



Advanced Top Heavy Testing and Plan Design

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Agenda

- Top Heavy Plans Background
- Key Employees
- Account Balance on Determination Date
- Aggregation of Plans
- Minimum Vesting, Minimum Benefits
- Plans Exempt from Top Heavy Rules
- Safe Harbor 401(k) and Top Heavy Rules, FAQs
- What Is Working on Last Day of Year?
- EPCRS and Corrections
- Other Issues
- Top Ten Top Heavy Mistakes

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Top Heavy Plans - Code Section 416

- Code Section 401(a)(10) requires all qualified plans to satisfy Section 416
 - Top-heavy rules are found in Code Section 416 and the 1.416 regulations
- Top heavy test must be run every year
 - If a plan is top heavy it must meet additional qualification requirements
 - Plan can be top heavy one year and not top heavy the next
- Top heavy plans are constantly on the IRS most common plan failures list

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When is a plan Top Heavy?

- DC Plan: When more than 60% of the account balances are attributable to the “key” employees
 - Primarily benefit officers and owners (key employees)
- DB Plan: When more than 60% of the present value of the cumulative accrued benefits in the plan is for the key employees

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Top Heavy Test

- ▶ If the balance attributed to the key employees exceeds 60% of the aggregate plan balance, the plan is top heavy. Code Section 416
- ▶ There is no de minimis amount in the code. Example:
 - On Dec. 31, 2013, keys balance → \$433,050; plan balance → is \$720,900.
 - Keys → 60.07% of plan balance, plan is top heavy for 2014.
 - A little can make a big difference,
 - If keys had \$575 less (and the non-key \$575 more) and the plan balance had been the same, the plan would have not been top heavy with a ratio of 59.997%.

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Managing Employer Expectations for Plans That May Be Top Heavy

- **When selling new prospects a retirement plan that may become subject to the top-heavy rules, it is critical to explain the top-heavy requirements.**
- **A sales force should set the proper expectations for the employer by informing them of the:**
 - **Costly consequences of becoming top heavy**
 - **Attribution and Aggregation Rules Apply**
 - **Alternate plan design options to avoid top heavy contributions such as safe harbor 401(k) and the SIMPLE plan.**

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Managing Employer Expectations for Plans That May Be Top Heavy

- ▶ **Potential for being top heavy → plans with:**
 - **< 25 participants: most likely to be top heavy**
 - **25 to 50 participants: less likely**
 - **50 to 100 participants: even less likely**
 - **>100 participants: least likely, but it still happens**
 - **The above generalizations are dependent on:**
 - **Demographics i.e. number of key employees**
 - **Amount contributed by key employees**

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Key Employees

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Key Employees Three Categories

- **Top Heavy testing purposes only**
- **Key → Any of Three categories**
 1. **5% Owner* (owns more than 5%)**
 2. **Officer Earning More Than \$170,000**
 3. **1% Owner* (Owns more than 1%) and earns more than \$150,000**
 - If an employee is in any one of the above categories during the year ending on the determination date → a key employee.
- All other employees are “non-key”

* Stock attribution is applicable

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Key Employees Stock Attribution – Tax Code 318(a)

- An employee is deemed to own the stock that is owned by certain family members:
 - Spouse; Parents; Children (including legally adopted) and Grandchildren

Notes:

- There is no attribution among siblings
- Grandpa owns grandson's shares. Grandson does not own Grandpa's shares
- For determining Key EE and HCEs, Code Sec. 318(a) has no age limit on children for attribution.
 - Code Sec. 1563 attribution for children under age 21 is for controlled groups. Over age 21 only if more than 50%.

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Key Employees

- **5% Owner* (owns more than 5%)**
 - EE owns more than 5% of the outstanding stock of the corporation, or stock possessing more than 5% of the total combined voting power of all stock of the corporation, (or related employer) at any time during the relevant plan year. No minimum compensation required
- **1% Owner* (owns more than 1%)**
 1. EE owns more than 1% of the outstanding stock of the corporation, or stock possessing more than 5% of the total combined voting power of all stock of the corporation (or related employer), at any time during the relevant plan year. and
 2. EE annual compensation exceeds \$150,000
 - a. \$150,000 is not indexed to COLAs.

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Key Employees Officer Test

- Officers earning > \$130,000.
 - COLA applies, increments of \$5,000
 - \$170,000 for 2014
 - \$165,000 for 2013
 - Maximum Number of Officers*:
 - Greater of 10% or 3, capped at 50
 - > 500 employees → Maximum of 50 officers
 - 30 - 500 employees → Max. 10% of EEs as officers
 - < 30 employees → Maximum of 3
 - If more than the maximum, then rank by compensation
 - If number needs to be rounded, round it up
- * When using 10% cap, disregard the same employees disregarded under the top-paid group election

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Key Employees Officer Test

For 10% limit, disregard the following employees:

- Less than 6 months of service
 - Part timers
 - Seasonal Employees
 - Under age 21
 - Nonresident aliens
 - Union Employees
- Then rank remaining employees in compensation order and use the top 20%.
 - If more than 10%, start with those with the highest compensation and stop at 10%.

