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Report to the Chairman, Special Committee on Aging, U.S. Senate

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PRIVATE PENSIONS

"Top-Heavy" Rules for Owner-Dominated Plans

G A O

Accountability * Integrity * Reliability

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Contents

Abbreviations

IRS	Internal Revenue Service
PWBA	Pension and Welfare Benefits Administration

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Health, Education, and
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The Honorable Charles E. Grassley
Chairman, Special Committee on Aging
United States Senate

Dear Mr. Chairman:

At about $76 billion, tax preferences for pension plans[1] are the largest "tax expenditure," exceeding those for either home mortgages or health benefits.[2] The purpose of these pension tax preferences is to raise private savings for workers' retirement. They are structured to strike a balance between providing incentives for employers to start and maintain voluntary, tax-preference-qualified plans and ensuring that employees receive an equitable share of the tax-subsidized benefits. In 1998, about 61.5 million workers, or 47 percent of the employed labor force, excluding the self-employed, participated in employer-sponsored pension plans.

To achieve "tax-qualified" status, plans must comply with several sets of rules that promote equity and inclusiveness. Two sets of these rules address required apportionment of contributions and benefits, and both generally apply to all private employers' plans—rules on nondiscrimination in contributions and benefits, and the "top-heavy" rules. A plan is deemed top-heavy if more than 60 percent of its contributions or benefits accrue to the top employees—the owners and officers of the business. Top-heavy rules require such plans to provide "workers"—as contrasted with owners

[1]The two basic types of pension plans are defined benefit plans and defined contribution plans. In a defined benefit plan, the employee's benefit at retirement can be specifically determined by using such factors as salary and number of years of service. In defined contribution plans, individual accounts are established for each participant, and the plan defines the amount or share of profits or pay to be contributed to an individual's account each year.

[2]Fiscal year 2000 estimate from the Joint Committee on Taxation, *Estimates of Federal Tax Expenditures for Fiscal Years 2000-2004*, prepared for the House Committee on Ways and Means and the Senate Committee on Finance, JCS-13-99 (Dec. 22, 1999), p. 23. "Tax expenditures" are revenue losses attributable to provisions of federal tax laws and include any reductions in income tax liabilities that result from special tax provisions or regulations that benefit particular taxpayers.

and officers—higher minimum benefits and earlier rights to those benefits than would otherwise be required under the general qualification rules.

Over time, the role and effectiveness of top-heavy rules in ensuring plan equity have been questioned. Some contend that the nondiscrimination rules alone are adequate to address equity in distribution of benefits; they maintain that top-heavy rules are costly and burdensome, discouraging small employers in particular from providing pensions. Others argue that these rules provide necessary protections to workers who—even when participating in a pension plan—might otherwise receive little or no benefit. You asked us to review the top-heavy rules in relation to other pension laws and regulations intended to ensure that workers benefit equitably from their pension plans. In response, this report (1) identifies key differences between top-heavy rules and the general rules for nondiscrimination and vesting in contributions and benefits, (2) summarizes the most recent data available for our analysis on the characteristics of new plans that report being top-heavy, and (3) discusses what is known about the overall effects of top-heavy rules on numbers of plans and participants and on employer costs.

To do this work, we reviewed pension literature and legislative history and interviewed personnel from cognizant federal agencies; personnel from actuarial and employee benefit associations; pension consultants suggested to us by leading actuarial and benefit associations, the Small Business Administration, and the Department of the Treasury; and others knowledgeable about pension law and practices. We also analyzed top-heavy plans established in 1996 using a Department of Labor data set based on reports that plans submit annually to the Internal Revenue Service.[3] We conducted our work between March 1999 and June 2000 in accordance with generally accepted government auditing standards. (Our scope and methodology are presented in more detail in app. I.)

[3]We used the Department of Labor's electronic data set derived from 1996 Form 5500 "Return/Report of Employee Benefit Plan" submissions from plan sponsors across the country; these were the most recent data available during our analysis. Sponsors of tax-qualified pension plans are generally required to submit the Form 5500 to the Internal Revenue Service to satisfy annual reporting requirements under the Employee Retirement and Income Security Act and the Internal Revenue Code.

Results in Brief

The top-heavy rules for measuring how benefits are apportioned, together with required minimum benefits and vesting, ensure that workers get certain minimum benefits that they would otherwise not receive under the general nondiscrimination and vesting rules. Top-heavy rules are designed to address situations prevalent in owner-dominated firms. The rules identify pension plans in which the majority of benefits accrue to owners and officers, and they require higher minimum benefits and faster vesting for workers in such plans. Top-heavy rules utilize a single measure of the current value of participants' accumulated contributions or benefits. In contrast, nondiscrimination rules permit employers to choose among many optional measures for valuing the amount of benefits, a number of which may rely on projections that overstate the value of pension benefits workers actually receive. Use of certain nondiscrimination rules can leave workers who are outside the top employee group with annual employer contributions or benefit accruals that are well below those that are required if the top-heavy rules are applied.

New plans reporting top-heavy status tend to be small, defined contribution plans in the service sector of the economy. Approximately 84 percent of all top-heavy plans established in 1996, the most recent year for which data were available, had fewer than 10 participants. The vast majority of all new plans, and of new top-heavy plans, were defined contribution plans. Whereas 52 percent of new plans were in the service sector of the economy, plans of service firms constituted 70 percent of new top-heavy plans in 1996. Within the service sector, two-thirds of plans started by physicians, dentists, and legal service firms were top-heavy, a rate far higher than for other parts of the service sector.

Little is known about the overall effects of top-heavy rules on plan formation. Formidable data and methodological challenges make it difficult to isolate the incremental effect of top-heavy rules from the many other economic and regulatory factors that influence employers' behavior regarding pension plan formation. We found no research that has quantified the overall effects of the top-heavy rules on the number of pension plans and participants. However, survey research on small business suggests that while employer contribution costs are a major obstacle to forming pension plans, uncertain revenues, average employee tenure, and employees' preferences for wages and health benefits are the primary disincentives to providing coverage. Available research and our interviews with pension consultants suggest that incremental administrative costs associated with top-heavy rules are not likely to be significant enough to discourage plan formation or maintenance. The most significant pension costs added by the top-heavy rules are instead those associated with increased employer contributions and faster vesting of participants; any negative effect top-heavy rules might exert upon plan formation would likely stem primarily from these costs. In evaluating top-heavy rules' impact, the federal government must weigh the extent to which top-heavy rules discourage coverage against the higher participant benefits they provide.

Background

A fundamental requirement for all tax-qualified pension plans is that contributions or benefits be apportioned in a nondiscriminatory manner between a top group of highly paid employees and owner-employees, and workers who are outside the top group. The Congress first legislated requirements for nondiscrimination in pension plan coverage of a firm's employees in 1942.[4] To ensure that employers would meet the coverage requirement with meaningful benefits for workers, the Congress also required that the amount of contributions or benefits provided to those covered under the plan not discriminate in favor of a top group of officers, shareholders, supervisors, or highly compensated employees. A highly complex and flexible set of rules has evolved for assessing whether a plan's coverage and its apportionment of contributions and benefits are nondiscriminatory. Under the rules, employers can develop a custom-tailored plan design and apply complex general testing techniques to a plan's apportionment of contributions or benefit accruals each year, or they can elect one of several standardized "safe harbor" designs that obviate or reduce the need for annual testing to determine compliance with nondiscrimination rules.

In addition to the general rules on nondiscrimination and vesting, owner-dominated firms have always faced additional, more stringent rules for pension plan tax qualification. In establishing more stringent rules, the Congress cited a greater potential for tax shelter abuses in such plans. The current top-heavy rules are the latest generation of such restrictions. Before 1962, sole proprietors, partners, and the self-employed were prohibited altogether from participating in tax-qualified pension plans, though as employers they could establish a plan for the benefit of their employees. In contrast, shareholder-employees in corporations could participate in qualified plans, and the general nondiscrimination rules set

[4]Revenue Act of 1942, P.L. 77-753, 162 (1942).

requirements for the apportionment of contributions and benefits between a top employee group and other workers. After 1962, plans created by unincorporated "owner-employees" became eligible for tax qualification with owner-employee participation in the plan, but the plans were subjected to both the nondiscrimination rules and a second, more restrictive set of requirements for equitable apportionment of contributions and benefits. The latter rules originated as the "H.R. 10" or "Keogh" rules under the law that first allowed sole proprietors, partners, and the self-employed to participate as owner-employees in tax-qualified plans.[5] The current top-heavy rules came about as part of the Tax Equity and Fiscal Responsibility Act of 1982,[6] when the Congress decided that additional restrictions on owner-dominated plans should not be based on corporate versus noncorporate business structures but on whether any plan's delivery of contributions and benefits was "top-heavy" in favor of owners and officers.[7]

