

(4) No voluntary employee contributions are made by the participant under any defined benefit or defined contribution plan.

(5) No mandatory employee contributions are made by the participant under any defined contribution plan.

(d) *Limitation year for aggregated plans.* If the plans which are aggregated under this section have different limitation years, subparagraph (1) or (2) of this paragraph must be complied with.

(1) The relevant employer or employers must elect the limitation year that is to be controlling. This election shall be made by the adoption of a written resolution by the employer or employers. See §1.415-2(b)(4) for rules relating to a change in the limitation year.

(2) The employer or employers may continue to use different limitation years for each plan in accordance with rules determined by the Commissioner. If, in accordance with paragraph (d)(1) of this section, one limitation year is elected, and if the plans which are aggregated covered at least one common participant prior to being aggregated, that limitation year shall be applicable for past years for purposes of computing the defined contribution fraction for those years. For special rules relating to the computation of the defined contribution plan fraction where records are not available for past periods, see §1.415-7(f).

(e) The provisions of this section may be illustrated by the following examples:

Example (1). J is an employee of two unrelated corporations, N and M. Each corporation has a qualified defined benefit plan in which J participates. Each plan provides a benefit which is equal to 75 percent of a participant's average compensation for his high 3 years of service and is payable in the form of a straight life annuity beginning at age 65. J's average compensation (within the meaning of §1.415-2(d)) for his high three years of service from each corporation is \$80,000. Each plan uses the calendar year for the limitation and plan year. In July, 1978, N Corporation becomes a wholly owned subsidiary of M Corporation, and as a result, J is treated as being employed by a single employer under section 414(b). Therefore, because section 415(f)(1)(A) requires that all defined benefit plans of an employer be treated as one defined benefit plan, the two plans must be aggregated for purposes of applying the limitations of section 415. (Although, under para-

graph (a)(2) of this section, since the plans were not aggregated as of the first day of the 1978 limitation year (January 1, 1978), they will not be considered aggregated until the limitation year beginning January 1, 1979.) As a result of such aggregation, J becomes entitled to a combined benefit which is equal to \$120,000, which is in excess of the section 415(b) dollar limitation for 1979 of \$98,100. However, under paragraph (b) of this section, the limitations of section 415(b) and §1.415-3 applicable to J may be exceeded in this situation without plan disqualification, so long as J's accrued benefit derived from employer contributions is not increased during the period within which the limitations are being exceeded.

Example (2). A, age 30, owns all of the stock of X Corporation and also owns 10 percent of the stock of Z Corporation. F, A's father, directly owns 75 percent of the stock of Z corporation. Both corporations have qualified defined contribution plans in which A participates and both plans use the calendar year for the limitation and plan year. A's compensation (within the meaning of §1.415-6(a)(3)) for 1976 is \$40,000 from Z Corporation and \$150,000 from X Corporation. During 1976, annual additions of \$10,000 are credited to A's account under the plan of Z Corporation, while annual additions of \$26,825 are credited to A's account under the plan of X Corporation. In both instances, the amount of annual additions represent the maximum allowable under section 415(c) and §1.415-6. On July 15, 1976, F dies, and A inherits all of F's stock in Z in 1976. Because under section 414(b), A is considered to be in control of X and Z Corporations, the two plans must be aggregated for purposes of applying the limitations of section 415. However, even though A's total annual additions for 1976 are \$36,825, the limitations of section 415(c) and §1.415-6 are not violated for 1976, because, under paragraph (a)(2) of this section, the two plans are considered separate plans for that year since they were not aggregated as of the first day of that year.

[T.D. 1718, 46 FR 1718, Jan. 7, 1981]

§ 1.416-1 Questions and answers on top-heavy plans.

The following questions and answers relate to special rules for top-heavy plans under section 416 of the Internal Revenue Code of 1954, as added by section 240 of the Tax Equity and Fiscal Responsibility Act of 1982 (Pub. L. 97-248) (TEFRA), and amended by sections 524 and 713(f) of the Tax Reform Act of 1984 (Pub. L. 98-369):

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G. GENERAL PROVISIONS

G-1 Q. What requirement plans are subject to the top-heavy rules added to the Code by the Tax Equity and Fiscal Responsibility Act and amended by the Tax Reform Act of 1984?

A. All stock bonus, pension, or profit-sharing plans intended to qualify under section 401(a), annuity contracts described in section 403(a), and simplified employee pensions described in section 408(k) are subject to the new top-heavy rules added to the Code by the Tax Equity and Fiscal Responsibility Act and amended by the Tax Reform Act ("TRA") of 1984.

G-2 Q. Is a multiple employer plan subject to the top-heavy requirements of section 416?

A. A multiple employer plan is subject to the requirements of section 416, but only with respect to each individual employer. Thus, if twelve employers contribute to a multiple employer plan and the accrued benefits for the key employees of one employer exceed 60 percent of the accrued benefits of all employees for such employer, the plan is top-heavy with respect to that employer. A failure by the multiple employer plan to satisfy section 416 with respect to the employees of such employer means that all employers are maintaining a plan that is not a qualified plan.

G-3 Q. As of what date must plan amendments to comply with top-heavy rules be effective?

A. Amendments required to comply with the top-heavy rules must be effective as of the first day of the first plan year which begins after 1983. See § 1.401(b)-1 for the date by which such amendments must be adopted.

T. TOP-HEAVINESS DETERMINATIONS

T-1 Q. What factors must be considered in determining whether a plan is top-heavy?

A. (a) In order to determine whether a plan is top-heavy for a plan year, it is necessary to determine which employers will be treated as a single employer for purposes of section 416; what

the determination date is for the plan year; which employees are or formerly were key employees; which former employees have not performed any service for the employer maintaining the plan at any time during the five-year period ending on the determination date; which plans of such employers are required or permitted to be aggregated to determine top-heavy status; and the present value of the accrued benefits (including distributions made during the plan year containing the determination date and the four preceding plan years) of key employees, former key employees, and non-key employees.

(b) All employers that are aggregated under section 414 (b), (c), and (m) must be taken into account as a single employer for the plan year in question, and those employees in all plans maintained by the employers that are aggregated must be categorized as key employees, as former key employees, or as non-key employees. See Question and Answer T-12 for the determination of which employees are or were key employees. All plans maintained by the employers in which a key employee participates, and certain other plans, must then be aggregated (the required aggregation group). See Question and Answer T-6 for rules concerning required aggregation. Other plans may in some cases be aggregated with the required aggregation group. See Question and Answer T-7 for rules concerning such permissive aggregation.

(c) Once aggregated, all plans that are required to be aggregated will either be top-heavy or not top-heavy, depending upon whether the aggregation group is top-heavy. A plan or aggregation group will be considered top-heavy if the sum of the present value of the accrued benefits for key employees is more than 60 percent of the sum of the present value of accrued benefits of all employees.

(d) Except as otherwise stated, for purposes of section 416(g), an employee is an individual currently or formerly employed by an employer. Former key employees are non-key employees and are excluded entirely from the calculation to determine top-heaviness. In all

cases, the present value of accrued benefits includes distributions made during the plan year containing the determination date and the preceding four plan years. See Questions and Answers T-24 and T-25 for rules concerning the account balances and present value of accrued benefits. For plan years beginning after December 31, 1984, the accrued benefit of an employee who has not performed any service for the employer maintaining the plan at any time during the five-year period ending on the determination date is excluded from the calculation to determine top-heaviness. However, if an employee performs no services for five years and then performs services, such employee's total accrued benefit is included in the calculation for top-heaviness.

T-2 Q. To what extent are multiemployer plans and multiple employer plans to which an employer makes contributions on behalf of its employees treated as plans of that employer for top-heavy purposes?

A. Multiemployer plans described in section 414(f) and multiple employer plans described in 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.

T-3 Q. Must a collectively-bargained plan be aggregated with other plans of the employer to determine whether some or all of the employer's plans are top-heavy?

