

TOP-HEAVY RULES AND KEOGH PLANS

By

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- I. **Introduction.** Top-heavy rules require annual testing and generally impose minimum contribution and vesting requirements on top-heavy retirement plans. Keogh plans involve plans of unincorporated entities.

- II. **History of Top-Heavy Rules.** Internal Revenue Code of 1986 ("Code") Section 416 was added by the Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA"), Pub. L. No. 97-248 (1982) and was subsequently amended. See Code Section 401(a)(10).
 - A. The regulations for Code Section 416 can be helpful, but generally are not up to date and so need to be used with caution. The regulations were adopted on December 28, 1984 (T.D. 7997), amended on August 8, 1991 (T.D. 8357), and revised April 5, 2007 (T.D. 9319). Treas. Reg. Section 1.416-1 generally has not been amended to reflect changes made by the following:
 1. Tax Reform Act of 1986, Pub. L. No. 99-514 (1986) (affected \$200,000 compensation limit);
 2. Technical and Miscellaneous Revenue Act of 1988, Pub. L. No. 100-647 (1988);
 3. Small Business Job Protection Act of 1996, Pub. L. No. 104-188 (1996) (removed 90% test);
 4. Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. No. 107-16 (2001) (changed definition of key employee, including removing prior top ten owners test, and modifying officer compensation limit and changing five year look back period to one year) (made permanent by Pension Protection Act of 2006, Pub. L. No. 109-280, Section 811 (2006));
or
 5. Job Creation and Worker Assistance Act of 2002, Pub. L. No. 107-147 (2002).
 - B. Code Section 416 is referred to in other Code Sections, such as: Code Sections 401(a)(9) and 414(q)(2) (definition of 5% owner); and Code Sections 79, 125, 401(h), and 420 (key employee references).

- III. **What factors determine whether a plan is top-heavy?** In order to determine whether a plan is top-heavy for a plan year, generally it is necessary to determine:
 - A. Plans subject to the rules;
 - B. Employers treated as a single employer;
 - C. Determination date;
 - D. Key employees;

- E. Former employees who have not performed any service for the employer maintaining the plan at any time during the one-year period ending on the determination period;
 - F. Plans of the employers required or permitted to be aggregated to determine top-heavy status; and
 - G. The present value of the accrued benefits (with certain adjustments).
- Treas. Reg. Section 1.416-1, Q&A T-1 (not updated for changes to Code Section 416).

IV. What plans are subject to the top-heavy rules?

- A. Stock bonus, pension, and profit-sharing plans under Code Section 401(a), Code Section 403(a) annuity contracts, and simplified employee pensions described in Code Section 408(k) generally are subject to the top-heavy rules. Treas. Reg. Section 1.416-1, Q&A G-1.
- B. A multiple employer plan is subject to Code Section 416, but only with respect to each individual employer. A failure by the multiple employer plan to satisfy Code Section 416 with respect to the employees of such employer means that all employers are maintaining a plan that is not a qualified plan. Treas. Reg. Section 1.416-1, Q&A G-2.
- C. Multiemployer plans (Code Section 414(f)) and multiple employer plans (Code Section 413(c)) to which an employer makes contributions on behalf of its employees are treated as plans of that employer to the extent that benefits under the plan are provided to employees of the employer because of service with that employer. Treas. Reg. Section 1.416-1, Q&A T-2. See Section V.C.
- D. **Requirement to Include Top-Heavy Provision in Plan Document.** Code Section 401(a)(10)(B) provides that a plan will qualify only if it contains provisions which will take effect if the plan becomes top-heavy and which meet the requirements of Code Section 416. See Treas. Reg. Section 1.416-1, Q&A T-39 and T-40 for rules on what provisions must be included. Under Code Section 401(a)(10)(B)(ii), regulations may waive this requirement for some plans. See Treas. Reg. Section 1.416-1, Q&A T-38 for a description of plans that need not include such provisions. Treas. Reg. Section 1.416-1, Q&A T-35.
- E. Plans covering few employees are more likely to be top-heavy than plans covering a large number of employees. For example:
 - 1. If key employees make up a substantial percentage of the workforce, it is more likely the plan will become top-heavy.
 - 2. Plans of larger employers also can 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.

Internal Revenue Manual Section 4.72.5.1.2 (rev. 3/1/2006).

V. What plans are exempt from the top-heavy rules?

- A. SIMPLE retirement accounts under Code Section 408(p) are exempt from the top-heavy rules. Code Section 416(g)(4)(G). SIMPLE 401(k) plans are excluded if the plan only permits contributions under Code Section 401(k)(11). Code Section

401(k)(11)(D)(ii).

- B. Plans which consist solely of safe harbor Code Section 401(k)(12) or 401(k)(13) and Code Section 401(m)(11) or 401(m)(12) (match) are not subject to the top-heavy rules. Code Section 416(g)(4)(H).
 - 1. If a design-based safe harbor plan otherwise would be treated as a top-heavy plan because it is a member of an aggregation group which is a top-heavy group, contributions under the design-based safe harbor plan may be taken into account in determining whether any other plan in the group meets the Code Section 416 minimum contribution requirements for a defined contribution plan.
- C. Collectively bargained plans are not subject to minimum vesting or contributions/benefits if the retirement benefits were subject to good-faith bargaining. Code Section 416(i)(4). Treas. Reg. Section 1.416-1, Q&A T-2 and T-38.
- D. Governmental plans (Code Section 414(d)) are exempt from top-heavy rules. Code Section 401(a)(10)(B)(iii) and Treas. Reg. Section 1.416-1, Q&A T-38.
- E. An eligible combined defined benefit 401(k) plan under Code Section 414(x) is exempt. Code Section 414(x)(4) (effective for plan years beginning after December 31, 2009). See the Pension Protection Act of 2006, Pub. L. No. 109-280, Section 903 (2006).

VI. **Which employers are treated as a single employer?** All employers in the same controlled group or affiliated service group are treated as a single employer for Code Section 416. Code Sections 414(b), (c), and (m), but see Code Section 416(i)(1)(C) which limits aggregation for purposes of determining ownership key employees.

