



Detailed information on safe harbor contributions to 401(k) plans

Safe harbor brief explanation:

A plan sponsor may elect to contribute safe harbor minimum contributions to a 401(k) or to another plan sponsored by the employer (such as a money purchase plan), and thereby avoid Actual Deferral Percentage (ADP) testing of pre-tax elective deferral and after-tax Roth elective deferral contributions (elective deferrals) and/or Average Contribution Percentage (ACP) testing of employer matching contributions.

Safe harbor contributions must be tracked separately from other matching or discretionary employer contributions because distributions are restricted, eligibility to receive a contribution may be different, and the contributions must be 100% vested.

- **General safe harbor contribution requirements:** The employer must make either a safe harbor matching contribution or a safe harbor non-elective contribution. Either of the contribution types will meet the ADP and ACP test requirements if all other requirements are also met. The safe harbor contribution may satisfy only the ADP test if additional requirements for satisfying the ACP test are not met (see *Additional requirements to satisfy the ACP test* below). The safe harbor contribution may also be made to a different plan sponsored by the employer, if that plan is properly amended, that plan has the same plan year, and everyone eligible to participate in the 401(k) is also eligible to participate in the other plan. Both the safe harbor matching contribution and the safe harbor non-elective contribution must be 100% vested and have specific withdrawal restrictions. Hardship distributions and in-service withdrawals prior to age 59½ are not allowed from safe harbor contributions. The safe harbor matching contribution must match elective deferrals and catch-up contributions.

The safe harbor contribution must be made to all non-highly compensated employees (NHCEs) eligible to make elective deferrals regardless of hours worked or employment on the last day with the following exception: the employer may choose not to provide a safe harbor contribution to participants who have not attained age 21 and/or completed one year of service. This group would have to be tested separately without the benefits of safe harbor provisions. If the employer chooses, the safe harbor contribution may be provided to the highly compensated participants (HCEs).

Safe Harbor contributions to satisfy the ADP test

Internal Revenue Code (IRC) Section 401(k)(12)

- **Safe harbor non-elective contribution:** The employer may make a non-elective contribution equal to at least 3% of compensation to all eligible NHCE and HCEs. This contribution can be larger than 3%. A non-elective contribution is made regardless of whether the employee makes salary deferral contributions to the plan. The additional requirements listed in the *General safe harbor contribution requirements* above regarding vesting, eligibility and withdrawal restrictions must also be met. This non-elective contribution satisfies the ADP test. It may also satisfy the ACP test, if all other ACP safe harbor conditions are met (see *Additional requirements to satisfy the ACP test* below).

The safe harbor non-elective contribution can be “tentative” or “fixed.” If the contribution is “tentative,” the employer can wait until 30 days before the end of the plan year to decide whether or not to make a safe harbor non-elective contribution, if the following notice requirements have been met: 1) employees receive notice within a reasonable period before the beginning of the plan year of the possibility of a safe harbor contribution, and 2) a second notice is provided at least 30 days before the end of the plan year that the employer has decided to make or not make the safe harbor non-elective contribution. This type of safe harbor non-elective contribution is known as the “tentative” safe harbor contribution. The plan document will have to be amended before the end of the plan year each time the “tentative” safe harbor contribution is made to specify the contribution for that plan year. This process is repeated annually.

- **Safe harbor BASIC matching contribution:** Alternatively, the employer may satisfy the ADP safe harbor contribution requirement by making the following fixed matching contribution to NHCEs, and HCEs if desired, and meeting the other requirements regarding vesting, eligibility and withdrawal restrictions listed in *General safe harbor contribution requirements* on page 1:
 - a. Match 100% of the employee salary deferral up to 3% of compensation AND
 - b. Match 50% of the employee salary deferral from 3% to 5% of compensation.
 - c. The rate of any plan matching contribution with respect to any elective contribution of an eligible HCE cannot be greater than the rate of matching contribution for any eligible NHCE. For example, if HCEs of the employer work for Division A of the employer, the rate of matching contribution provided them cannot be greater than the rate of matching contribution provided to NHCEs who may work for Division B of the employer. An hour and/or last day requirement is not allowed for the safe harbor match contribution.

