.25.

4.72.5.4.6 (07-31-2001)
Examination Steps

(1) Determine whether any non-key employees are covered under both a top-heavy defined contribution plan and a top-heavy defined benefit plan of the same employer. Check the plan to see what minimum contributions and benefits it provides those non-key employees.

(2) Check whether they receive one of the four safe harbor minimums specified in the plan.

(3) Test check to determine whether annual additions for employees covered under both a top-heavy defined contribution plan and a top- heavy defined benefit plan of the same employer are based on an IRC 415(e) fraction that uses a reduced factor of 1.0 in the denominator to determine the dollar limit.

(4) If you find that an unreduced factor of 1.25 is used, make sure the combined defined contribution and defined benefit plans are not super top-heavy and that the non-key employees receive the extra top-heavy minimums.

(5) Determine whether non-key employees who participate in both a top-heavy defined contribution plan and a top-heavy defined benefit plan of the same employer which use a factor of 1.25 receive one of the four safe harbor extra minimums specified in the plan.

4.72.5.5 (07-31-2001)
Top-Heavy Vesting

(1) 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. See IRC 416(b)(1)(A) and (B).

(2) Top-heavy vesting applies to all amounts contributed or accrued in a plan, even though accrued prior to the plan becoming top-heavy.

a. The rules apply to an employee who has at least one hour of service after the plan becomes top-heavy.
b. It does not apply to an employee who has no 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 provides for a 3–year vesting schedule in a year in which it is top-heavy. Plan X became top-heavy in the plan year beginning 7/1/94. Employee A became a plan participant

on 8/1/91, and terminated service on 8/15/94 with 280 hours of service during the top-heavy plan year. Employee A becomes 100% vested in his/her accrued benefit under the top-heavy vesting schedule because Employee A had hours of service in the plan year in which the plan became top-heavy.

(3) When a top-heavy plan ceases to be top-heavy, the vesting schedule can be changed to a normal vesting schedule. See Reg. 1.416–1, V–7 and IRC 411(a)(10).

a. 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 cannot be reduced.
b. Any employee with three or more years of service must be given the option to remain under the top-heavy vesting schedule.

4.72.5.5.1 (07-31-2001)

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.