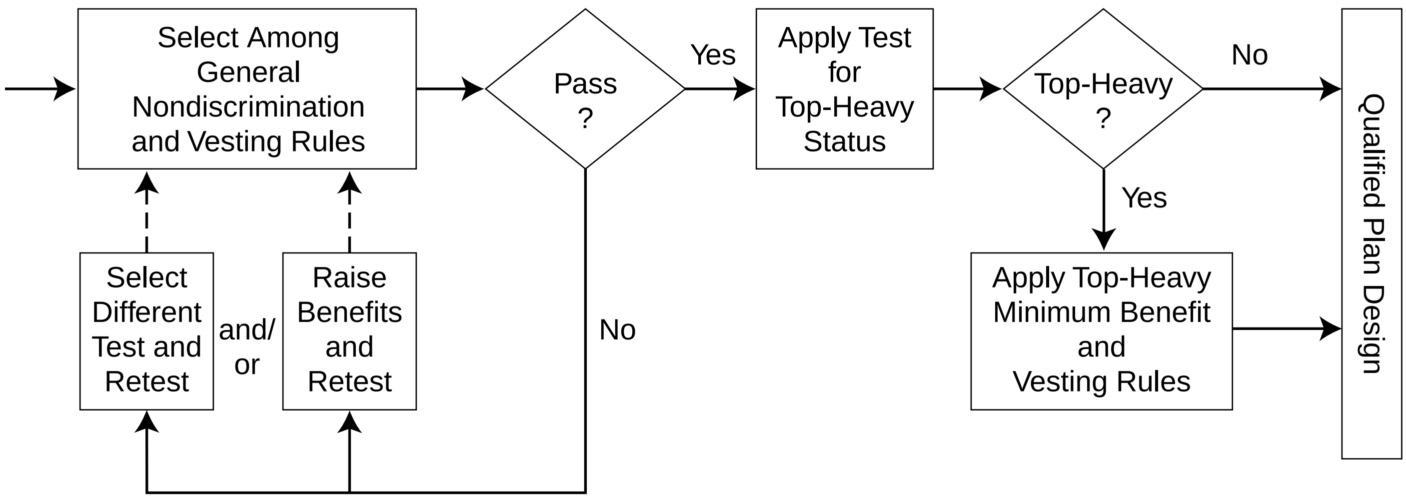
The general nondiscrimination and vesting rules and the top-heavy rules share the goal of ensuring an appropriate distribution of pension benefits to a broad group of workers—not just to a top employee group. In addition, the two sets of rules have parallel, though different, steps for testing the way contributions and benefits are apportioned, different requirements for minimum contributions or benefits, and different requirements for vesting participants with nonforfeitable rights to benefits. Figure 1 illustrates the steps a plan must take in testing its compliance with the rules on nondiscrimination in contributions and benefits and then testing its compliance with top-heavy rules.

[5]P.L. 87-792, the Self-Employed Individuals Tax Retirement Act of 1962, emerged from bill H.R. 10, sponsored by Congressman Keogh.

[6]P.L. 97-248, title II, subtitle C (1982).

[7]In response to proposals in House bill H.R. 6410 that would have extended certain H.R. 10 rules to personal service corporations, or professional corporations, the Department of the Treasury proposed the alternative top-heavy concept ("key employee concept") in the Hearing on the Pension Equity Tax Act of 1982, before the Committee on Ways and Means, House of Representatives, 97th Congress, June 10, 1982, Serial 97-65, pp. 24-25.

Figure 1: Sequence of Rules for Ensuring That a Plan's Apportionment of Contributions and Benefits Is Tax-Qualified



Note: The use of a design-based "safe harbor" obviates the need for the general nondiscrimination test. In addition, inclusion of required top-heavy minimum contributions or benefits, and vesting, obviates the need for top-heavy testing.

To attain tax-qualified status, the Internal Revenue Code and regulations provide distinct compliance testing rules for three categories of pension plans: defined benefit plans; defined contribution plans; and defined contribution plans with cash or deferred arrangements, known as 401(k) plans.[8] In a defined benefit plan, the employee's benefit at retirement can be specifically determined using such factors as salary and number of years of service. In defined contribution plans, individual accounts are established for each participant, and the plan defines the amount or share of profits or pay to be contributed to an individual's account each year; but an employer contribution is not required every year in profit-sharing defined contribution plans. In addition to employer contributions for all participants, 401(k) defined contribution plans can provide for two additional types of contributions: (1) employee "elective deferrals," or "elective contributions," in which an employee elects to have the employer contribute to a tax-deferred 401(k) account in lieu of providing the same amount as salary and (2) employer "matching contributions" made on the basis of employee elective contributions.[9] In all defined contribution plans, the account balance accumulates any investment earnings tax-free until an individual withdraws it for retirement. Generally, all plans, regardless of type, must comply with both the nondiscrimination rules and the top-heavy rules to be tax-qualified. The rules for defined benefit plans generally are more extensive and complex than for defined contribution plans, and this complexity is reflected in higher administrative expenses for such plans.

Top-Heavy Rules Ensure Benefits That Workers Would Not Receive Under the General Nondiscrimination and Vesting Rules

Important differences exist between top-heavy rules and the general nondiscrimination and vesting rules. The top-heavy rules were developed to address opportunities for pension-plan-related tax abuses in owner-dominated firms. Top-heavy rules differ from nondiscrimination rules in

- how they measure or test whether top employees receive a disproportionate share of contributions or benefits, compared with workers;

[8]The term "hybrid" plan is used to refer to plans that have characteristics of both traditional defined contribution and defined benefit plans. In this category are "cross-tested" defined contribution plans and "cash balance" defined benefit plans, among others.

[9]401(k) refers to the section of the Internal Revenue Code that sets out rules for these cash-or-deferred defined contribution arrangements.

- requiring top-heavy plans to meet more generous minimum standards for benefits[10] to workers, including (1) higher minimum benefits than nondiscrimination rules may require and (2) a shorter length of time the employee must work before acquiring vested, or nonforfeitable, rights to benefits.

Rules for Testing Top-Heavy Status of Plans Differ From General Nondiscrimination Standards

The test for top-heavy status differs from general nondiscrimination standards in two basic ways:

- the definition of the "plan" and of the top employee group whose benefits are to be measured against those of workers and
- the use of fundamentally different techniques and assumptions to measure equity in apportionment of contributions and benefits.

Without the unique test for top-heavy status, a disproportionate accumulation of pension plan assets by owners and officers may not be detected, and such plans would not be required to provide the top-heavy rules' larger minimum benefits and faster vesting schedules. The following sections provide a summary of how the tests differ; additional explanation is provided in appendix II.

Top Employee Groups and Grouping of Plans Differ

Both nondiscrimination and top-heavy testing rules divide plan participants into a top employee group and a remaining group of "workers" before measuring whether the top group received a disproportionate share of pension plan benefits. Top-heavy rules define a top group, called "key employees," primarily on the basis of whether an employee is an owner or officer of the firm, with compensation factored in. Nondiscrimination rules define a different top group, called "highly compensated employees," on the basis of compensation or a 5-percent ownership status. While one can be in the top, highly compensated group solely on the basis of salary, one cannot be in the key employee group on that basis alone. The top-heavy rules' key employee definition emphasizes ownership because in small, owner-dominated firms, compensation may not be a reliable indicator of who controls the firm and the pension plan design. Without identifying key employees, owners of smaller firms could manipulate assignments and

[10]In this report, we use "benefits" to refer generically to benefit accruals under defined benefit plans and contributions under defined contribution plans, unless the context indicates a specific technical meaning of a defined benefit plan benefit accrual.

salaries to avoid top-heavy status and exclude nonfamily workers from top-heavy benefits.

The retirement plan in which a worker participates can differ from what nondiscrimination or top-heavy rules define as the “plan” or the part of a plan to be tested, and the two sets of rules can aggregate or subdivide plans very differently. Nondiscrimination rules generally permit employers to choose whether to combine or to subdivide their plans when this may aid in meeting testing requirements. As a result, employers are able to reward different groups of employees differently. In contrast, top-heavy rules set a fixed boundary as to what the “plan” is for top-heavy testing and for requiring top-heavy minimum benefits and vesting schedules; this is to ensure that all workers are equally eligible for top-heavy minimum benefits. Without the mandated top-heavy definition of the aggregated plan to be tested, an employer could divide employees into two plans so that only one would be top-heavy, leaving workers in the remaining plan without the intended protection of top-heavy minimum benefits and vesting.

Measures and Thresholds Differ

Nondiscrimination and top-heavy testing rules use fundamentally different measurements. Nondiscrimination testing rules allow employers to choose among several optional methods to measure contributions and benefits as a percentage of compensation. In contrast, top-heavy rules allow an employee’s benefit to be measured in only one way. The different measures of benefits allowed under nondiscrimination rules can result in an apportionment of benefits that is most favorable to older employees, those employees with long periods of service, those who remain with the company their entire career and retire under the plan, or those who earn wages well above the Social Security taxable wage base. In a small firm, the owner is most likely to fit this profile and is most likely to retire under the plan, because a plan often terminates upon the owner’s retirement. To address typical conditions for smaller, owner-dominated plans, top-heavy rules assess how well employees have fared under the plan to date—measuring the amount to which the employee would be entitled if the plan were terminated at that point.[11] For example, the top-heavy test of accumulated values apportioned to owners and officers versus workers is more effective in detecting whether forfeitures of nonvested benefits by workers in high-turnover, small firms is leading to a plan becoming largely a tax shelter for owners. Appendix II includes a comparison of the single

[11]For defined benefit plans that terminate, adequacy of funds can also affect participants’ entitlements.

benefit measure of the top-heavy rules with those benefit measures allowable under nondiscrimination rules.

The nondiscrimination rules provide employers many optional ways to measure benefits or contributions, and differing choices can result in a wide range of required minimum allocations to workers that satisfy the rules. An owner can choose to compare a defined contribution plan's contributions in current value, so that the owner and younger workers get the same percentage of pay. Alternatively, an employer can choose to compare estimated future benefits as a percentage of current compensation. In doing so, the benefits accruing to a younger worker can be found to be "equivalent" to those of an older owner, even though the current allocation for the older owner is up to 36 times the percentage of compensation going to the younger employee in a defined contribution plan. Larger disparities are possible under defined benefit plan rules.

