Considering Using A 401(k) Safe-Harbor Plan?

Safe-harbor 401(k) plans offer many advantages that some employers will gladly embrace. For other employers, the cost involved may be prohibitive. Either way, an understanding of the rules makes an informed decision possible.

General Rules for all Safe-Harbor Contributions

- All safe-harbor contributions are 100% vested (Except Auto Enroll – 2 year cliff)
- There may be no allocation requirements imposed on safe-harbor contributions, such as, a 1,000-hour service requirement or a **last day employment rule**.
- Safe-harbor contributions are not available for in-service withdrawal prior to age 59½.
- Safe-harbor contributions may not be used to satisfy permitted disparity (social security integration) allocation formulas.
- Safe-harbor contributions may be used towards satisfying the top-heavy plan minimum contribution requirement.
- All eligible participants must receive a written notice describing the applicable safe-harbor provisions between 30 and 90 days before the beginning of the plan year. This notice must be provided for each year the plan will be safe-harbored.
- Total Compensation must be used – no exclusions permitted, i.e. bonuses, overtime...etc

Why a Safe-Harbor 401(k) May Work for You

Adopting a safe-harbor 401(k) plan design permits an employer to avoid discrimination testing of the rates of employee elective deferrals and/or employer matching contributions (ADP/ACP testing). The price for avoiding testing is a safe-harbor contribution. Generally, there are three types of safe-harbor contributions.

The Non-elective Contribution – Guaranteed or Flexible Option 3%

One type is the safe-harbor Non-elective Contribution (NEC) of 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 selects which type of contribution 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 that it may give a safe-harbor NEC contribution for that year. No later than the first day of the 12th month of the plan year, the employer must provide another notice indicating that the safe-harbor has been elected and that the NEC is being given. If the NEC is made, discrimination testing of elective deferrals is not required; if the NEC is not given, elective deferral contributions must be tested.

Safe Harbor 3% Non-Elective Pension Plan											
Employee Contribution	0%	1%	2%	3%	4%	5%	6%	7%	8%	9%	10%
Employer Contribution	3%	3%	3%	3%	3%	3%	3%	3%	3%	3%	3%

e.g. 1 An employee making $30,000.00 defers 5% the employer would contribute 3% ($900.00)
e.g. 2 An employee making $30,000.00 defers 0% the employer would contribute 3% ($900.00)

The Matching Contribution – Basic or Enhanced Match Formula

The other type of safe-harbor contribution is a matching contribution. There are two options from which to choose, the basic or the enhanced match.

The basic safe-harbor matching contribution is defined as a 100% match on the first 3% deferred and a 50% match on deferrals between 3% and 5%.

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 highly compensated employee group (HCE's) may not exceed the rate of match for the non-highly compensated employee group (NHCE's).

The type of safe-harbor contribution selected must be described in the annual notice to eligible participants.

Thus, implementing a safe-harbor design can be critically important for HCE's if the plan has been having trouble passing the ADP/ACP test. This is because making a safe-harbor contribution permits the plan to satisfy ADP/ACP testing requirements, and the HCE's may make the maximum elective deferral to the plan, including a catch-up contribution (if eligible). In 2011, the maximum 401(k) deferral is $16,500. In addition, if the participant is over age 50, or will attain age 50 during 2011, a catch-up contribution of $5,500 may also be made. For a total of $22,000.00.

Safe Harbor Matching Pension Plan											
Employee Contribution	0%	1%	2%	3%	4%	5%	6%	7%	8%	9%	10%
Employer Match	0%	1%	2%	3%	3.5%	4%	4%	4%	4%	4%	4%

e.g. 1 An employee making $30,000.00 defers 5% the employer would match it with 4% ($1,200.00)
e.g. 2 An employee making $30,000.00 defers 0% the employer would match it with 0% ($0.00)

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, matching contributions may not be made on more than 6% of compensation. The rate of match for any HCE may not be more than that of any NHCE.

The **Auto-Enrollment Matching Contribution** (effective 1/1/2008)

The other type of safe-harbor contribution is an auto enrollment matching contribution.

The basic auto enrollment safe-harbor matching contribution is defined as a 100% match on the first 1% deferred and a 50% match on deferrals between 2% and 6%. For a Maximum Exposure of 3.5%.

Other Criteria:

- Enroll new employees at a deferral percentage of at least 3 percent of compensation. Existing employees who are not contributing to the plan must be enrolled unless they have declined to participate.

