

the Pension Studio

The Safe Harbor 401(k)

The safe harbor 401(k) plan is one of the most popular plan designs for small employers. The beauty of the safe harbor plan is that for the price of a safe harbor employer contribution, the discrimination tests that apply to employee deferrals (ADP) and matching contributions (ACP) are deemed satisfied and, thus, the Highly Compensated Employees (HCEs) may make the maximum allowable deferral of compensation without the need for the plan to pass the discrimination tests. In 2008, the maximum deferral to a 401(k) plan is \$15,500. In addition, if the participant is over age 50, or will attain age 50 during 2008, a catch-up contribution of \$5,000 may also be made.

However, employers need to be aware that all safe harbor contributions are immediately 100% vested and that all eligible employees must receive a safe harbor contribution, even if they do not work 1,000 hours or are not employed on the last day of the plan year.

The Safe-Harbor 401(k) Non-elective Contribution – Guaranteed or Flexible Option

An employer may satisfy the safe-harbor by making a Non-elective Contribution (NEC) of at least 3% or more of compensation (commonly known as the “3% NEC”). Generally, the 3% NEC must be provided to all employees eligible to make elective deferrals to the plan. The NEC may be either a guaranteed contribution or a flexible contribution. The employer will make this selection in the plan document. The guaranteed contribution requires that a NEC be made each plan year, unless the employer amends the plan and removes the provision before the start of the new plan year. The flexible NEC allows the employer to decide each year whether to provide a NEC contribution. If this option is selected, the employer provides a “conditional notice” 30 to 90 days before the start of the plan year in which the employer may give a safe-harbor NEC contribution. No later than the first day of the 12th month of that plan year, the employer must provide another notice indicating whether the safe-harbor status has been elected and thus if the NEC is being given. If the NEC is made, discrimination testing of elective deferrals (and matching contributions) is not required; if the NEC is not given, elective deferral contributions (and matching contributions) must be tested. This contribution also satisfies the top-heavy requirement.

The Matching Contribution – Basic or Enhanced Match Formula

The alternative safe-harbor contribution is an employer matching contribution. There are two options, the basic or the enhanced match.

The basic safe-harbor matching contribution is defined as a 100% match on the first 3% of compensation deferred and a 50% match on deferrals between 3% and 5%. If this is the only contribution made to the plan it can satisfy top-heavy contribution. **Remember it must be the only contribution, no profit sharing, no forfeitures.**

Alternatively, the employer may choose an **enhanced matching formula** equal to at least the amount of the basic match; for example, 100% of the first 4% deferred. The enhanced matching contribution rate may not increase as the percentage of deferrals goes up, and the rate of match for the HCE group may not exceed the rate of match for the nonhighly compensated employee group (NHCEs).

The type of safe-harbor matching contribution selected (basic or enhanced) must be described in the plan document and in the annual notice to eligible participants. Unlike the nonelective contribution, there is no flexible matching contribution option.

Further, there are some requirements that must be met for a plan to attain safe-harbor status. The plan document must be amended to add the applicable safe harbor formula, and a safe harbor notice must be given to all eligible employees between 30 and 90 days before the beginning of plan year. Failure to give this notice will result in the employer being unable to claim safe harbor status for the affected plan year,

yet still required to make the safe harbor contribution (in addition to any contribution formula other than the conditional NEC has been adopted). The IRS has announced that merely not providing the notice on a timely basis does not remove the contribution requirement.

Safe-Harbor Plans May Make Additional Matching Contributions

A safe-harbor plan may make additional matching contributions without falling out of safe-harbor status. However, if the additional matching contribution is discretionary, the contribution may not exceed 4% of compensation. Further, discretionary matching contributions may not be made on elective deferrals above 6% of compensation. The rate of match for any HCE may not be more than that of any NHCE.

Note: for plans with a formula based matching contributions specified in the document, the 4% of compensation limit does not apply.

May Safe-Harbor Contributions be Stopped During a Plan Year in the Event of Financial Setbacks?

An employer that provides a guaranteed 3% NEC must make that contribution regardless of subsequent financial reverses during that plan year. Thus, the flexible NEC has become a more popular plan design choice. However, an employer may stop making safe-harbor matching contributions during the year. This is accomplished by providing a written notice to the employees at least 30 days before the contributions are to be stopped. The contribution must still be made up until the effective date of the notice. If this occurs, the ADP and ACP tests must be performed for the entire plan year.

May a plan become a safe-harbor plan mid-year?

Safe-harbor 401(k) plans are generally required to be established for the entire plan year (before the plan year starts). Mid-year adoption is possible for either a new 401(k) plan or a profit-sharing plan that adds a 401(k) feature mid-year. Generally, there must be at least three months remaining in the plan year for a new plan or a converted plan to make elective deferrals; however, a plan sponsored by a new business entity may have an initial plan year as short as one month. Employee notice may be made at the time the safe-harbor design is adopted.

Safe harbor plan designs are perfect for many employers because they eliminate testing and permit the highly compensated employees to maximize contributions. However, some employers may be reluctant to abandon vesting schedules and 1000 hour/last day rules for entitlement to matching or nonelective contributions. Clearly, each employer's expectations, finances and demographics are unique and they should be carefully weighed before committing to a safe-harbor plan.

NOTE: When the actual contribution data is examined, occasionally the employer's safe-harbor contribution amount is less than the amount being returned because of failed tests. Not to examine the possible advantage could be penny wise and pound foolish.

This is not a legal document.

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