If an employer's pension plan fails a nondiscrimination test under one choice of measurement rules, the employer may be able to choose different measurement rules and pass the test using the same allocations. The employer may also elect to increase plan benefit allocations to workers to pass the test or can elect to both increase allocations and choose different measurement rules. After passing the nondiscrimination test, a plan undergoes the top-heavy test. An employer is permitted to increase plan allocations to workers to avoid top-heavy status but cannot vary the top-heavy method of measuring contributions and benefits. Plan consultants and Treasury officials said that many employers elect to bypass the administrative burdens associated with nondiscrimination testing and top-heavy testing. The use of master or prototype plans with design-based safe harbors obviates the need for the general nondiscrimination test. In addition, inclusion of required top-heavy minimum contributions or benefits, and vesting, obviates the need for top-heavy testing.

Top-Heavy Plans Have Higher Minimum Standards for Benefits Going to Workers

If a plan has a top-heavy apportionment of benefits, it must provide workers—that is, those not in the top employee group—two things: (1) a specified minimum-level contribution or benefit that can be higher than required in certain design and testing options allowed under nondiscrimination rules and (2) faster minimum vesting schedules. The minimum vesting schedule is the amount of time workers must have with their employer before they must receive nonforfeitable rights to benefits contributed on their behalf.

Top-Heavy Minimum Benefits Can Exceed Minimums Under Nondiscrimination Rules and Tests

The minimum required employer contribution for workers in top-heavy defined contribution plans is 3 percent of compensation;[12] the only exception to this minimum rate occurs if the highest contribution rate for an owner or officer is below the 3-percent standard. If so, top-heavy plans must contribute for workers at the highest rate received by any owner or officer in the top employee group. Many top-heavy plans adopt designs that already comply with top-heavy minimum benefits rules, so that incremental allocations to workers are not required. However, plan design and testing choices that are likely to require additional contributions to workers in order to comply with top-heavy minimums include custom plan designs that apportion larger annual increments—as a percentage of compensation—to owners in comparison to workers. Examples include defined benefit plans using methods that favor older, longer-service owners; and hybrid, “cross-tested” defined contribution plans that test compliance with nondiscrimination rules on the basis of benefits projected to each individual’s retirement age, rather than on the basis of current contributions. In addition, 401(k) defined contribution plans that rely on elective employee salary deferrals will have to add a full 3-percent top-heavy contribution if an equivalent “nonelective” employer contribution to all participants has not been included in the plan’s design.

To illustrate a situation that requires added contributions for workers to meet top-heavy minimums, table 1 shows an actual top-heavy defined contribution plan that is cross-tested and age-weighted.[13] This is one of the designs that can leave workers with an annual contribution well below the required top-heavy minimum of 3 percent of compensation, while giving owners a percentage of pay that is much higher. The plan passed the nondiscrimination test with contributions to workers of about 1 percent of pay. However, under the top-heavy rules, the employer had to reallocate about a quarter of the $20,000 budgeted for pension contributions from top

[12]We address defined contribution plan contributions in this discussion and in the examples to avoid the additional complexity of discussing the more involved actuarial rules and options that accompany defined benefit plans. The standard minimum top-heavy benefit for defined benefit plans is a total accrued benefit of 2 percent of average annual pay for each year a plan is top-heavy, up to a maximum benefit of 20 percent (2 percent times 10 top-heavy years). The top-heavy minimum no longer applies if an individual’s accrued benefit has reached 20 percent or more.

[13]Under a pledge of confidentiality, a practitioner provided us this client example to illustrate the incremental effects of top-heavy rules on an age-weighted, cross-tested plan. We present an age-weighted, cross-tested example to avoid the added complexity of “new comparability” cross-testing.

employees in order to meet the 3-percent minimum contribution that top-heavy rules require for workers.

Table 1: Effect of Top-Heavy Rules on Contributions in a Defined Contribution Plan Using an Age-Weighted Allocation Formula and Cross-Testing to Satisfy the Nondiscrimination Rules

			Employer contributions				
			Allocation satisfying nondiscrimination rules		Incremental allocation to meet top-heavy minimum	Total allocation to meet top-heavy minimum	
Employee status	**Age**	**Salary**	**Amount (dollars)**	**Percentage of pay**	**Amount (dollars)**	**Amount (dollars)**	**Percentage of pay**
Key employee							
	60	$160,000[a]	$15,360	9.6	- $4,630	$10,730	6.7
	32	31,400	310	1.0	-100	210	0.7
	54	10,700	630	5.9	-190	440	4.1
Nonkey employee							
	35	34,200	430	1.3	600	1,030	3.0
	35	26,900	340	1.3	470	810	3.0
	36	24,900	340	1.4	410	750	3.0
	38	61,300	980	1.6	860	1,840	3.0
	36	49,400	670	1.4	810	1,480	3.0
	33	66,600	710	1.1	1,290	2,000	3.0
	33	23,700	250	1.1	460	710	3.0
Plan total			**$20,000**		**$0**	**$20,000**	

Note: Dollar amounts are rounded to the nearest 10, so they may not add to total.

[a]The limit on annual compensation that can be used to compute allowed contributions under Internal Revenue Code 401(a)(17) was $160,000; owner-employee's salary exceeded this limit.

In this example, the nondiscrimination rules, absent the top-heavy rules, would have allocated to the owner a contribution equal to 9.6 percent of the $160,000 salary amount, versus 1.1 percent of salary ($250) to the youngest and lowest-paid worker. The top-heavy standard for a minimum contribution resulted in nearly all the workers getting an incremental allocation that was larger than the initial allocation needed to satisfy nondiscrimination rules.

Another design that plan consultants told us can require additional employer contributions due to top-heavy minimums is a 401(k) plan that ordinarily has elective deferrals and possibly employer matching contributions, but not employer nonelective contributions. Nondiscrimination rules for 401(k) plans apply different tests for employees' elective deferrals of salary and for employer matching contributions. Both tests have thresholds that permit average salary deferrals and matching contributions for the higher-paid group to exceed the average for the lower-paid group by specific margins. In addition, because the tests *average* contributions for each group, lower-paid employees who are eligible to participate but elect not to contribute are averaged into the group as "zeros." The nondiscrimination rules consider zeros as "covered" or benefiting under the plan because they had the opportunity to participate.

In contrast, all workers in a top-heavy 401(k) plan, including zero contributors, must receive a contribution equal to 3 percent of pay that is in addition to elective contributions and employer matching contributions made on their behalf.[14] Treasury officials explained that allowing the counting of matching contributions toward top-heavy minimum contributions would have the effect of eliminating the employee participation incentive of matching contributions, and therefore they would lose their character as a match if used to satisfy the top-heavy rules. The actual plan illustration presented in table 2 shows the effect of top-heavy rules on workers' added benefits and on employer contributions for a top-heavy 401(k) plan.[15]

[14]26 C.F.R. 1.419-1, sections M-19 and M-20, address prohibiting the counting of matching and elective contributions, respectively, toward satisfying top-heavy minimum contributions.

[15]Under a pledge of confidentiality, a practitioner provided us several examples of 401(k) plans in which added top-heavy 3-percent contributions had been required. This example was selected to illustrate top-heavy minimums going to "participants" with zero contributions, as well as to those who made an elective deferral and received matching contributions.

Table 2: Minimum Contributions Under a Top-Heavy 401(k) Plan

Employee status	Salary	Contributions: Employee elective	Contributions: Employer match	Contributions: 3% required top-heavy minimum
Key employee				
	$93,530	$5,980	$920	0
	75,490	4,550	700	0
	34,170	1,710	340	0
Nonkey employee				
	3,900	390	40	$120
	25,170	1,180	240	750
	2,110	320	20	60
	31,160	3,120	310	930
	8,950	360	90	0[a]
	23,940	0	0	720
	21,940	970	200	660
Plan total	**$320,360**	**$18,570**	**$2,850**	**$3,250**

Note: Dollar amounts are rounded to the nearest 10, so they may not add to total.

[a]Nonkey employee terminated employment, so did not receive a top-heavy contribution.

In addition to providing protection to employees whose pensions are structured as 401(k) plans, top-heavy minimum benefit rules provide protection under other scenarios in which plan terms permitted under the nondiscrimination rules can leave participants ineligible to receive a contribution or benefit. These include, for example,

- defined contribution plan participants who would be considered part-time and ineligible for contributions because they worked fewer than 1,000 hours in a year and
- defined benefit plan participants who worked at least 1,000 hours but are ineligible for an annual accrual because they left the employer before the last day of the plan year.

Top-heavy rules require that these participants receive the top-heavy minimums. Because part-time workers and high turnover are often found in small businesses, these top-heavy rules on eligibility for contributions can deliver more benefits to workers.

Vesting Requirements Differ

The pension plan qualification rules set standards for the maximum time an employer can delay granting plan participants full, 100-percent vesting—that is, nonforfeitable rights to pension contributions or benefit accruals made on an employee's behalf. For plans that are not top-heavy, two standard options exist: (1) immediate full vesting—called "cliff" vesting in the pension community—after a 5-year delay and (2) a gradual buildup to 100-percent vesting—called "graded" vesting in the pension community—at the rate of 20 percent each year, beginning after a 3-year delay and culminating in 100-percent vesting after 7 years. However, if a plan is top-heavy, the top-heavy rules require that plans fall within either a 3-year cliff vesting option or a 2- to 6-year gradual schedule.[16] These requirements are contrasted in figure 2.