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Key Employees Compensation

- Compensation for key employee determination is 415 compensation with deferrals included.
- Compensation from all related employers is taken into account.
 - Employee with \$76,000 from one controlled group member and \$92,000 from another are added together for the key employee test. i.e. \$168,000

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Key Employees Related Employer

- Ownership not aggregated
 - EE owns 3% of A and 4% of B → does not equal a 5% owner
 - EE owns 5.7% of D and 0% of H → a 5% owner
- Compensation is aggregated
- Employee count aggregated

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Key Employees Acquisition or Disposition of Entity

- No IRS guidance on key EE determination when new related group member added in year
 - Transition rule for coverage but no such rule exists for determining key EEs.
- Best practical solution:
 - Use determination year as reference point:
 1. If companies related during determination date year, treat as one employer
 2. If companies are not related during the determination date year, treat as unrelated.

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Key Employees Acquisition of Entity

- Best practical solution when adding a new related group member during plan year:
 - Treat all firms as one employer, including the newly added firm for applying the key EE tests
 1. Ownership and Officer tests:
 - Ownership or officer in any member of the related group considered for key EE
 - Including prior year when not related
 - Ownership not aggregated, ownership in any member taken into account for key EE status for all related members

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Key Employees Acquisition of Entity

2. Compensation for key status
 - Compensation from any of the related group should be counted, including for a determination year prior to being in the related group.
 - Compensation aggregated among related members, even compensation before a related group member

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Key Employees Disposition of Entity

- As a best practice, as there is no guidance:
 - For the year of disposition, the companies should be treated as related -- as was done for an acquisition.
 - Once beyond the year of disposition, these are separate unrelated entities

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Key Employees Asset Sale

- As a best practice, as there is no guidance:
 - If there is a severance of employment, then disregard prior employer info, i.e. compensation, officer and ownership
 - If plan “maintained” by new employer, then treat as employee’s similar to stock acquisition

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Key Employees Severance of Employment

Q. How long does a key employee remain a key employee after severing from service?

– 1 year, or 5 years, or ?

A. Until the key has not been a key for an entire plan year that includes a determination date, (example on next slide)

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Key Employees Severs Service Example

- Key employee severs service June 23, 2012.
- For the 2013 year:
 - Top heavy test based on the 12-31-12 determination date.
 - He would still be key for 2013: due to earned income during 2012.
 - Balance stays in 12-31-12 test as key ee
- For the 2014 year:
 - Top heavy test based on the 12-31-13 determination date.
 - He would no longer be key: he had no earned income during the 2013 year.
 - Balance drops out of 12-31-13 test, as no income in 2013

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Former Key Employee Example

- Jim owns 15% of Alaska Tanning Salon
 - Jim has no ownership via attribution
- January 12, 2012, Jim sells his entire 15% to an unrelated individual
 - As of December 31, 2012, Jim is a 5% owner and a key employee.
 - Jim's Key EE balance is included on the determination date of December 31, 2012.

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Former Key Employee Example

- **Jim works in 2012 and 2013.**
- **Jim is a former-key employee for the entire 2013 plan year and thus:**
 1. **Jim's benefits earned as a Key EE are excluded from Dec. 31, 2013 determination date balance.**
 2. **Distributions Jim took over the last 5 years are excluded from the determination date balance.**
 3. **Plan year 2013 contributions made for or by Jim, a former-key employee, are excluded from the determination date balance on Dec. 31, 2013.**

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Change in Status of Key EE Due to Compensation Change

- 3% owner → \$190,000 comp. → Dec. 31, 2013.
- 3% owner → \$120,000 comp. → Dec. 31, 2014
- For 2013, satisfies 1% owner rule
- For 2014, does not satisfy 1% owner rule
- A key employee in 2013 and a non-key in 2014.
- According to code sec. 416(g)(4)(B), a non-key employee's benefit is completely disregarded if formerly was a key EE

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Change in Status of Key EE Due to Compensation Change

- So for Dec. 31, 2013, determination date, the 3% owner is included as a key employee
- For the Dec. 31, 2014 determination date, the 3% owner's entire benefit is excluded from the determination date balance.

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Testing Period for Key Employee

- Testing period for determining a key employee is the year including the determination date.
 1. Balances belonging to key employees for the top heavy determination is based on who is a key employee on the determination date or any day in the year ending on the determination date
 2. For purposes of providing the top heavy allocation, the question is whether to use the same definition as in one, or look to who is a non-key employee in the year in which the allocation is to be made

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Testing Period for Key Employee

- So, who is a non-key for top heavy allocation?
- Prevailing view:
- Use the same definition to both determine who is a key employee and to allocate TH benefits
 - Uniformly determine for calculating TH status and identifying non-keys for TH allocation
- Example on next slide

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Testing Period for Key Employee

- Mary is a non-key participant for 6 years
- In 2013, Mary becomes an officer with enough compensation to be a key-employee.
- As of Dec. 31, 2012, Mary had \$95,000 in plan
- Mary's balance is included as a non-key on the Dec. 31, 2012 determination date for the 2013 TH determination.
- Is Mary entitled to top heavy allocation for 2013?
- Yes, because she was not a key employee in the determination date year.
- For 2014, Mary would be a key and not entitled to the TH allocation.

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Testing Period for Key Employee

- Joe is hired in May of 2013 and enters the plan July 1, 2013. Joe buys 10% of the firm in 2013.
- Joe had no balance on Dec. 31, 2012 and is not a key employee during 2012.
- Does Joe receive a top heavy allocation for 2013?
- Yes, based on his not being a key employee in 2012 and on his having no key employee balance on Dec. 31, 2012.
- For 2014, Joe is a key employee and his balance on Dec. 31, 2013 is included as a key employee.
- IRS Prototype language uses this approach

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Testing Period for Key Employee

- Less prevalent view
- Use different period for TH allocation/benefit purposes
 - Key employee for determination date for purposes of determining if plan TH
 - Determine who is a key employee as of the end of the year the allocation is to be made to see whether a TH benefit is to be provided.