- A. The recipient of the services of a leased employee within the meaning of Code Section 414(n) is treated as an employer for top-heavy purposes. See Internal Revenue Manual Section 4.72.5.2.2 (rev. 3/1/2006) and Code Section 414(n)(3)(B).

VII. **Determination Date. "Determination date"** means:

- A. The last day of the preceding plan year; or
 - B. In the case of the first plan year of any plan, the last day of such plan year.
- See Code Section 416(g)(4)(C) and Treas. Reg. Section 1.416-1, Q&A T-22.

VIII. **Key Employees.**

- A. **"Key employee"** means an employee who, at any time during the plan year (see Subsection 4 below), is:
 - 1. A **more than 5% owner** of the employer;
 - 2. A **more than 1% owner** of the employer having an annual compensation from the employer of more than \$150,000 (not indexed for cost of living); or
 - 3. An **officer** of the employer having an annual compensation greater than \$130,000 (indexed for cost of living). The \$130,000 officer limit is adjusted for cost of living increases to the next lower multiple of \$5,000. See http://www.irs.gov/irb/2008-45_IRB/ar13.html

Adjusted Officer Compensation Amounts

| Testing Year | Preceding "Look Back" Year | Compensation Limit |
|--------------|----------------------------|--------------------|
| 2010 | 2009 | >\$160,000 |
| 2009 | 2008 | >\$150,000 |
| 2008 | 2007 | >\$145,000 |

Code Section 416(i)(1).

4. **Year for Determining Key Employee.** For purposes of assessing top-heavy status, key employees are identified using the year containing the determination date (sometimes referred to as "look back" year). See Internal Revenue Manual Section 4.72.5.2.4 (rev. 3/1/2006). There is some ambiguity regarding whether the plan year should be the determination date with respect to both determining key employees for testing and for imposing minimum vesting and contribution/benefit requirements. Some commentators argue that the current plan year is intended for minimum vesting, contributions, and benefits. However, see the Internal Revenue Manual Section 4.72.5.2.4 (rev. 3/1/2006), the plan year containing the determination date is used in defining "key employee."
5. An individual may be considered a key employee in a plan year for more than one reason. For example, an individual may be both an officer and one of the more than 5% owners. Treas. Reg. Section 1.416-1, Q&A T-12 (not updated for changes to Code Section 416).

B. "More than 5% owner" means:

1. Any person who owns (or is considered as owning within the meaning of Code Section 318) more than 5% of the outstanding stock of the employer corporation or stock possessing more than 5% of the total combined voting power of all stock of the corporation; or
2. Any person who owns more than 5% of the capital or profits interest in a non-corporate employer.

Code Section 416(i)(1)(B)(i).

3. The rules of Code Sections 414 (b), (c), and (m) do not apply for purposes of determining who is a more than 5% owner. Treas. Reg. Section 1.416-1, Q&A T-17.

C. "More than 1% owner" means any person who would be a more than 5% owner if "1%" were substituted for "5%."

1. The rules of Code Sections 414 (b), (c), and (m) do not apply for purposes of determining who is a more than 1% owner.

Code Section 416(i)(1)(B)(ii).

D. Constructive Ownership Rules. For purposes of determining more than 5% owners and more than 1% owners, Code Section 318 applies. Code Sections 416(i)(1)(B)(i) and (ii). Code Section 318 addresses constructive ownership of stock. Code Section 318(a)(2)(C) (attribution from corporations) is applied by substituting "5%" for

"50%." Code Section 318(i)(1)(B)(iii).

1. For purposes of determining ownership is an entity other than a corporation, the rules of Code Section 318 apply in a manner similar to the way in which they apply for purposes of determining ownership in a corporation. For non-corporate interests, capital or profits interest is substituted for stock. See Code Section 416(i)(1)(B)(iii)(II) and Treas. Reg. Section 1.416-1, Q&A T-18 (not updated for changes to Code Section 416).

E. **Compensation.** When determining "key employee," "compensation" means compensation defined by Code Section 414(q)(4) (which refers to Code Section 415(c)(3)).

1. The definition of compensation used to determine whether an individual has compensation of more than \$150,000 (see Section VIII.A.2.), is the definition in Treas. Reg. Section 1.415(c)-2, however, compensation must be determined for a plan year, not a limitation year. Alternatively, compensation that would be stated on an employee's Form W-2, "Wage and Tax Statement," for the calendar year that ends with or within the plan year may be used, although amounts that would have been stated on the employee's Form W-2 but for an election under Code Section 125, 132(f)(4), 401(k), 403(b), 408(k), 408(p)(2)(A)(i), or 457(b) must be included. A plan must use the same definition of compensation for all top-heavy plan purposes for which the definition in Q&A T-21 of the top-heavy regulations must be used. Treas. Reg. Section 1.416-1, Q&A T-21.

2. For purposes of determining whether an individual has compensation of \$150,000 (see Section VIII.A.2.), or whether an individual is a key employee by reason of being an officer, compensation from each entity required to be aggregated under Code Sections 414(b), (c), and (m) is taken into account.

- a. Example: An individual owns 2% of the value of a professional corporation, which in turn owns a 1/10th of 1% interest in a partnership. The entities must be aggregated in accordance with Code Section 414(m). The individual performs services for the professional corporation and for the partnership. The individual receives compensation of \$125,000 from the professional corporation and \$26,000 from the partnership. The individual is considered to be a key employee with respect to the employer that comprises both the professional corporation and the partnership because he has a 2% interest in the professional corporation and because his combined compensation from both the professional corporation and the partnership is more than \$150,000.

Treas. Reg. Section 1.416-1, Q&A T-20 (not updated for changes to Code Section 416).

F. **Officer Status.** Officer status is determined on the facts, including, for example, the source of the officer's authority, the term for which elected or appointed, and the nature and extent of his or her duties. Generally, an officer is an administrative executive who is in regular and continued service. Officer status is not based on whether or not the individual has the title of an officer. Officer status is determined

based upon responsibilities with respect to the person's direct employer, and not with respect to the controlled group of corporations, employers under common control, or affiliated service group. Treas. Reg. Section 1.416-1, Q&A T-13.

