

RETIREMENT
Insight

Plan Design

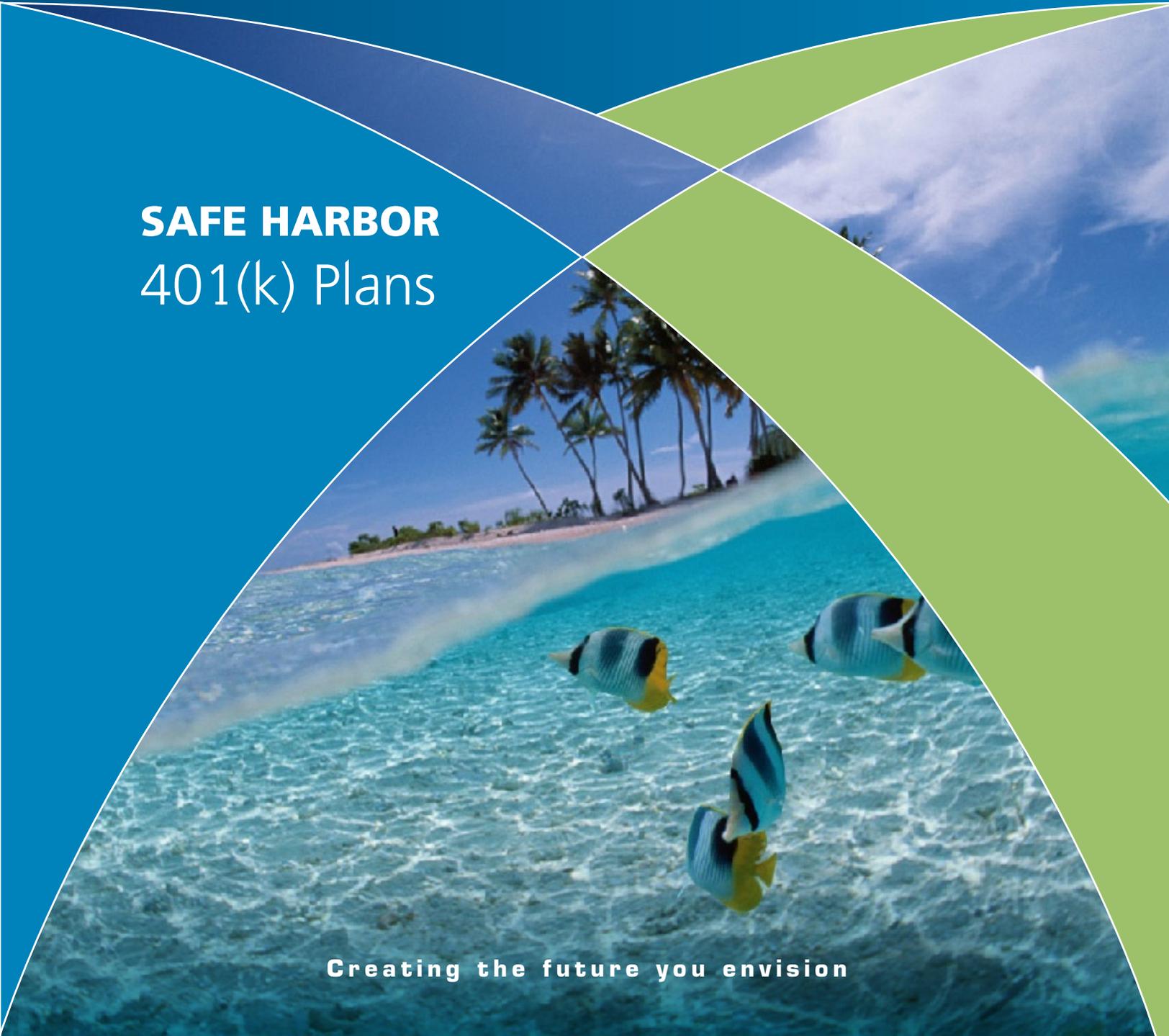
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SAFE HARBOR
401(k) Plans

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SAFE HARBOR 401(k) Plans

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.

Therefore, Highly Compensated Employees (HCEs) may make the maximum allowable deferral of compensation without the need for the plan to pass the discrimination tests.

Employers need to be aware that all safe harbor contributions are normally 100% vested immediately. There is one safe harbor design that provides an exception to this requirement, and that is if the plan also adopts the automatic enrollment feature in conjunction with automatic increase.

All eligible employees 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. This applies for the safe harbor non-elective contribution, as well as for employees who defer money into a safe harbor matching plan.

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 that 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 Plan Options

The Matching Contribution

Basic Match or Enhanced Match

The match is only allocated to employees who defer monies into the plan.

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 requirements.

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 non highly compensated employee (NHCE) group.

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 non-elective contribution, there is no flexible matching contribution option.

Non-elective Contribution

Guaranteed or Flexible

An employer may satisfy the safe harbor by making a non-elective contribution (NEC) of at least 3% 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 states it 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.

COMMON QUESTIONS

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

An employer who provides a guaranteed 3% NEC is required to make that contribution regardless of any financial distress fallen upon during that plan year. Thus, the flexible NEC has become a more popular plan design choice. The safe harbor matching design does allow an employer to 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.

Can Safe Harbor Plans 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. Furthermore, 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 with ERISA law.

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 a 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. The employee notice would be distributed at the time the safe harbor design is adopted.

SUMMARY

Safe harbor plan designs are perfect for many employers because they eliminate testing and permit the highly compensated employee to maximize contributions. However, some employers may be reluctant to abandon vesting schedules and the 1,000 hour/last-day rules for entitlement to matching or non-elective contributions. Clearly, each employer's expectations, finances, and demographics are unique and should be carefully weighed before committing to a safe harbor plan.

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