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Testing Period for Key Employee

- Less prevalent view
- Prior Example using Mary
 - She became a key during 2013 but was not on Dec. 31, 2012
 - Under the less prevalent view, Mary would not receive a TH benefit in 2013 because she became a key during 2013.
- Prior example using Joe who was hired in 2013 and bought 10%
 - He would not receive a TH benefit in 2013.
- *Beware terms of plan document!*

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Differences Between Key and HCE

- All categories of key require ownership or officer status
 - There is no key based only on compensation, there is for HCEs
- There is no 1% owner HCE, nor is there an officer HCE
- Testing period
 - Key based on one year, i.e. the determination date year
 - HCE 5% owner based on current or prior year
 - HCE compensation based on look back year

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Account Balance on Determination Date

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Determination Date

- Last day of preceding plan year
 - December 31, 2013 is the determination date for the 2014 TH test
 - Exception: Last day of first plan year
 - New plan effective Jan. 1, 2014 → determination date → December 31, 2014
 - Note: DB plans use the valuation date (may not be last day of year)

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Account Balance

- ▶ **For TH test, the account balance includes:**
 - **Employer contributions**
 - 1. Profit Sharing Plans → cash basis
 - First plan year only on accrual basis
 - 2. Money Purchase plans → accrual basis
 - **Voluntary or Required After-Tax**
 - » **But not deemed IRA or VDEC**
 - **Rollover prior to January 1, 1984**
 - **Related Rollover after January 1, 1984**
 - **Investment Earnings**
 - **Forfeitures**
 - **Distributions (see next slide)**

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Distributions

- Within one year of “determination date”
 - Severance
 - Death
 - Disability
- Example
 - December 31, 2014 determination date must include all distributions made during 2014.

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In-Service Distributions – Five Year Look back Rule

- In-service distributions from the last FIVE years are added back
 - These include: Hardships, Excess Deferrals, Excess Contributions, Excess Aggregate Contributions
- When performing the 2014 top-heavy test
 - Add to the Dec. 31, 2013 determination date balance:
 - in-service, hardship and corrective distributions for:
 - 2013, 2012, 2011, 2010 and 2009
- Plan design issue: Beware takeover plans and plans acquired through acquisition

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Example

- **A participant terminated employment and received a full distribution in March 2014. The person was rehired in September 2014. Should the termination distribution the participant received be added back in for the December 31, 2014, top heavy determination?**
- Regulations state that all distributions made in the five-year look back period — other than those for severance, death, or disability — are to be added to the determination date account balance.
- Since this was a distribution due to severance from employment, the amount would ordinarily *not be added back*. (The fact that the employee was rehired did not change the severance distribution reason.)
- But, because the determination date is within one year of the date of distribution, the amount *should* be added back in.
- Note: Employers must be careful to comply with the restrictive distribution rules for 401(k) plans. A severance from employment that is *not bona fide* will result in possible plan disqualification and penalties.

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Former Employees Who Leave a Balance in the Plan - Example

- **Key employee, Jon, terminated service July 31, 2012 and left his balance of \$500,000 in the plan.**
 - **2013 TH test using Dec. 31, 2012 determination date, includes \$500,000, as Jon worked in 2012**
- **Jon still owns 15% of the company, but for 2013, he is not an employee as he did not work during 2013.**
 - **2014 TH test using the Dec. 31, 2013 determination date, excludes the \$500,000**

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Aggregation of Plans

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Aggregated Plans Required Aggregation Group

- Required Aggregation Group → General Rule:
 - If the employer maintains more than one plan, the top heavy ratio is based on an aggregate of the plans not on a plan-by-plan basis.
- The required aggregation group:
 1. Any plan covering at least one key employee
 - (does not have to be the same key employee), AND
 2. Plans that are combined with a plan in the first bullet to pass 410(b) coverage or 401(a)(4) nondiscrimination testing

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Aggregated Plans Permissive Aggregation

- A plan of the same Employer – without a key employee – that is voluntarily permissively aggregated; provided the plans can still pass coverage and nondiscrimination aggregately
- Once aggregated all are either TH or not

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Aggregation and 401(k) Plans

- A 401(k) plan with deferrals, matching and profit sharing contributions
 - Each part may be disaggregated for coverage and nondiscrimination testing
 - However, since all three (PS, deferrals and match) are in the same plan, all three *must be together for top heavy testing*
 - **if profit sharing is a separate plan from the 401(k) and (m) plan and there are no key employees in 401(k) or (m) plan, then the two plans would not be required to be aggregated**

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Aggregation and SEP

- A SEP plan must be aggregated with a qualified plan for top heavy determination
 - Employer may count SEP balances on basis of employer contributions, if records available
 - IRC §416(i)(6)(A) treats SEP IRAs as defined contribution plans for top-heavy purposes

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Aggregation and Related Employers

- Control group members or affiliated service group members are treated as a single employer for top heavy purposes
 - For required aggregation group purposes, all the plans are taken into account

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IRS CPE Controlled Group Manual 2013