A. A collectively-bargained plan that includes a key employee of an employer must be included in the required aggregation group for that employer. See Question and Answer T-6 for rules concerning required aggregation. A collectively-bargained plan that does not include a key employee may be included in a permissive aggregation group. See Question and Answer T-7 for rules concerning permissive aggregation. However, the special rules in section 416 (b), (c), or (d) applicable to top-heavy plans do not apply with respect to any employee included in a unit of employees covered by an agreement which the Secretary of Labor finds to be a collective-bargaining agreement

between employee representatives and one or more employers if there is evidence that retirement benefits were the subject of good faith bargaining between such employee representatives and such employer or employers. In determining whether there is a collective-bargaining agreement between employee representatives and one or more employers, the additional condition of section 7701(a)(46) must be satisfied after March 31, 1984.

T-4 Q. How is a terminated plan treated for purposes of the top-heavy rules?

A. A terminated plan is treated like any other plan for purposes of the top-heavy rules. For purposes of section 416, a terminated plan is one that has been formally terminated, has ceased crediting service for benefit accruals and vesting, and has been or is distributing all plan assets to participants or their beneficiaries as soon as administratively feasible. Such a plan must be aggregated with other plans of the employer if it was maintained within the last five years ending on the determination date for the plan year in question and would, but for the fact that it terminated, be part of a required aggregation group for such plan year. Distributions which have taken place within the five years ending on the determination date must be accounted for in accordance with section 416(g)(3). No additional vesting, benefit accruals or contributions must be provided for participants in a terminated plan.

T-5 Q. How are frozen plans treated for purposes of the top-heavy rules?

A. For purposes of section 416, a frozen plan is one in which benefit accruals have ceased but all assets have not been distributed to participants or their beneficiaries. Such plans are treated, for purposes of the top-heavy rules, as any non-frozen plan. That is, such plans must provide minimum contributions or benefit accruals, limit the amount of compensation which can be taken into account in providing benefits, and provide top-heavy vesting. A frozen defined contribution plan may not be required to provide additional contributions because of the rule in section 416(c)(2)(B).

T-6 Q. What is a required aggregation group?

A. 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 section 401(a)(4) or 410 is part of the required aggregation group. This concept may be illustrated by the following examples:

Example (1). 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 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 section 410(b) or the non-discrimination requirements of section 401(a)(4) only when it is considered together with the other plan in accordance with § 1.410(b)-1(d)(3), the plan not covering key employees would be part of the required aggregation group.

Example (2). A sole proprietor terminated a Keogh plan in 1981. In 1982, the sole proprietor incorporated and established a corporate plan with a calendar-year plan year. For purposes of determining whether the corporate plan is top-heavy for its 1984 plan year, the terminated Keogh plan and the corporate plan would be part of a required aggregation group. The sole proprietor and the corporation would be treated as a single employer under section 414(c). Under Question and Answer T-4, the terminated plan would be aggregated with the corporate plan because it was maintained within the five-year period ending on the determination date for the 1984 plan year and because, but for the fact that it terminated, it would be aggregated with the corporate plan because it covered a key employee.

T-7 Q. What is a permissive aggregation group?

A. A permissive aggregation group consists of plans of the employer that are required to be aggregated, plus one

or more plans of the employer that are not part of a required aggregation group but that satisfy the requirements of sections 401(a)(4) and 410 when considered together with the required aggregation group. This concept may be illustrated by the following examples:

Example (1). (a) An employer maintains two plans:

1. Plan A covers key employees and independently satisfies the requirements of sections 410 and 401(a)(4).

2. Plan B covers no key employees. It also independently satisfies the requirements of sections 410 and 401(a)(4).

(b) As indicated in Question and Answer T-6, Plan B is not required to be aggregated with Plan A. Further, if Plan B provided contributions or benefits that were not at least comparable to the contributions or benefits provided under Plan A, then Plan B could not be permissively aggregated with Plan A because the contributions and benefits would discriminate if the two plans were considered as a unit. However, if the benefits or contributions under Plan B were comparable to those under Plan A, the two plans would be permitted to be aggregated to determine whether or not the group consisting of both plans is top-heavy. If Plan A and Plan B are permitted to be aggregated, and if the permissive aggregation group is not top-heavy, then neither Plan A nor Plan B would be considered top-heavy.

Example (2). (a) Employer W maintains two plans.

1. Plan C covers salaried employees and independently satisfies the requirements of sections 410 and 401(a)(4).

2. Plan D covers employees who are included in a unit of employees covered by an agreement which the Secretary of Labor has found to be a collective-bargaining agreement between employee representatives and the employer and retirement benefits were bargained for between employee representatives and the employer.

(b) The fact that Plan D is a collectively-bargained plan does not necessarily mean that it may be permissively aggregated with Plan C. In order to be permissively aggregated with Plan C, Plan D must provide contributions or benefits with respect to service with Employer W that are at least comparable to the contributions or benefits provided under Plan C.

T-8 Q. May an employer permissively aggregate multiemployer plans, multiple employer plans and simplified employee pension plans to which the employer contributes with a plan covering key employees or a required aggregated group?

A. Yes. Multiemployer plans, multiple employer plans and simplified employee pensions to which an employer makes contributions may be permissively aggregated with a plan covering key employees or with a required aggregation group if the contributions or benefits provided under the multiemployer plan, multiple employer plan or simplified employee pension by the employer are comparable to the contributions or benefits provided under the plan covering key employees or the plans in the required aggregation group. In making this determination, only the employer's contribution to the simplified employee pension may be used.

T-9 Q. What plans will be treated as top-heavy if they are part of a required aggregation group that is top-heavy?

A. In the case of plans that are required to be aggregated, each plan in the required aggregation group will be top-heavy if the group is top-heavy. No plan in the required aggregation group will be top-heavy if the group is not top-heavy.

T-10 Q. If a required aggregation group is top-heavy, and one plan of the group satisfies the requirements of sections 416 (b), (c), and (d), may other plans in the group include provisions which do not satisfy sections 416 (b), (c) and (d)?

A. No. Each plan in a required aggregation group is top-heavy if the group is top-heavy. Thus, each plan must contain provisions satisfying the requirements of sections 416 (b) and (d). If all the plans are defined contribution plans, only one plan need satisfy the requirements of 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 requirements of 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. See Question and Answer M-12 in the case of employees who are covered under both

a defined benefit and a defined contribution plan.

T-11 Q. What plans will be treated as top-heavy if a permissive aggregation group is top-heavy?

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 requirements of section 416 (b), (c) and (d). Plans that are not part of the required aggregation group will not be subject to these requirements. Thus, if an employer wishes to demonstrate that the plans maintained by the employer are not top-heavy, the employer need consider only the required aggregation group. If, after considering the required aggregation group, it is determined that the plans are not top-heavy, the requirements of section 416 (b), (c) and (d) will not apply to any of the plans. If, on the other hand, the plans required to be aggregated are top-heavy, the employer may wish to determine whether there are any plans that may be permissively aggregated to demonstrate that the plans are not top-heavy. 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.

T-12 Q. For purposes of determining whether a plan is top-heavy for a plan year, who is a key employee?

A. Under section 416(i)(1), a key employee is any employee (including any deceased employee) who at any time during the plan year containing the determination date for the plan year in question or the four preceding plan years (including plan years before 1984) is:

1. An officer of the employer having annual compensation from the employer for a plan year greater than 150 percent of the dollar limitation in effect under section 415(c)(1)(A) for the calendar year in which such plan year ends (see Questions and Answers T-13, T-14, and T-15),

2. One of the ten employees having annual compensation from the employer for a plan year greater than the

dollar limitation in effect under section 415(c)(1)(A) for the calendar year in which such plan year ends and owning (or considered as owning within the meaning of section 318) both more than a ½ percent interest and the largest interests in the employer (see Question and Answer T-19),

3. A 5-percent owner of the employer, or

4. A 1-percent owner of the employer having annual compensation from the employer for a plan year more than \$150,000 (see Questions and Answers T-16 and T-21).