Figure 2: Vesting Schedules Under General and Top-Heavy Qualification Rules

Vesting Under General Rules		Vesting Under Top-Heavy Rules	
5-Year Cliff	100% Vested After 5 Years of Service.	**3-Year Cliff**	100% Vested After 3 Years of Service.
or		**or**	
3- to 7-Year Gradual	• 20% After 3 Years • 40% After 4 Years • 60% After 5 Years • 80% After 6 Years • 100% After 7 Years	**2- to 6-Year Gradual**	• 20% After 2 Years • 40% After 3 Years • 60% After 4 Years • 80% After 5 Years • 100% After 6 Years
or		**or**	

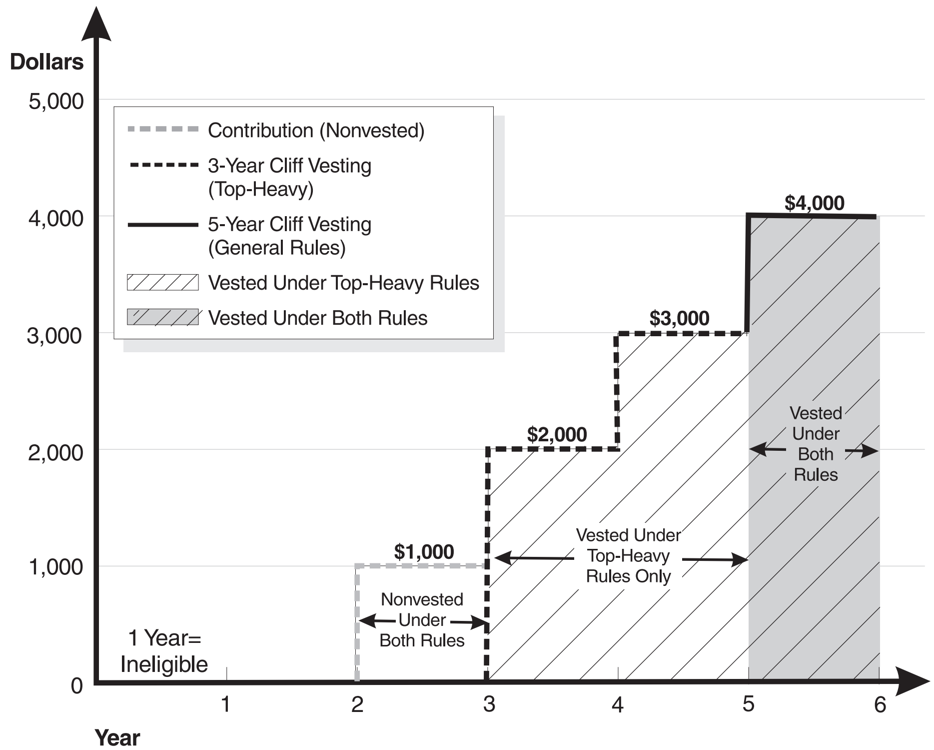
Optional Vesting Based on Extended Ineligibility

2-Year Cliff Vesting — 100% Vested Upon Entry to Plan After 2-Year Ineligibility Period (Normal Maximum Ineligibility Is 1 Year). Under This Option, Benefits Are Not Accrued Until the Employee's Third Year of Service.

[16] A 2-year cliff vesting schedule is mandated if an employer elects to exclude employees from eligibility for plan participation for a period longer than the 1-year standard qualification rule. Ineligibility can be extended up to 2 years but will require immediate cliff vesting after 2 years. This extended ineligibility is not allowed for 401(k) plans.

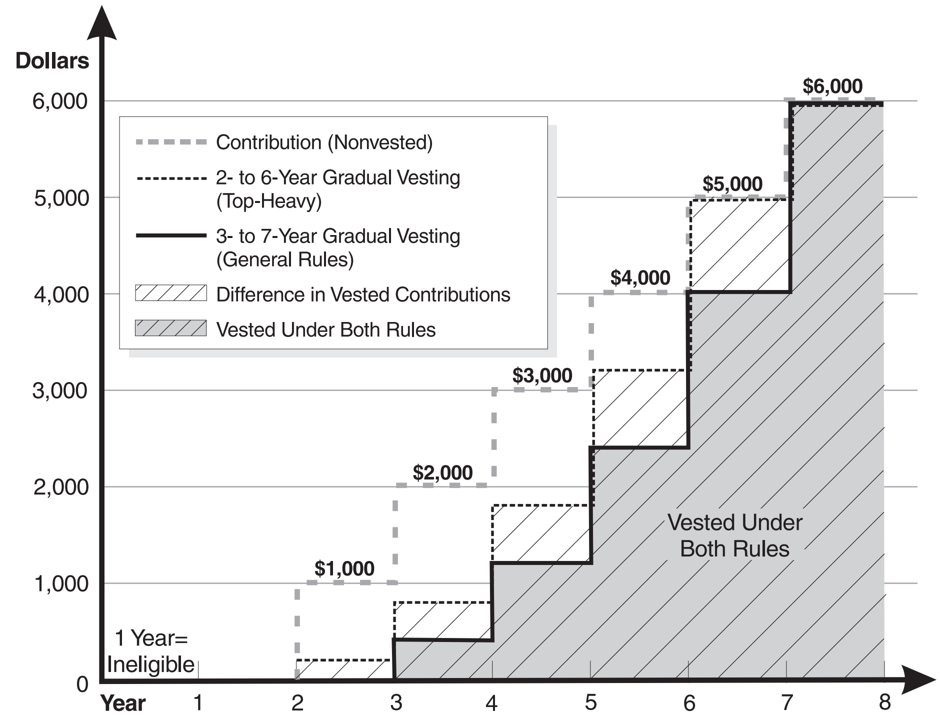
The top-heavy rules' faster vesting schedules can result in higher benefits for workers. This faster vesting affects employees who leave their employer after the top-heavy schedule begins but before the year when top-heavy and nondiscrimination vesting schedules have both reached 100 percent vesting. Under cliff vesting, this would occur for those working for an employer at least 3 years but fewer than 5 years (see fig. 3). Under gradual vesting, the differences in the amounts vested between the top-heavy and general vesting schedules are smaller (see fig. 4).

Figure 3: Difference in Vested Benefits Under Cliff Vesting Schedules for Worker With 3 to 5 Years' Service in a Defined Contribution Plan With End-of-Year $1,000 Profit-Sharing Contribution



Note: The dollar amounts in this figure exclude investment earnings.

Figure 4: Difference in Vested Benefits Under Gradual Vesting Schedules for Worker With 2 to 7 Years' Service in a Defined Contribution Plan With End-of-Year $1,000 Profit-Sharing Contribution



	2	3	4	5	6	7
2- to 6-Year Gradual						
Vested Contributions,	20%	40%	60%	80%	100%	100%
Actual Dollars Vested	$200	$800	$1,800	$3,200	$4,000	$6,000
3- to 7-Year Gradual						
Vested Contributions,	0%	20%	40%	60%	80%	100%
Actual Dollars Vested		$400	$1,200	$2,400	$4,000	$6,000

Note: The dollar amounts in this figure exclude investment earnings.

Some Differences Between the Rules Have Narrowed

After the 1984 implementation of top-heavy rules, the Tax Reform Act of 1986 shortened the maximum permitted delays in vesting for all non-top-heavy plans from 10 to 5 years for cliff vesting and from the former 5- to 15-year gradual schedule to a 3- to 7-year schedule. Although this brought vesting schedules under the general rules much closer to top-heavy vesting schedules, the remaining difference between the schedules can still increase benefits to workers who leave after 3 years' employment, but before 5 years. Bureau of Labor Statistics' 1998 data on length of service with employers showed a median job tenure for workers age 25 and older of 4.7 years across all industries. On the basis of this statistic, many workers would have had no vested pension benefits with the company employing them in 1998 under a 5-year cliff vesting schedule but would have been vested under 3-year top-heavy cliff vesting.

In addition to the vesting schedule changes, other changes have narrowed differences between general nondiscrimination and parallel top-heavy rules. Different limits on annual benefits and contributions have disappeared; as a result, limits are now the same for all plans.[17] All plans now are subject to the same upper limit on individual compensation that can be the basis for tax-qualified contributions or benefits. Top-heavy plans originally had a lower limit than allowed by nondiscrimination rules. In addition, top-heavy rules no longer have a more stringent upper limit on contributions or benefits when an employer sponsors both a defined benefit and a defined contribution plan, because recent legislation repealed the dual-plan limit for all plans.