- G. **Maximum Number of Officers.** Officers are limited to no more than 50 employees (or, if lesser, the greater of 3 or 10% of the employees).

| Non-Excludable Employees | Maximum Number of Officers as Key Employees |
|--------------------------|---|
| 0-30 | 3 |
| 31-499 | 10% of Non-Excludable Employees |
| 500+ | 50 |

1. Employees excluded under Code Section 414(q)(5) for purposes of determining the highly compensated employee top-paid group also are excluded for purposes of determining the number of officers taken into account.
2. After aggregating all employees (including leased employees under Code Section 414(n)) of employers required to be aggregated under Code Section 414(b), (c), or (m), the maximum number of officers that are to be taken into account as officers for the entire group of employers that are so aggregated. The number of employees for the plan year containing the determination date is the greatest number of employees during that plan year. Employees include only those individuals (including part-time employees) who perform services for the employer during a plan year.
 - a. If 10% of the number of employees is not an integer, the maximum number of individuals to be treated as key employees by reason of being officers is increased to the next integer.
Treas. Reg. Section 1.416-1, Q&A T-14 (not updated for changes to Code Section 416).
3. If officers are limited, they are limited to officers who had the largest annual plan-year compensation in that one-year period. Treas. Reg. Section 1.416-1, Q&A T-14 (not updated for changes to Code Section 416).
4. In determining the officers of an employer, an employee who is an officer is counted as an officer for key employee purposes even if the employee is a key employee for another reason. Treas. Reg. Section 1.416-1, Q&A T-14 (not updated for changes to Code Section 416).
5. Example: A company is testing to see if its plan is top-heavy for the 2005 plan year. In 2004, it has more than 500 employees. Assume that the annual plan year compensation of each officer exceeds the dollar limit in effect for the calendar year in which the plan year ends. Under the limitations, only a total of 50 individuals would be considered to be key employees by virtue of being officers in testing for top-heaviness for the 2005 plan year. See Treas. Reg. Section 1.416-1, Q&A T-14 (not updated for changes to Code Section

416).

- H. **"Non-key employee"** means any employee who is not a key employee. Code Section 416(i)(2).
- I. **Self-employed individuals** described in Code Section 401(c)(1):
 - 1. Are treated as employees; and
 - 2. Such individual's earned income (within the meaning of Code Section 401(c)(2)) is treated as compensation.Code Section 416(i)(3).
- J. The terms "employee" and "key employee" include their **beneficiaries**. Code Section 416(i)(5).

IX. **Which plans are required or permitted to be aggregated to determine top-heavy status?**

- A. **Aggregated Plans.** Code Section 416(g)(2).
 - 1. **"Aggregation group"** means:
 - a. Each plan of the employer in which a key employee is a participant in the plan year containing the determination date; and
 - b. Each other plan of the employer which during this period enables any plan with a key employee to meet the requirements of Code Section 401(a)(4) or 410.See Treas. Reg. Section 1.416-1, Q&A T-6 (not updated for changes in Code Section 416).
 - 2. **Employers Included.** All employers that are aggregated under Code Sections 414(b), (c), and (m) must be taken into account as a single employer for the plan year in question. All plans maintained by the employers in which a key employee participates and certain other plans, must be aggregated. See Treas. Reg. Section 1.416-1, Q&A T-1(b).
 - 3. **Five-Year Look Back Period for Required Aggregation.** Although changes were made in EGTRRA largely reducing the prior five-year look back rule to one year (see Section II.A.4), the IRS appears to continue to apply the old rule from the regulations for required aggregation purposes. According to the Internal Revenue Manual, the required aggregation group 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 requirements of Code Section 401(a)(4) or 410. Internal Revenue Manual Section 4.72.5.2.5.1 (rev. 3/1/2006). According to the regulations, for purposes of determining whether the plans of an employer are top-heavy for a particular plan year, the required aggregation group includes each plan of the employer in which a key employee participates in the plan year containing the determination date, or any of the four preceding plan years. In addition, each other plan of the employer which, during this period, enables any plan in which a key employee participates to meet the requirements of Code Section 401(a)(4) or 410 is part of the required aggregation group.

- a. Example: An employer maintains two plans. Key employees participate in one plan, but not in the other. If the plan containing key employees independently satisfies the coverage and non-discrimination rules of Code Sections 410 and 401(a)(4), it may be tested independently to determine whether it is top-heavy. Also, the plan not covering key employees would not be part of a required aggregation group and would not need to be tested to determine whether it is top-heavy. However, if the plan containing key employees satisfies the coverage requirements of Code Section 410(b) or the nondiscrimination requirements of Code Section 401(a)(4) only when it is considered together with the other plan in accordance with Treas. Reg. Section 1.410(b)-1(d)(3), the plan not covering key employees would be part of the required aggregation group.

See Treas. Reg. Section 1.416-1, Q&A T-6.

4. Each plan of an employer in an aggregation group is a top-heavy plan if the aggregation group is a top-heavy group. Treas. Reg. Section 1.416-1, Q&A T-9.
5. A collectively-bargained plan that includes a key employee of an employer must be included in the required aggregation group for that employer. A collectively-bargained plan that does not include a key employee may be included in a permissive aggregation group. However, the special rules in Code Sections 416(b) and (c) (minimum vesting and minimum contributions/benefits) applicable to top-heavy plans do not apply with respect to any employee if benefits were collectively bargained. Treas. Reg. Section 1.416-1, Q&A T-3.
6. Each plan in a required aggregation group must contain provisions satisfying the minimum vesting requirements of Code Section 416(b). Treas. Reg. Section 1.416-1, Q&A T-10. If all the plans are defined contribution plans, only one plan need satisfy the minimum contribution requirements of Code Section 416(c)(2) with respect to any non-key employee who participates in more than one of the plans. If all the plans are defined benefit plans, only one plan need satisfy the minimum benefits requirements of Code Section 416(c)(1) with respect to any non-key employee who participates in more than one of the plans. However, in the case of non-key employees who do not participate in more than one plan, each plan must separately provide the applicable minimum contribution or benefit with respect to each such employee. Treas. Reg. Section 1.416-1, Q&A T-10.
7. When two or more plans are in an aggregation group, the present value of the accrued benefits (including distributions for key employees and all employees) is determined separately for each plan as of each plan's determination date. The plans are then aggregated by adding together the results for each plan as of the determination dates for such plans that fall within the same calendar year. The combined results will indicate whether or not the plans so aggregated are top-heavy.