- Automatically increase employees' deferral percentage by at least 1 percentage point annually until it reaches 6 percent of compensation or the employee stops the increases. The employer may continue the automatic increases up to 10 percent of compensation.

- Vest employer contributions after two years of service. Employers must notify employees of their rights to make contribution and investment elections and describe default investments. Employees must be given a reasonable amount of time to make these elections.

The automatic enrollment safe harbor differs from the previous safe harbors in that it does **NOT** require **immediate** vesting of employer matching contributions. Instead a 2 year cliff vesting can be implemented.

The type of safe-harbor contribution selected must be described in the annual notice to eligible participants.

Auto Enrollment Safe Harbor Matching Pension Plan										
Employee Contribution	0%	1%	2%	3%	4%	5%	6%	7%	8%	9%	10%
Employer Match	0%	1%	1.5%	2%	2.5%	3%	3.5%	3.5%	3.5%	3.5%	3.5%

e.g. 1 An employee making $30,000.00 does not return the enrollment form to OPT OUT, will have 6% (trustee discretion) deducted from their pay and the employer would match it with 3.5% ($1,050.00)

e.g. 2 An employee making $30,000.00 does return the enrollment form and elects NOT to participate, the deferral from the paycheck will be 0% and the employer would match it with 0% ($0.00)

Top-Heavy Plans Can Get Twice the Bang for the Buck

If the plan is top heavy, the employer can get twice the mileage out of its safe-harbor contribution. There are three ways this can happen.

1. When a 3% NEC is made to a top-heavy plan, the 3% NEC generally satisfies the top-heavy contribution requirement.

2. If the plan is making a safe-harbor match and the plan is top heavy, the match counts towards satisfying the top-heavy minimum contribution for those employees who receive it. For example, if a participant defers 2% and receives a 2% match, when the employer makes the top-heavy contribution, that employee would only have to receive 1% more to satisfy the 3% top-heavy contribution requirement.

3. A plan that only permits elective deferrals and contributions that satisfy the ADP and ACP safe harbor provisions is exempt from the top-heavy rules. To be exempt, there cannot be any other employer contribution (i.e., profit sharing contribution) and forfeitures cannot be allocated on a basis other than as a match that satisfies the ACP safe harbor. To further clarify, discretionary matching contributions that do not trigger the ACP test (as described above) may also be made.

Cross-Tested Plans

For those employers who have a new comparability plan and who are using the 5% gateway, the 3% NEC safe-harbor contribution can perform as the first 3% towards the 5%. In addition, as stated above, if the plan is top-heavy, the 3% NEC can serve as the top-heavy contribution as well as towards the new comparability gateway while also providing the safe-harbor.

NOTE: In a safe-harbor 401(k), if a participant leaves before the end of the plan year and is not eligible for the cross-tested allocation due to a last-day rule, the participant must be given a safe-harbor 401(k) 3% non-elective contribution. Assuming the plan uses the 5% gateway, the participant must receive an additional 2% contribution to satisfy the gateway. This is because the minimum gateway allocation must be made to any non-highly compensated employee who has received any allocation of employer contributions.

Keep in mind that if the 3 times gateway design is used, the minimum gateway contribution will still have to be met. However, a safe-harbor 3% NEC may be sufficient to meet the gateway if the allocation to HCE's does not exceed 9%.

Establishing A Safe-Harbor 401(k) Plan

Existing 401(k) Plan

Safe-harbor 401(k) plan provisions may **not** be added to an existing 401(k) plan in the middle of a plan year. Instead, the plan must be timely amended to add the safe-harbor 401(k) provisions for the next plan year. It is critical that the amendment should be adopted not later than the last day of the current plan year to ensure that the safe-harbor notice to participants is provided not less than 30 days before the first day of the following plan year. If the deadline to amend the plan is missed, then the plan cannot be safe-harbored and you will have to wait until the following plan year to adopt a safe-harbor design.

New 401(k) Plan

In an exception to the timing requirements for giving the safe-harbor notice, a new 401(k) may adopt a safe-harbor design at the same time that the plan is established, assuming the notice is provided simultaneously. There must be at least 3 months remaining in the plan year to make elective deferrals for a plan to use this provision. An existing profit-sharing plan that is amended to add a 401(k) feature is eligible to use this rule. Further, a totally new business entity establishing a new 401(k) plan may have as short as a one-month initial plan year (assuming that the initial year is then followed by the normal 12 month year).