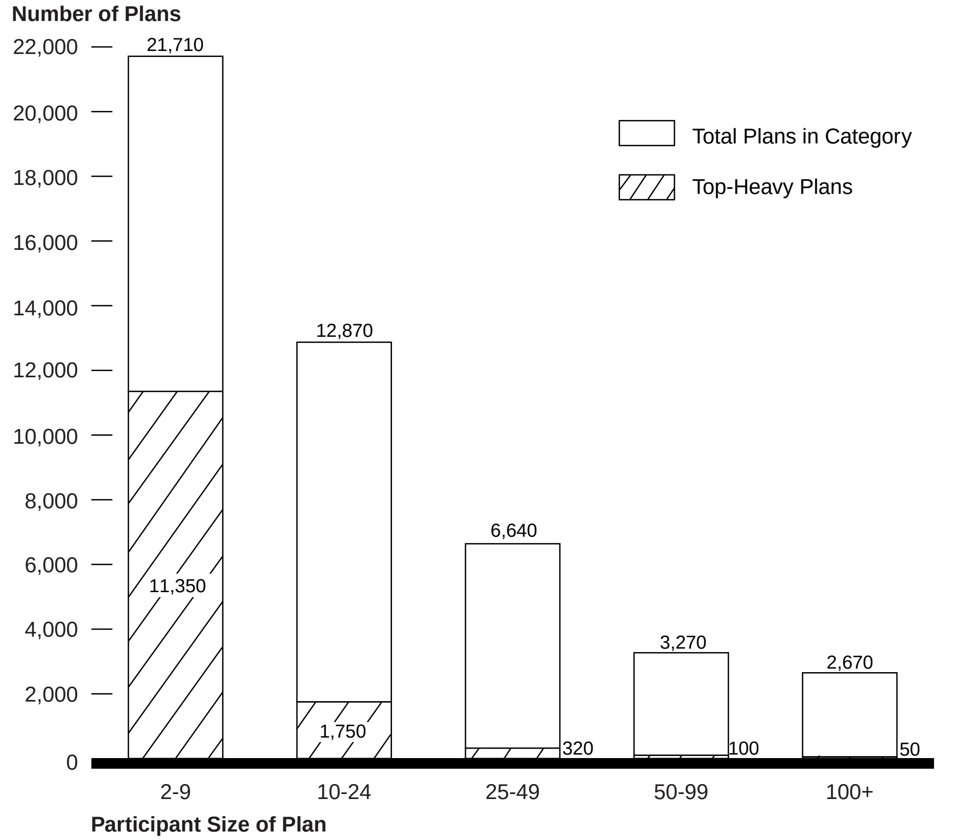
[17]26 U.S.C. 416(d), the top-heavy compensation limit, was repealed when section 401(a)(17), the annual compensation limit, was extended to all plans as part of the Tax Reform Act of 1986. 26 U.S.C. 416(h), dual-plan limit rules for super top-heavy plans, were repealed with the repeal of section 415(e) in the Small Business Job Protection Act of 1996 (P.L. 104-188).

Most New Top-Heavy Plans Have Few Participants and Are Defined Contribution Plans in the Service Sector

Most new top-heavy plans had few participants—approximately 84 percent had fewer than 10 participants in 1996.[18] Furthermore, the incidence of a top-heavy apportionment of benefits drops rapidly as plan size increases (see fig. 5), which may be due largely to a higher proportion of owners to total employees in small firms. While 52 percent of plans with 2 to 9 participants reported being top-heavy, the proportion dropped to 14 percent of plans with 10 to 24 participants, 5 percent of plans with 25 to 49 participants, and 3 percent in the 50- to 99-participant range. Only 2 percent of plans with 100 or more participants reported top-heavy status.

[18]"New" plans in 1996 are defined as plans indicating an effective date of 1996. These data are not projectable to the universe of qualified plans. We used these data because they were the best available data to identify top-heavy status and plan characteristics. Our analysis used data from 1996 Form 5500 annual reports that tax-qualified plans submitted to the Internal Revenue Service and that are made available through the Department of Labor. Our use of these data is discussed further in app. I.

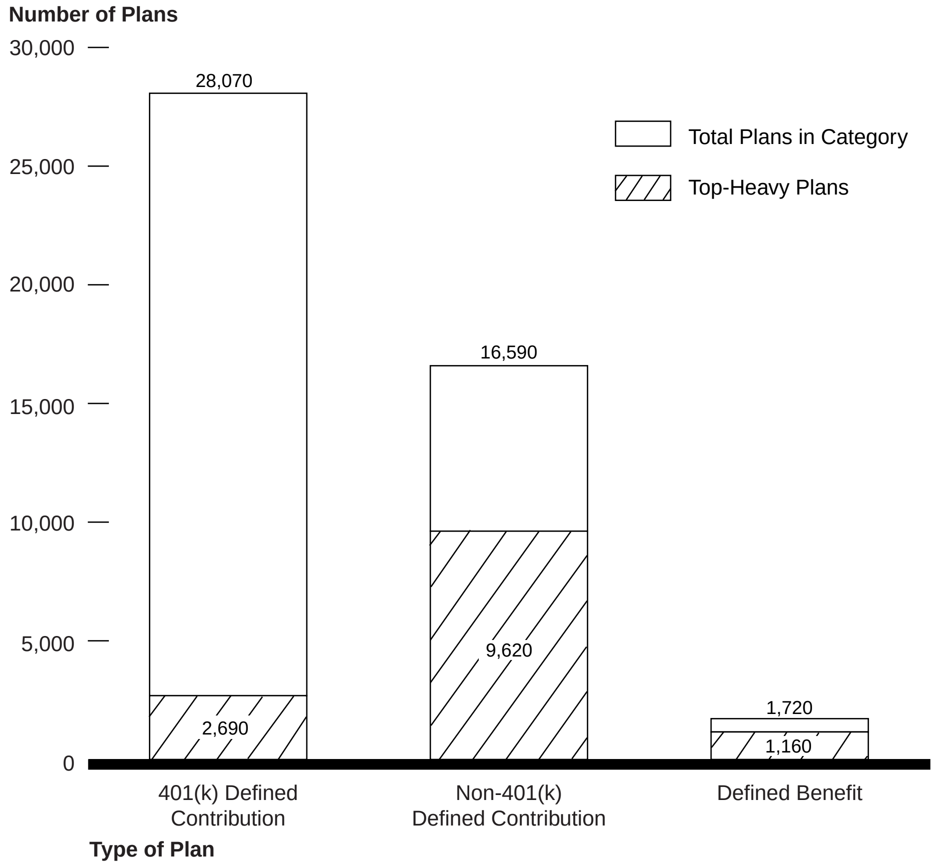
Figure 5: Very Small Plans Are Most Likely to Be Top-Heavy



Note: Analysis is based on 1996 plan reports that indicated an effective date of 1996.

Different plan types reported top-heavy status with widely varying frequency, as shown in figure 6. While 401(k) defined contribution plans were the most numerous type of new plan in 1996, they reported top-heavy status less than 10 percent of the time. Defined contribution plans without 401(k) features were the next most numerous type of new plan and reported being top-heavy 58 percent of the time; they constituted 71 percent of the 13,461 new plans that reported top-heavy status. While defined benefit plans were the least frequent type among new plans, they reported being top-heavy at the highest rate—67 percent of the time.

Figure 6: Top-Heavy Status Varies Widely With Plan Type



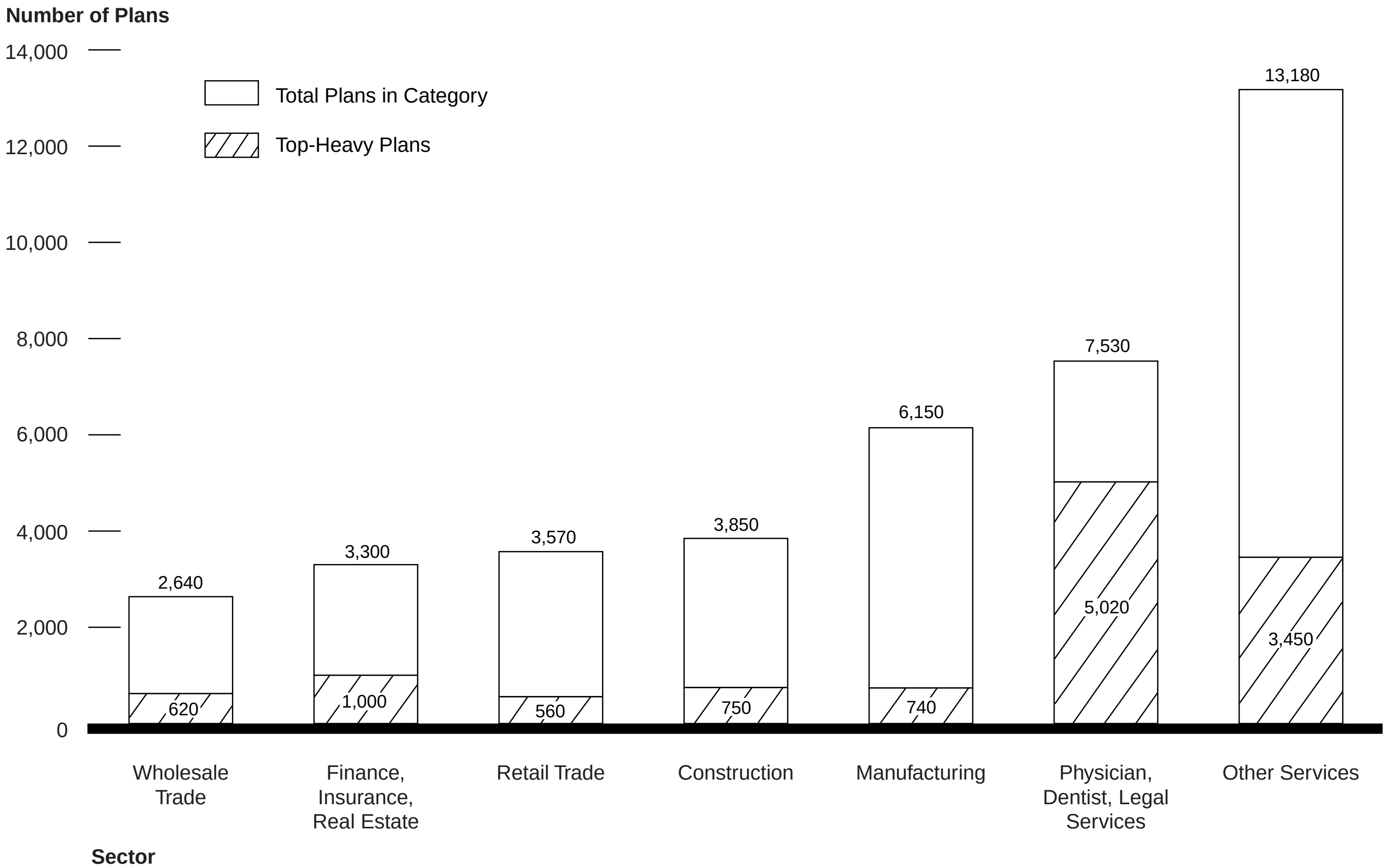
Note: Analysis is based on 1996 plan reports that indicated an effective date of 1996.