- All employees of the members of the controlled group are considered together in identifying key employees. For example if an employee is a 9% owner in one company and a 1% owner in the other member of the controlled group, that employee is considered a key employee since they have met the 5% ownership test in the first company.
- The employers must aggregate all years of service and compensation earned by organization within a controlled group for purposes of:
 - Top-heavy minimum vesting
 - Top-heavy minimum contributions and benefits
 - Determining if a plan is top-heavy
- http://www.irs.gov/pub/irs-tege/2013cpe_related_employers.pdf

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Aggregation Union Plan and Non-union Plan

- If a union has a key employee,
 - it must be aggregated with employer's non-union plan
- If TH minimum contribution or TH vesting required, they do not have to be applied to the union employees
 - However, plan document may provide for top heavy contribution or vesting
- If the union plan has no key employee,
 - it may be permissively aggregated, provided it would not cause the plan to fail coverage or nondiscrimination

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Aggregation Union and Non-union in the Same Plan

- Union must be part of required aggregation group, even if only non-union has a key employee
 - If plan is top heavy, the TH contribution and vesting need not be provided to union employees.

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Minimum Vesting

Minimum Benefits

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Vesting Issues

- Must meet one of the following schedules:
 - 2/20 graded, or
 - 3 year cliff
 - *For DC plans,*
 - Since 2007, this is the only game in town
 - *For DB plans:*
 - Use of 5 year cliff or 7 year graded permitted, unless plan becomes TH.

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Minimum Allocations

- DC Plans: All non-keys get lesser of:
 - 3% of compensation, or
 - Highest % allocation to a key employee
- Example
 - Highest benefiting key defers 6% to a 401(k) Plan
 - All eligible non-key employees must receive at least 3% allocation
 - A deferral for a key employee will count as an accrual to trigger TH contributions!

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Who Gets the Allocation

- All non-key employees in a DC plan employed on last day of the plan year
- Does not matter if they have 1000 hours of service
- Do not have to give to participants who are terminated employees no matter how many hours worked during year

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TH Allocation Requirement Example

- A-1's PS Plan NEC allocation requirements: 1000 hours & last day.
 - Elle is a non-key employee who is an eligible participant employed at year-end.
 - Elle only has 750 hours of service.
 - Elle is not eligible for NEC, but she must receive the 3% TH contribution (as a key deferred 4%).

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Rollovers Before Participation Date

- Plan provisions can permit rollover by employee before becoming a participant
 - Rev. Rul. 96-48 such employees referred to as limited participants until they meet the plan's eligibility requirements.
 - Rev. Rul. 96-48 states that limited participants are not considered participants for top heavy purposes and thus are not entitled to top heavy allocation until meeting plan's eligibility.
 - Plan may be more generous and provide top heavy anyway.
 - Check your plan document

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Examining What a TH Contribution Is?

- Is it a NEC contribution?
 - Yes, sort of
- Is there an allocation formula?
 - Sort of. The total DC TH allocation formula will be no more than 3% of 415 compensation, based on if a key put in 3% or more.
- May employer NEC and matching contributions be used to satisfy TH contribution?
 - Yes
- Is the TH the profit sharing contribution?
 - It can be
- Can the plan document call for the TH to be satisfied by a NEC and matching? And if not sufficient, then the remainder will be added to fulfill the TH allocation requirement?
 - Yes
- Does match have to be used to satisfy TH?

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Beware Dual Eligibility

- If someone is eligible for ANY part of the plan, then they are eligible for TH
- Example
 - Plan has immediate eligibility to defer
 - One year wait for match and NEC
 - Participant hired July 15, 2014 is eligible to defer, thus:
 - entitled to 2014 TH, provided employed on last day of plan year
 - even though not eligible for match or NEC!!
- IRS 401(k) Questionnaire reflected 1 year eligibility to defer in > 50% of the plans



Key Employee Top Heavy Allocation

- Plans may be designed to provide the top heavy allocation to only non-key employees
 - This still satisfies the top heavy allocation rules
- Plans may be designed to provide the top heavy allocation to all eligible employees
 - This would include the keys

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Compensation for Allocation

- Use **ALL compensation** for year to calculate the top heavy allocation
 - Do not net out deferrals
 - Do not reduce by any exclusions to compensation in the document
 - Use full year compensation *even pre-participant entered*
 - 401(a)(17) compensation cap applies, \$260,000 for 2014

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Compensation - Example

- Non-key is employed for all of 2014
 - Earns \$30,000 for 2014
 - Entered Plan on July 1, 2014
 - “Compensation computation period” in plan for NEC is “while a participant”, thus use Earnings July 1 to Dec. 31, 2014: \$15,000
 - TH allocation is based on \$30,000

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Eligible Participant at Beginning of Year; Ineligible EE on Last Day

- A non-key participant is no longer eligible for the plan as a result of an amendment which takes effect on October 1st. They are still employed on last day of year.
 - Are they eligible for the top-heavy minimum?
- One answer would have been that since they were no longer eligible for the plan on the last day of the plan year, they don't meet the definition of eligible participant and they would not receive a top-heavy minimum.
- 2013 ASPPA Annual 2013 “Ask the Experts” Workshop question

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Eligible Participant at Beginning of Year; Ineligible EE on Last Day

- The answer provided at the conference was that since they were a participant during the year and are still employed at the end of the year, they may not receive the normal allocation, but must receive the top-heavy minimum.
- The TH would be based on 415 full year compensation, even though they were only eligible for 9 months.
 - This is because the definition of compensation under Code Section 416(i) is 415 Compensation, which is based on all 12 months of the limitation year.

