INNOVATIVE PENSION

Strategy & Design

SAFE HARBOR 401(k) PLANS

INTRODUCTION

The 401(k) plan is currently one of the most popular forms of retirement plan, allowing employers to share the cost of providing retirement benefits with employees and getting employees actively involved in planning for their own retirement. But annual testing to ensure that a plan does not discriminate in favor of highly paid employees can be complex and costly for the plan sponsor. The tests often limit the ability of highly compensated employees (HCEs) to maximize savings. Test failures can result in returned contributions, forfeitures of matching contributions, possible penalties if the tests are not performed by a prescribed time, and the potential of requiring employers to provide additional contributions to the non-highly compensated employees (NHCEs).

Since 1999, sponsors have had the option of adopting a "safe harbor" 401(k) plan, which eliminates the need to test and allows HCEs to maximize their savings, but which also requires employer contributions. Recent IRS guidance makes the safe harbor plan an attractive and flexible alternative plan design. This article examines the safe harbor 401(k) plan design and explores the key issues—particularly the contribution requirement—that plan sponsors should consider in determining if it presents a good design alternative.

THE CONTRIBUTION REQUIREMENT

The most important requirement for a plan to be considered a safe harbor plan is for the employer to provide contributions to employees' accounts. The contribution requirement can be satisfied in one of two ways:

- The employer may make a 3% fully vested nonelective employer contribution for all NHCEs, or

- The employer may provide to all NHCEs a fully vested matching contribution that is either: a "basic match," consisting of a 100% match of employee elective deferrals up to the first 3% of pay and 50% match of deferrals on the next 2% of pay; or an "enhanced match," such as a 100% match of deferrals up to 4% of pay.

ADDED FLEXIBILITY

The safe harbor design has evolved into a relatively flexible alternative to the traditional 401(k) design, particularly with the issuance earlier this year of IRS Notice 2000-3, which provided additional guidance on and greater flexibility to safe harbor plans. For example:

- An employer using the matching method may amend the plan part of the way through the year to elect not to be a safe harbor plan, if it meets certain notice requirements and gives participants a reasonable opportunity to change their deferral amounts. The plan then becomes subject to the nondiscrimination testing requirements for the entire year.
- A plan may provide the safe harbor match on a combination of elective deferrals and after-tax contributions.
- An employer may operate the plan as a safe harbor plan and amend the plan to use the 3% nonelective contribution method as late as one month before the plan year ends.
- A plan may be changed from a safe harbor plan to a nonsafe harbor plan on a year-by-year basis.
- Safe harbor matching contributions may be based on periodic payroll periods.

SAFE HARBOR CANDIDATES

Employers should consider the 401(k) safe harbor plan design if their plans fall into one or more of the following categories:

- The plan is already "top heavy." A plan generally is considered top heavy if key employees own more than 60% of the plan's accrued benefits. All plans of an employer must be aggregated to determine if the plans are top heavy. Top heavy plans, which must comply with special rules under the tax code, already could be making a 3% contribution to non-key employees (generally, those who are not owners or highly paid officers of the employer). To meet the safe harbor requirements, the plan sponsor will have to provide full vesting of the 3% contribution and possibly include some additional participants in the allocation.
- The plan experiences test failures. The safe harbor design will remove the need for annual nondiscrimination testing. It will also allow HCEs to maximize their deferrals without the problem of the employer having to return some contributions at year-end or make mid-year cutbacks in the amount HCEs may defer. In addition, the sponsor will not have to make adjustments outside the plan to make up for other lost HCE benefits, such as forfeited matching contributions.
- The plan benefits a large number of HCEs. As long as the safe harbor contribution requirement is met, the rate of contribution on the part of the few NHCEs will not affect the HCEs' ability to maximize elective deferrals.
- The plan already provides generous employer contributions. If the current level of match or elective contribution is generous, the plan already may be close to satisfying the safe harbor contribution requirements. The safe harbor match or employer nonelective contribution must be 100% vested, but the cost of vesting those amounts might be offset by the cost of data gathering and testing. If the sponsor contributes at least 3% to a money purchase plan, then the 401(k) plan can be a safe harbor plan, provided the 3% is fully vested and the money purchase plan formula is not integrated with Social Security.
- The objective is to maximize deductions. For sponsors that are attempting to maximize their tax deductions (i.e., 15% of payroll after subtracting employee elective deferral amounts) for the year and provide as large a benefit as possible to the HCEs, the safe harbor design can provide an effective way to meet such objectives.

OTHER CONSIDERATIONS

The safe harbor plan also must satisfy requirements applicable to amendments and notification to employees. If the plan uses the 3% employer nonelective contribution method, employees must be notified prior to the beginning of the plan year that the plan may be a safe harbor plan, but the employer has until one month before the plan year ends to make a final decision about amending the plan and provide the appropriate notification. If it is using a matching method, the plan sponsor must amend the plan and notify participants one month before the plan year begins.

There are some other considerations for a plan sponsor contemplating the adoption of a safe harbor design:

- After-tax contributions must continue to be tested for nondiscrimination. The safe harbor design does not apply to after-tax contributions.

- Some restrictions apply to new plans with short plan years and profit-sharing plans that are amended to be 401(k) plans in the middle of the year, but in most cases the safe harbor design can be used for these plans as well.

- Plans that have fixed or discretionary matching contributions in addition to safe harbor matching contributions must keep the additional contributions within prescribed limits.

CONCLUSION

Ultimately, plan sponsors must weigh the cost of providing additional contributions to NHCEs against the benefits of eliminating the burden of nondiscrimination testing and having the ability to provide more for HCEs. For large plans, the major advantage is likely to be the removal of the administrative burdens of testing. For small plans, the safe harbor design is more likely to enhance the HCEs' ability to maximize retirement benefits.

(For more information on 401(k) Plans or to find out about setting up a Pension or Profit Sharing Plan for your company, please call Innovative Pension at 858-748-6500.)

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