

# The PRS Report

## The Unfortunate Case of the Upward Creeping Top-Heavy Percentage in a 401(k) Plan

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### THE UNFORTUNATE CASE OF THE UPWARD CREEPING TOP- HEAVY PERCENTAGE IN A 401(K) PLAN

Woe is the employer who sponsors a 401(k) Plan who suddenly learns from the company's Third Party Administrator (TPA) that the company is on the hook for a top-heavy contribution for the plan year because the company's 401(k) Plan has become top-heavy. Such a contribution can cost the company thousands of dollars, an expense never anticipated by the plan sponsor. (A plan is considered top-heavy when at least 60% of the account balances in the plan are for "key" employees, generally the owner(s) of the company.)

Just as the employer is disturbed by the situation, so too should the company's TPA be upset. This is because the TPA should know full well that it might have anticipated and possibly helped to avoid this unfortunate event. Below is an actual case study.

Early in the year, during the season of contribution calculations and ADP testing, an accountant who frequently relies on Pension Review Services (PRS) for its pension expertise contacted us with a problem. His client (not a PRS client), a small manufacturing company, had received word from its TPA

that the company had to make a top-heavy contribution of upwards of \$15,000 to participants in the company's 401(k) Plan for the 2011 plan year. Even participants who had never made a 401(k) contribution would have to receive this employer contribution. The



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accountant asked whether this was possible. I informed him that sadly this was indeed possible.

We informed the accountant that this is a problem a more attentive TPA might have noticed in the years leading up to the year the plan became top-heavy. “How so?” asked our accountant friend. We explained that many times the plan’s top-heavy ratio begins in a safe zone and creeps up over time to a ratio that is begging to be noticed by a competent TPA. This upwardly creeping top-heavy ratio can be the result of several factors:

- The employer perhaps once had good participation from the staff when he launched the 401(k) plan years before. However enthusiasm for participation may have waned over the years as the employer stopped actively encouraging employees to save towards retirement.
- Perhaps employees had felt the squeeze of the economic downturn and had lowered the amount they were contributing or even stopped contributing to their 401(k) Plan. At the same time this was happening, the owner of the company never stopped contributing to the plan.
- Another possibility is that during the stock market downturn, the owner more aggressively invested his 401(k) contributions, while the staff may have been uneasy and converted all account balances and future contributions to a money market fund.

Had the TPA been paying attention, it would have noticed what was happening and alerted the owner of the company to the danger ahead. As shown below, the owner should have been advised to take any number of steps to delay or perhaps even avoid the plan becoming top-heavy.

- The employer could have begun to more actively “sell” the plan to the staff. The plan’s broker of record and TPA should have been invited to hold annual employee seminars to educate the staff about saving towards retirement via the 401(k) plan.
- With natural turnover, new employees who are hired should have received more than cursory mention of the 401(k) plan. They too should have met with an investment professional to discuss the tax benefits of saving in the 401(k) plan to attain the goal of a financially secure

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retirement.

- The key employees (“owners”) should have been advised not to make 401(k) contributions the next year so that the plan’s top-heavy ratio could first be determined by the TPA. Although this might prevent the owner from making any 401(k) contributions that year, at least no top-heavy contribution would have to be made.
- If the above steps are followed and the plan’s top-heavy ratio is still trending towards the danger level, consideration should be given to changing the plan to a Safe Harbor 401(k) plan. Some Safe Harbor Plans, by design,

are not required to make top heavy contributions. Such plans would be required however to make an employer contribution. Others may use the safe harbor contributions to satisfy top heavy requirements, while not having to satisfy discrimination testing.

PRS puts a lot of effort into avoiding unpleasant surprises, as in the above situation. While preparing the annual valuation for each plan we service, we monitor the plan’s top-heavy ratio as only one of the many checks we perform. We communicate any situation warranting concern or action in the cover letter which accompanies each valuation report and/or with a telephone call to the plan sponsor or advisor.



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