- a. Example: An employer maintains Plan A and Plan B, each containing a key employee. Plan A's plan year commences July 1 and ends June 30. Plan B's plan year is the calendar year. For Plan A's plan year commencing July 1, 2008, the determination date is June 30, 2008. For Plan B's plan year in 2009, the determination date is December 31, 2008. These plans are required to be aggregated. For each of these plans as of their respective determination dates, the present value of the accrued benefits for key employees and all employees are separately determined. The two determination dates, June 30, 2008, and December 31, 2008, fall within the same calendar year. Accordingly, the present values of accrued benefits as of each of these determination dates are combined for purposes of determining whether the group is top-heavy. If, after combining the two present values, the total results show that the group is top-heavy, Plan A will be top-heavy for the plan year commencing July 1, 2008, and Plan B will be top-heavy for the 2009 calendar year.

See Treas. Reg. Section 1.416-1, Q&A T-23.

- 8. **Permissive Aggregation.** The employer may treat any plan not required to be included in an aggregation group as being part of such aggregation group if such aggregation group would continue to meet the requirements of Code Sections 401(a)(4) and 410 with such plan being taken into account. Code Section 416(g)(2)(A)(ii).

- a. If a permissive aggregation group is top-heavy, only those plans that are part of the required aggregation group will be subject to the minimum vesting and minimum contribution and benefit requirements of Code Sections 416(b) and (c). Plans that are not part of the required aggregation group will not be subject to these requirements. Assuming that there are plans that are eligible for permissive aggregation, the employer may take these plans into consideration. If, after taking such plans into consideration, the net result is that the entire group is not top-heavy, the top-heavy requirements do not apply to any plan in the group. See Treas. Reg. Section 1.416-1, Q&A T-11 (not updated for changes to Code Section 416).

X. **Determining 60% Top-Heavy Status.**

- A. **"Top-heavy plan"** means, with respect to any plan year:

- 1. Any defined benefit plan if, as of the determination date, the present value of the cumulative accrued benefits under the plan for key employees exceeds 60% of the present value of the cumulative accrued benefits under the plan for all employees; and
- 2. Any defined contribution plan if, as of the determination date, the aggregate of the accounts of key employees under the plan exceeds 60% of the aggregate of the accounts of all employees under such plan.

Code Section 416(g)(1).

- B. **An aggregation group** is a "**top-heavy group**" if Subsection (1) below exceeds 60% of Subsection (2):
1. The sum (as of the determination date) of:
 - a. The present value of the cumulative accrued benefits for **key employees** under all defined benefit plans included in the aggregation group; and
 - b. The aggregate of the accounts of key employees under all defined contribution plans included in the aggregation group.
 2. The sum (as of the determination date) of:
 - a. The present value of the cumulative accrued benefits for **all employees** under all defined benefit plans included in the aggregation group; and
 - b. The aggregate of the accounts of all employees under all defined contribution plans included in the aggregation group.

Code Section 416(g)(2)(B).

C. **Valuation as of Determination Date.**

1. **Defined Contribution Plans.**

- a. The present value of accrued benefits as of the determination date is the sum of:
 - (1) An individual's account balance as of the most recent valuation date occurring within a 12-month period ending on the determination date; and
 - (2) An adjustment for contributions due as of the determination date.
- b. **Cash Basis.** In the case of a plan **not subject to** the Code Section 412 minimum funding requirements, the adjustment is generally the amount of any contributions actually made after the valuation date but **on or before** the determination date.
 - (1) However, in the first plan year of the plan, the adjustment also should reflect the amount of any contributions made after the determination date that are allocated as of a date in that first plan year.
- c. **Special Rule for Code Section 412.** In the case of a plan that is subject to the minimum funding requirements of Code Section 412, the account balance should include contributions that would be allocated as of a date not later than the determination date, even though those amounts are not yet required to be contributed.

Treas. Reg. Section 1.416-1, Q&A T-24.

2. **Defined Benefit Plans.**

- a. The present value of an accrued benefit as of a determination date must be determined as of the most recent valuation date which is within a 12-month period ending on the determination date. The accrued benefit for a current employee must be determined as if the individual terminated service as of the valuation date with special rules for the first plan year allowing use of the determination date or

valuation date (with estimated accrued benefit as of the determination date). Treas. Reg. Section 1.416-1, Q&A T-25.

- b. There are no specific prescribed actuarial assumptions that must be used for determining the present value of accrued benefits. The assumptions used must be reasonable and need not relate to the actual plan and investment experience. Treas. Reg. Section 1.416-1, Q&A T-26.
- c. The present value generally should reflect a benefit payable commencing at normal retirement age (or attained age, if later). Thus, benefits not relating to retirement benefits, such as pre-retirement death and disability benefits and post-retirement medical benefits, must not be taken into account. Further, subsidized early retirement benefits and subsidized benefit options must not be taken into account unless they are nonproportional subsidies. Where the plan provides for a nonproportional subsidy, the benefit should be assumed to commence at the age at which the benefit is most valuable. Treas. Reg. Section 1.416-1, Q&A T-26.

D. **Accrued Benefit Counted Once.** An individual may be considered a key employee in a plan year for more than one reason. For example, an individual may be both an officer and one of the more than 5% owners. However, in testing whether a plan or group is top-heavy, an individual's accrued benefit is counted only once. Key employees and non-key employees include the beneficiaries of such individuals.