- **Safe harbor alternative (“ENHANCED”) matching contribution:** The employer may make a different rate of matching contribution to satisfy the matching contribution safe harbor if the following are met: (1) the contribution is a fixed matching contribution, (2) the rate of any matching contribution in the plan does not increase as an employee’s rate of elective deferrals increases, and (3) the safe harbor matching contribution amount for each employee in the aggregate is at least equal to the amount that would have been contributed under the safe harbor basic matching formula described in *Safe harbor BASIC matching contribution* above. This means a plan can have a safe harbor matching formula different from the safe harbor basic matching contribution described above, but the actual dollar amount contributed for each NHCE cannot be less than that produced by applying the formula in *Safe harbor BASIC matching contribution* above (i.e., the matching formula cannot be “escalating”).

The additional requirements listed in the *General safe harbor contribution requirements* on page 1 regarding vesting, eligibility, and withdrawal restrictions still apply. No last day and/or hour requirement is allowed in the safe harbor match contribution.

Examples: A 401(k) plan provides a fixed matching contribution equal to 100% of 401(k) elective deferrals up to a maximum of 4% of compensation; this formula satisfies the matching contribution safe-harbor because all participants who are deferring will get a contribution at least the same as the contribution which would be made under the safe harbor basic matching contribution described above. Another example is a fixed matching contribution equal to 150% of 401(k) elective deferrals up to a maximum of 3% of compensation. Conversely, if the fixed matching formula is a 50% match of elective deferrals up to 6% of compensation, and then a 100% match for elective deferrals exceeding 6% of compensation, this is not a safe harbor match contribution because of the prohibition for an escalating formula.

- **Additional plan contributions:** Additional non-elective or matching contributions may be made to the plan. These additional contributions do not have to meet the safe harbor requirements of 100% vesting, eligibility and withdrawal restrictions. The normal plan rules still apply to these additional contributions.

Caution, if the additional plan contribution is a matching contribution and the plan intends to meet the requirements for the ACP safe harbor, the additional matching contributions must meet the requirements detailed in the *Additional requirements to satisfy the ACP test* below.

Additional requirements to satisfy the ACP test

IRC Section 401(m)(11)

The ACP test is satisfied if any of the safe harbor ADP contributions described in *Safe Harbor contributions to satisfy the ADP test* above are made, including the safe harbor non-elective contribution. If the plan wants to take advantage of the ACP safe harbor, there are additional requirements for all of the employer matching contributions made to the plan. These additional requirements are automatically met if the plan uses only the safe harbor basic matching formula described in *Safe harbor BASIC matching contribution* above. If the plan intends to provide a matching contribution in addition to the safe harbor contribution, the plan must observe these additional limitations applied to this other matching contribution. The “other” match does not have to be 100% vested or have withdrawals restricted to have the ACP test waived as an ACP safe harbor plan. This additional “other” match must be tracked separately. The additional limitations for the “other” match are as follows:

1. Matching contributions for any employee cannot be based on an employee’s elective deferrals in excess of 6% of compensation.
2. The rate of match cannot increase as the rate of elective deferral increases (i.e., the matching formula cannot “escalate”).
3. The matching contribution percent for eligible HCEs at any deferral rate cannot be greater than the matching contribution percent for eligible NHCEs. But an “other” matching contribution may have an age 21 and/or 1 year of service eligibility requirement.
4. The total dollar amount of the “other discretionary” matching contribution cannot exceed 4% of an employee’s compensation.
5. The additional matching contributions may not impose an hour and/or last day requirement to receive the “other” matching contribution.

Examples: The 4% and 3% examples in *Safe harbor BASIC matching contribution* above would meet the ACP safe harbor requirement as well as the ADP safe harbor requirement. A matching contribution that matched 100% of deferrals up to 8% of compensation would not be an ACP safe harbor because it exceeds the 6% ceiling, but would be an ADP safe harbor if properly stated in the document, 100% vested, contributed to all eligible participants and has withdrawals restricted.

