

Safe Harbor 401(k) Plans

In this edition of Ekon Explains, we consider the benefits of Safe Harbor provisions in a 401(k) plan, outline the standard contribution and notice requirements and discuss additional safe harbor options.

Introduction

Each year, traditional 401(k) plans must successfully pass nondiscrimination testing to ensure that the Plan does not benefit owners and highly compensated employees (HCEs) disproportionately to non-highly compensated employees (NHCEs). Consistent failure of nondiscrimination testing is a primary reason for implementing Safe Harbor provisions as the adoption of Safe Harbor provisions allow for employers to avoid certain testing in exchange for making required contributions to participants.

A plan that provides Safe Harbor contributions avoids both Average Deferral Percentage (ADP) and Average Contribution Percentage (ACP) testing and, in many cases, Top Heavy testing. The ADP and ACP tests can restrict 401(k) contributions for HCEs and “top heavy” plans will result in a required employer contribution to non-key employees. The Safe Harbor plan design enables highly compensated employees to defer greater amounts by avoiding these restrictive tests.

Although an employer contribution is required with Safe Harbor Plans, the tax advantages for the owners and Highly Compensated Employees may far outweigh the costs, especially for small and mid-sized companies.

For 2014, the IRS limits allow 401(k) elective contributions of up to \$17,500. Those participants who are age 50 or older by the end of the Plan Year can make additional catch-up contributions of \$5,500 for a total of \$23,000. If employer contributions are made, participants can receive total allocations of \$52,000 plus the additional \$5,500 catch-up if age 50 or over.

Customary Safe Harbor Contribution Requirements

In accordance with Safe Harbor rules, the employer must make required contributions to participants in order to be exempt from non-discrimination testing. This typically takes one of two forms as outlined below:

1. a contribution equal to 3% of compensation for each eligible employee;
2. a matching contribution effectively equal to dollar-for-dollar up to 4% of compensation;

The 3% non-elective contribution must be made to all participants regardless of the amount they elect to contribute under the plan, if any. However, the matching contribution only matches the elective contributions of those participants who make them. The basic matching formula is tiered and provides a different match as the

employee's elective contribution increases. The tiered formula produces a maximum match of 4% of compensation but can be confusing to compute. For this reason, many employers choose to use the enhanced matching formula which is more simply stated as a dollar-for-dollar match up to 4% of compensation.

Safe Harbor contributions are different in several ways. Most importantly they are fully vested when contributed therefore the employee has a vested right to their Safe Harbor contribution account as soon as they are eligible to participate. Safe Harbor contributions must be made during the entire period that the employee is eligible to participate in the plan. The plan cannot require employment at the end of the year or the employee to work a specific number of hours of service to receive the Safe Harbor contribution. Finally, Safe Harbor contributions cannot be withdrawn in service before 59½ even in the case of Hardship.

Notice Requirement

The Safe Harbor provisions to a 401(k) may not be adopted unless the employer provides a written notice to all eligible employees. The written notice must be provided in a reasonable period of time, typically 30-90 days before the beginning of the Plan Year. Because the notice must be sent prior to the start of a Plan Year, a regular 401(k) cannot be converted to a Safe Harbor at any time besides the beginning of a Plan Year. However a profit sharing plan can add the Safe Harbor 401(k) feature if the plan has been established for at least three months.

Additional Safe Harbor Options

The Pension Protection Act of 2006 introduced a new safe harbor plan. A Qualified Automatic Contribution Arrangement (QACA) allows plan sponsors to fulfill safe harbor requirements by including an automatic enrollment feature in the plan. The QACA appears to be more generous to the plan sponsor as the matching contribution maximum is 3.5% versus 4% and there is a 2 year vesting schedule rather than the immediate vesting required under the regular Safe Harbor. However, the required automatic enrollment feature in conjunction with the contribution requirements may reduce or even eliminate these savings.

If the Plan provides, elective contributions can now be designated as after-tax Roth contributions. The Roth option allows you to forego the usual tax-deferred character of your regular 401(k) contributions and to designate them as after-tax money that grows tax-free. The income limitations that restrict highly compensated employees from making Roth IRA contributions do not apply to Roth 401(k)s.

A New Comparability Plan allows for the participants in a plan to be divided into two or more groups with different contribution rates for each group thus allowing more highly compensated employees such as managers and owners to increase their contribution rates. The plan type avoids nondiscrimination testing by requiring minimum contributions to participants. The 3% contribution rate serves double duty both as the

Safe Harbor contribution and the base contribution to meet the “gateway” requirements of a new comparability allocation formula. If the demographics permit, this 3% contribution to the rank-in-file allows for a 9% contribution for the key employees.

Safe Harbor Examples

Example #1: Age 50 owner with 2 employees
Safe Harbor dollar-for-dollar match up to 4%

<u>Salary</u>	<u>401(k)</u>	<u>Match</u>	<u>Total</u>
\$260,000	23,000	10,400	33,400
50,000	2,000	2,000	4,000
30,000	1,200	1,200	2,400

Total employer staff cost of \$3,200 allowing for tax deferred contributions of \$3,400.

Example #2: New Comparability

Safe Harbor non-elective match of up to 3% plus 6% profit sharing for HCEs

<u>Salary</u>	<u>401(k)</u>	<u>3%/9%</u>	<u>Total</u>
\$260,000	23,000	23,400	46,400
50,000	2,000	1,500	3,500
30,000	1,200	900	2,100

Total employer staff cost of \$2,400 allowing for tax deferred contributions of \$46,400.