- 1. Example: An employer maintains a calendar-year plan. An individual who was an employee of the employer and a 5% owner of the employer in 2006 was neither an employee nor an owner in 2007 or thereafter. Even though the individual is no longer an employee or owner of the employer, the individual would be treated as a key employee for purposes of determining whether the plan is top-heavy for the 2007 plan year. However, for purposes of determining whether the plan is top-heavy for the 2008 plan year and for subsequent plan years, the individual would be treated as a former key employee.
- 2. Example: The facts are the same as in the prior Example, except that the individual died in early 2007 and his total benefit under the plan was distributed to his beneficiary in 2007. Such distribution would be treated as the accrued benefit of the individual for the 2007 plan year. However, such individual would be treated as a former key employee for purposes of determining whether the plan is top-heavy for the 2008 plan year and for subsequent plan years. The conclusions are not affected by whether the beneficiary of the individual is a non-key employee or a key employee of the employer.

See Treas. Reg. Section 1.416-1, Q&A T-12.

E. **Add Back Distributions Before Determination Date.**

- 1. **One-Year Period.** The present value or account amount is increased by the aggregate distributions made with respect to such employee under the plan during the one-year period ending on the determination date. The preceding

- sentence also applies to distributions under a terminated plan which if it had not been terminated would have been required to be included in an aggregation group. Code Section 416(g)(3).
2. No additional vesting, benefit accruals, or contributions need to be provided for participants in a terminated plan. Treas. Reg. Section 1.416-1, Q&A T-4.
 3. **Five-Year Period In Case of In-Service Distribution.** In the case of any distribution made for a reason other than severance from employment, death, or disability, a "five-year period" is used instead of a "one-year period." Code Section 416(g)(3)(B).
- F. **Benefits paid on account of death** are treated as distributions for purposes of Code Section 416(g)(3) to the extent such benefits do not exceed the present value of accrued benefits existing immediately prior to death; benefits paid on account of death are not treated as distributions for purposes of Code Section 416(g)(3) to the extent such benefits exceed the present value of accrued benefits existing immediately prior to death. The distribution from a defined contribution plan (including the cash value of life insurance policies) of a participant's account balance on account of death is treated as a distribution for purposes of Code Section 416(g)(3). See Treas. Reg. Section 1.416-1, Q&A T-31.
- G. A **rollover contribution** (or similar transfer) initiated by the employee, to a plan generally is not taken into account with respect to the transferee plan for purposes of determining whether such plan is a top-heavy plan. Code Section 416(g)(4)(A).
- H. **Benefits Not Taken into Account if Employee Ceases to Be Key Employee.** If any individual is a non-key employee with respect to any plan for any plan year, but such individual was a key employee with respect to such plan for any prior plan year, any accrued benefit for such employee (and the account of such employee) is not taken into account. Code Section 416(g)(4)(B). Code Section 416(g)(4)(A). Former key employees are non-key employees and are excluded entirely from the calculation to determine top-heaviness. Treas. Reg. Section 1.416-1, Q&A T-1.
- I. **Benefits Not Taken into Account if Employee Not Employed for Last Year Before Determination Date.** If any individual has not performed services for the employer maintaining the plan at any time during the one-year period ending on the determination date, any accrued benefit for such individual (and the account of such individual) is not taken into account. Code Section 416(g)(4)(E).
- J. Accrued benefits treated as accruing ratably. The accrued benefit of any employee (other than a key employee) shall be determined:
1. Under the method which is used for accrual purposes for all plans of the employer; or
 2. If there is no method described above, as if the benefit accrued not more rapidly than the slowest accrual rate permitted under Code Section 411(b)(1)(C).
- Code Section 416(g)(4)(F).
- K. A **simplified employee pension** is treated as a defined contribution plan.
1. Election to have determinations based on employer contributions. In the case of a simplified employee pension, at the election of the employer, the determination of top-heavy status is applied by taking into account aggregate

employer contributions in lieu of the aggregate of the accounts of employees.
Code Section 416(i)(6).

- L. A **catch-up contribution** is not included in top-heavy calculations for the year in which it is made. However, catch-up contributions for prior years are taken into account. Thus, catch-up contributions for prior years are included in the account balances that are used in determining whether the plan is top-heavy under Code Section 416(g). Since top-heavy determination dates usually are as of the prior year, catch-up contributions presumably are included. However, this would not be the case with the first plan year. See Code Section 414(v)(3)(B) and Treas. Reg. Section 1.414(v)-1(d)(3)(i).
- M. **Deemed IRAs** are treated as an individual retirement plan and not a qualified employer plan. Code Section 408(q). See also Treas. Reg. Section 1.408(q)-1(c). Amounts attributable to deductible employee contributions (as defined under Code Section 72(o)(5)(A)) are not considered to be part of accrued benefits. Treas. Reg. Section 1.416-1, Q&A T-28.

XI. **Minimum Vesting.** A top-heavy plan must meet minimum vesting requirements. The Pension Protection Act of 2006 changed the non-top heavy defined contribution vesting schedule to be the same as the top-heavy schedule generally for contributions made after December 31, 2006 so many defined contribution plans will be unaffected by the top-heavy vesting minimum. Pension Protection Act of 2006, Pub. L. No. 109-280, Section 114(b)(1) (2006).

- A. A plan must meet either a three-year cliff vesting or six-year graded vesting schedule. Code Section 416(b).
 - 1. **Three-Year Cliff Vesting.** An employee who has completed at least three years of service with the employers maintaining the plan must have a nonforfeitable right to 100% of his or her accrued benefit derived from employer contributions.
 - 2. **Six-Year Graded Vesting.** An employee has a nonforfeitable right to a percentage of his or her accrued benefit derived from employer contributions determined under the following table:

| Years of service | The nonforfeitable percentage is: |
|------------------|-----------------------------------|
| 2..... | 20% |
| 3..... | 40% |
| 4..... | 60% |
| 5..... | 80% |
| 6 or more..... | 100% |

- 3. Except to the extent inconsistent with the top-heavy vesting rules, the rules of Code Section 411 apply for purposes of the top-heavy vesting rules. Code Section 416(b).
- B. All accrued benefits within the meaning of Code Section 411(a)(7) must be subject to the minimum vesting schedule. These accrued benefits include benefits accrued

before a plan becomes top-heavy. However, when a plan becomes top-heavy, the accrued benefits of any employee who does not have an hour of service after the plan becomes top-heavy are not required to be subject to the minimum vesting schedule. Accrued benefits which have been forfeited before a plan becomes top-heavy need not vest when a plan becomes top-heavy. Treas. Reg. Section 1.416-1, Q&A V-3.

