Benefit Insights

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A non-technical review of qualified retirement plan legislative and administrative issues **June 2005**

Safe Harbor 401(k) Plans Provide Smooth Sailing

The term “safe harbor” has a multitude of meanings in conjunction with the administration of qualified retirement plans. But in recent years the term has predominantly been associated with the provisions applicable to safe harbor 401(k) plans. These plans have become extremely popular, especially among smaller employers. And when you consider the overall benefits, it’s no surprise.

One advantage of 401(k) plans to employers is that the employees bear at least a portion of the cost of their retirement benefits. A drawback is the rigorous nondiscrimination testing that must be performed each year, as well as the possible remedies for a failed test, such as corrective distributions. **A safe harbor plan eliminates the need for nondiscrimination testing!** That alone would justify the safe harbor option in many situations. But there are other benefits as well, and you will want to know all of them.

What is a Safe Harbor 401(k) Plan?

The basic principle of a safe harbor 401(k) plan is that a certain minimum contribution is provided by the employer in exchange for being able to eliminate deferral (ADP) and matching (ACP) nondiscrimination testing. The benefit of eliminating the testing is that highly compensated employees (HCEs)–generally more than 5% owners and those earning over a specified threshold in the prior year ($95,000 in 2005)–can defer up to the annual limit without concern for what the non-HCEs defer.

Under the normal 401(k) plan rules, the average deferral percentage allowed for HCEs is slightly higher (generally 2%) than the average percentage deferred by non-HCEs. For 2005, the maximum deferral allowed per participant is $14,000, with an additional $4,000 allowed as a catch-up contribution for those age 50 and older. Consider the following example:

Susanne and Alex each own 50% of the ABC Company which has three other employees. Susanne and Alex are both under age 50 and earn $100,000 each. In 2004 the three other employees deferred an average of 5% of compensation into the plan. Using the prior year testing method, Susanne and Alex, as the only HCEs, would be allowed to defer an average of 7% into the plan in 2005, which would be $7,000 each. However,

if the plan were a safe harbor plan, they could each defer the maximum $14,000 since no testing would be required. That's an additional $14,000 between the two of them!

Establishing the Plan

In general, a safe harbor 401(k) plan must be in effect for the entire plan year and adopted before the plan year begins. A midyear adoption is permitted for a new 401(k) plan as long as the initial plan year is at least three months long. The initial plan year can be reduced to as little as one month for a newly established company. Midyear adoption is also permitted for an existing non-401(k) profit sharing plan that is amended during the year to include safe harbor 401(k) provisions as long as it is effective for at least the final three months of the plan year.

Notice Requirement

Eligible employees must be provided with a safe harbor notice within a reasonable period before the beginning of the plan year. The notice is automatically deemed to be timely if it is distributed at least 30 days and no more than 90 days prior to the beginning of the plan year.

The notice must contain participants' rights and obligations under the plan. It should include the type of safe harbor contribution being offered, any other contributions to be made, procedures for making deferral elections, withdrawal and vesting provisions of the plan as well as other detailed information as specified in the regulations. Some of the information can be incorporated by reference to the plan's summary plan description.

As an alternative to the standard safe harbor contribution commitment, a plan can provide that a conditional notice (referred to as a "maybe" notice) be distributed, stating that the employer *may* make a safe harbor nonelective contribution (discussed below). A follow-up notice is required to be given out by the beginning of the last month of the plan year stating whether or not such contribution will be made. If not, the nondiscrimination tests will have to be performed for that year. This gives the employer the ability to delay the decision until the needs of the company can be considered.

Plan Document

When establishing a safe harbor plan, the plan document must state whether it intends to be a guaranteed safe harbor or a potential safe harbor that will distribute the "maybe" notice. It can't allow for complete flexibility to be dependent upon the type of notice, if any, that is given out each year.

Safe Harbor Employer Contributions

Employers may choose between two types of contributions: a safe harbor nonelective contribution or a safe harbor matching contribution. These contributions must be 100% vested and are not available for hardship or other in-service withdrawals before age 59½. No minimum hours of service can be required, and a participant cannot be required to be employed on the last day of the plan year.

Nonelective Contribution

The nonelective contribution requires the employer to contribute 3% of each eligible employee's compensation for the year. For an employee's initial year of participation, compensation prior to plan entry can be excluded.

The safe harbor nonelective contribution can be made to another qualified plan maintained by the employer, which must be stated in the notice.

Matching Contribution

The basic safe harbor matching contribution requires the employer to match elective deferrals at the following rate: 100% of the first 3% of

compensation deferred, plus 50% of the next 2% deferred.

