retirement plan news

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Satisfying Top-heavy Requirements: It's All in the Design

Top heavy is a term used to describe qualified retirement plans that favor "key employees" over non-key employees (as determined by certain formulas). For instance, a defined contribution retirement plan (DC plan) is "top heavy" when the combined value of key employee plan accounts exceeds 60% of the total value of all plan accounts.

For a defined benefit pension plan (DB plan), top-heavy status is determined by a similar formula using the "present value of accrued benefits" instead of plan account values.

Who are the key employees? A key employee is someone who, at any time during the prior plan year, was:

- A more than 5% owner of the employer. (See the definition of 5% owner on page 2.)
- An officer with annual compensation greater than $130,000 in 2004 or $135,000 in 2005.
- A more than 1% owner with annual compensation greater than $150,000. (Family attribution rules apply.)

If a DC plan is top heavy, then top-heavy contributions — generally up to 3% of compensation — must be made for all non-key employees. For a top-heavy DB plan, top-heavy accruals are required — generally an additional benefit accrual of 2% — for all non-key employees who complete 1,000 hours of service during the year (even if separated from employment). Plus, if the plan is not using a top-heavy vesting schedule, it will be required to accelerate its vesting schedule.

There are a number of plan design strategies that can help satisfy top-heavy requirements while providing more "bang for the buck" for the employer.

Employer maintains a DC and a DB plan that cover the same employees. An employer with both a DC and a DB plan may make top-heavy allocations to both plans separately or make a single allocation to just one of the plans. In many cases, the most cost-efficient method is to make an accrual contribution to the DB plan.

Why? If the work force is relatively young, then the current value of contributions may be less than a DC plan contribution allocation. In addition, accruals to a DB plan are capped at 10 years. Many times, the DB plan's normal benefit accrual will satisfy the top-heavy allocation.

Employer maintains a money purchase plan (MPP) and another DC plan that cover the same employees. An employer with a top-heavy profit sharing or 401(k) plan and an MPP must make a top-heavy contribution to

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OFFICES IN WISCONSIN AND ARIZONA

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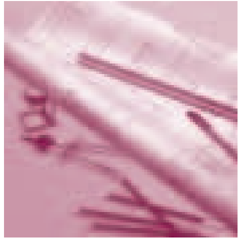

only one of the plans. Making the contribution to the MPP provides the more cost-effective solution. For example, if the MPP is already required to provide a fixed contribution formula of at least 3%, the top-heavy 3% allocation is automatically satisfied.

The profit sharing or 401(k) plan document must be amended to indicate that the top-heavy contribution will be made to the MPP.

If the plans have different eligibility provisions, employees who aren't eligible to participate in the MPP but are eligible to participate in the other DC plan must receive a minimum contribution through that plan.

Top-heavy 401(k) plan issues. Elective deferrals made by key employees are considered employer contributions for top-heavy purposes. If a key employee makes a deferral to a top-heavy plan, then the plan *must* make a minimum top-heavy contribution, even if there are no other employer contributions. (The key employee may not disgorge the elective deferral to avoid this situation.)

Top-heavy 401(k) plans have several options. For example, employer contributions — including matching, profit sharing, qualified, or safe harbor contributions — may be used to satisfy the 3% top-heavy contribution.

A 401(k) plan may be designed as a safe harbor 401(k) plan and will be exempt from the top-heavy rules as long as only elective deferrals and contributions that satisfy the safe harbor are allocated in a given year. If the employer makes additional nonelective contributions, the safe harbor plan would not be exempt, although employer contributions may count toward satisfying the top-heavy contribution.

Note: SIMPLE 401(k) plans and SIMPLE IRAs are exempt from the top-heavy rules. ❖

Who Is a 5% Owner?

A 5% owner is an individual who owns more than 5% of the employer. Family attribution rules apply, which means the ownership of a company can be attributed to other family members.

According to the tax law, an individual is considered to own any stock that is owned, directly or indirectly, by his or her spouse, parents, children (including those who are legally adopted), and grandchildren. (Certain exceptions apply.) ❖

The Three-legged Stool in Transition

For decades, the "three-legged stool" concept has been used as a model to help educate employees about preparing for their retirement.

- **Leg #1** symbolizes the employee's personal savings, including IRAs and possible home equity.
- **Leg #2** signifies the private retirement system.
- **Leg #3** represents the "public system" of Social Security payments.

Historically, defined benefit (DB) retirement plans rewarded employees for long years of service. The investment risk for providing a pension income was the employer's responsibility. However, DBs are being replaced by defined contribution (DC) plans, such as 401(k)s, which are funded by employer *and* employee contributions. And DC plan investments are under the employee's direction.

The combination of widespread termination of DB plans and proliferation of DC plans is putting more pressure on participants to fund their own retirement benefit and take on the investment risk for this leg of the stool.

If Social Security is partially privatized, as has been proposed, participants will have even more control over their retirement investments. Privatization could also have an impact on how much they contribute to an employer's 401(k) and/or their own IRAs.