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More Than One Plan of Same Employer

- Two DC Plans
 - Can go in either plan as long as total is 3%
 - Example
 - Money Purchase and 401(k) Plans, the plans can be written so that if they are top heavy, the TH contribution will be made to the money purchase plan.
Twice the bang for the buck.

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DB Plan Top Heavy Accruals

- Accrual goes to all that have 1,000 hours of service (even if not employed at year end)
 - Strangely, there is no last day requirement to get a DB top heavy benefit and there is a 1,000 hour requirement

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Defined Benefit Plan Minimum Top Heavy Benefit

- In a nutshell: 2% of Compensation accrual per year to a maximum of 20%
- Accurately: TH minimum is an accrued benefit which at any point in time equals at least the product of A times B where:
 - A. A is the employee's average annual code sec. 415(c)(3) compensation for the period of consecutive years (not exceeding 5) when the employee had the highest aggregate code sec. 415(c)(3) compensation from the employer
 - B. B is the lesser of 2% per year of service or 1-year period of service, as applicable, with the employer, or 20% subject to the rules of code sec. 416 and the regulations thereunder.

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Satisfying TH When ER has DB and DC and Both Are Top Heavy

- TH can be satisfied by making applicable TH to the DC and the DB, OR by providing :
 - The minimum TH benefit to the DB, or
 - DB top heavy minimum with a floor offset where the minimum DB is offset by the DC benefit, or
 - TH just to the DC, but, then TH contribution must be 5% not 3%, or
 - Some TH to DC and DB, provided the combined benefits are at least equal to the DB top heavy minimum, (a demonstration using a comparability analysis, RR 81-202, must show that the plans provide a benefit at least equal to the DB minimum)
 - Treasury Regulation 1.416-1, M-12 and M-15

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What If an Employee Is in Only One Plan?

- The plan should have language to provide TH to only those employees who are eligible for it.
 - If EE only eligible for DC TH, then that is all that should be provided
 - If EE only eligible for DB TH, then that is all that should be provided.
- Treasury Regulation 1.416-1, M-8 and M-12

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Cross-tested Plan Design Issue

- Employee not eligible for cross-tested allocation because did not work 1,000 hours required by plan
- Employee receives 3% top heavy as employed on last day
- 5% cross-tested gateway being used by plan. Because the employee is benefiting at 3% (due to top heavy), the employer must give 2% more to pass gateway test

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Plans Exempt from Top Heavy

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Plans Exempt from TH

- SIMPLE IRA
- SIMPLE 401(k)
- 403(b)
- 457(b)
- Safe harbor 401(k) that meets certain requirements (to be discussed next)

- Remember SEP is not exempt

- Plan design concept for top heavy plan:
 - Key employees no longer defer and no longer receive employer contributions

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Top Heavy Rules and Safe Harbor Plans

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Top-Heavy and Safe Harbor Rules

- Safe harbor used to satisfy top-heavy minimum
 - **SH NEC**
 - May be used towards satisfying the TH minimum
 - Additional amounts needed if safe harbor based on compensation from date of participation, or if 415 compensation not used for SH NEC
 - **Example:**
 - Maggie's plan year compensation is \$30,000, and her compensation from date of participation on October 1 is \$7,500.
 - The 3% SH NEC is based on compensation while a participant.
 - Her SH NEC is \$225.
 - The top-heavy minimum is \$900.
 - \$675 more is required to fully fund the top-heavy minimum.

Top-Heavy and Safe Harbor Rules

- Safe harbor used to satisfy top-heavy minimum
 - **Matching contribution**
 - May satisfy minimum, but not all participants receive a match (don't defer) or get enough match
 - **Example.**
 - Jennifer's top heavy minimum is \$900.
 - Jennifer defers \$600 and receives a \$600 SH match.
 - An additional \$300 is required to fund the top-heavy minimum.



Exemption from Being Top Heavy Citation: EGTRRA & RR 2004-13

- If only contributions made to the plan are safe harbor permitted contributions and deferrals, then plan is exempt from being top heavy for that year
- Example
 - Safe harbor 401(k) plan permits only the safe harbor matching contribution and deferrals. In such a case, the plan is exempt from the top heavy rules.
- Also permitted as a plan design:
 - SH Contributions, deferrals and a discretionary match within limits of 4% of compensation and deferring up to 6%
 - Because all the contributions are safe harbored from testing

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Top Heavy Exemption, EGTRRA & RR 2004-13 - Continued

- Safe Harbor 401(k) Plan *not* exempt from TH:
 - If a profit sharing contribution is made
 - If forfeitures are allocated as NEC
 - If the SH match eligibility is longer than eligibility to defer
- TH exemption is an annual determination

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Top Heavy Exemption Recap

- Plan consists solely of deferrals and safe harbored contributions
 - **No profit sharing contributions**
 - **No forfeiture allocations**
 - **Plan provision vs. allocation**
 - **Determined on a year-by-year basis**

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Top Heavy Exemption Examples

- **Nonelective:**
 - Safe Harbor 3% NEC and Deferrals only permitted
 - Joan's enters plan mid-year and earned \$12,000 as a participant.
 - Joan receives SH 3% NEC of \$360 for 6 months while a participant.
 - Although Joan made \$24,000 for the entire year, **no additional top heavy contribution amount is required to satisfy the top-heavy minimum because the plan met the exemption from being a top heavy plan.**

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Top Heavy Exemption Examples

- **Matching:**
 - Safe Harbor Matching and Deferrals only permitted
 - Mary defers all year at a 1% rate.
 - Mary receives SH dollar/dollar 1% match of \$400 for 12 months of deferrals.
 - Although Mary made \$40,000 for the year, no additional top heavy contribution amount is required to satisfy the top-heavy minimum because the plan met the exemption from being a top heavy plan.