Employers in the service sector of the economy represented 52 percent of new plans and 70 percent of new top-heavy plans in 1996. Within the service sector, plans for physician, dentist, and legal services firms were top-heavy most frequently—at 67 percent, a rate far higher than that for other components of the service sector. The higher proportion of top-heavy plans among physician, dentist, and legal services firms likely reflects the relatively high salaries of key employees versus other workers and may indicate that the key employees can afford to defer salaries to the maximums available under qualification rules.[19] The “other services” sector had the most new plans—13,180—and 26 percent reported top-heavy status.[20] (See fig. 7.)

[19]A legislative proposal rejected in favor of the top-heavy rules was to apply these more stringent rules only to professional firms. Tax court cases as well as journal and news articles had raised concerns about tax shelter abuses among medical and other professionals.

[20]Other services include educational or engineering services and other services not classified elsewhere.

Figure 7: Top-Heavy Status, by Industry Sector



Note: Analysis is based on 1996 plan reports that indicated an effective date of 1996.

Top-Heavy Rules' Aggregate Effects Have Not Been Quantified

The overall effects of the top-heavy rules have not been quantified. Identifying the effects of the top-heavy rules in isolation from effects of other pension rules has become more difficult over time. Some have voiced concern over additional benefit commitments and the administrative burden, saying that such requirements have discouraged small businesses from offering pensions. Available research suggests that, although contribution costs are indeed a major obstacle to establishing a pension plan, the primary obstacles are the overall economic situation of the company, which can make contribution costs prohibitive, and characteristics and preferences of employees. In addition, pension consultants indicated that the incremental administrative costs added by top-heavy rules are a minor part of total administrative costs, and available studies of administrative costs did not find top-heavy costs significant enough to isolate and quantify.

Top-Heavy Rules' Overall Effects Have Not Been Isolated

We found no studies that quantified overall effects—positive or negative—of the top-heavy rules on numbers of plans or participants, or on employers' contributions or administrative costs. The lack of such analysis reflects methodological obstacles generally; it also likely reflects the fact that baseline empirical research was not mandated at the time the rules went into effect. It is extremely difficult to develop a sound or credible estimate of the overall effect of top-heavy rules. The dramatic pace and scope of regulatory and economic changes since the enactment of the top-heavy rules significantly complicate efforts to isolate the top-heavy rules' overall effects.

Available studies provide limited quantitative indicators of top-heavy rules' effect or rely on expert opinion. We surveyed a sample of plans when the top-heavy rules became effective in 1984, and we reported in 1989 that many more participants would have had smaller or no vested benefits if the top-heavy vesting rules had been replaced with the general vesting rules implemented under the Tax Reform Act of 1986.[21] However, we could not quantify the added employer contributions due to the top-heavy rules or any administrative costs the employers bore. Other assessments of the top-heavy rules relied on expert opinion and anecdotal illustrations and produced a range of positive and negative views of the top-heavy rules. Similarly, our more recent discussions with practitioners and experts yielded mixed reactions. Consultants' reactions ranged from a judgment that the rules did not result in enough benefits to be worth the costs they add, to the conclusion that they add little burden. Others noted that the rules could be simplified by applying the top-heavy minimums to all businesses. Advocates for workers generally saw the top-heavy rules as necessary and important.

[21] *Private Pensions: Impact of Vesting and Minimum Benefit and Contribution Rules in Top-Heavy Plans* (GAO/HRD-90-4BR, Oct. 23, 1989), p. 3.

Employer Contribution Costs Are Important but Are Not a Primary Barrier to Small Business Pension Plan Formation

Surveys of small employers without pension plans indicate that the primary obstacles to offering a plan are the economic situation of the employer and the characteristics and preferences of the workforce typical of small firms. In a recent survey, most employers also cited the expense associated with employer contributions as a major barrier, but not the primary barrier, while a minority of respondents cited administrative costs as a major barrier.

An extensive 1991 survey done for the Small Business Administration found that employer economic reasons were the overwhelmingly dominant deterrent to small firm pension plan formation, as shown in table 3.[22] The study also noted that small employers reported placing a higher priority on offering health insurance to their employees than on offering a pension plan; yet nearly half did not offer health insurance.

Table 3: Small Employers' Primary Reasons for Not Offering a Pension Plan, 1991
Numbers in percent (percentages are rounded)

Primary reason for not offering retirement plan	Employers with 1-24 employees	Employers with 25-99 employees
Employer economic reasons (uncertain income, mergers and plant shutdowns, owner has other job with a plan)	61	43
Employee economic reasons (high turnover rate, employees are part-time, employees are too young or too old to want retirement plan)	12	27
Employee/employer preference reasons (employees prefer cash or other fringe benefits, or employer prefers other types of savings plans)	8	13
Setup or annual administrative costs too high	9	11
Federal laws or regulations (too costly to comply with, change too frequently, limit benefits to owners)	9	6

In a 1999 Employee Benefit Research Institute survey of small business, employers with 5 to 100 employees cited uncertain revenue and workforce characteristics as primary reasons for not offering a plan (see table 4).[23]

[22]David L. Kennell, Arnold T. Brooks, and Terry Savela, *Retirement Plan Coverage in Small and Large Firms*, final report submitted to the Office of Advocacy, U.S. Small Business Administration (Vienna, Va.: Lewin-ICF, June 1992), p. III.27.

[23]Paul Yakoboski, Pamela Ostuw, and Bill Pierron, *The 1999 Small Employer Retirement Survey: Building a Better Mousetrap Is Not Enough*, Issue Brief No. 212 (Washington, D.C.: Employee Benefit Research Institute, Aug. 1999), p. 5.

Fifty-five percent of firms cited revenue-related or employee-related reasons as the most important reason for not offering a plan. Although only 10 percent cited the expense of company contributions as the most important reason for not offering a plan, 51 percent said it was a major reason. The 1999 study concluded that “while cost and administrative issues do matter, they are not the sole reason for low plan sponsorship rates among small employers.”

Table 4: Small Employers’ Reasons for Not Offering a Pension Plan, 1999

	Percentage who cited reason as the	
Reasons cited for not offering a plan	**Most important reason**	**Major reason**
Revenue-related		
Revenue is too uncertain	19	50
Employee-related		
Large portion of employees are seasonal or part-time, or turnover rate is high	19	42
Employees prefer wages or other benefits	17	53
Cost and administration		
Costs too much to set up and administer	12	30
Required company contributions are too expensive	10	51
Too many government regulations	3	32
Other		
Vesting requirements provide too much to short-term workers	2	38
Don’t know where to obtain information to start a plan	2	5
Benefits for the owner are too small	1	17
Other	12	17

Top-Heavy Rules Can Increase an Employer’s Pension Costs

The top-heavy rules’ required minimum 3 percent of pay contribution for defined contribution plans can increase employers’ costs above what nondiscrimination rules require. Actual plan illustrations presented in tables 1 and 2 showed that top-heavy minimums can require employers to raise contributions for nonkey employees. In such cases, nondiscrimination rules—absent the top-heavy rules—could leave some younger workers with about 1 percent of pay.

Top-heavy vesting schedules can also increase benefits for workers who leave an employer after 3-year top-heavy vesting begins but before a standard 5-year vesting schedule would have granted them nonforfeitable rights to contributions or benefits (see figs. 2 and 3). Given that the median tenure across industries for workers age 25 and older was 4.7 years, it is reasonable to expect that significant numbers of employees leave plans after working between 3 and 5 years.

Administrative Costs of Top-Heavy Rules Appear Small

Annual administrative costs to ensure compliance with the top-heavy rules generally appear to be a minor part of an employer's total administrative costs to operate a tax-qualified plan. Studies on the administrative costs of pension plans did not find these costs significant enough to count separately. Indeed, pension consultants we interviewed estimated the costs to be low in most situations. However, the rules can introduce significant costs in certain nonroutine situations. While per capita administrative costs for very small plans are generally much higher than for larger plans, this is a general issue for pension administration that extends well beyond top-heavy rules. The high per capita costs are caused by high fixed costs and the absence of economies of scale in very small firms.

Pension plan consultants told us they do not separately account for or charge separate fees for routine tasks for compliance with top-heavy rules. Consultants we interviewed estimated that the cost increment top-heavy rules added to their administrative fees ranged from "insignificant" to "5- to 10-percent." Staff at one large firm consulting for small businesses estimated that the costs of dealing with issues related to top-heavy rules were about 0.6 percent of their compliance-related costs. Practitioners explained that computer software makes running top-heavy tests as routine as hitting a key on a computer.