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 ten largest owners. However, in testing whether a plan or group is top-heavy, an individual's accrued benefit is counted only once. The terms key employee, former key employee, and non-key employee include the beneficiaries of such individuals. This Question and Answer is illustrated by the following examples:

Example (1). An employer maintains a calendar-year plan. An individual who was an employee of the employer and a 5-percent owner of the employer in 1986 was neither an employee nor an owner in 1987 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 each plan year through the 1991 plan year. However, for purposes of determining whether the plan is top-heavy for the 1992 plan year and for subsequent plan years, the individual would be treated as a former key employee.

Example (2). The facts are the same as in example (1), except that the individual died in early 1987 and his total benefit under the plan was distributed to his beneficiary in 1987. Such distribution would be treated as the accrued benefit of the individual for each year through the 1991 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 1992 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.

T-13 Q. For purposes of defining a key employee, who is an officer?

A. Whether an individual is an officer shall be determined upon the basis of

all the facts, including, for example, the source of his authority, the term for which elected or appointed, and the nature and extent of his duties. Generally, the term officer means an administrative executive who is in regular and continued service. The term officer implies continuity of service and excludes those employed for a special and single transaction. An employee who merely has the title of an officer but not the authority of an officer is not considered an officer for purposes of the key employee test. Similarly, an employee who does not have the title of an officer but has the authority of an officer is an officer for purposes of the key employee test. In the case of one or more employers treated as a single employer under sections 414(b), (c), or (m), whether or not an individual is an officer shall be determined based upon his responsibilities with respect to the employer or employers for which he is directly employed, and not with respect to the controlled group of corporations, employers under common control or affiliated service group. A partner of a partnership will not be treated as an officer for purposes of the key employee test merely because he owns a capital or profits interest in the partnership, exercises his voting rights as a partner, and may, for limited purposes, be authorized and does in fact act as an agent of the partnership.

T-14 Q. For purposes of determining whether a plan is top-heavy for a plan year, how many officers must be taken into account?

A. There is no minimum number of officers that must be taken into account. Only individuals who are in fact officers within the meaning of Question and Answer T-13 must be considered. For example, a corporation with only one officer and two employees would have only one officer for purposes of section 416(i)(1)(A)(i). After aggregating all employees (including leased employees within the meaning of section 414(n)) of employers required to be aggregated under section 414(b), (c) or (m), there is a maximum limit to the 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 an employer (including all employers required to be aggregated under section 414(b), (c), or (m)) has for the plan year containing the determination date is the greatest number of employees it had during that plan year or any of the four preceding plan years. For purposes of this Question and Answer, employees include only those individuals who perform services for the employer during a plan year. If the number of employees (including part-time employees) of all the employers aggregated under section 414(b), (c) or (m) is less than 30 employees, no more than three individuals shall be treated as key employees for the plan year containing the determination date by reason of being officers. If the number of employees of all organizations aggregated under section 414(b), (c) or (m) is greater than 30 but less than 500, no more than 10% of the number of employees will be treated as key employees by reason of being officers. (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 shall be increased to the next integer). If the number of employees of employers aggregated under section 414 (b), (c) and (m) exceeds 500, no more than 50 employees are to be considered as key employees by reason of being officers. This limited number of officers is comprised of the individual officers, selected from the group of all individuals who were officers in the plan year containing the determination date or any one of the four preceding plan years, who had annual plan year compensation (in the officer year) in excess of 150 percent of the dollar limitation in effect under section 415(c)(1)(A) for the calendar year in which the plan year ends and who had the largest annual plan-year compensation in that five-year period. (The definition of compensation contained in Question and Answer T-21 is to be used for this purpose.) In determining the officers of an employer, an employee who is an officer shall be counted as an officer for key employee purposes without regard to whether the employee is a key employee for any other reason. However, in testing whether the plan(s)

is top-heavy, an individual's present value of accrued benefits is counted only once.

Example. A company is testing to see if its plan is top-heavy for the 1985 plan year. In each year from 1980 through 1984 it has more than 500 employees. Assume that (1) because of rapid turnover among officers, the individuals who are officers each year are different from the individuals who are officers in any preceding year, and (2) the annual plan year compensation of each officer exceeds 150 percent of the dollar limitation in effect under section 415(c)(1)(A) 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 1985 plan year. Further, the 50 individuals considered as key employees under this test would be determined by selecting the 50 out of 250 individuals (50 different officers each year) who had the highest annual plan-year compensation during the 1980-1984 period (while officers).

T-15 Q. For purposes of section 416, do organizations other than corporations have officers?

A. Yes. For purposes of the top-heavy rules, sole proprietorships, partnerships, associations, trusts, and labor organizations may have officers. This rule is effective for purposes of determining whether a plan is top-heavy for plan years which begin after February 28, 1985.

T-16 Q. Who is a 1-percent owner of the employer?

A. (a) If the employer is a corporation, a 1-percent owner is any employee who owns (or is considered as owning within the meaning of section 318) more than 1 percent of the value of the outstanding stock of the corporation or stock possessing more than 1 percent of the total combined voting power of all stock of the corporation. If the employer is not a corporation, a 1-percent owner is any employee who owns more than 1 percent of the capital or profits interest in the employer. The rules of subsections (b), (c), and (m) of section 414 do not apply for purposes of determining who is a 1-percent owner.

(b) For purposes of determining who is a 1-percent owner, 5-percent owner, or top-ten owner, value means fair market value taking into account all facts and circumstances.

T-17 Q. Who is a 5-percent owner of the employer?

A. If the employer is a corporation, a 5-percent owner is any employee who owns (or is considered as owning within the meaning of section 318) more than 5 percent of the value of the outstanding stock of the corporation or stock possessing more than 5 percent of the total combined voting power of all stock of the corporation. If the employer is not a corporation, a 5-percent owner is any employee who owns more than 5 percent of the capital or profits interest in the employer. The rules of subsections (b), (c), and (m) of section 414 do not apply for purposes of determining who is a 5-percent owner.

T-18 Q. How do the rules of section 318 apply for purposes of determining ownership in an entity other than a corporation?

A. For purposes of determining ownership is an entity other than a corporation, the rules of 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 must be substituted for stock.

T-19 Q. Which employees will be considered one of the top ten owners?

A. (a) For purposes of determining whether a plan is top-heavy for a plan year, the top ten owners are the ten employees who (1) own (or are considered as owning within the meaning of section 318) during the plan year containing the determination date or any of the four preceding plan years both more than a ½ percent ownership interest in value and the largest percentage ownership interests in value of any of the employers required to be aggregated under section 414(b), (c), or (m), and (2) have during the plan year of ownership annual plan year compensation from the employer more than the limitation in effect under section 415(c)(1)(A) for the calendar year in which such plan year ends. The five years for which the test is made will be referred to as the "testing period." An employee whose annual plan year compensation exceeds the section 415(c)(1)(A) limit in effect for the calendar year in which a plan year in the testing period ends who has an ownership interest greater than ½ percent in that plan year is considered to be one

of the top ten owners unless at least ten other employees own a greater interest in the employer during any year of the testing period and have annual plan year compensation during such plan year of ownership greater than the section 415(c)(1)(A) limit in effect for the calendar year in which such plan year ends. Ownership each plan year is determined on the basis of percentage of ownership interest in total ownership value and not dollar amounts. Thus, an employee whose stock interest is valued at 15 percent of the total stock value of a corporation in year one that was worth \$15,000 is ranked higher than an employee whose stock interest is valued at 5 percent of the total stock value of the same corporation in year three which is now worth \$50,000.

(b) If an employee's ownership interest changes during a plan year, his ownership interest for the year is the largest interest owned at any time during the year. If two employees have the same ownership interest in the employer during the testing period, the employee having the largest annual compensation from the employer for the plan year during any part of which that ownership interest existed shall be treated as having a larger interest. Thus, if 25 employees each own 4 percent in value of the employer during the testing period, the 10 employees with the largest single plan year compensation during this period will be considered the top ten owners. For purposes of this Question and Answer, compensation has the meaning set forth in Question and Answer T-21. This Question and Answer is illustrated by the following examples:

Example 1. Corporation K maintains a calendar year defined contribution plan. On January 1, 1986, Corporation K has five owners who owned the following value percentages of K stock: A=50%, B=20%, C=15%, D=10%, and E=5%. On June 30, 1987, the five owners of Corporation K sold all of their shares of stock. The new owners and their respective ownership percentages were: F=40%, G=30%, H=10%, I=10%, and J=10%. Assume that, for 1986, A, B, C, D, and E had annual compensation from Corporation K greater than the section 415(c)(1)(A) limit and that, for 1987, F, G, H, I, and J also had compensation from Corporation K greater than the section 415(c)(1)(A) limit. For purposes of determining whether the plan is top-heavy for

the 1991 plan year, the top ten owners will include A, B, C, D, E, F, G, H, I, and J because no 10 individuals during the testing period, 1986-1990, had a greater ownership interest than these individuals.