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Top-Heavy Exemption and Otherwise Excludable Employees

- ***Top Heavy Exemption is not available in a plan designed with early eligibility for deferrals and statutory eligibility for the safe harbor***
 - To qualify for top-heavy exemption, plan must satisfy safe harbor rules as a whole
 - **Can't "divide" plan into a plan for statutory participants and a plan for otherwise excludable employees**
 - Failure to provide safe harbor contributions to otherwise excludable employees renders the whole plan subject to the top-heavy rules
 - **Top-heavy minimum contribution required for all non-key employees, including otherwise excludable employees**

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401(k) Safe Harbor FAQs – 1

- **May the Safe Harbor 401(k) 3% NEC be used to satisfy the Top Heavy contribution?**
- Yes.
 - All employees eligible to make elective deferrals will receive the 3% SH NEC for the plan year, the 3% SH NEC may be used to satisfy the top heavy contribution as well as the SH. IRS Notice 98-52,VIII.C.1
 - The employer must be careful that the 3% is not part of an integrated allocation formula.
 - The top-heavy minimum and the 3% SH NEC may not be integrated.

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401(k) Safe Harbor FAQs – 2

- **When is a safe harbor 401(k) matching contribution plan not exempt from being top heavy?**
 - When the employer makes a discretionary nonelective contribution
 - When forfeitures are allocated to participants' accounts in the same manner as nonelective contributions.
 - When employees are eligible to make elective deferrals upon hire but are not eligible for the match until after one year of service is completed.
- Revenue Ruling 2004-13

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401(k) Safe Harbor FAQs – 3

- **A SH plan provides for only elective deferrals and a SH basic match and has no forfeitures. The SH match is provided only to the NHCEs. Does this plan satisfy the top heavy exemption for the year?**
- Yes.
- Even though the SH match is given to only NHCEs, and not necessarily to all non-key employees, the plan meets the requirements of RR 2004-13 and is, thus, exempt from the top heavy rules for the year.

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401(k) Safe Harbor FAQs – 4

- **A SH 401(k) plan is top heavy.**
- **3% SH NEC is made.**
- **A discretionary match of dollar-for-dollar on the first 3% of compensation.**
- **The plan has a one-year eligibility requirement for all sources and semiannual entry dates.**
- **Must an employee who becomes a participant on July 1 receive a 3% top-heavy minimum contribution for the entire year? Or only for the period from July 1 to December 31?**

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401(k) Safe Harbor FAQs – 4 Continued

- The top-heavy contribution is based on the Section 415 compensation definition, i.e. compensation for the entire year.
- But, if the plan is deemed to be not top-heavy for the year, then the entry date does not matter.
- The plan in this scenario has only a discretionary match within the SH rules, deferrals & 3% SH NEC.
 - Thus, the plan is exempt from being top-heavy for the year.
 - Keep in mind that whether a safe harbor 401(k) is deemed to be not top heavy is an annual determination.

401(k) Safe Harbor FAQs – 5

- **A safe harbor 401(k) plan provides for only elective deferrals and a safe harbor basic matching contribution and has no forfeitures. The safe harbor matching contribution is provided only to the nonhighly compensated employees. Does this plan satisfy the top heavy exemption for the year?**
- Yes.
- Even though the safe harbor matching contribution is given to only NHCEs, and not necessarily to all non-key employees, the plan meets the requirements of Rev. Ruling 2004-13 and is, thus, exempt from the top heavy rules for the year.

What Is Considered Working on the Last Day of the Plan Year?

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What Is Considered Working on the Last Day of the Plan Year?

- **Working on the last day of the plan year**
- For plans that have a last-day requirement, what happens when the last day of the plan year falls on a weekend or on a holiday? Is the last business day of the year treated as the last day of the plan year? According to the IRS, the answer is “Generally, yes.” This issue was addressed, along with similar situations, at the 2005 ASPPA National Conference Q&A 32.
- **Employment is a “Relationship”**
 The IRS guidance started with this rule of thumb:
 - Being “employed” on the last day of the year is not necessarily the same as “working” on the last day of the year.
 - The IRS indicated that employment is a “relationship” with the employer.
 - For example, if you are on vacation, you are still employed by the firm, even if you may not be actually working there during the vacation time period.

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What Is Considered Working on the Last Day of the Plan Year?

- **Plan Year Ends on a Weekend or Holiday**
If last day of a plan year = Saturday, Sunday, or holiday, and a participant is considered an “employee” on the last *business* day of the plan year, then the participant is considered “employed” on last day of plan year.
- Example: a retirement plan has a last day of the plan year rule and Dec. 31 falls on a Saturday. If the company usually conducts business from Monday to Friday only, and an employee’s last day of work was Friday, Dec. 30, the employee is deemed to have satisfied the last-day requirement.
- The same holds true for any other type of allocation with a last-day requirement, i.e. the TH contribution.
- However, if someone were actually terminated from employment on December 30, then the employment relationship ceased *before* the last day of the year, and the ex-employee would not be entitled to an allocation.

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What Is Considered Working on the Last Day of the Plan Year?