Other safe harbor provisions

- **Vesting:** The safe harbor contribution must be 100% vested, also known as full and immediate vesting.
- **Elective deferrals:** The plan can continue to impose restrictions on starting, stopping and changing salary reduction elections. The amount of elective deferral may be limited by plan design, as long as each participant is allowed to make an elective deferral that is sufficient to receive the maximum amount of matching contributions available under the plan for that plan year. Also, a participant must be able to elect any lesser amount of elective deferrals. The participant must have a “reasonable” period of time, interpreted to be 30 days, after receiving notice of the safe harbor plan to start or change the elective deferral percent.
- **Eligibility:** The safe harbor contribution can have different eligibility requirements from the elective deferral contribution. If a plan permits employees to make elective deferrals prior to attaining age 21 and 1 year of service, the plan may choose to not provide these employees with a safe harbor contribution. This concept is called “permissive disaggregation”, and it is permitted. Such a provision must be reflected in the plan document, and the employees who do not receive the safe harbor contribution may be subject to ADP and ACP testing. Usually this group of employees who are not age 21 with 1 year of service does not contain HCEs so generally no testing is required.
- **Distributions restricted:** The safe harbor employer contribution may not be distributed on account of hardship. Restrictions that apply to withdrawals from elective deferral accounts will also apply to the employer safe harbor contribution amounts. In-service distributions prior to age 59½ are not permitted. Additionally, distributions may not be made from either of these accounts as a result of plan termination if the employer sponsors another defined contribution plan within 12 months of the plan termination.
- **Multiple duty:** The safe harbor non-elective contribution may serve to satisfy the ADP test, may satisfy the ACP test if other matching contribution limitations are observed, and can be used to satisfy the top-heavy minimum contribution, if required. It can also be used to satisfy IRC Section 401(a)(4) nondiscrimination testing in a cross-tested plan.

- **Top-heavy:** For safe harbor plans, the term ‘top-heavy plan’ shall not include a plan which consists solely of:

- (i) A cash or deferred arrangement which meets the requirements of IRC Section 401(k)(12), and
- (ii) Matching contributions with respect to which the requirements of IRC Section 401(m)(11) are met.

IRC Section 401(k)(12) refers to the safe harbor ADP rules; IRC Section 401(m)(11) refers to the safe harbor ACP rules. This means that a safe harbor plan will be exempt from top-heavy requirements if it contains only safe harbor contributions.

In a plan year in which the employer does not make a discretionary profit sharing contribution and the plan does not allocate any forfeitures, the top-heavy exemption applies. However, if profit sharing contributions or other types of contributions are made to the plan or if any type of forfeiture is reallocated using any formula to participant accounts, the plan will not automatically satisfy the requirements to be excluded from top-heavy consideration. Forfeitures must be used to reduce employer contributions for the top heavy exemption to apply.

Additionally, if the plan allows all employees to defer, but imposes an age 21 and 1 year of service requirement to receive a safe harbor contribution, the plan will not be automatically exempt from top-heavy rules. The plan must meet the top-heavy 3% contribution minimum for all of the participants in the plan. Matching contributions can also be used to satisfy the top-heavy 3% minimum contribution requirement. Since both the safe harbor matching contribution and the safe harbor non-elective contribution are always at least 3% of compensation, for those participants receiving any type of safe harbor contribution, the top-heavy minimum requirement, in most cases, will be met through the use of the safe harbor contribution. Only those employees who are not age 21 with 1 year of service, do not receive the safe harbor contribution, and are employed on the last day of the plan year will be required to receive top-heavy contribution. As a reminder, the top-heavy contribution minimum requirement is 3% of annual compensation.