Alternatively, the employer may contribute an "enhanced" match which is greater than that required by the basic match. Under the enhanced match, the contribution rate cannot increase as an employee's deferral rate increases, and the contribution rate for HCEs cannot exceed the contribution rate for non-HCEs.

A plan may allow additional matching contributions on top of the safe harbor match. The plan will still be exempt from nondiscrimination testing if the following requirements are met:

- If the additional match is discretionary, it does not exceed 4% of compensation, and
- The match is not made on deferrals above 6% of compensation.

Matching contributions that do not meet the safe harbor rules must be tested, even if the 3% nonelective contribution is made.

The safe harbor match may be discontinued during the year if a written notice is provided to participants at least 30 days in advance. In such cases, the plan reverts to non-safe harbor status and must perform the nondiscrimination tests for the entire year.

Impact on Other Plan Requirements

Now that you understand how safe harbor plans eliminate ADP and ACP nondiscrimination testing, you will want to know the additional advantages they provide in top heavy plans and cross-tested profit sharing plans.

Top Heavy Plans

A plan is considered top heavy if the account balances of the key employees (generally owners and certain officers) exceed 60% of the total account balances under the plan. These plans are required to provide a minimum employer contribution to all non-key employees of at least 3% of compensation if any key employee receives a contribution of 3% or more (including deferrals).

Plans that meet the safe harbor requirements are exempt from the top heavy rules unless one of the following applies:

- The employer makes a contribution to the plan other than deferrals or the safe harbor contribution (such as a discretionary profit sharing contribution). Additional match contributions that stay within the safe harbor guidelines can be made without eliminating the top heavy exemption;
- Forfeitures are allocated as additional contributions during the plan year; or
- The eligibility requirements for elective deferrals are more liberal than for safe harbor contributions, so that some eligible employees do not receive the safe harbor contribution.

Where the plan does provide more liberal eligibility for making elective deferrals, nondiscrimination testing must be performed for the group not eligible for the safe harbor contribution. If no HCEs are included in this group, the tests will automatically pass.

Even if a plan is not exempt from the top heavy rules, safe harbor contributions can be used towards satisfying the top heavy minimum contribution. In most cases, the 3% nonelective contribution will satisfy this requirement. If the safe harbor match is utilized, these contributions can help reduce the top heavy contribution.

Cross-Tested Plans

An additional benefit of the 3% nonelective contribution is that it can be used towards the minimum gateway allocation required in cross-tested plans (also called "new comparability plans"). These plans factor in participants' ages

and can often provide a large contribution for certain key participants with minimal contributions for others.

Here is an example of an ideal situation in which a 3% safe harbor contribution is used to satisfy the nondiscrimination requirements, the top heavy requirements and the cross-tested gateway contribution:

Employee	Compen-sation	Deferrals	3% Employer Contribution	Additional Employer Contribution	Total
Owner A	$200,000	$18,000*	$6,000	$12,000	$36,000
Owner B	200,000	18,000*	6,000	12,000	36,000
Staff C	50,000	?	1,500	0	1,500
Staff D	40,000	?	1,200	0	1,200
Staff E	30,000	?	900	0	900
	$520,000	$36,000	$15,600	$24,000	$75,600

*Includes $4,000 catch-up contribution since over age 50.

The total employer contribution provides 3% for the staff and 9% for the owners, which satisfies the gateway since the higher percentage is not more than three times the lower percentage. This example assumes that the overall contributions satisfy the cross-testing requirements which are dependent in part on the ages of the participants.

This plan allows the owners to contribute $72,000 for themselves at a cost of only $3,600 for their employees, which is over 95% of the total. Employees can also defer a portion of their compensation.

The plan will likely be top heavy and is not exempt because of the additional employer contribution. But the 3% contribution satisfies the top heavy requirement.

Conclusion

A safe harbor 401(k) plan can provide a variety of benefits to employers as compared to a traditional 401(k) plan. Employers who intend to provide some level of matching or profit sharing contribution may find that a small increase in contributions for the staff goes a long way. Safe harbor contributions can also be used to satisfy top heavy as well as cross-tested contribution requirements. As a result, safe harbor provisions often enable employers to get the most value out of their 401(k) plans.

The information contained in this newsletter is intended to provide general information on matters of interest in the area of qualified retirement plans and is provided with the understanding that our company is not engaged in rendering legal or tax advice. Legal or tax questions should always be referred to a qualified tax advisor such as an attorney or CPA.

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