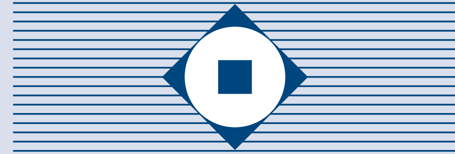
Benefit Insights



RETIREMENT PLAN CONSULTANTS

1080 W. Shaw, Suite 101 ■ Fresno, CA 93711

Providing Third Party Administrative Services Since 1986

A non-technical review of qualified retirement plan legislative and administrative issues **August 2010**

Safe Harbor 401(k) Plan Offers Many Advantages

The continuing popularity of the 401(k) plan has made it the most widely used savings plan in the country. As employers have had to shift limited resources to cover the ever-increasing cost of other benefits, the ability for employees to contribute to their retirement savings helped to ensure the continuation of these plans.

There are numerous regulations that govern 401(k) plans by encouraging broad based participation and preventing owners and highly paid employees from receiving disproportionately greater benefits than other employees. Plans must either satisfy a series of nondiscrimination tests each year or be designed to satisfy certain "safe harbor" standards that are predetermined not to be discriminatory.

While the term "safe harbor" is used in many different retirement plan contexts, it has a very specific meaning when it comes to 401(k) nondiscrimination tests. Before considering the specifics, it is helpful to have a general understanding of the nondiscrimination rules.

Nondiscrimination Testing

Contributions to a 401(k) plan may include employee salary deferrals, employer matching contributions and/or profit sharing (a/k/a nonelective) contributions. Each year, the plan must demonstrate that contributions for highly compensated employees (HCEs) are not disproportionately larger than those for non-HCEs (NHCEs). HCEs are generally owners of more than 5% of the company and any employee with compensation in the prior plan year over a specified level ($110,000 for 2009 and 2010).

The actual deferral percentage (ADP) test and the actual contribution percentage (ACP) test are run after the end of each plan year. The ADP test compares the average deferral rate for the HCE group to that of the NHCE group. In most cases, as long as the HCE average is not more than 2 percentage points greater than the NHCE average, the test passes. The ACP test works the same way except that it analyzes employer matching contributions. Consider this example:

Elaine owns a small company and has one employee, Mark, who earns $150,000 per year. She has eight other employees who all earn under

$100,000 per year. All employees are eligible to participate in the company's 401(k) plan. Elaine and Mark are considered HCEs, while the other eight employees are NHCEs. If the average deferral rate for the NHCEs is 3%, then the average for Elaine and Mark cannot exceed 5%. If Mark defers 2% of his compensation, Elaine could defer up to 8% of her compensation and keep their average at or below 5%.

The top heavy determination is another test that is based on the assets in the plan. If, on the last day of the previous year, the combined accounts of certain company officers and owners (referred to as "key employees") exceed 60% of the plan's total assets, the plan is considered top heavy. Such plans are generally required to provide a minimum contribution of 3% of compensation for all eligible non-key employees. This can come as an unwelcome surprise for employers that had not anticipated or budgeted for contributions to their retirement plans.

Safe Harbor Plan Eliminates Nondiscrimination Testing

The primary benefit of the safe harbor 401(k) plan is that the plan is deemed to automatically satisfy the ADP and ACP tests. This allows HCEs to defer up to the annual dollar limit ($16,500 for 2010) regardless of how much or how little the NHCEs defer. In addition, plans that include only employee salary deferrals and safe harbor contributions (described below) are deemed to satisfy the top-heavy requirements. As a trade-off, safe harbor plans must meet a number of requirements including minimum employer contributions, immediate vesting and participant notices.

Safe Harbor Contributions

The employer can satisfy the contribution requirement by making either a nonelective contribution or a matching contribution on behalf of each eligible NHCE. The contribution can, but is not required to, be made on behalf of HCEs as well.

Nonelective Contribution

The nonelective contribution must be at least 3% of compensation for the plan year for each eligible employee regardless of whether or not they make salary deferral contributions. Compensation earned prior to an employee's eligibility date can be ignored. Plans that allocate profit sharing contributions using a new comparability (a/k/a cross-tested) formula may prefer the nonelective option, because the safe harbor contribution may also be used to satisfy some of the complex testing requirements applicable to such plans.

Matching Contribution

The matching option requires the employer to match participants' elective deferrals at the rate of 100% of the first 3% of compensation deferred, plus 50% of the next 2% of compensation deferred (maximum match of 4%). The employer can choose to make an enhanced match, for example, 100% of the first 4% of compensation deferred, as long as certain guidelines are followed.

Additional matching contributions can also be made, and they will be exempt from the ACP test, as long as:

- They are not based on deferrals in excess of 6% of compensation, and
- If they are discretionary, they do not exceed 4% of compensation.