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

The sponsor of a plan using a guaranteed 3% NEC must make that contribution regardless of its subsequent financial condition during that plan year. However, an employer may stop making safe-harbor matching contributions by providing a notice to the employees. This notice must be given at least 30 days before the contributions are to be stopped. If an employer stops safe-harbor matching contributions before the plan year is completed, the ADP and ACP tests must be preformed for the entire plan year.

Testing Otherwise Excludable Employees

A safe-harbor 401(k) plan which has an eligibility of 1 year of service and age 21 for the safe-harbor matching contribution or the safe-harbor non-elective contribution and yet permits entry into the plan for elective deferrals without the 1 year of service and age 21 statutory requirements, must test those who have not met the statutory requirements separately from those who have achieved the statutory requirements. For a safe-harbor 401(k) plan, the non-statutory group to be tested would include both the HCE's and NHCE's. Therefore, the HCE's in the under age 21 and/or under 1 year of service group would be limited by the ADP/ACP or the NHCE's in the non-statutory group. Why? Since there is no safe-harbor contribution made for participants making elective deferrals who have not satisfied the 1 year and age 21 requirements; testing must be done for the non-statutory group if there is any HCE-s in the non-statutory group.

Allocation Conditions May Cause Nondiscrimination Failure

A practitioner, in designing *certain types* of cross-tested plans with allocation conditions for the cross-tested non-elective contributions, *inadvertently* may cause the plan to fail nondiscrimination. A plan may use cross testing to test for nondiscrimination only if the plan satisfies either the "broadly available allocation rates" or "minimum gateway allocation" requirements in the cross-tested regulations. Most cross-tested plans will rely upon satisfaction of the minimum gateway allocation requirement. Under the gateway requirement, all non-highly compensated employees ("NHCE's") who receive any type of non-elective contribution must receive a minimum gateway allocation. Generally, the minimum gateway allocation is 5% of compensation, or if less, one-third of the highest allocation rate for any highly compensated employee ("HCE").

A *top-heavy* cross-tested plan or a *3% non-elective* safe harbor 401(k) cross-tested plan *that imposes allocation conditions for the cross-tested non-elective contribution*, likely will not, in form, provide for the minimum gateway allocation to all NHCE's who must receive it. Certain NHCE's in these plans may receive either a top-heavy minimum contribution or a safe harbor contribution, but will not receive the cross-tested allocation made for the NHCE group, because they fail to satisfy the plan's allocation conditions applicable to the cross-tested allocation.

Example 1

X maintains a calendar year, top-heavy cross-tested plan. Joe is a non-key/NHCE who is employed on December 31, 2002, but Joe worked only 850 hours of service ("HOS") in 2002. Plan X requires both 1,000 HOS and employment on the last day of the plan year for a participant to receive an allocation of the non-elective cross-tested contribution for the NHCE group. All X NHCE's who satisfied both allocation conditions in 2002 received a 5% allocation. HCE's under the plan who satisfied the allocation conditions in 2002 received a 20% allocation. Plan X would satisfy nondiscrimination testing in 2002 using cross testing. However, Joe received only a 3% top-heavy minimum allocation since he worked less than 1,000 HOS. Since Joe is benefiting in the X non-elective contributions, X may not use cross testing to pass nondiscrimination unless it provides an additional 2% contribution to Joe, satisfying the 5% minimum gateway allocation requirement.

Example 2

Assume the same facts as in Example 1, except Mary, a non-key/NHCE, terminated employment with X on July 10, 2002. Mary is not entitled to a top-heavy minimum allocation or to the 5% NHCE cross-tested allocation. Since Mary does not benefit in *any* X non-elective contributions for 2002, she is not entitled to a minimum gateway allocation.

Example 3

Assume the same facts as in Example 1, except that Plan X are a 3% non-elective safe harbor 401(k) cross-tested plan. Both Joe and Mary must receive the 3% safe harbor non-elective contribution. As such, both must receive an additional 2% allocation for Plan X to satisfy the minimum gateway requirements.

Note: This is not an issue for safe harbor 401(k) plans using a *basic* or *enhanced* match to satisfy the ADP test safe harbor, since the plan administrator disaggregates matching contributions from non-elective contributions for nondiscrimination testing.