- **Caveat:** The termination of a large group of employees at year-end might trigger a possible partial termination, or cause a plan to fail coverage testing, thus requiring the sponsor to increase vesting or provide allocations to the affected group.
- This rule also applies to off-calendar-year plans. For example, assume the last day of the plan year for an off-calendar-year plan is September 30. If September 30 falls on a Saturday, and an employee works on Friday, September 29, the employee is deemed to be employed on the last day of the plan year.

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What Is Considered Working on the Last Day of the Plan Year?

- **Unused Vacation Time**
Can unused vacation time be added to an employee's termination date to extend his or her employment beyond the last day of the plan year?
- No. According to the IRS, unused vacation time *may not be added* to an employee's termination date in order to reach the end of the plan year.
- *Example:* An employee with two weeks of unused vacation time terminates employment on December 23, and the last day of the plan year is December 31. The employee is not permitted to add the two weeks of unused vacation time to the December 23 termination date. Therefore, the employee is not considered to be employed on the last day of the plan year.

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What Is Considered Working on the Last Day of the Plan Year?

- **Firm is on Vacation when Plan Year Ends**
A company sponsors a retirement plan with a December 31 year-end. It also regularly closes for a company-wide winter holiday the last week of December and the first week of January. The vacation period ran from December 24 to January 8. Were employees who worked on December 23 considered employed on the December 31, the last day of the plan year?
- The IRS says "Yes." Because this was a company-wide vacation, anyone who did not terminate or resign before December 31 was considered employed on the last day.
- Seasonal employees were not addressed in the IRS discussion of this matter. Industry standards may have a bearing on the answer to this question.

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EPCRS and Top Heavy Corrections

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Correction for Failure to Make Top Heavy per EPCRS Rev. Proc. 2013-12

- TH mentioned in three places in EPCRS
 1. 4.04, Established practices and procedures. (page 16). *To be eligible for SCP, plan administrator must have established practices and procedures, both formal and informal.*
 - E.G.: plan that may be TH may include in its plan operating manual a specific annual step to determine whether the plan is TH, and if so, to ensure that the minimum contribution requirements of the top-heavy rules are satisfied. A plan document alone does not constitute evidence of established procedures.

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Correction for Failure to Make Top Heavy per EPCRS Rev. Proc. 2013-12

2. Section 9, SCP of Significant Operational Failures, 9.05 Example 1. page 51
 - ER established QP in 2003. In 2007, during self-audit of 2006, plan administrator discovered that despite practices and procedures:
 - Several eligible employees were excluded from participation,
 - Several employees exceeded the 402(g) limit,
 - ER failed to make the TH minimum contribution
 - ER had intended in 2006 to implement correction for plan year 2005 failed ADP test

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Correction for Failure to Make Top Heavy per EPCRS Rev. Proc. 2013-12

2. Example 1 continued
 - During 2008 plan year, the plan sponsor:
 - Made QNECs on behalf of excluded employees, (plus earnings)
 - Distributed the excess deferrals to affected employees (plus earnings)
 - Made the TH minimum contribution to all employees entitled to it for the 2006 plan year (plus earnings)
 - ER made a QNEC to correct the failed 2005 plan year ADP test (plus earnings), using the SCP correction method under Appendix A, Section 3.
 - IRS states that the above satisfies the requirements of SCP.

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Correction for Failure to Make Top Heavy per EPCRS Rev. Proc. 2013-12

3. Appendix A Section .02 Operational Failures

“Failure to properly provide the minimum top-heavy benefit under § 416 to non-key employees.

In a defined contribution plan, the permitted correction method is to properly contribute and allocate the required top-heavy minimums to the plan in the manner provided for in the plan on behalf of the non-key employees (and any other employees required to receive top-heavy allocations under the plan). In a defined benefit plan, the minimum required benefit must be accrued in the manner provided in the plan.”

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Correction for Failure to Make Top Heavy per EPCRS Rev. Proc. 2013-12

Example of a VCP solution approved by the IRS

- Employer going out of business and taking money from his own 401(k) account to pay for top heavy for non-key employees.
- This has been known to be approved by the IRS.

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Correction for Failure to Make Top Heavy per EPCRS Rev. Proc. 2013-12

There is NO correction method known as:
“rescind or return the key-employee’s
deferrals”,
so that the TH allocation will not be
required !!!

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Other Issues

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Deadline for TH Contribution

- No guidance on TH contribution deadline.
- The terms of the plan document require a TH contribution, so:
 - Best practice would suggest by tax filing deadline in order to take a tax deduction.
 - 415 regulations provide that a contribution will be treated as an annual addition for the limitation year, if contributed within 30 days after the due date for the filing of the tax return, including extensions

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RMD and Top Heavy

- Are RMD's paid to 5% owners who are still working an in-service distribution for the five-year look-back?
- Yes.
- If the employee worked at least an hour during the look back year, the five-year look back rule for adding back in-service distributions applies.
- For someone who is working, an RMD would be a distribution made while in-service and thus subject to the five-year look-back.

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Plan Termination and Top Heavy

- Plan termination date is considered the last day of the plan year for TH allocation requirement purposes
 - Even if termination date is not the last day of the plan year, the top heavy contribution is due based on the termination date being the last day of the plan.
 - i.e.: **Termination date is considered last day of plan year for top heavy allocation purposes**
 - Some practitioners had viewed this differently in the past, but the IRS at the 2010 ASPPA National Conference has stated that the termination date is the last day and that a top heavy is due as of that time

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Top Heavy and Beneficiaries

- **For determining TH status, the terms, key, non-key, former-employee or former key include the beneficiaries of the individual.**
- For the year of death, the status of the participant is also held by the beneficiary. So if the participant was a key employee in his or her year of death, the beneficiary would hold the same status for that year. Similarly, for a deceased key employee, once a full plan year after the year of death has passed, then the key employee's balance would be excluded from the determination date balance.
- Treas. Reg. 1.416-1, T-12
- There is no TH guidance on QDROs, but the alternate payee as the beneficiary of the QDRO is presumed to be handled similarly to the beneficiary of a deceased participant.