Studies on pension plan administrative costs did not isolate the costs that top-heavy rule compliance adds to employers' routine costs to maintain a tax-qualified plan. Rather, most identified the rapid pace of legislative change and the resulting costs and regulatory complexity as the primary drivers of pension plan administrative costs. Plan administrators and small employers cited the frequency and complexity of regulatory changes as the main problem with pension regulation—a problem significantly affecting plan formation, administration, and termination, according to a 1990 Small Business Administration-sponsored study.[24]

Pension consultants did cite specific situations in which the top-heavy rules can generate significant one-time administrative costs or pose unusual burdens. These situations can occur when a moderate-sized plan—for example, a plan with 100 to 200 participants—is audited by the Internal Revenue Service and must develop the necessary records to demonstrate that it is not top-heavy. In other cases, practitioners that gain an existing pension plan as a new client may need to create records or correct poorly maintained records. Typically, however, several consultants noted that the common practice is to make an initial judgment as to whether top-heavy status is likely and to bypass added top-heavy determination costs by simply designing top-heavy minimum contributions and vesting schedules into the plan.

Concluding Observations

The federal government has for many years granted tax incentives as a way of encouraging the formation of private pension plans. The granting of these incentives stems from federal pension policy that seeks to balance a desired benefit—reasonable levels of retirement income for a broad complement of workers—against the cost to the government of the related income tax preferences and, to the extent possible, the regulatory costs imposed on firms that choose to form plans. Top-heavy rules were designed to achieve an equitable balance between small business owners' tax benefits and future pension benefits to workers, but their mandated benefit levels and the administrative costs of compliance may discourage some small employers from offering pension plans at all.

From the small employer's perspective, the decision of whether to form a pension plan appears driven primarily by the financial stability of the firm and the characteristics and preferences of its employees. Firms considering initiating pension plans must also weigh the trade-off between the tax savings the plan can provide for the owners and employees and the costs to the firm of contributing to and administering the plan. Reducing the top-heavy rules' costs or administrative requirements could induce some employers to form new pension plans, but it might also result in lowering the benefit levels offered to currently covered workers under those plans.

[24]John Trutko and John Gibson, *Cost and Impact of Federal Regulation on Small Versus Large Business Retirement Plans*, final report submitted to the Office of the Chief Counsel for Advocacy, Small Business Administration (Arlington, Va.: James Bell Associates, Inc., June 1990), pp. v, 54.

In evaluating top-heavy rules' impact, the federal government must weigh the extent to which the rules may in fact discourage pension coverage against the higher benefit levels and faster vesting schedules the top-heavy rules have brought about for certain workers, a task made difficult by the lack of quantifiable information. Fundamentally, however, the government must balance the larger issues of the cost of favorable tax treatment and regulation on one hand and the benefits workers receive on the other.

Agency Comments

In commenting on a draft of this report, the Department of the Treasury agreed with our findings. Its response emphasized the view that the aim of national policy in this area should be to ensure an equitable distribution of pension benefits to all Americans, not solely to generate more plans. Treasury's comments appear in their entirety in appendix III.

The Department of Labor also reviewed the draft report and provided technical comments. We incorporated these comments where appropriate.

As agreed with your staff, unless you publicly announce its contents earlier, we plan no further distribution of this report until 30 days after its issue date. We will then send copies to the Honorable Lawrence H. Summers, Secretary of the Treasury; the Honorable Alexis M. Herman, Secretary of Labor; the Honorable Charles O. Rossotti, Commissioner of Internal Revenue; and others who are interested.

If you or your staff have any questions concerning this report please call me on (202) 512-7215. The major contributors to this report are Charles A. Walter III, Paula J. Bonin, Andrew M. Davenport, Roger J. Thomas, and Anthony J. Wysocki.

Sincerely yours,

Barbara D. Bovbjerg

Barbara D. Bovbjerg
Associate Director
Education, Workforce, and
Income Security Issues

Scope and Methodology

Analysis of Top-Heavy and General Nondiscrimination and Vesting Rules

To identify and summarize key differences between the top-heavy rules and the general nondiscrimination and vesting rules, we

- reviewed the Internal Revenue Code and regulations;
- reviewed the legislative history of laws for both sets of rules, as well as relevant congressional hearings;
- obtained input from practitioner associations and from pension consultants selected on the basis of recommendations from leading actuarial and employee benefit associations, the Small Business Administration, and the Department of the Treasury;
- discussed the rules with Treasury and Internal Revenue Service (IRS) officials;
- reviewed texts and training materials from actuaries and actuarial associations, tax attorneys, accountants, and other pension professionals;
- discussed the differences with advocates for workers and retirees; and
- reviewed literature on pension benefits published from 1983 to 1999 that documented differences between the rules.

We assessed and illustrated the potential effects of these differences in discussions with pension professionals and officials of the Treasury and IRS and by reviewing case examples provided by small-plan consultants and training materials. We provided a pledge of confidentiality to plan consultants who gave us client plan examples and proprietary information.

Characteristics and Data on Top-Heavy Plans

To describe the characteristics of new top-heavy plans formed in 1996, we analyzed the Department of Labor’s electronic database of 1996 Form 5500 “Return/Report of Employee Benefit Plan” submissions from plan sponsors across the country (1996 data were the most recent available during our analysis). Sponsors of tax-qualified pension plans are generally required to submit Form 5500 and applicable schedules to IRS to satisfy annual reporting requirements under the Employee Retirement and Income Security Act and the Internal Revenue Code. Form 5500 data are the only data available on pension plan sponsor characteristics and top-heavy status. IRS constructs a database of all Form 5500 submissions it receives and conducts quality control procedures to correct data errors or omissions before providing the data to the Department of Labor. Labor’s Pension and Welfare Benefits Administration (PWBA) performs additional completeness and consistency edits on the Form 5500 filings it receives from IRS. We did not independently verify the accuracy of IRS’ and PWBA’s quality control procedures on Form 5500 data because it would be costly and impractical.

We focused our analysis of Form 5500 data on top-heavy status and major plan and sponsor characteristics. The specific characteristics we chose to analyze included (1) number of plan participants, (2) plan type, and (3) industrial classification of the sponsor. The Labor database is used to publish similar data annually. Statistics on these major characteristics should provide reasonable comparative indicators because they should be less subject to self-reporting errors than the more detailed characteristics requested on Form 5500.

We limited our data analysis to newly formed[1] pension plans because the Form 5500 reports do not clearly identify the current top-heavy status of established plans. Employers are simply asked to code the form to indicate whether the plan was top-heavy “in 1984 or subsequent plan year.” For the year 2000 and beyond, this top-heavy question is no longer asked. Because we only analyzed data on newly formed plans in 1996, our results cannot be projected to the universe of all tax-qualified pension plans or all top-heavy pension plans. We excluded single-participant plans from our analysis, as top-heavy rules have no effect on such plans.

Analysis of Top-Heavy Rules’ Aggregate Effects

To analyze what is known about the overall effects of the top-heavy rules, we reviewed relevant professional and academic literature we obtained in our review of the key differences between the top-heavy and nondiscrimination rules. We also conducted detailed interviews with small-plan practitioners representing a variety of industries and plan types to identify barriers to plan formation, key cost components of pension plan administration, and representative illustrations of the effects of the top-heavy rules on an employer’s pension contribution costs. In addition, we discussed the effects of the top-heavy rules with Treasury, IRS, PWBA, and

[1]“Newly formed” plans in 1996 are defined as plans indicating an effective date of 1996. Of these, about 9 percent are plans that indicated they had been amended in 1996. A plan can be amended in its first year of existence. However, there is no means, using these 1996 Form 5500 data, to distinguish plans that are both new and amended in 1996 from amended older plans that may have indicated an effective date of 1996 because of the amendment. About one-fourth of 1 percent of plans indicated they were merged plans; these may have been started before 1996.

Small Business Administration officials as well as other pension and employee benefit researchers and industry representatives.

Detailed Differences in Testing Apportionment of Benefits Under Nondiscrimination and Top-Heavy Rules

Although nondiscrimination and top-heavy rules follow parallel steps in assessing the apportionment of contributions or benefits, the rules generally differ at each step. Nondiscrimination testing alone cannot ensure the detection of disproportionate accumulation of benefits by owners and officers that the top-heavy test is designed to identify.

Rules for Testing Top-Heavy Status of Plans Differ From General Nondiscrimination Standards

Nondiscrimination rules for measuring the apportionment of contributions and benefits between the top, “highly-paid employee” group versus other workers permit employers many choices that do not exist in top-heavy rules. Top-heavy rules for defining the plan and the top, “key employee” group to be tested are designed to address the special situation of owner-dominated firms. In addition, top-heavy rules provide a fixed, present-value measure of what the employer has contributed into the plan and what those amounts have earned, or what an employer may be obligated to provide to fund accrued benefits. In contrast, nondiscrimination rules allow employers to choose among various options that yield significantly different values of contributions and benefits, and required allocations to workers.

Employee Groups and Grouping of Plans Differ

To prevent employers from artificially partitioning their operations in ways that would exclude workers from pension benefits, a preliminary step in testing a plan’s apportionment of benefits for either top-heavy status or nondiscrimination is to define the two employee groups whose benefits are to be assessed. Table 5 compares the rules for dividing employees into a top employee group and other workers and for deciding which plans must be treated as a single entity for testing if an employer has more than one plan.

Table 5: Rules Governing What and Who Are Being Tested Differ

Nondiscrimination rules	Top-heavy rules
Top employee group	
Highly compensated employees[a] Criteria for inclusion: • $85,000 compensation or • 5% ownership in firm.[b]	**Key employees**[a] Criteria for inclusion: • 5% ownership in firm,[b] or • 10 largest owner-employees with compensation over $30,000,[b] or • 1% owners with compensation over $150,000,[b] or • officers with compensation over $67,500.
"Plan" or entity to be tested	
Employers are generally permitted to choose whether to aggregate or subdivide plans.	Employers must aggregate any plans in which a key employee participates or that were aggregated to pass the nondiscrimination test.