Example 2. Assume the same facts in *Example 1*, except that on June 1, 1988, F, G, H, I, and J sold their interests to new owners, K, L, M, N, and O. K, L, M, N, and O owned, respectively, 30%, 30%, 30%, 5% and 5% of the value of the shares of X. Assume also that for 1988 K, L, M, N, and O earned more than the section 415(c)(1)(A) limitation. For purposes of determining whether the plan is top-heavy for the 1991 plan year, the top ten owners will include: A, B, F, K, G, L, M, and C because these eight individuals owned the highest value percentages of the Corporation K stock. Since D, H, I, and J owned equal 10% interests in value, the two employees of this group who had the largest annual plan year compensation during the plan years of their ownership will be the last 2 top ten owners.

T-20 Q. For purposes of determining whether an employee is a key employee under section 416(i)(1)(A), what aggregation rules apply?

A. In the case of ownership percentages, each employer that would otherwise be aggregated under section 414 (b), (c) and (m) is treated as a separate employer. (See section 416(i)(1)(C).) However, for purposes of determining whether an individual has compensation of \$150,000, or whether an individual is a key employee by reason of being an officer or a top ten owner, compensation from each entity required to be aggregated under sections 414 (b), (c) and (m) is taken into account. These rules may be illustrated by the following example:

Example. An individual owns two percent of the value of a professional corporation, which in turn owns a 1/10th of 1 percent interest in a partnership. The entities must be aggregated in accordance with 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 two percent interest in the professional corporation and because his combined compensation from both the professional corporation and the partnership is more than \$150,000.

T-21 Q. For purposes of testing whether an individual has compensation of more than \$150,000, what definition of compensation must be used?

A. The definition of compensation to be used is the definition in §1.415-2(d). In the case of an individual, including a self-employed individual, §1.415-2(d)(2)(i) excludes from compensation amounts contributed to a plan of deferred compensation. Alternatively, compensation that would be stated on an employee's Form W-2 for the calendar year that ends with or within the plan year may be used. A plan must use the same definition of compensation for all top-heavy purposes for which the definition in this Question and Answer must be used.

T-22 Q. In the case of an employer who maintains a single plan, when must the determination whether the plan is top-heavy be made?

A. Whether a plan is top-heavy for a particular plan year is determined as of the determination date for such plan year. The determination date with respect to a plan year is defined in section 416(g)(4)(C) as (1) the last day of the preceding plan year, or (2) in the case of the first plan year, the last day of such plan year. Distributions made and the present value of accrued benefits are generally determined as of the determination date. (See Questions and Answers T-24 and T-25 for more specific rules.)

T-23 Q. In the case of an aggregation group, when must the determination whether the group is top-heavy be made?

A. When two or more plans constitute an aggregation group in accordance with section 416(g)(2), the following procedures are used to determine whether the plans are top-heavy for a particular plan year. First, 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. These rules may

be illustrated by the following example:

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, 1984, the determination date is June 30, 1984. For Plan B's plan year in 1985, the determination date is December 31, 1984. 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, 1984, and December 31, 1984, 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, 1984, and Plan B will be top-heavy for the 1985 calendar year.

T-24 Q. How is the present value of an accrued benefit determined in a defined contribution plan?

A. The present value of accrued benefits as of the determination date for any individual is the sum of (a) the account balance as of the most recent valuation date occurring within a 12-month period ending on the determination date, and (b) an adjustment for contributions due as of the determination date. In the case of a plan not subject to the minimum funding requirements of section 412, the adjustment in (b) is generally the amount of any contributions actually made after the valuation date but on or before the determination date. However, in the first plan year of the plan, the adjustment in (b) should also reflect the amount of any contributions made after the determination date that are allocated as of a date in that first plan year. In the case of a plan that is subject to the minimum funding requirements, the account balance in (a) 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. Thus, the account balance will include contributions waived in prior years as reflected in the adjusted account balance and contributions not

paid that resulted in a funding deficiency. The adjusted account balance is described in Rev. Rul. 78-223, 1978-1 C.B. 125. Also, the adjustment in (b) should reflect the amount of any contribution actually made (or due to be made) after the valuation date but before the expiration of the extended payment period in section 412(c)(10).

T-25. Q. How is the present value of an accrued benefit determined in a defined benefit plan?

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. In the first plan year of a plan, the accrued benefit for a current employee must be determined either (i) as if the individual terminated service as of the determination date or (ii) as if the individual terminated service as of the valuation date, but taking into account the estimated accrued benefit as of the determination date. For the second plan year of a plan, the accrued benefit taken into account for a current participant must not be less than the accrued benefit taken into account for the first plan year unless the difference is attributable to using an estimate of the accrued benefit as of the determination date for the first plan year and using the actual accrued benefit as of the determination date for the second plan year. For any other plan year, the accrued benefit for a current employee must be determined as if the individual terminated service as of such valuation date. For this purpose, the valuation date must be the same valuation date for computing plan costs for minimum funding, regardless of whether a valuation is performed that year.

T-26. Q. What actuarial assumptions are used for determining the present value of accrued benefits for defined benefit plans?

A. (a) 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. The assumptions need not be the same as those used for

minimum funding purposes or for purposes of determining the actuarial equivalence of optional benefits under the plan. The accrued benefit for each current employee is computed as if the employee voluntarily terminated service as of the valuation date. The present value must be computed using an interest and a post-retirement mortality assumption. Pre-retirement mortality and future increases in cost of living (but not in the maximum dollar amount permitted by section 415) may also be assumed. However, assumptions as to future withdrawals or future salary increases may not be used. In the case of a plan providing a qualified joint and survivor annuity within the meaning of section 401(a)(11) as a normal form of benefit, for purposes of determining the present value of the accrued benefit, the spouse of the participant may be assumed to be the same age as the participant.

(b) Except in the case where the plan provides for a nonproportional subsidy, the present value 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. See Question and Answer

T-27.

(c) 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. In the case of two or more defined benefit plans which are being tested for determining whether an aggregation group is top-heavy, the actuarial assumptions used for all plans within the group must be the same. Any assumptions which reflect a reasonable mortality experience and an interest rate not less than five percent or greater than six percent will be considered as reasonable. Plans, however, are not required to use an interest rate in this range.

T-27 Q. In determining the present value of accrued benefits in a defined

benefit plan, what standards are applied toward determining whether a subsidy is nonproportional?

A. A subsidy is nonproportional unless the subsidy applies to a group of employees that would independently satisfy the requirements of section 410(b). If two or more plans are considered as a unit for comparability purposes under §1.410(b)-1(d)(3), subsidies may be necessary in both plans or else the subsidy may be nonproportional. Thus, for example, in the case of a plan which provides an early retirement benefit after age 55 and 20 years of service equal to the normal retirement benefit without actuarial reduction and if the employees who may conceivably reach age 55 with 20 years of service would, as a group, satisfy the requirements of section 410(b), that subsidy is proportional. However, in contrast, consider a plan that provides an early retirement benefit that is the actuarial equivalent of the normal retirement benefit. In determining the early retirement benefit, the plan imposes the section 415 limits only on the early retirement benefit (not on the normal retirement benefit before applying the early retirement reduction factors). In such a plan, a participant with a normal retirement benefit (before limitation by section 415) in excess of the section 415 limits will receive a subsidized early retirement benefit, whereas a participant with a lower normal retirement benefit will not. Thus, such a benefit would be a nonproportional subsidy if the group of individuals who are limited by the limitations under section 415 do not, by themselves, constitute a cross section of employees that could satisfy section 410(b).