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Top Ten Top Heavy Plan Mistakes

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Top Ten Top Heavy Plan Mistakes Number 1

- **415 compensation for the entire plan year must be used for the top heavy contribution**
 - **No compensation exclusions**
 - Although overtime, bonuses, commissions and similar payments may be excluded when calculating other employer contributions; the top-heavy minimum contribution is based on total compensation for the entire plan year without any of the foregoing exclusions.
 - If using a NEC or matching toward satisfying the TH minimum, if it does not meet the 415 definition, then additional TH minimum will be needed.
 - **Full year compensation, not compensation while a participant**

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Top Ten Top Heavy Plan Mistakes Number 2

- **Determination date balance includes only employees who performed an hour of service in the year ending on the determination date**
- **The participants included in the test must have been employed during the look-back year.** If a plan participant does not have any earned income during the look back year, his or her balance is excluded from the test.
 - **Example 1** A participant terminates employment on April 23, 2013 and on September 16, 2013 withdrew his entire balance in the plan. For the 2014 top-heavy test, the determination date balance of December 31, 2013 is used. Since the participant withdrew everything, the balance would be zero, but any amounts distributed during the one-year look-back period, (i.e. the amount distributed on September 16, 2013), are added back into the December 31, 2013 determination date balance.

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Top Ten Top Heavy Plan Mistakes Number 3

- **Disaggregation rule for otherwise excludable employees not applicable to the determination of who is entitled to a top heavy minimum**
- **Otherwise excludable non-key employees are entitled to a top heavy contribution.**
- **Treasury Reg. 1.410(b)-7(c)(3)**

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Top Ten Top Heavy Plan Mistakes Number 4

- **If the participant is a key employee at any time during the look-back year, the person was a key employee for the entire year.**

Example 3

Donald owned 51% of his company for many years. Donald sells his interest in the company January 10, 2012, but stays on as an employee working one day a week as of August 2, 2013. Donald continues to work only one day a week. When does Donald stop being a key employee for testing purposes?

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Top Ten Top Heavy Plan Mistakes Number 4 (continued)

- As of the Dec. 31, 2013 determination date (for the 2014 top-heavy test), Donald is still classified as a key employee because he had key employee status during part of the 2013 year. As of the Dec. 31, 2014 determination date (for the 2015 top heavy test), Donald is no longer considered a key employee since he had no ownership during any period after 2013.
- Donald continues to work in 2014 and his earned income in 2014 is classified as non-key employee income.
- For the Dec. 31, 2014 determination date, Donald's entire balance drops out of the Dec. 31, 2014 determination date calculation.

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Top Ten Top Heavy Plan Mistakes Number 5

- **No 1,000 hour requirement in a defined contribution plan for a top-heavy allocation.**
- An eligible participant who works as little as one hour during the year and who is employed on the last day of the plan year has met the service requirement for a top-heavy allocation in a defined contribution plan. A 1,000-hour of service requirement may not be imposed even if the plan requires 1,000 hours of service for an allocation of matching or non-elective contributions.
- **Note:** The defined benefit plan top-heavy rules are different and may require the completion of a year of service to be entitled to a top-heavy benefit accrual. In addition, defined benefit top heavy rules do not require the participant to be employed on the last day to accrue a top-heavy benefit.

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Top Ten Top Heavy Plan Mistakes Number 6

- **If an employee is eligible to defer, he is eligible for a TH minimum, even if not eligible for a NEC or matching contribution.**

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Top Ten Top Heavy Plan Mistakes Number 7

- **For top-heavy testing purposes, how long does a key employee remain a key employee after a severance of employment from the company?**
- When a key employee terminates employment, he or she is still a key employee in the year containing the severance date, provided they have earned income during that year.
- However, when testing the following year's determination date -- in which the key employee had absolutely no earned income -- then the key employee is no longer key.

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Top Ten Top Heavy Plan Mistakes Number 8

- **Refunding a key employees deferrals in order to avoid a TH minimum allocation is not a permitted distributable event.**
- Once a key employee contributes deferrals in a TH plan, a minimum TH allocation is required and the deferrals are not permitted to be returned to the key employee as a way of avoiding the TH requirements.

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Top Ten Top Heavy Plan Mistakes Number 9

- **If the key employee account balances exceed 60%, the plan is top-heavy. There is no de minimis amount.**
- **Manage the employers expectations and monitor the situation.**
- **Design the plan to provide top heavy allocation only to non-key.**
 - **Unless plan will always be top heavy and the owner wants to also give a top heavy allocation to the keys**
- **Stopping a safe harbor plan mid-year will end the top heavy exemption for the year**

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Top Ten Top Heavy Plan Mistakes Number 10

- **TH rules are qualification requirements and are in every plan document.**
- **If there is more than one plan, stipulate in which plan the TH is to be provided.**
- **If a non-key will be in both a DB and a DC, indicate in the plan documents how the top heavy minimum will be provided.**

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Questions & Comments

- Thanks for attending
- E-mail any questions or comments to me at: bgrossman@mhco.com

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