Top Heavy Warning

New 401(k) Plans – Possible Top Heavy Status

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Special Warning Regarding New 401(k) Plans

Possible Top-Heavy Status

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I. Introduction – Be Careful About Who Makes Large Initial Contributions To A New 401(k) Plan

A. It is very difficult to explain all of the applicable rules regarding a 401(k) Plan to an employer who is considering installing a plan for the benefit of their employees. However, it is important that the Plan Sponsor understands two major possible problems. To avoid these problems, certain "Key-Employees" and "Highly Compensated Employees" may need to be constrained relative to their salary deferrals for the first year of the Plan.

B. Many times a Plan Sponsor simply wants to make a 401(k) plan available to employees so that the employees have the ability to do personal salary deferrals on either a Roth or traditional pre-tax basis. This might be necessary because employees are demanding it or the company needs the 401(k) plan for recruiting purposes. The employer may not want to make any company contributions to the plan or may be willing to make a small matching contribution.

1. For 2013, the salary deferral limit is $17,500. There is no a limitation as a percentage of pay.
2. For 2013, if someone is age 50 or more by 12/31/13, the limit is $23,000 (the regular $17,500 plus $5,500 of over age 50 "make-up" contributions).

C. 401(k) are often installed fairly late in a Calendar Year and it is likely that higher paid employees are in a financial position to make large contributions during the balance of the Calendar Year whereas most of the lower paid support staff cannot afford to do much. ***This can create some problems!***

D. There are two major things that the Plan Sponsor must be very careful about relative to the first plan year:

1. **Top-Heavy Status:** Will the Plan accidentally become "Top-Heavy" thereby forcing the Plan Sponsor to make a 3% of compensation Top-Heavy minimum contribution for all of the "Non-Key Employees" for both the first and second Plan Years? This could be a major surprise for the Plan Sponsor.
2. **The ADP Discrimination Test**: Will your Highly Compensated Employees be able to make large end of the year contributions without having to get big refunds in the following year? This is not as big of a problem as the Top-Heavy status problem, but still something of which you will want to be aware.

II. Accidentally Making the 401(k) Plan into a "Top-Heavy Plan"

A. There is a special test done on the last day of the first plan year of a 401(k) plan called the "Top-Heavy test". If the account balances of the Key-Employees are more than 60% of the total account balances on the last day of the Plan Year, then the plan is "Top-Heavy" for both the first plan year and the second plan year.

B. The problem with becoming a Top-Heavy Plan is that the employer will have to make a 3% of annual compensation company contribution for all of the "Non-Key Employees" if any of the Key-Employees do salary deferrals of 3% of pay or more. This can be a very nasty surprise to the employer. If the employer is planning on making a profit sharing contribution of more than 3% for the eligible participants, then this is not a problem. But many employers are not planning on contributing that much.

C. You can avoid the problem by constraining the salary deferral contributions of the Key-Employees so that they do not have more than 60% of the total account balances at the end of the first plan year.

D. The Key-Employee definition is ***not*** the same as the Highly Compensated Employee definition. A participant is a Key-Employee for 2008 if they are:

1. A greater than 5% owner or certain family members of a greater than 5% owner
2. An Officer of the company who makes more than $165,000
3. A greater than 1% owner who makes more than $150,000

E. Example: Suppose you have the following situation for the first short plan year of a new 401(k). The plan is installed in July. The two owners can afford to do large salary deferral limits for the year. The five support employees elect to do a very high 10% of their compensation for July through December. Assume no investment earnings for the plan for simplicity. As you can see from the calculations below, the accounts of the Key-Employees as of the last day of the first plan year are in the aggregate more than 60% of the total of all account balances, even though the employees participated heavily. Therefore, the plan is Top-Heavy for the first two plan years forcing the employer to make 3% Top-Heavy Minimum contributions for all of the Non-Key Employees. To avoid this result, the two Key-Employees should constrain their salary deferrals to under $7,000 each so that their account balances at the end of the year are well under 60% of the total.