- **Other plan:** The safe harbor contribution can be contributed to another plan maintained by the employer if it is made to all the participants who would be eligible to receive a safe harbor contribution were it in the 401(k) plan. Distributions must be properly restricted, and the contribution must be 100% vested. Also, the other plan must have the same plan year and eligibility requirements as the 401(k) plan. For example, a 3% money purchase plan would satisfy the ADP safe harbor test if all the additional requirements are met. If the match in the 401(k) plan is properly limited and meets all other requirements, this 3% money purchase contribution would also satisfy the ACP safe harbor test in the 401(k) plan.
- **Advance notice:** A detailed advance notice must be provided to all eligible participants of the employer’s intent to activate safe harbor 401(k) provisions. The notice requirement has two parts – a “content requirement” and a “timing requirement;” both must be satisfied. It must be customized for each 401(k) plan sponsor. A plan sponsor can satisfy the notice requirement by providing the notice either in written form or through electronic medium, as long as:

- a. the electronic medium is “reasonably accessible” to the eligible employees,
- b. the system for providing electronic notice is “reasonably designed” to provide notice in a manner no less understandable than a written paper document,
- c. employees are advised that they can request, at no cost, a copy of the notice on paper, and
- d. a paper version of the notice is in fact provided at no cost upon request.

The content requirement requires a description of (i) the plan’s safe harbor contribution, either matching or non-elective; (ii) any additional contributions to the plan; (iii) the plan to which the safe harbor contribution will be made; (iv) the type and amount of compensation that may be deferred; (v) how to administratively make cash or deferred elections; (vi) the periods available for making the elections; and (vii) applicable withdrawal and vesting provisions. A notice must be provided within a “reasonable period” before the beginning of the plan year. Such reasonable period is deemed to be satisfied if the notice is provided to each eligible employee between 30 – 90 days before the beginning of the plan year. Additionally, if an individual becomes eligible to participate in the plan during the plan year, they must receive the notice, in a form outlined above, during the 90-day “window” that ends on their first eligible entry date. If the plan has no eligibility requirements, the notice should be provided to the employee upon their date of hire, or as soon as administratively feasible. For all employees in a new plan, the notice must be provided within 90 days ending on date of entry.

An employer can choose whether or not to make the non-elective contribution up to 30 days before the end of the plan year; this is called the “tentative” safe harbor contribution. If the employer wants to exercise this right to have the “tentative” safe harbor contribution, the participants must be notified 30 days before the first day of the plan year of the possibility that the employer may make a safe harbor non-elective contribution. Then the participants must be notified at least 30 days and no more than 90 days prior to the beginning of the plan year end whether the employer chooses or chooses not to make the safe harbor non-elective contribution. If the employer wants to continue this practice into the next plan year, the year-end notice and the notice for the following year can be combined into one notice given at least 30 days before the first day of the next plan year. This flexibility is not available for safe harbor matching contributions. In addition, the plan will have to be amended before the last day of the plan year to specify the contribution for that plan year. This process is repeated annually.

- **Current year testing:** Any plan that utilizes a safe harbor contribution to meet ADP and/or ACP testing is deemed to be using current year testing for all tests, even though ADP and ACP testing is usually not required. However, if ACP testing is required for any reason, the plan is deemed to be using current year testing. If a plan sponsor who currently provides a safe harbor matching contribution decides to stop making the safe harbor match after the plan year commences or fails to meet all the safe harbor requirements, the plan will then have to pass the ADP and ACP tests for the entire plan year using current year testing methods. For ceasing the safe harbor matching contribution, see *Removing a safe harbor contribution* below.

A plan may not switch to prior year testing methods until it abandons the safe harbor plan design and it satisfies the requirements of the Final 401(k) and (m) Regulations for switching, i.e., 5 years of using current year testing or some other acceptable reason for switching. In addition, the plan will have to be amended before the last day of the plan year in order to switch to the prior year testing method.

