Is Your Employer Sponsored Retirement Plan "Top Heavy?"

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Just when you thought the impact of the recent economic downturn had finished dealing blows to employers, there is one more issue that employers may have forgotten to address. Whether it is due to layoffs or reductions in force, there has been a substantial change in the composition of many workforces over the last few years. With this change in workforce composition, employers may have failed to consider the impact of this change on its employer sponsored retirement plans. Specifically, where layoffs or reductions in force have significantly altered the company structure, the employer's retirement plan(s) may now be "Top Heavy," where the benefits provided to key employees are too great. A “Top Heavy” plan can lead to required plan modifications, the providing of additional benefits or contributions, and unnecessary litigation.

Generally, qualified retirement plans are designed to not favor key employees or corporate officers or owners; otherwise they become "Top Heavy" and are in violation of the law. In order to maintain its tax qualified status, a plan should include provisions which will take effect if the plan becomes “Top Heavy,” including measures to meet the Employee Retirement Income Security Act ("ERISA") and the Internal Revenue Code’s ("IRC") additional qualifications for a “Top Heavy” plan. However, many employers have failed to monitor the “Top Heavy” status of its retirement plans, and in turn, have failed to ensure that the additional qualifications have been satisfied. These failures have recently led many employers into litigation initiated by current and former employees, who believe they have accrued higher benefit levels than the employer has provided.

What Is A "Top Heavy" Benefit Plan?

Qualified retirement plans under ERISA and the IRC can be created as a Defined Contribution Plan or a Defined Benefit Plan. As a general matter, all Defined Benefit and Defined Contribution Plans are subject to the “Top Heavy” rules in the IRC. A Defined Contribution Plan is a plan that provides an individual account for each participant and in which benefits are based solely upon the amount contributed to the account. A Defined Benefit Plan is a plan designed to provide participants with a definite benefit at the time of retirement.

A "Top Heavy" Defined Contribution Plan is a plan where on the annual determination date, the total accounts of all key employees exceeds 60 percent of the total accounts of all employees.[i] A "Top Heavy" Defined Benefit Plan is a plan where on the annual determination date, the present value of the accrued benefits of all key employees exceeds 60 percent of the present value of the accrued benefits of all employees.[ii] The determination date for assessing whether a plan is “Top Heavy” or not may change whether it is a newly created plan, or whether it is an existing plan. For a new plan, the determination date of the assessment is the last day of the first plan year.[iii] However, with respect to an existing plan, the determination date is the last day of the preceding plan year.[iv]

Another integral piece to the “Top Heavy” analysis is determining which employees are considered key employees, which directly impacts the determination of whether a plan is “Top Heavy.” A key employee is an employee who at any time during the plan year is:

1. An officer having annual compensation greater than $130,000.00;
2. A five percent owner;
3. A one percent owner whose annual compensation exceeds $150,000.00.[v]

On the other hand, the IRC defines a non key employee as any employee who is not a key employee.[vi] When determining whether an employee is an officer of the company, all of the facts and circumstances must be examined, including the employee’s duties, term of position, and extent of his or her authority. Interestingly, an employee who does not have the title of an officer, but has the same authority as an officer, is considered an officer for the key employee test.[vii]

Accordingly, an employer should examine its retirement plans on an annual basis, in conjunction with an assessment of its workforce structure, in order to determine if its plan is “Top Heavy.”

What If An Employer Has More Than One Qualified Retirement Plan?

If an employer has more than one qualified retirement plan, the IRC has established aggregation rules, where all of the employer’s retirement plans may or may not be required to be examined together, in order to determine whether the aggregate group of plans is “Top Heavy.” A required aggregation group consists of each plan of the employer in which a key employee is a participant, and each other plan of the employer that enables a retirement plan covering key employees to satisfy the coverage and non-discrimination requirements of the IRC.[viii] Additionally, the IRC has created permissive aggregation groups where an employer can choose to incorporate plans into the group for a “Top Heavy” determination. A permissive aggregation group consists of all plans that are required to be aggregated, as well as any other plan that satisfies the coverage and non-discrimination requirements of the IRC to be a qualified plan.[ix] An employer can permissively add qualified retirement plans to the aggregation group in order to avoid the group being considered “Top Heavy.”

An aggregation group, whether required or permissive, has a very similar analysis performed to determine whether it is a “Top Heavy” group. An aggregation group is “Top Heavy” if, as of the determination date, the sum of the present value of the cumulative accrued benefits for key employees under all Defined Benefit Plans included in the group, and the aggregate of the accounts of key employees under all Defined Contribution Plans included in the group exceed 60 percent of the same amount determined for all employees.[x]

What Occurs After A Plan Is Determined To Be "Top Heavy?"