How the Plan is Established

Any 401(k) plan can be set up as, or amended to become, a safe harbor plan. Generally, safe harbor provisions must be in effect for the entire plan year, although a new plan can be established during the year as long as it will be in effect for at least three months. This can be reduced to as little as one month for newly formed companies with a short initial fiscal year. Existing profit sharing

plans without 401(k) provisions can be amended mid-year to become safe harbor 401(k) plans, subject to the three-month requirement.

The plan document must specify whether the plan will use the nonelective or matching contributions formula, and it must address all other safe harbor requirements described below.

Notice Requirement

A notice must be provided to eligible employees within a reasonable period before the beginning of the plan year (or safe harbor effective date). It will automatically be considered timely if distributed 30 to 90 days prior to the beginning of the plan year. For plans that provide for immediate eligibility, new hires should be provided the notice on their dates of hire.

The notice must contain the basic features of the plan, including the safe harbor contribution to be provided and rules relating to elective deferrals, other contributions, withdrawals, vesting, etc. Some details can be provided by reference to the Summary Plan Description.

Safe harbor plans using the nonelective contribution can be designed as "maybe" plans. Such a design requires that two notices be provided to participants. The timing of the first notice is the same 30 to 90 days described above, and it must inform participants that the employer might make a safe harbor contribution for the coming year. The second notice is provided 30 to 90 days before the end of the year and informs participants whether or not the contribution will be made. In addition to satisfying this expanded notice requirement, the "maybe" provisions must be reflected in the plan document.

Other Rules

Safe harbor employer contributions must be fully vested and are not available for in-service distribution prior to age 59½. An eligible participant cannot be required to work a specified number of hours or be employed on the last day of the plan year in order to receive the safe harbor contribution.

Suspension of Contribution

The safe harbor matching contribution can be eliminated during the year by adopting a formal plan amendment and providing notice to participants 30 days prior to the effective date. Contributions must be made through the end of the 30-day period. Plans making this change lose safe harbor status for the entire year, subjecting them not only to the ADP/ACP tests but also to the top heavy minimum contribution requirement which could be more expensive than the safe harbor match would have been.

As a result of the struggling economy, the IRS issued proposed regulations in 2009 (which can be relied upon pending final regulations) that also allow employers to suspend safe harbor nonelective contributions if they are experiencing a substantial business hardship. This is determined based upon whether or not:

- The employer is operating at an economic loss;
- There is substantial unemployment or underemployment in the trade of business and in the industry concerned;
- The sales and profits of the industry concerned are depressed or declining; and
- It is reasonable to expect that the plan would not continue unless the contributions are reduced or suspended.

The 30-day notice and testing requirements that apply to the suspension of safe harbor matching contributions also apply to the suspension of safe harbor nonelective contributions.

Automatic Enrollment Safe Harbor

A modified version of the safe harbor plan is available for 401(k) plans that contain automatic

enrollment features. They provide that eligible employees will automatically defer a specified percentage of their compensation into the plan unless they elect not to participate, and the default deferral rate must generally escalate each year.

The rules for so-called Qualified Automatic Contribution Arrangements (QACA) are similar to the regular safe harbor rules, except that the QACA matching requirement is 100% of the first 1% of compensation deferred, plus 50% of the next 5% of compensation deferred (maximum match of 3.5%). In addition, safe harbor contributions under the QACA must be 100% vested after two years of service rather than the immediate vesting required of traditional safe harbor plans. The participant notice must contain additional information describing the automatic enrollment features.

Eligible Combined Plan

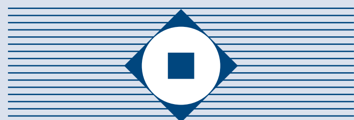
Beginning in 2010, there is a new type of safe harbor plan that includes the combination of a 401(k) and a defined benefit formula in the same plan. In order to qualify for this arrangement, the plan must include an automatic enrollment 401(k) provision, a safe harbor match or nonelective contribution as well as a minimum defined benefit. The so-called DB(k) plan is only available for employers with fewer than 500 employees and is so new that the IRS has not yet issued regulations describing the mechanics of how the plans are supposed to operate.

Conclusion

A safe harbor design is an excellent way for many employers to get the most out of their 401(k) plans. By eliminating ADP/ACP nondiscrimination testing, all employees can contribute up to the annual deferral limit and not be concerned about the possibility of refunds after year-end. Safe harbor contributions may also eliminate top heavy requirements and can be coordinated with other contribution allocations. There is much to like about the safe harbor 401(k) plan.

This newsletter is intended to provide general information on matters of interest in the area of qualified retirement plans and is distributed with the understanding that the publisher and distributor are not rendering legal, tax or other professional advice. You should not act or rely on any information in this newsletter without first seeking the advice of a qualified tax advisor such as an attorney or CPA.

©2010 Benefit Insights, Inc. All rights reserved.



RETIREMENT PLAN

CONSULTANTS

- 401(k) Plans
- Profit Sharing / New Comparability Plans
- Defined Benefit Plans
- 403(b) Plans
- 125 Plan Consulting

Please contact us at (559) 437-7070 or Fax (559) 437-7071