- C. When a top-heavy plan ceases to be top-heavy, the vesting schedule may be changed to one that would otherwise be permitted. However, in changing the vesting schedule, the rules described in Code Section 411(a)(10) apply. Thus, the nonforfeitable percentage of the accrued benefit before the plan ceased to be top-heavy must not be reduced; also, any employee with three or more years of service must be given the option of remaining under the prior (i.e., top-heavy) vesting schedule. Treas. Reg. Section 1.416-1, Q&A V-7. Internal Revenue Manual Section 4.72.5.5 (rev. 3/1/2006). Consider also the anti-cutback regulations regarding vesting changes. Treas. Reg. Section 1.411(d)-3(a)(3).

XII. Minimum Benefits - Defined Contribution Plans. The employer contribution for the year for each non-key employee (counting employer matching contributions) generally must not be less than Subsection A or B below:

- A. 3% of such participant's compensation (within the meaning of Code Section 415); and
- B. The percentage at which contributions are made (or required to be made) under the plan for the year for the key employee for whom such percentage is the highest for the year.

Code Sections 416(c)(2) and 416(c)(2)(B). See Internal Revenue Manual Section 4.72.5.3.1.2(3) (rev. 3/1/2006) and Code Section 416(c)(2)(A) (regarding inclusion of match).

- C. Generally, elective deferrals (including designated Roth contributions) are treated as employer contributions for purposes of Code Section 416. Treas. Reg. Section 1.401(k)-1(a)(4)(ii).
- D. Elective deferrals on behalf of key employees are taken into account in determining the minimum required contribution under Code Section 416(c)(2). However, elective deferrals on behalf of employees other than key employees may not be treated as employer contributions for purposes of the minimum contribution or benefit requirement of Code Section 416. Treas. Reg. Section 1.416-1, Q&A M-20. Internal Revenue Manual Section 4.72.5.3.1(1)(a) (rev. 3/1/2006).
- E. Qualified nonelective contributions are treated as employer contributions for purposes of the minimum contribution or benefit requirement of Code Section 416. Treas. Reg. Section 1.416-1, Q&A M-18. See Internal Revenue Manual Section 4.72.5.3.1.2 (rev. 3/1/2006).
- F. Forfeitures allocated to a participant's account are included in determining whether a 3% minimum contribution has been made. Internal Revenue Manual Section 4.72.5.3.1(1)(a) (rev. 3/1/2006).
- G. All defined contribution plans required to be included in an aggregation group under Code Section 416(g)(2)(A)(i) are treated as one plan for purposes of Section XI.B. Section XI.B does not apply to any plan required to be included in an aggregation

group if such plan enables a defined benefit plan required to be included in such group to meet the requirements of Code Section 401(a)(4) or 410. See Treas. Reg. Section 1.416-1, Q&A M-7 (not updated for changes in Code Section 416).

1. If the required aggregation group includes a defined contribution plan and a defined benefit plan aggregated to meet the requirements of Code Section 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%. Internal Revenue Manual Section 4.72.5.3.1(2) (rev. 3/1/2006).

H. **Which Employees Receive Minimum Contributions.** Those non-key employees who are participants in a top-heavy defined contribution plan who have not separated from service by the end of the plan year must receive the defined contribution minimum. Non-key employees who have become participants but who subsequently fail to complete 1,000 hours of service (or the equivalent) for an accrual computation period must receive the defined contribution minimum. A non-key employee may not fail to receive a defined contribution minimum because either the employee is excluded from participation (or accrues no benefit) merely because the employee's compensation is less than a stated amount, or the employee is excluded from participation (or accrues no benefit) merely because of a failure to make mandatory employee contributions or, in the case of a cash or deferred arrangement, elective contributions. Treas. Reg. Section 1.416-1, Q&A M-10. See Internal Revenue Manual Section 4.72.5.3.1.1 (rev. 3/1/2006).

XIII. **Minimum Benefits - Defined Benefit Plans.** The minimum benefit for defined benefit plans is the accrued benefit from employer contributions of each participant who is a non-key employee, expressed as an annual retirement benefit, is not less than the applicable percentage of the participant's average compensation for years in the testing period. Code Section 416(c)(1).

A. The "**applicable percentage**" is the lesser of:

1. 2% multiplied by the number of **years of service** with the employer; or
2. 20%.

Code Section 416(c)(1)(B).

B. **Years of service** are determined under Code Sections 411(a) (4), (5), and (6), except that:

1. A year of service with the employer is not taken into account if:
 - a. The plan was not a top-heavy plan for any plan year ending during such year of service, or
 - b. Such year of service was completed in a plan year beginning before January 1, 1984.
2. For purposes of determining an employee's years of service with the employer, any service with the employer is disregarded to the extent that such service occurs during a plan year when the plan benefits (within the meaning of Code Section 410(b)) no key employee or former key employee.

Code Section 416(c)(1)(C).