T-28 Q. For purposes of determining the present value of accrued benefits in either a defined benefit or defined contribution plan, are the accrued benefits attributable to employee contributions considered to be part of the accrued benefits?

A. The accrued benefits attributable to employee contributions are considered to be part of the accrued benefits without regard to whether such contributions are mandatory or voluntary. However, the amounts attributable to deductible employee contributions (as

defined in section 72(o)(5)(A)) are not considered to be part of the accrued benefits.

T-29 Q. How are plans described in section 401(k) treated for purposes of the top-heavy rules?

A. No special top-heavy rules are provided for plans described in section 401(k), except a transitional rule. For plan years beginning after December 31, 1984, amounts which an employee elects to defer are treated as employer contributions for purposes of determining minimum required contributions under section 416(c)(2). However, for plan years beginning prior to January 1, 1985, amounts which an employee elects to have contributed to a plan described in section 401(k) are not treated as employer contributions for these purposes. A plan described in section 401(k) which is top-heavy must provide minimum contributions by the employer and limit the amount of compensation which can be taken into account in providing benefits under the plan.

T-30 Q. What distributions are added to the present value of accrued benefits in determining whether a plan is top-heavy for a particular plan year?

A. Under section 416(g)(3)(A), distributions made within the plan year that includes the determination date and within the four preceding plan years are added to the present value of accrued benefits of key employees and non-key employees in testing for top-heaviness. However, in the case of distributions made after the valuation date and prior to the determination date, such distributions are not included as distributions in section 416(g)(3)(A) to the extent that such distributions are included in the present value of the accrued benefits as of the valuation date. In the case of the distribution of an annuity contract, the amount of such distribution is deemed to be the current actuarial value of the contract, determined on the date of the distribution. Certain distributions that are rolled over by the employee are not included as distributions. See Question and Answer T-32. A distribution will not fail to be considered in determining the present value of accrued benefits merely because it was made before the effective date of section 416.

For purposes of this question and answer, distributions mean all distributions made by a plan, including all distributions of employee contributions made during and before the plan year.

T-31 Q. Are benefits paid on account of death treated as distributions for purposes of section 416(g)(3)?

A. Benefits paid on account of death are treated as distributions for purposes of 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 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 will be treated as a distribution for purposes of section 416(g)(3).

T-32 Q. How are rollovers and plan-to-plan transfers treated in testing whether a plan is top-heavy?

A. The rules for handling rollovers and transfers depend upon whether they are unrelated (both initiated by the employee and made from a plan maintained by one employer to a plan maintained by another employer) or related (a rollover or transfer either not initiated by the employee or made to a plan maintained by the same employer). Generally, a rollover or transfer made incident to a merger or consolidation of two or more plans or the division of a single plan into two or more plans will not be treated as being initiated by the employee. The fact that the employer initiated the distribution does not mean that the rollover was not initiated by the employee. For purposes of determining whether two employers are to be treated as the same employer, all employers aggregated under section 414(b), (c) or (m) are treated as the same employer. In the case of unrelated rollovers and transfers, (1) the plan making the distribution or transfer is to count the distribution as a distribution under section 416(g)(3), and (2) the plan accepting the rollover or transfer is not to consider the rollover or transfer as

part of the accrued benefit if such rollover or transfer was accepted after December 31, 1983, but is to consider it as part of the accrued benefit if such rollover or transfer was accepted prior to January 1, 1984. In the case of related rollovers and transfers, the plan making the distribution or transfer is not to count the distribution or transfer under section 416(g)(3) and the plan accepting the rollover or transfer counts the rollover or transfer in the present value of the accrued benefits. Rules for related rollovers and transfers do not depend on whether the rollover or transfer was accepted prior to January 1, 1984.

T-33 Q. How are the aggregate defined benefit and defined contribution limits under section 415(e) affected by the top-heavy rules?

A. Section 416(h) modifies the aggregate limits in section 415(e) for super top-heavy plans and for top-heavy plans that are not super top-heavy but do not provide for an additional minimum contribution or benefit. A plan is a super top-heavy plan if the present value of accrued benefits for key employees exceeds 90% of the present value of the accrued benefits for all employees. In the case of a top-heavy aggregation group, the test is applied to all plans in the group as a whole. These present values are computed using the same rules as are used for determining whether the plan is top-heavy. In the case of a super top-heavy plan, in computing the denominators of the defined benefit and defined contribution fractions under section 415(e), a factor of 1.0 is used instead of 1.25 for all employees. In the case of a top-heavy plan that is not super top-heavy, the same rule applies unless each non-key employee who is entitled to a minimum contribution or benefit receives an additional minimum contribution or benefit. In the case of a defined benefit plan, the additional minimum benefit is one percentage point (up to a maximum of ten percentage points) for each year of service described in Question and Answer M-2 of the participant's average compensation for the years described in Question and Answer M-2. In the case of a defined contribution plan, the additional minimum contribution is one percent of the par-

participant's compensation. If a plan does not provide the applicable additional one percent minimum or if a plan is super top-heavy, the factor of 1.25 may be used for an individual only if there are both no further accruals for that individual under any defined benefit plan and no further annual additions for that individual under any defined contribution plan until the combined fraction satisfies the rules of section

415(e) using the 1.0 factor for that individual. The rules contained in this Question and Answer apply for each limitation year that contains any portion of a plan year for which the plan is top-heavy. This Question and Answer may be illustrated by the following example:

Example. A Corporation maintains a profit-sharing plan and a defined benefit plan, and these plans constitute a required aggregation group. Both plans use the calendar year for the plan year and the limitation year under section 415. The plans were determined to be top-heavy for plan year 1986. The plans use the 1.25 factor under section 415(e), and non-key employees covered by both the profit-sharing and the defined benefit plan accrue, under the defined benefit plan, 3% of compensation for each year of service (up to a maximum of 30%). The plans become super top-heavy for the 1990 plan year. In order to satisfy section 415, no further accruals and no further annual additions may take place for any employee covered by both plans until the combined defined benefit-defined contribution fraction for such employee is less than 1.0, using the 1.0 factor in place of 1.25.

T-34 Q. May plans be permissively aggregated to avoid being super top-heavy?

A. Yes, plans may be permissively aggregated to avoid being super top-heavy.

T-35 Q. What provisions must be contained in a plan to comply with the top-heavy requirements?

A. 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 section 416. See Questions and Answers T-39 and T-40 for rules on what provisions must be included. Under section 401(a)(10)(B)(ii), regulations may waive this requirement for some plans. See Question and Answer T-38 for a description of plans that need not include such provisions.

T-36 Q. For an employer who has no employee who has participated or is eligible to participate in both a defined benefit and defined contribution plan (or a simplified employee pension, "SEP") of that employer, what provisions must be in the plan(s) to comply with the top-heavy requirements?

A. (a) If the defined benefit plan has no participants who are or could be participants in a defined contribution plan of the employer (or vice versa), the defined benefit plan (or defined contribution plan) need not include provisions describing the defined benefit or defined contribution fractions for purposes of section 415 and, thus, the plan need not contain provisions to determine whether the plan is super top-heavy or to change any plan provisions if the plan becomes super top-heavy. Furthermore, if the plan contains a single benefit structure that satisfies the requirements of section 416 (b), (c), and (d) for each plan year without regard to whether the plan is top-heavy for such year, the plan need not include separate provisions to determine whether the plan is top-heavy or that apply if the plan is top-heavy. If the plan's single benefit structure does not assure that section 416 (b), (c), and (d) will be satisfied in all cases, then the plan must include three types of provisions.

(b) First, the plan must contain provisions describing how to determine whether the plan is top-heavy. These provisions must include (1) the criteria for determining which employees are key employees (or non-key employees), (2) in the case of a defined benefit plan, the actuarial assumptions and benefits considered to determine the present value of accrued benefits, (3) a description of how the top-heavy ratio is computed, (4) a description of what plans (or types of plans) will be aggregated in testing whether the plan is top-heavy, and (5) a definition of the determination date and the valuation date applicable to the determination date. These determinations must be based on standards that are uniformly and consistently applied and that satisfy the rules set forth in section 416 and these Questions and Answers. The provisions in (1) and (3) above may be incorporated in the plan by reference to the

applicable sections of the Internal Revenue Code without adversely affecting the qualification of the plan. However, the plan must state the definition of compensation for purposes of determining who is a key employee.