Changes in the stability of one or more of the stool's three legs could cause it to become wobbly or unstable. The proposed changes to Social Security will bear careful watching. We will keep you posted. ❖

All About RBDs

RBD stands for "required beginning date." It is the deadline for receiving the first required minimum distribution (RMD) from a tax-advantaged retirement plan. For a traditional individual retirement account (IRA), the rule is simple: The required beginning date is April 1 of the year following the year the IRA owner reaches age 70½. For a qualified retirement plan, such as a 401(k) plan, profit sharing plan, or money purchase plan, the RBD rule is a bit more complex.

The RBD for these qualified plans depends on whether or not an individual is a 5% owner and on his or her retirement status.

April 1 of the year following the year an individual reaches age 70½ for those who are:

- Owners of more than 5% of a business entity. (See the definition of 5% owner on page 2.)
- Individuals who are not 5% owners, but who retire before or during the year in which they reach age 70½.

April 1 of the year following the year an individual retires for those who are:

- Not owners of more than 5% of a business and who continue to work for the employer beyond the year they reach age 70½.

How is "retirement" defined for RBD purposes? An employee is considered to be retired from an employer if his or her employment has been severed. The person's employment status with *other* employers is not considered. Thus, an individual may be retired from one job and be subject to required distribution rules, even though he or she is working for another employer.

A change in job status with the same employer is *not* considered to be a severance from employment. For example, an employee who transitions from full-time to 800 hours of service a year is *not* considered to be retired and may continue to participate in the plan or make 401(k) contributions. Thus, this person has not yet reached his or her RBD.

What happens when a 5% owner sells his or her interest? It depends. If the individual was a 5% owner at his or her RBD, then the participant will *always* be considered a 5% owner, even if his or her interest is later sold. Conversely, if an individual *becomes* a 5% owner after RBD, he or she is *not* considered a 5% owner for RBD purposes.

What about RBD and plan documents? A retirement plan may define the RBD. However, if a plan document sets the RBD at April 1 of the year following the year participants reach age 70½, it does not need to adopt the broader regulatory definition of RBD. And the administration of RMDs is simplified.

What if the plan document selects an RBD of April 1 after retirement? The principal argument for starting RBDs at age 70½ is that non-5% owner participants who work beyond 70½ often count on RMDs to supplement their income. So, if a plan delays the RBD for non-5% owners until *retirement* after age 70½, it must reflect whether distributions are permitted for active participants at and after age 70½.

However, when active participants are permitted to take distributions after age 70½, the distributions are considered "in-service" distributions, which are eligible rollover distributions, not RMDs. Such distributions are subject to a mandatory 20% withholding (unless certain conditions are met). Note: The plan document would need to include an "in-service withdrawal" provision to allow distributions to active participants. ❖

recent developments

The Pension Benefit Guarantee Corporation (PBGC) was created in 1974 as a part of the Employee Retirement Income Security Act (ERISA) to ensure that defined benefit plan participants receive retirement benefits should their employers become insolvent. To pay for this coverage, companies maintaining a defined benefit plan pay annual premiums to the PBGC.

Because of a recent series of large bankruptcies, especially in the airline and steel industries, PBGC's ability to continue to pay benefits may be seriously compromised, and Congress may soon have to find a way to fund the PBGC's financial debt. The rescue may be reminiscent of the savings and loan industry bailout of the early 1980s.

A directive was issued recently alerting IRS field staff to take action to discourage certain cross-tested plan designs. The focus is on plans that use allocations to extremely short-term, nonhighly paid employees (while excluding long-term, nonhighly paid employees) to pass nondiscrimination testing. Although such plans may pass the tests on a numeric basis, the IRS indicates that they are misinterpreting the regulations and circumventing the spirit of the regulations.

In Field Assistance Bulletin (FAB) 2004-3, the Department of Labor (DOL) comments on the fiduciary responsibilities of a directed trustee. According to the FAB, a directed trustee is a fiduciary under ERISA and must exercise his or her duties prudently and solely in the interest of the plan participants and beneficiaries when purchasing, selling, or holding publicly traded securities. Barring any extraordinary circumstances, a directed trustee generally may follow the employer's or participant's directions.

Also, the DOL has issued the 2004 Form 5500. This is much earlier than usual and permits practitioners who prepare the form more time to prepare this year.

The Working Families Tax Relief Act of 2004 creates a uniform definition of "dependent" that will apply to all employee benefit plans in 2005. This change may affect several areas of retirement plan administration, including hardship withdrawals for medical or tuition reimbursement, qualified domestic relations orders issued in favor of children or other non-spousal dependents, and eligibility for the savers tax credit associated with "deemed IRAs" provided under qualified retirement plans.

The U.S. Supreme Court will not review the decision of the U.S. Circuit Court of Appeals in Boston (*Hoult v. Hoult*, 373 F.3d 47) that a creditor may attach pension benefits once the plan administrator has distributed them to the participant. ❖

This publication is designed to provide accurate and authoritative information in regard to the subject matter covered. It is provided with the understanding that the publisher is not engaged in rendering legal, accounting, or other professional service. If legal advice or other expert assistance is required, the services of a competent professional person should be sought.

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