- **After-tax contributions:** Employee after-tax contributions are still subject to ACP testing. The safe harbor contribution does not satisfy these requirements.
- **Matching contribution per pay period:** A plan can make a safe harbor matching contribution for compensation on a payroll, monthly, quarterly, or annual basis. Monthly, quarterly and annual safe harbor matching contributions must be deposited no later than 12 months after the close of the plan year. However, if the payroll basis method is selected, then the safe harbor matching contribution made during a plan year quarter must be deposited no later than the last day of the next quarter.
- **Removing a safe harbor contribution:** A plan sponsor using a safe harbor matching contribution may change or eliminate the safe harbor matching contribution provisions in the middle of the year. The safe harbor matching contribution must be provided for elective deferrals made up to the date of the change. The notice and an opportunity to change elective deferrals must be provided to the employees 30 days prior to the change. By stopping the safe harbor matching contributions, the ADP and/or ACP testing is reinstated for the entire plan year using the current year testing method. The plan may continue to make matching contributions that do not meet the safe harbor requirements after the date of the change. *Note: In most situations, the “fixed” safe harbor non-elective contribution must be made for the entire plan year unless the plan or the elective deferral feature is new for that plan year.*
- **Disaggregation of plan:** There are special testing provisions for a 401(k) plan with more generous eligibility requirements than required by law (age 21 and 1 year of service). Qualified plans may choose to “disaggregate” these “otherwise excludable” employees and test them separately under 410(b) coverage testing. The plan may contribute a safe harbor contribution for one of the disaggregated portions of the plan, and not the other. In other words, if a plan does not require the maximum age 21 and 1 year of service eligibility requirement for elective deferrals permitted by law, the plan may choose to make safe harbor contributions only to those participants who would meet this age 21 and 1 year of service maximum eligibility allowed by law. This provision must be in the plan document. The participants who did not receive the safe harbor contribution must be tested for ADP and ACP. However, this group of participants rarely contains HCEs; testing is not required if the group is only NHCEs. If the plan is top-heavy, these participants must receive a top-heavy contribution. This plan design will also void the top-heavy exemption for the entire plan.

- **QMAC and QNEC for another plan:** The safe harbor matching and non-elective contributions may not be used as a QNEC or QMAC for another plan or for any prior plan year. This might be of issue if a plan is using QNECs to boost a “prior year” ADP or ACP test or if a plan is permissively aggregated with another plan and the contribution would be used in that plan to satisfy ADP or ACP testing. In other words, the same contribution cannot be used to satisfy this year’s safe harbor requirement and to satisfy the prior year’s ADP and/or ACP test.
- **Plan year:** The plan year for a safe harbor plan must be 12 months long; however, there are two exceptions. The first exception is for a newly established plan with a plan year of at least 3 months. The other exception is for a newly established plan of a newly established employer, and the plan is established as soon as administratively feasible after the employer comes into existence. A newly established plan may have a short first plan year, if the plan is begun in the middle of the proposed plan year. Conversely, the plan effective date may be retroactive, but the safe harbor matching contribution must be made for compensation and elective deferrals after the safe harbor provisions are adopted. Essentially, a new plan with a retroactive effective date will be operated as a profit sharing plan until the time when elective deferrals are permitted. A short plan year is permitted if a plan is terminated on account of merger, acquisition or substantial business hardship, a plan is terminated and the employer made the safe harbor contributions for the short plan year, and where the plan year is changed but is preceded and followed by a 12 month plan year during which the plan was a safe harbor plan.
- **Adding safe harbor and 401(k) provisions to an existing profit sharing plan:** A plan may add an elective deferral feature and the accompanying safe harbor contribution to an existing profit sharing plan no later than 3 months before the end of the plan year. The safe harbor matching or non-elective contribution is required only for the months during which the safe harbor provisions are effective, but may be retroactive to the first day of the plan year if the plan sponsor desires.