(c) Second, the plan must specifically contain the following provisions that will become effective if the plan becomes top-heavy: vesting that satisfies the minimum vesting requirements of section 416(b), benefits that will not be less than the minimum benefits set forth in section 416(c), and the compensation limitation described in section 416(d). The compensation limitation described in section 416(d) may be incorporated by reference. If a plan always meets the requirements of either section 416(b), (c) or (d), the plan need not include additional provisions to meet any such requirements.

(d) Third, the plan must include provisions insuring that any change in the plan's benefit structure (including vesting schedules) resulting from a change in the plan's top-heavy status will not violate section 411(a)(10). Thus, if a plan ceases being top-heavy, certain restrictions apply with respect to the change in the applicable vesting schedule.

T-37 Q. For an employer who maintains or has maintained both a defined benefit and a defined contribution plan (or a simplified employee pension, "SEP") and some participants do or could participate in both types of plan, what provisions must be in the plans to comply with the top-heavy requirements?

A. If an employer maintains (or has maintained) both a defined benefit plan and a defined contribution plan (or SEP), and the plans have or could have participants who participate in both types of plans, then the plans must contain more provisions than those described in Question and Answer T-36. First, the plans may exclude rules to determine whether the plan is top-heavy (or to apply when the plan is top-heavy) only if both plans contain a single benefit structure that satisfies sections 416 (b), (c), and (d) without regard to whether the plans are top-heavy. Second, unless the plans always satisfy the requirements of section 415(e) using the 1.0 factor in the defined

benefit and defined contribution fractions as described in section 416(h)(i), the plans must include provisions similar to those in Question and Answer T-36 (for top-heavy) to determine whether the plan is super top-heavy and to satisfy section 416(h) if it is.

T-38 Q. Are any plans exempted from including top-heavy provisions?

A. Section 401(a)(10)(B) exempts governmental plans (as defined in section 414(d)) from the top-heavy requirements and provides that regulations may exempt certain plans from including the top-heavy provisions. A plan need not include any top-heavy provisions if the plan: (1) is not top-heavy, and (2) covers only employees who are included in a unit of employees covered by a collective-bargaining agreement (if retirement benefits were the subject of good faith bargaining) or employees of employee representatives. The requirement set forth in section 7701(a)(46) must be met before an agreement will be considered a collective-bargaining agreement after March 31, 1984.

T-39 Q. Must ratios be computed each year to determine whether a plan is top-heavy?

A. No. 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 Internal Revenue Service requests a demonstration as to whether the plan is top-heavy (or super top-heavy; see Question and Answer T-33) the employer must demonstrate to the Service's satisfaction that the plan is not operating in violation of 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 percent, the plan would not be con-

sidered 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 percent.

Several methods that may be used to simplify the determinations are indicated below.

(1) If the top-heavy ratio, computed considering all the key employees and only some of the non-key employees, is less than 60 percent, then it is not necessary to accumulate employee data on the remaining non-key employees. Inclusion of additional non-key employees would only further decrease the ratio.

(2) If the number of key employees is known but the identity of the key employees is not known (i.e. if the only key employees are officers and the limit on officers is applicable), the numerator may be determined by using a hypothetical "worst case" basis. Thus, in the case of a defined benefit plan, if the numerator of the top-heavy ratio were determined assuming each key employee's present value of accrued benefits were equal to the maximum section 415 benefits at the age that would maximize such present value, that assumption would only overstate the present value of accrued benefits for key employees. Thus, if that ratio is less than 60 percent, the plan is not top-heavy and accurate data on the key employees need not be collected.

(3) If the employer has available present value of accrued benefit computations for key and non-key employees in a defined benefit plan, and these values differ from those that would be produced under Question and Answer T-25 only by inclusion of a withdrawal assumption, the present value for the key employees (but not the non-key employees) may be adjusted to a "worst case" value by dividing by the lowest possible probability of not withdrawing from plan participation before normal retirement age. If the top-heavy ratio based on this inflated key employee value is less than 60 percent, the present value need not be recomputed without the withdrawal assumption. The methods set forth in this answer may also be used to determine whether a plan is super top-heavy by

inserting “90%” for “60%” in the appropriate places.

T-40 Q. Will a plan fail to qualify if it provides that the \$200,000 maximum amount of annual compensation taken into account under section 416(d) for any plan year that the plan is top-heavy may be automatically increased in accordance with regulations under section 416?

A. No.

T-41 Q. If a plan provides benefits based on compensation in excess of \$200,000 and the plan becomes top-heavy, must any accrued benefits attributable to this excess compensation be eliminated?

A. No. For any year that a plan is top-heavy, section 416(d) provides that compensation in excess of \$200,000 must not be taken into account. However, a top-heavy plan may continue to provide for any benefits attributable to compensation in excess of \$200,000 to the extent such benefits were accrued before the plan was top-heavy. Furthermore, section 411(d)(6) will be violated if any individual’s pre-top-heavy benefit is reduced by either (1) a plan amendment adding the \$200,000 restriction, or (2) an automatic change in the plan benefits structure imposing the \$200,000 restriction due to the plan’s becoming top-heavy.

T-42 Q. Under a top-heavy defined benefit plan, are the requirements of section 416(d) satisfied if the annual compensation of an employee taken into account to determine plan benefits is limited to the amount currently described in section 416(d) for years during which the plan is top-heavy but higher compensation is taken into account for years before the plan became top-heavy?

A. No. For the top-heavy plan to meet the requirements of section 416(d), compensation for all years, including years before the plan became top-heavy, that is taken into account to determine plan benefits must not exceed the amount currently described in section 416(d). However, if the accrued benefit as of the end of the last plan year before the plan became top-heavy (ignoring any plan amendments after that date) is greater than the accrued benefit determined by limiting compensation in accordance with section

416(d), that higher accrued benefit as of the end of the last plan year before the plan became top-heavy must not be reduced. Providing such higher accrued benefit will not cause the plan to violate section 416(d).

T-43 Q. What happens to an individual who has ceased employment before a plan becomes top-heavy?

A. If an individual has ceased employment before a plan becomes top-heavy, such individual would not be required to receive any additional benefit accruals, contributions, or vesting, unless the individual returned to employment with the employer. See Questions and Answers V-3, M-4, and M-10. In addition, if the individual is receiving benefits based on annual compensation greater than \$200,000, such benefits cannot be decreased.

V. VESTING RULES FOR TOP-HEAVY PLANS

V-1 Q. What vesting must be provided under a top-heavy plan?

A. Under section 416(b), the accrued benefits attributable to employer contributions must be nonforfeitable in accordance with one of two statutory standards. Either such accrued benefits must be nonforfeitable after 3 years of service or the nonforfeitable portion of accrued benefits must be at least 20 percent after 2 years of service, 40 percent after 3 years of service, 60 percent after 4 years of service, 80 percent after 5 years of service, and 100 percent after 6 years of service. The accrued benefits attributable to employer contributions has the same meaning as under section 411(c) of the Code. As under section 411(a), the accrued benefits attributable to employee contributions must be nonforfeitable at all times.

V-2 Q. What service must be counted in determining vesting requirements?

A. All service required to be counted under section 411(a) must be counted for these purposes. All service permitted to be disregarded under section 411(a)(4) may similarly be disregarded under the schedules of section 416(b).

V-3 Q. What benefits must be subject to the minimum vesting schedule of section 416(b)?

A. All accrued benefits within the meaning of section 411(a)(7) must be

subject to the minimum vesting schedule. These accrued benefits include benefits accrued before the effective date of section 416 and 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.

V-4 Q. May a top-heavy plan provide a minimum eligibility requirement of the later of age 21 or the completion of 3 years of service and provide that all benefits are nonforfeitable when accrued?