- C. **Average Compensation for High Years.** A participant's testing period is the period of consecutive years (not exceeding five) during which the participant had the greatest aggregate compensation from the employer.
1. The years taken into account are adjusted for years not included in a year of service.
 2. A year is not taken into account if the year begins after the close of the last year in which the plan was a top-heavy plan, or the year ends in a plan year beginning before January 1, 1984.
- Code Section 416(c)(1)(D).
- D. **"Annual retirement benefit"** means a benefit payable annually in the form of a single life annuity (with no ancillary benefits) beginning at the normal retirement age under the plan.
- Code Section 416(c)(1)(E).
- E. **Which Employees Receive Minimum Benefits.** Each non-key employee who is a participant in a top-heavy defined benefit plan and who has at least 1,000 hours of service (or equivalent service as determined under Department of Labor regulations Section 2530.200b-3) for an accrual computation period must accrue a minimum benefit in a top-heavy defined benefit plan for that accrual computation period. If the accrual computation period does not coincide with the plan year, a minimum benefit must be provided, if required, for both accrual periods within the top-heavy plan year. For a top-heavy plan that does not base accruals on accrual computation periods, minimum benefits must be credited for all periods of service required to be credited for benefit accrual. A non-key employee may not fail to accrue a minimum benefit merely because the employee was not employed on a specified date. Similarly, a non-key employee may not fail to accrue a minimum benefit because either an employee is excluded from participation (or accrues no benefit) merely because the employee's compensation is less than a stated amount, or the employee is excluded from participation (or accrues no benefit) merely because of a failure to make mandatory employee contributions. Treas. Reg. Section 1.416-1, Q&A M-4. See Internal Revenue Manual Section 4.72.5.3.2.1 (rev. 3/1/2006).
- XIV. **Other Limitations.** A top-heavy plan must meet the vesting and minimum contribution requirement without taking into account contributions or benefits under Chapter 2 (relating to tax on self-employment income), Chapter 21 (relating to Federal Insurance Contributions Act), Title II of the Social Security Act, or any other Federal or State law. Code Section 416(e).
- A. The defined benefit minimum or the defined contribution minimum may not be integrated with social security. Treas. Reg. Section 1.416-1, Q&A M-11.
- XV. **Top-Heavy Contributions or Benefits for More Than One Plan.**
- A. In the case of an employer maintaining only one plan, if such plan is a defined benefit plan, each non-key employee covered by that plan must receive the defined benefit minimum. If such plan is a defined contribution plan, each non-key employee covered by the plan must receive the defined contribution minimum. In the case of an employer who maintains more than one plan, employees covered

under only the defined benefit plan must receive the defined benefit minimum. Employees covered under only the defined contribution plan must receive the defined contribution minimum. In the case of employees covered under both defined benefit and defined contribution plans, the rules are more complicated. Code Section 416(f) precludes, in the case of employees covered under both defined benefit and defined contribution plans, either required duplication or inappropriate omission. Therefore, such employees need not receive both the defined benefit and the defined contribution minimums. Treas. Reg. Section 1.416-1, Q&A M-12. See Code Section 416(f).

B. There are four safe harbor rules a plan may use in determining which minimum must be provided to a non-key employee who is covered by both defined benefit and defined contribution plans:

1. Since the defined benefit minimums are generally more valuable, if each employee covered under both a top-heavy defined benefit plan and a top-heavy defined contribution plan receives the defined benefit minimum, the defined benefit and defined contribution minimums will be satisfied.
2. Another approach that may be used is a floor offset approach (see Rev. Rul. 76-259) under which the defined benefit minimum is provided in the defined benefit plan and is offset by the benefits provided under the defined contribution plan.
3. Another approach that may be used in the case of employees covered under both defined benefit and defined contribution plans is to prove, using a comparability analysis (see Rev. Rul. 81-202) that the plans are providing benefits at least equal to the defined benefit minimum.
4. Finally, in order to preclude the cost of providing the defined benefit minimum alone, the complexity of a floor offset plan and the annual fluctuation of a comparability analysis, a safe haven minimum defined contribution is being provided. If the contributions and forfeitures under the defined contribution plan equal 5% of compensation for each plan year the plan is top-heavy, such minimum will be presumed to satisfy the Code Section 416 minimums.

Treas. Reg. Section 1.416-1, Q&A M-12.

XVI. **Effect of Other Code Sections.**

A. Under Code Section 414(u), making USERRA contributions will not cause a plan to fail the top-heavy requirements of Code Section 416. Code Section 414(u)(1)(C).

XVII. **Proof of Compliance.** In order to administer the plan, the plan administrator must know whether the plan is top-heavy. However, precise top-heavy ratios need not be computed every year. If, on examination, the IRS requests a demonstration as to whether the plan is top-heavy the employer must demonstrate to the IRS's satisfaction that the plan is not operating in violation of Code Section 401(a)(10)(B). For purposes of any demonstration, the employer may use computations that are not precisely in accordance with this section but which mathematically prove that the plan is not top-heavy. For example, if the employer determined the present value of accrued benefits for key employees in a simplified manner

which overstated that value, determined the present value for non-key employees in a simplified manner which understated that value, and the ratio of the key employee present value divided by the sum of the present values was less than 60 %, the plan would not be considered top-heavy. This would be a sufficient demonstration because the simplified fraction could be shown to be greater than the exact fraction and, thus, the exact fraction must also be less than 60 %. Treas. Reg. Section 1.416-1, Q&A T-39.

XVIII. **Keogh Plans.** Keogh plans or H.R. 10 plans are common terms used to refer to plans for unincorporated entities. Plans of unincorporated entities have to comply with both the Code Section 401(a) and some special provisions.

A. **History of Keogh Plans.** H.R. 10 was enacted as the Self-Employed Individuals Tax Retirement Act of 1962, Pub. L. No. 87-792 (1962).

1. The Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA"), Pub. L. No. 97-248 (1982), made significant changes for plans of unincorporated entities. TEFRA generally made corporate and unincorporated plans more equivalent. For example, TEFRA created top-heavy rules under Code Section 416 which included three-year minimum vesting. TEFRA, Pub. L. No. 97-248, Section 240 (1982). See also former Code Section 401(d)(3)(A). TEFRA eliminated some unincorporated plan rules, such as limits on trustees (removed Code Section 401(d)(1)). TEFRA, Pub. L. No. 97-248, Section 237 (1982).

2. Restrictions on loans to owner-employees under Code Section 401(c)(3) were removed by the Economic Growth and Tax Relief and Reconciliation Act of 2001 ("EGTRRA") (Code Section 4975(f)(6)(B)) (made permanent by Pension Protection Act of 2006, Pub. L. No. 109-280, Section 811 (2006)).

B. The regulations under Code Section 401(c) are old and in many instances have not been updated for subsequent changes in the law:

1. Treas. Reg. Sections 1.401-10 and 1.401-11, definitions and general rules relating to plans covering self-employed individuals (published September 17, 1963 by T.D. 6675).