If a plan or aggregated group of plans is determined to be "Top Heavy" under the IRC, it is in violation of the law. In turn, the plan must take certain measures to ensure compliance with the IRC. If the plan fails to satisfy the "Top Heavy" requirements of the IRC it will lose its status as a qualified trust.[xi]

In order for the "Top Heavy" plan to maintain its qualified status for the plan year it must meet the "Top Heavy" requirements of the IRC, by satisfying:

1. The Internal Revenue Code's "Top Heavy" vesting requirement; and
2. The Internal Revenue Code's "Top Heavy" minimum benefit or contribution requirement.

Vesting

If a plan is considered "Top Heavy," the employer must adopt one of two vesting options established by the IRC.[xii] Specifically, the plan must allow for a three year vesting term or a six year graded vesting schedule.[xiii] Within the three year vesting schedule, an employee who completes at least three years of service must be 100 percent vested. Pursuant to the six year graded vesting schedule, an employee must become vested consistent with the table below:

Completed Years of Service	Vested Percentage
2	20%
3	40%
4	60%
5	80%
6	100%

The purpose of the IRC's vesting requirements for "Top Heavy" plans is to accelerate the accrued benefits of an employee.

When a plan ceases to be "Top Heavy," the employer may change the vesting schedule to its previous schedule, or to a schedule that would otherwise be permissible under the law. However, this change cannot be to the detriment of the employee, as the employee cannot be required to forfeit any benefits accrued during the time period that the plan was "Top Heavy."[xiv] Moreover, any employee with three or more years of service must be given the option of remaining under the "Top Heavy" vesting schedule.[xv]

Minimum Benefit Or Contribution

In addition to complying with the “Top Heavy” vesting requirement, the employer must also provide certain minimum benefits or contributions to rectify the “Top Heavy” status, depending on whether it is a Defined Benefit or Defined Contribution Plan.

If a Defined Benefit Plan is determined to be “Top Heavy,” then the required accrued benefit, when expressed as an annual retirement benefit of a non key employee, must not be less than the employee’s average compensation multiplied by the lesser of: (1) two percent times the number of years of service; or (2) 20 percent.[xvi] The term “annual retirement benefit” under the IRC means a benefit attributable to employer contributions payable in the form of a single life annuity beginning at the retirement plan’s normal retirement age.[xvii] If the employee does not retire at the normal retirement age, then the amount of the benefit must at least be the actuarial equivalent of the minimum single life annuity benefit of normal retirement age. The benefit may be more or less depending upon whether the benefit commences before or after the normal retirement age. This minimum benefit must be provided to any non key employee who is a participant in the plan and who has at least 1,000 hours of service during the plan year.

If a Defined Contribution Plan is determined to be “Top Heavy,” then the employer’s required contribution for each non key employee must not be less than three percent of the employee’s compensation.[xviii] However, the IRC has carved out a special exception where the highest contribution rate for any key employee does not exceed three percent. In this instance, the required minimum contribution rate is the equivalent of the highest contribution rate of any key employee.[xix] This minimum contribution must be made for any non key employee who is a participant in the plan and has not separated from service at the end of the plan year, regardless of whether they have completed 1,000 hours of service.

Conclusion

With so many employers instituting layoffs or reducing the number of non key employees within their workforce, coupled with the tendency to provide heightened retirement benefits for officers and other key employees, employer retirement plans are becoming more and more vulnerable to becoming “Top Heavy.” Employers must be sure to review the status of their employee benefit plans annually and ensure that the proper measures have been taken to either prevent a “Top Heavy” plan, or to quickly remedy a “Top Heavy” plan by satisfying the requirements of the IRC. Given the economic climate, current and former employees are exacting much greater scrutiny on their accrued benefits as they look toward retirement. If an employer has not been diligent in complying with the “Top Heavy” requirements of the IRC, it may find itself in Court having to defend unnecessary litigation.

[i] I.R.C. §416 (g)(1)(A)(ii).

[ii] I.R.C. §416 (g)(1)(A)(i).

[iii] I.R.C. §416 (g)(4)(c).

[iv] I.R.C. §416 (g)(4)(c).

[v] I.R.C. §146 (i)(1).

[vi] I.R.C. §416 (i)(2).

[vii] Treas. Reg. §1.416-1, Q T-13.

[viii] I.R.C. §416 (g)(2)(A).

[ix] I.R.C. §416 (g)(2)(A).

[x]I.R.C. §416 (g)(2)(B).

[xi]I.R.C. §416 (a).

[xii]I.R.C. §416 (b)(1).

[xiii]I.R.C. §416 (b)(1).

[xiv]I.R.C. §411(a)(10), Treas. Reg. §1.416-1, V-7.

[xv]I.R.C. §411(a)(10), Treas. Reg. §1.416-1, V-7.

[xvi]I.R.C. §416 (c)(1).

[xvii]I.R.C. §416 (c)(1)(E).

[xviii]I.R.C. §416 (c)(2)(A).

[xix]I.R.C. §416 (c)(2)(B).