A. Yes. For plan years which begin after December 31, 1984, a top-heavy plan may provide a minimum eligibility requirement of the later of age 21, or the completion of 3 years of service, and provide that all benefits are nonforfeitable when accrued. For plan years which begin before January 1, 1985, "25" may be substituted for "21" in the preceding sentence.

V-5 Q. What does nonforfeitable mean?

A. In general, nonforfeitable has the same meaning as in section 411(a). However, the minimum benefits required under section 416 (to the extent required to be nonforfeitable under section 416(b)) may not be forfeited under section 411(a)(3) (B) or (D). Thus, if benefits are suspended (ceased) during a period of reemployment, the benefit payable upon the subsequent resumption of payments must be actuarially increased to reflect the nonpayment of benefits during such period of reemployment.

V-6 Q. Will a class-year plan automatically satisfy the minimum vesting requirements in section 416(b) if it provides that contributions with respect to any plan year become nonforfeitable no later than the end of the third plan year following the plan year for which the contribution was made?

A. No. Although this vesting schedule is similar to the 3-year minimum vesting schedule permitted by section 416(b)(1)(A), it does not satisfy that minimum. The 3-year vesting schedule

in section 416(b)(1)(A) requires that, after completion of 3 years of service, the entire accrued benefit of a participant be nonforfeitable. Under the class-year vesting schedule described above, a portion of a participant's accrued benefit (that portion attributable to contributions for the prior 3 years) is forfeitable regardless of the participant's years of service.

V-7 Q. When a top-heavy plan ceases to be a top-heavy, may the vesting schedule be altered to a vesting schedule permitted without regard to section 416?

A. 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 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 five or more years of service must be given the option of remaining under the prior (i.e., top-heavy) vesting schedule.

M. MINIMUM BENEFITS UNDER TOP-HEAVY PLANS

M-1 Q. Which employees must receive minimum contributions or benefits in a top-heavy plan?

A. Generally, every non-key employee who is a participant in a top-heavy plan must receive minimum contributions or benefits under such plan. However, see Questions and Answers M-4 and M-10 for certain exceptions. Different minimums apply for defined benefit and defined contribution plans.

M-2 Q. What is the defined benefit minimum?

A. (a) The defined benefit minimum requires that the accrued benefit at any point in time must equal at least the product of (i) an employee's average annual compensation for the period of consecutive years (not exceeding five) when the employee had the highest aggregate compensation from the employer and (ii) the lesser of 2% per year of service with the employer or 20%.

(b) For purposes of the defined benefit minimum, years of service with the employer are generally determined under the rules of section 411(a) (4), (5)

and (6). However, a plan may disregard any year of service if the plan was not top-heavy for any plan year ending during such year of service, or if the year of service was completed in a plan year beginning before January 1, 1984.

(c) In determining the average annual compensation for a period of consecutive years during which the employee had the largest aggregate compensation, years for which the employee did not earn a year of service under the rules of section 411(a) (4), (5), and (6) are to be disregarded. Thus, if an employee has received compensation from the employer during years one two, and three, and for each of these years the employee earned a year of service, then the employee's average annual compensation is determined by dividing the employee's aggregate compensation for these three years by three. If the employee fails to earn a year of service in the next year, but does earn a year of service in the fifth year, the employee's average annual compensation is calculated by dividing the employee's aggregate compensation for years one, two, three, and five by four. The compensation required to be taken into account is the compensation described in Question and Answer T-21. In addition, compensation received for years ending in plan years beginning before January 1, 1984, and compensation received for years beginning after the close of the last plan year in which the plan is top-heavy may be disregarded.

(d) The defined benefit minimum is expressed as a life annuity (with no ancillary benefits) commencing at normal retirement age. Thus, if post-retirement death benefits are also provided, the 2% minimum annuity benefit may be adjusted. (See Question and Answer M-3.) The 2% minimum annuity benefit may not be adjusted due to the provision of pre-retirement ancillary benefits. Normal retirement age has the same meaning as under section 411(a) (8).

(e) Any accruals of employer-derived benefits, whether or not attributable to years for which the plan is top-heavy, may be used to satisfy the defined benefit minimums. Thus, if a non-key employee had already accrued a benefit of 20 percent of final average pay at the

time the plan became top-heavy, no additional minimum accruals are required (although the accrued benefit would increase as final average pay increased). Accrued benefits attributable to employee contributions must be ignored. Accrued benefits attributable to employer and employee contributions have the same meaning as under section 411(c).

M-3 Q. What defined benefit minimum must be received if an employee receives a benefit in a form other than a single life annuity or a benefit other than at normal retirement age?

A. If the form of benefit is other than a single life annuity, the employee must receive an amount that is the actuarial equivalent of the minimum single life annuity benefit. If the benefit commences at a date other than at normal retirement age, the employee must receive at least an amount that is the actuarial equivalent of the minimum single life annuity benefit commencing at normal retirement age. Thus, the employee may receive a lower benefit if the benefit commences before the normal retirement age and the employee must receive a higher benefit if the benefit commences after the normal retirement age. No specific actuarial assumptions are mandated providing different actuarial equivalents. However, the assumptions must be reasonable.

M-4 Q. Which employees must accrue a minimum benefit in a top-heavy defined benefit plan?

A. Each non-key employee who is a participant in a top-heavy defined benefit plan and who has at least one thousand hours of service (or equivalent service as determined under Department of Labor regulations, 29 CFR 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. (See § 1.410(a)-

7). 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 (1) an employee is excluded from participation (or accrues no benefit) merely because the employee's compensation is less than a stated amount, or (2) the employee is excluded from participation (or accrues no benefit) merely because of a failure to make mandatory employee contributions.

M-5 Q. Would the defined benefit minimum be satisfied if the plan provides a normal retirement benefit equal to the greater of the plan's projected formula or the projected minimum benefit and if benefits accrue in accordance with the fractional rule described in section 411(b)(1)(C)?

A. No. The fact that this fractional rule would not satisfy the defined benefit minimum may be illustrated by the following example. Consider a non-key employee, age 25, entering a top-heavy plan in which the projected minimum for the employee is greater than the projected benefit under the normal formula. Under the fractional rule, the employee's accrued benefit ten years later at age 35 would be 5% ($20\% \times (10/40)$). Under section 416, the employee's minimum accrued benefit after ten years of service must be at least 20%. Thus, because the 5% benefit is less than the 20% benefit required under section 416, such benefit would not satisfy the required minimum.

M-6 Q. What benefit must an employer provide in a top-heavy defined benefit employee pay-all plan?

A. The defined benefit minimum in an employee pay-all top-heavy plan is the same as that for a plan which has employer contributions. That is, the employer must provide the benefits specified in Question and Answer M-2.

M-7 Q. What is the defined contribution minimum?

A. The sum of the contributions and forfeitures allocated to the account of any non-key employee who is a participant in a top-heavy defined contribution plan must equal at least 3% of such employee's compensation (see Question and Answer T-21 for the definition of compensation) for that plan

year or for the calendar year ending within the plan year. However, a lower minimum is permissible where the largest contribution made or required to be made for key employees is less than 3%. The preceding sentence 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 section 401(a)(4) or 410. The contribution made or required to be made on behalf of any key employee is equal to the ratio of the sum of the contributions made or required to be made and forfeitures allocated for such key employee divided by the compensation (not in excess of \$200,000) for such key employee. Thus, the defined contribution minimum that must be provided for any non-key employee for a top-heavy plan year is the largest percentage of compensation (not in excess of \$200,000) provided on behalf of any key employee for that plan year (if the largest percentage of compensation provided on behalf of any key employee for that plan year is less than 3%).

M-8 Q. If an employer maintains two top-heavy defined contribution plans, must both plans provide the defined contribution minimum for each non-key employee who is a participant in both plans?

A. No. If one of the plans provides the defined contribution minimum for each non-key employee who participates in both plans, the other plan need not provide an additional contribution for such employees. However, the other plan must provide the vesting required by section 416(b) and must limit compensation (based on all compensation from all aggregated employers) in providing benefits as required by section 416(d).