[a]The Internal Revenue Code provides different "look-back" time periods for classifying highly compensated employees versus key employees—a 1- or 2-year period for highly compensated employees and a 5-year period for key employees.

[b]Under family ownership attribution rules, 26 U.S.C. 318, spouses, children, and parents are deemed to own each other's shares. Both the top-heavy rules and the nondiscrimination rules incorporate these family attribution rules by reference; see 26 U.S.C. 416 (i)(1) and 414(q)(2), respectively.

Nondiscrimination rules define a top group, called "highly compensated employees," on the basis of high salaries or 5 percent ownership. Top-heavy rules' top group of "key employees" is based on ownership and officer criteria. The key employee criteria are designed to address the small business environment, where owners would otherwise have greater flexibility to structure their pension plans and their compensation as a tax shelter for themselves and their family. Treasury officials explained that without the key employee definition, including its supporting family ownership attribution rules, small business owners would have more latitude to manipulate ownership, assignments, and salaries in ways that exclude nonfamily employees from plan benefits or provide them little benefit.

After defining the top group, the "plan" to be tested is defined. Nondiscrimination rules generally give employers flexibility to choose to combine or subdivide their plans when it may aid in meeting the requirements. Top-heavy rules, however, mandate that certain plans be combined for testing in certain situations. Without the mandated aggregation requirements, an employer could divide employees into two plans so that one would have all the key employees and be top-heavy. This would leave workers in the remaining plan without the protection of the top-heavy minimum benefits and vesting.

Rules That Measure Apportionment of Benefits Differ

Table 6 contrasts top-heavy and nondiscrimination rules for assessing the apportionment of contributions and benefits between the top employee group and other workers. The methods of measurement listed here for the nondiscrimination rules represent the more basic optional design and testing rules employers can choose to give annual contributions or accruals that strongly favor highly compensated employees by providing annual allocations that are a significantly higher percentage of pay than workers receive. Other optional techniques exist but are not discussed here. Under these nondiscrimination design and testing options, smaller employers could direct the vast majority of cumulative plan contributions or benefits to themselves, their families, or other key employees. In contrast to the flexible choices under nondiscrimination rules, top-heavy rules measure contributions or benefits in just one way. Other special nondiscrimination testing rules applicable to 401(k) plans' testing of salary deferrals and employer matching contributions are not discussed here.

Table 6: Different Techniques Are Used in Compliance Tests to Measure Contributions and Benefits

Nondiscrimination—major options	Top-heavy—required
Compliance testing technique[a]	
1. Test benefits *or* contributions Benefits testing compares benefit annuities at each employee's future retirement age, expressed as a percentage of current pay. This applies to • defined benefit plans and • defined contribution plans opting to test contributions as though they were providing defined benefits.	Counts **cumulative, present value** of participants' pension contribution account or accrued benefit.
2. Choose measurement period Defined benefit plans may test • current plan year only; • current plan year and all prior plan years, divided by years of service; • current plan year and all prior and future years to retirement age, divided by years of service. Defined contribution plans that test contributions test current year only. Defined contribution plans that choose to "cross-test" as if they provided defined benefits can choose either • current plan year only or • current plan year and all prior plan years, divided by years of service.	
3. Choose to count Social Security contributions by employer in addition to pension contributions or benefit accruals.[b]	
Threshold for tests	
Is the proportion of highly compensated and non-highly compensated employees with a specific contribution or benefit rate, as a percentage of compensation, reasonably representative of the proportion for the employer as a whole?	Has more than 60 percent of the present value of cumulative plan benefits or individual accounts accrued to key employees?

[a]The use of a design-based "safe harbor" obviates the need for the general nondiscrimination test. In addition, inclusion of required top-heavy minimum contributions or benefits, and vesting, obviates the need for top-heavy testing.

[b]P.L. 99-514, the Tax Reform Act of 1986, among other requirements, modified methods of coordinating pension benefits with Social Security that resulted in some rank-and-file participants receiving little or no benefits. The new so-called "permitted disparity rules," which apply to plans that coordinate with Social Security, modified the types of benefit formulas that effectively denied lower-paid workers private pension benefits and required that they provide minimum benefits.

The general test for nondiscrimination in benefits calculates each participant's benefit as an annuity at the individual's retirement age. These annuities are expressed as a percentage of current pay, but current pay is not adjusted to reflect a differing value of money at individuals' differing future retirement ages. This sequence of computations makes a younger employee's benefit accrual or cross-tested contribution appear larger as a share of pay than if the pension allocation and pay were compared in present-value terms. The top-heavy test measures benefit accruals in present value. The result of testing a defined contribution plan as if it were providing a defined benefit is that the plan can favor an older owner over a young worker such that the allocation on behalf of the owner, as a share of pay, can be up to 36 times larger if one compares the age extremes of a 64-year-old owner and a 21-year-old employee. A defined benefit plan can favor an older owner by even greater margins.

The current-year contribution or accruals test for nondiscrimination can credit employers with significant allocations to workers that are subsequently forfeited when employees terminate prior to vesting. In contrast, the top-heavy cumulative measure better reflects the pattern of forfeitures and vesting of benefits.[1] General vesting rules permit employers to require up to 5 years of service before providing employees nonforfeitable rights to contributions or benefits accrued on the employee's behalf. This, in effect, excludes all but longer-term employees from receiving benefits.[2] In a small plan, the owner is generally fully vested. If employees typically leave without vesting, over time the owner can accumulate an ever-increasing share of the cumulative plan contributions or benefits. This "forfeiture effect" escapes detection in a 1-year measure of contributions and accruals, but the top-heavy cumulative measure is more effective in detecting an owner's increasing share.

Under nondiscrimination rules for defined benefit plans, an employer can, alternatively, choose to count all benefit accruals up to the current year, then divide each employee's accruals by the employee's years of service. In a small plan in which an owner is significantly older and has longer service

[1]When the Department of the Treasury proposed the top-heavy concept, it recommended measuring only *vested accrued benefits*. This stricter test was not adopted.

[2]Given that the median term of employment for workers aged 25 and older was 4.7 years in 1998, most would have had no vested pension benefits at the company employing them in 1998 under a 5-year cliff vesting schedule but would have had vested benefits under a 3-year top-heavy cliff vesting schedule.

than many employees, the effect of dividing by years of service is to make the owner's accrued benefit appear smaller relative to workers' than if one compared the present value of current allocations. In contrast, the top-heavy rules' measure of cumulative benefits captures the total present value of cumulative benefits.

Nondiscrimination rules further give a defined benefit plan the option of calculating benefits for employees projected out to retirement age, based on existing salary. In a small, owner-dominated business, plan consultants explain that the plan typically terminates at the retirement of the owner. Thus, the future benefits credited in testing are realized by the owner but are not fully realized by younger workers.

In testing compliance with nondiscrimination rules, retirement plans are permitted to count employers' Social Security contributions or benefits as though they were employer pension contributions on behalf of an employee.[3] Top-heavy testing counts only pension plan contributions. Counting Social Security contributions or benefits under nondiscrimination rules reduces the employer's required pension contributions for that portion of salaries under the Social Security taxable wage base, so that higher-paid employees receive higher pension benefits relative to salary.

[3]The Internal Revenue Code sec. 401(l) allows this "permitted disparity" in apportioning contributions or benefits to highly compensated and non-highly compensated employees. This was formerly referred to as "integration" with Social Security.

Comments From the Department of the Treasury

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

August 8, 2000

Ms. Barbara D. Bovbjerg
Associate Director, Education, Workforce and Income Security Issues
United States General Accounting Office
Washington, D.C. 20548

Dear Ms. Bovbjerg:

Thank you for sending to Secretary Summers a copy of your draft report to the Chairman, Special Committee on Aging, U.S. Senate, entitled Private Pensions: "Top-Heavy" Rules Play Distinct Role. Treasury, including Internal Revenue Service, personnel have reviewed the draft report, which addresses the effectiveness of the rules that apply to top-heavy plans in ensuring pension equity for all workers.

In general, the top-heavy rules require minimum contributions or benefits and accelerated vesting for workers in top-heavy plans. As the report notes, these rules "ensure that workers get benefits that they would not otherwise receive under nondiscrimination rules."

We agree with the points made in the Results in Brief section of the draft report to the effect that any reduction of the top-heavy requirements should be undertaken only after weighing the prospect of increased coverage against the prospect of reduced pension adequacy, and that policymakers must fundamentally consider the effect of any proposed policy changes on the balance between the cost of favorable tax treatment and benefits workers receive.

The aim of national policy in this area should be to ensure an equitable distribution of pension benefits to all Americans in order to enhance their retirement security; the aim is not solely to generate more plans. To the extent that employers adopt new plans, for example as a result of the recently effective repeal of the section 415(e) combined plan limit, it is important that moderate- and lower-wage workers participating in the plans receive and vest in a meaningful proportion of the benefits. The top-heavy rules are an important component of the statutory framework designed to accomplish this.

The top-heavy and nondiscrimination protections benefit the American taxpayer and protect the integrity of the pension tax preference by seeking to ensure that the tax preference equitably benefits workers throughout the income spectrum.

Very truly yours,

J. Mark Iwry
Benefits Tax Counsel

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