2. Treas. Reg. Section 1.401-12, requirements for qualification of trusts and plans benefiting owner-employees (last amended December 20, 1995 by T.D. 8635).

3. Treas. Reg. Section 1.401-13, excess contributions on behalf of owner-employees (published August 10, 1979 by T.D. 7636).

C. Note also old regulations: Treas. Reg. Section 11.401(d)(1)-1 (amended December 17, 1976 by T.D. 7448), and Treas. Reg. Sections 1.401(e)-1 through 6 (T.D. 7636, August 9, 1979).

XIX. **Earned Income.**

A. An employee includes a self-employed individual. Code Section 401(c)(1)(A). The term "**self-employed individual**" generally means an individual who has earned income within the meaning of Code Section 401(c)(2). Code Section 401(c)(1)(B).

B. Other Code Sections, not specifically discussed in this outline, referencing Code

Section 401(c)(1) include:

1. Code Section 72 (annuities);
2. Code Section 104 and 105 (health);
3. Code Section 120 (qualified legal service plans);
4. Code Section 127 (educational assistance);
5. Code Section 129 (dependant care assistance programs);
6. Code Section 132 (fringe benefits);
7. Code Section 408 (IRAs);
8. Code Section 414 (definitions and special rules);
9. Code Section 416 (top-heavy plans);
10. Code Section 4972(c)(4) (tax on nondeductible contributions); and
11. Code Section 4980B (health care continuation coverage).

- C. **Code Section 415 Compensation for Self-Employed Individuals.** Compensation means the participant's earned income (within the meaning of Code Section 401(c)(2), but determined without regard to any exclusion under Code Section 911). Code Section 415(c)(3)(B).
- D. Code Section 401(c)(2) defines "**earned income**" as net earnings from self-employment with respect to a trade or business in which personal services of the taxpayer are a material income-producing factor. Among other elements in the definition, it provides that earned income takes into account the deduction allowed to the taxpayer under Code Section 404.

XX. **Code Section 404 Contributions.** Contributions may not exceed earned income (determined without regard to Code Section 404 deductions). Code Section 404(a)(8). See also Code Section 404(a)(12) (compensation under Code Section 404(a)(8) includes elective deferrals).

XXI. **Timing of Compensation for Elective Deferrals.** See Treas. Reg. Section 1.401(k)-1(a)(6) for application of 401(k) rules to self-employed individuals. Both the elective deferrals and matching contributions generally are deductible by the partnership or sole proprietorship under Code Sections 402(g)(1)(B), 402(g)(1)(C), and 414(v).

- A. A partner's compensation is deemed currently available on the last day of the partnership taxable year and a sole proprietor's compensation is deemed currently available on the last day of the individual's taxable year. Accordingly, a self-employed individual may not make a cash or deferred election with respect to compensation for a partnership or sole proprietorship taxable year after the last day of that year. See Treas. Reg. Section 1.401(k)-2(a)(4)(ii) for the rules regarding when these contributions are treated as allocated. Treas. Reg. Section 1.401(k)-1(a)(6)(iii).
- B. For purposes of Code Sections 401(k) and 401(m), the earned income of a self-employed individual for a taxable year constitutes payment for services during that year. Thus, for example, if a partnership provides for cash advance payments during the taxable year to be made to a partner based on the value of the partner's services prior to the date of payment (and which do not exceed a reasonable estimate of the partner's earned income for the taxable year), a contribution of a portion of

these payments to a profit sharing plan in accordance with an election to defer the portion of the advance payments does not fail to be made pursuant to a cash or deferred election of this section merely because the contribution is made before the amount of the partner's earned income is finally determined and reported. However, see Treas. Reg. Section 1.401(k)-2(a)(4)(ii) for rules on when earned income is treated as received. Treas. Reg. Section 1.401(k)-1(a)(6)(iv).

XXII. Insurance Held By a Qualified Plan. For self-employed individuals under Code Section 401(c)(1), contributions to life, health, or other insurance are not deductible under Code Section 404(a)(1)-(3) (providing for deductibility of certain retirement plan contributions). Code Section 404(e). See also Treas. Reg. Section 1.404(e)-1A(g).

XXIII. Lump Sum Distributions and Self-Employed Individuals. Prior to the Small Business Job Protection Act of 1996 ("SBJPA"), Pub. L. No. 104-188 (1996), a special definition of lump sum distribution was used for five-year tax averaging. Under the definition, self-employed individuals could qualify for a lump sum distribution due to a disability, but other employees could not. However, self-employed individuals could not qualify for a lump sum distribution due to separation from service while other employees could. (Former Code Section 402(d)(4).)

A. SBJPA modified the lump sum distribution rules, but SBJPA Section 1401(c)(2) included some grandfathered rules for individuals who attained age 50 before January 1, 1986 (those born before 1936). Those individuals were allowed to apply prior capital gains and 10-year averaging tax treatment. See Tax Reform Act of 1986, Pub. L. No. 99-514, Section 1122(h)(3) and (5) (1986). Also, individuals must have elected such benefits on or before December 31, 1999, to be eligible for the special treatment under Code Section 402(d) (as in effect immediately before such amendments).

XXIV. Keogh Plans and ERISA. Under the Employee Retirement Income Security Act of 1974, as amended ("ERISA"), Pub. L. No. 93-406, Section 3(2) (1974), an ERISA pension plan generally is based on providing benefits to employees. For purposes of Title I of ERISA, an ERISA plan generally does not include any plan under which no employees are participants covered under the plan. For example, a so-called "Keogh" or "H.R. 10" plan under which only partners or only a sole proprietor are participants covered under the plan will not be covered under ERISA Title I. However, a Keogh plan under which one or more common law employees, in addition to the self-employed individuals, are participants covered under the plan, will be covered under Title I. DOL Reg. Section 2510.3-3(b). A plan covering only a sole proprietor and spouse or partner and spouse would not be subject to Title I of ERISA. DOL Reg. Section 2510.3-3(c).

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