M-9 Q. In the case of the waiver of minimum funding standards of section 412(d), how does section 416 treat the defined contribution minimum?

A. For purposes of determining the contribution that is required to be made on behalf of a key employee, a waiver of the minimum funding requirements is disregarded. Thus, if a defined contribution plan receives a

waiver of the minimum funding requirement, and if the minimum contribution required under the plan without regard to the waiver exceeds 3%, the exception described in Question and Answer M-7 does not apply even though no key employee receives a contribution in excess of 3% and even though the amount required to be contributed on behalf of the key employee has been waived. Also, a waiver of the minimum funding requirements will not alter the requirements of section 416. Thus, in the case of the top-heavy defined contribution plan in which the non-key employee must receive an allocation, a waiver of the minimum funding requirements may eliminate a funding violation and such waiver will preclude a violation under section 416 even though the required contribution is not made. However, the adjusted account balance (as described in Rev. Rul. 78-223, 1978-1 C.B. 125) of the non-key employees must reflect the required minimum contribution even though such contribution was not made.

M-10 Q. Which employees must receive the defined contribution minimum?

A. 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 (1) the employee is excluded from participation (or accrues no benefit) merely because the employee's compensation is less than a stated amount, or (2) 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.

M-11 Q. May either the defined benefit minimum or the defined contribution minimum be integrated with social security?

A. No.

M-12 Q. What minimum contribution or benefit must be received by a non-key employee who participates in a top-heavy 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 (including a target benefit 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. 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.

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. 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. Another approach that may be used is a floor offset approach (see Rev. Rul. 76-259, 1976-2 C.B. 111) 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. 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, 1981-2 C.B. 93) that the plans are providing

benefits at least equal to the defined benefit minimum. 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 section 416 minimums.

M-13 Q. An employer maintains a defined benefit plan and a profit-sharing plan. Both plans are top-heavy and are members of a required aggregation group. In order to meet the minimum contribution/minimum benefit requirements, the employer decides to contribute 5% of compensation to the profit-sharing plan. What happens if for a particular plan year there are no profits out of which to make contributions to the profit-sharing plan?

A. In this particular situation, in order to satisfy the requirements of section 416(c), the employer must provide the defined contribution minimum, 5% of compensation. This rule is an exception to the general rule that an employer cannot make a contribution to a profit-sharing plan if there are no profits. Alternatively, the employer may provide the defined benefit minimum for this year.

M-14 Q. What minimum contribution or benefit must be received by a non-key employee when he is covered under both a defined benefit plan and defined contribution plan (both of which are top-heavy) of an employer and the employer desires to use a factor of 1.25 in computing the denominators of the defined benefit and defined contribution fractions under section 415(e)?

A. In this particular situation, the employer may use one of the four rules set forth in Question and Answer M-12, subject to the following modifications. The defined benefit minimum must be increased by one percentage point (up to a maximum of ten percentage points) for each year of service described in Question and Answer M-2 of the participant's average compensation for the years described in Question and Answer M-2. The defined contribution

minimum is increased to 7½ percent of compensation. If the floor offset or comparability analysis approach is used, the defined benefit minimum must be increased by one percentage point (up to a maximum of ten percentage points) for each year of service described in Question and Answer M-2 of the participant's average compensation for the years described in Question and Answer M-2.

M-15 Q. May an employer use a different method each year to meet the requirements of Question and Answer M-12 or Question and Answer M-14 without amending the plans each year?

A. No. An employer must set forth in the plan document the method he will use to meet the requirements of Question and Answer M-12 or M-14, as the case may be. If an employer desires to change the method, the plan document must be amended.

M-16 Q. Will target benefit plans be treated as defined benefit or defined contribution plans for purposes of the top-heavy rules?

A. Target benefit plans will be treated as defined contribution plans for purposes of the top-heavy rules.

M-17 Q. Can a plan described in section 412(i) (funded exclusively by level premium insurance contracts) also satisfy the minimum benefit requirements of section 416?

A. The accrued benefits provided for a non-key employee under most level premium insurance contracts might not provide a benefit satisfying the defined benefit minimum because of the lower cash values in early years under most level premium insurance contracts, and because such contracts normally provide for level premiums until normal retirement age. However, a plan will not be considered to violate the requirements of section 412(i) merely because it funds certain benefits through either an auxiliary fund or deferred annuity contracts, if the following conditions are met:

(1) The targeted benefit at normal retirement age under the level premium insurance contract is determined, taking into account the defined benefit minimum that would be required assuming the current top-heavy (or non top-heavy) status of the plan continues until normal retirement age; and

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(2) The benefits provided by the auxiliary fund or deferred annuity contracts do not exceed the excess of the defined benefit minimum benefits over the benefits provided by the level premium insurance contract.

If the above conditions are satisfied, then the plan is still exempt from the minimum funding requirements under section 412 and may still utilize the special accrued benefit rule in section 411(b)(1)(F) subject to the following modifications: Although the portion of the plan funded by the level premium annuity contract is exempt from the minimum funding requirements, the portion funded by an auxiliary fund is subject to those requirements. (Thus, a funding standard account must be maintained and a Schedule B must be filed with the annual report). The accrued benefit for any participant may be determined using the rule in section 411(b)(1)(F) but must not be less than the defined benefit minimum.

M-18 Q. May qualified nonelective contributions described in section 401(m)(4)(C) be treated as employer contributions for purposes of the minimum contribution or benefit requirement of section 416?

A. Yes. This is the case even if the qualified nonelective contributions are taken into account under the actual deferral percentage test of § 1.401(k)-1(b)(2) or under the actual contribution percentage test of § 1.401(m)-1(b).

M-19 Q. May matching contributions described in section 401(m)(4)(A) be treated as employer contributions for purposes of the minimum contribution or benefit requirement of section 416?

A. Matching contributions allocated to key employees are treated as employer contributions for purposes of determining the minimum contribution or benefit under section 416. However, if a plan uses contributions allocated to employees other than key employees on the basis of employee contributions or elective contributions to satisfy the minimum contribution requirement, these contributions are not treated as matching contributions for purposes of applying the requirements of sections 401(k) and 401(m) for plan years beginning after December 31, 1988. Thus these contributions must meet the nondiscrimination requirements of sec-

tion 401(a)(4) without regard to section 401(m). See § 1.401(m)-1(f)(12)(iii).

M-20 Q. May elective contributions be treated as employer contributions for purposes of satisfying the minimum contribution or benefit requirement of section 416(c)(2)?

A. Elective contributions on behalf of key employees are taken into account in determining the minimum required contribution under section 416(c)(2). However, elective contributions 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 section 416. See section 401(k)(4)(C) and the regulations thereunder. This Question and Answer is effective for plan years beginning after December 31, 1988.

[T.D. 7997, 49 FR 50646, Dec. 31, 1984, as amended by T.D. 8357, 56 FR 40550, Aug. 15, 1991]

§ 1.417(a)(3)-1 Required explanation of qualified joint and survivor annuity and qualified preretirement survivor annuity.

(a) *Written explanation requirement—*
(1) *General rule.* A plan meets the survivor annuity requirements of section 401(a)(11) only if the plan meets the requirements of section 417(a)(3) and this section regarding the written explanation required to be provided a participant with respect to a QJSA or a QPSA. A written explanation required to be provided to a participant with respect to either a QJSA or a QPSA under section 417(a)(3) and this section is referred to in this section as a section 417(a)(3) explanation. See § 1.401(a)-20, Q&A-37, for exceptions to the written explanation requirement in the case of a fully subsidized QPSA or QJSA, and § 1.401(a)-20, Q&A-38, for the definition of a fully subsidized QPSA or QJSA.

(2) *Time for providing section 417(a)(3) explanation—*(i) *QJSA explanation.* See § 1.417(e)-1(b)(3)(ii) for rules governing the timing of the QJSA explanation.

(ii) *QPSA explanation.* See § 1.401(a)-20, Q&A-35, for rules governing the timing of the QPSA explanation.

(3) *Required method for providing section 417(a)(3) explanation.* A section 417(a)(3) explanation must be a written