Safe harbor plan design tips

- **When does a safe harbor plan make sense:** The safe harbor plan design is quite expensive, especially for large plans, because of the level of contribution required and the full and immediate vesting requirement. The safe harbor design makes sense for a client that has a money purchase plan with a 3% contribution as well as a 401(k) plan which is failing the ADP and/or the ACP tests, if that client does not object to full and immediate vesting. Additionally, it assists a top-heavy 401(k) plan that is failing the ADP and/or ACP tests because a 3% contribution is required for top-heavy; again, please note full and immediate vesting is required for the safe harbor non-elective contribution. Alternatively, if only a matching contribution is being made, the safe harbor match plan design may be exempt from top-heavy requirements. Any top-heavy 401(k) plan should consider adopting a safe harbor formula to reduce administration. Moreover, a small 401(k) plan such as a doctor group in which the owners would like to make higher elective deferral contributions and are willing to provide the safe harbor contribution to NHCEs would guarantee passage of the ADP and ACP tests. Another reason is to simplify administration for an employer who is already contributing an employer contribution that meets or exceeds the safe harbor contribution requirement, if the employer does not object to full and immediate vesting. Finally, a safe harbor 401(k) plan may be an alternative to sponsoring a SIMPLE 401(k) plan because of higher employee and employer contribution limits or having more flexibility.
- **Cross-tested plans:** Effective plan design for a small employer might be a safe harbor cross-tested 401(k) plan utilizing the safe harbor non-elective contribution. In a safe harbor plan, the HCEs can defer up to the IRC 402(g) limit, which is \$16,500 for 2011 with no ADP testing plus the additional catch-up elective deferral if HCE is over age 50. An additional match may be contributed, and if it meets the safe harbor requirements, there is no ACP testing. The safe harbor non-elective contribution can be used to meet any left over top-heavy contribution requirement. Additionally, the safe harbor non-elective contribution can be used in the IRC Section 401(a)(4) general test of the base contribution for the NHCEs in a cross-tested profit sharing allocation formula. A cross-tested plan design with a safe harbor non-elective contribution may permit the employer to make an additional profit sharing contribution to either HCEs only or another select group of participants. No additional contribution would be required for NHCEs if the safe harbor non-elective contribution satisfies the cross-testing minimum contribution requirement as well as the gateway requirement.

For example, if the employer makes a 13.25% profit sharing contribution to an HCE making \$200,000, which is \$26,500, with the maximum elective deferral contribution of \$16,500 for 2011 and the 3% non-elective safe harbor contribution of \$6,000, the total contribution for that HCE is \$49,000, which is the maximum IRS Code 415 limit. The plan's total allocation must pass the complex "general" testing allowed in IRC Section 401(a)(4) for the cross testing method, and the plan must be amended to provide for this allocation formula. Also, the cross-tested plan must satisfy the "gateway" requirement that no NHCE benefiting, who is receiving a safe harbor contribution, can get less than the lesser of 1/3 of the contribution made to the HCE with the highest allocation rate for the plan year or 5% of the NHCE's compensation. In this example, 1/3 of 13.25% is 4.42%, which is the minimum required contribution for all NHCEs, assuming this contribution would satisfy the IRC Section 401(a)(4) general testing.

The plan will more than likely be able to effectively utilize this contribution design and pass the cross-testing method if the employer has the following characteristics:

- a. the business has 25 or fewer employees,
- b. the HCEs or owners ("select group") are making between \$170,000 – \$200,000 per year,
- c. there is about a 10-year age difference in the average age of the select group and the average age of the non-select group,
- d. the employer is stable with relatively little employee turnover,
- e. the employer generally employs young people, and
- f. the employer wants to contribute the maximum allowed by law for the select group.

The safe harbor 401(k) plan works well for cross-testing because the select group is able to make the IRC Section 402(g) maximum due to the waiver of the ADP test, and if a matching contribution is provided, no ACP test may be required. Assuming ACP testing requirements are met, the cross-testing profit sharing formula would only provide for the difference in the elective deferral, the match contribution and the maximum IRC Section 415 limit of \$49,000 for 2011. The safe harbor non-elective contribution serves as the base profit sharing contribution for the non-select group. The factors listed makes it easier for a plan to pass the IRC Section 401(a)(4) general test. A third party administrator must be involved in any cross-tested plan design and ongoing administration.

Summary

If an employer is either making or is willing to make an employer contribution to meet safe harbor requirements and does not object to full and immediate vesting of that contribution, the safe harbor plan design can simplify administration and allow maximum elective deferral contributions by the HCEs and matching contributions for HCEs without the concern of having either elective deferrals returned or matching contributions forfeited.

Be sure to check with your current plan service provider or the third party administrator regarding administration fees.

Important notice: The information contained in this article does not constitute legal or tax advice and is intended to be general guidance. The plan sponsor should consult with its legal counsel or tax advisor regarding the specifics of safe harbor plans.