	Key-EE	Compen-sation for Year	End of Year Account Balance	As % of Pay	% of Total	Limited Contri-butions	As % of Pay	% of Total
50% Owner	Y	$120,000	$15,000	12.5%	**36.7%**	$7,000	5.83%	**28.2%**
50% Owner	Y	$120,000	$15,000	12.5%	**36.7%**	$7,000	5.83%	**28.2%**
Employee 1	N	$48,000	$2,400	5%		$2,400	5%	
Employee 2	N	$48,000	$2,400	5%		$2,400	5%	
Employee 3	N	$48,000	$2,400	5%		$2,400	5%	
Employee 4	N	$36,000	$1,800	5%		$1,800	5%	
Employee 5	N	$36,000	$1,800	5%		$1,800	5%	
			$40,800		**73.4%**	$24,800		**56.4%**

III. 401(k) plans are subject to what is known as an "ADP Test" (Average Actual Deferral Percentage Test).

A. Eligible participants are divided up into two groups. Highly Compensated Employees ("HCE's) and Non-Highly Compensated Employees ("NHCE's) for testing purposes.

B. For 2013, HCE's are defined primarily as greater than 5% owners or shareholders, certain family members of greater that 5% owners and participants who made more than $115,000 in 2012. Note: A person hired during the plan year who is not an owner cannot be an HCE for their first year of employment because they did not make more than $115,000 in the prior year. For example, suppose you hire someone on 1/5/2013 and pay them $400,000 for 2013. That person would still not in the HCE group for 2013. They would be an HCE for 2014, unless the Plan uses as Top Paid Group election and this employee is not in the top 20% of employees by salary.

C. HCE's are limited in what they can do as salary deferrals based on what the average is for the NHCE's, Generally, NHCE's will average at least 2% but less than 8% of pay and if that is the case, then the HCE's can average 2% more than the NHCE's.

D. For example, if the NHCE's average the following, the HCE's can average the percentages shown:

1. 2% for NHCE's allows 4% for HCE's
2. 4% for NHCE's allows 6% for HCE's
3. 5.25% for NHCE's allows 7.25% for HCE's, etc.

E. Unfortunately, this can result in the HCE's not being allowed to do as much in salary deferrals as they would like to do. For example, suppose the NHCE's average 4% and this limits the average of the HCE's to 6% and suppose an HCE makes $100,000 in salary. This HCE would be limited to 6% of $100,000 or $6,000 vs. the limit of $17,500. Even an HCE making $150,000 would be limited to $9,000 in salary deferrals rather than being able to do the $17,500 limit.

F. Note: Most everything we are stating in this write-up is a gross oversimplification of the real rules, however, our goal here is to communicate just the basics.

G. If the NHCE's do less than a 2% average, then the HCE's can do double what the NHCE's do. For example, if the NHCE's only averaged 1.5%, then the HCE's can only average 3% (2 x 1.5%).

H. If the NHCE's do more than 8% average, then the HCE's can do 1.25 x the NHCE average. For example, if the NHCE's were to average 10%, then the HCE's could average 12.5%.

I. If the Plan Sponsor is not making any matching contributions, or any "Safe Harbor contributions" or any Profit Sharing contributions, then the only cost to the employer is for the set-up and administration of the plan.

J. The primary way to encourage NHCE's to utilize the plan is to provide quality education showing them all the reasons why they should participate and making sure they feel they understand the plan. If you simply throw a quick overview and enrollment forms at them, they will not do much. People do not take part in something they do not understand or something with which they are not comfortable.

K. Automatic enrollments with default investments is one way to overcome the inertia of people not enrolling. They have to take action not to participate.

L. Both the Top Heavy minimum contribution and the ADP test problem can be solved by adopting a Safe Harbor 401(k) Plan. For a new plan, this must be done by October 1 for a Calendar Year plan. For an existing 401(k) plan, the change to a Safe Harbor plan must be done before a new year begins.

M. Please request a copy of our ***"A Primer on 401(k) Plan Alternatives"*** write-up for more information about the ADP test and the Safe Harbor plan alternatives.