



RETIREMENT PLAN NEWS

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Safe Harbor 401(k) Plans for 2005

With the new year coming, it's time to consider if a safe harbor 401(k) plan is a good choice for you for 2005. So, we thought it would be helpful if we devoted this issue of *Retirement Plan News* to the concept of the safe harbor 401(k) plan. Included are:

- An overview of safe harbor plans;
- An updated chart of the safe harbor plan rules;
- An article on how safe harbor 401(k) plan rules interact with top-heavy rules; and
- Examples of different safe harbor 401(k) allocation formulas.

Safe Harbor Benefits

The beauty of the safe harbor 401(k) is that it is not subject to many of the complex tax rules that are associated with a traditional 401(k) plan, including annual nondiscrimination testing. A safe harbor employer contribution satisfies the discrimination tests that apply to employee deferrals (ADP test) and matching contributions (ACP test).

As a result, highly compensated employees (HCEs) may defer the maximum amount of compensation allowed without the plan having to pass the above discrimination tests. In 2005, the maximum deferral to a 401(k) plan will be \$14,000. In addition, participants who are age 50 or older in 2005 can make catch-up contributions of up to \$4,000.

However, employers need to be aware that all safe harbor contributions are immediately 100% vested. And all eligible employees must receive a safe harbor contribution, even if they do not meet the 1,000-hours-worked requirement or they are not employed on the last day of the plan year.

Before a plan attains safe harbor status, there are some requirements that must be met.

- The plan document must be amended to add the applicable safe harbor formula, and
- A safe harbor notice must be given to all eligible employees between 30 and 90 days prior to the beginning of the plan year.

Nonelective Contribution Options

An employer may satisfy the safe harbor contribution by making a nonelective contribution (NEC) of at least 3% or more of compensation (commonly known as the "3% NEC"). Generally, the 3% NEC must be provided to all employees who are eligible to make elective deferrals to the plan. The NEC may be either

guaranteed or flexible, as specified by the employer 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 contribution* allows the employer to decide each year whether to provide a NEC. If this option

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HIGHLIGHTS

- Safe Harbor Plan Chart
- Top-heavy Rules for Safe Harbor Plans
- Safe Harbor 401(k) Formulas

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is selected, a “conditional notice” must be provided 30 to 90 days before the start of the plan year stating that the employer may give a safe harbor NEC for that year. Then, the employer must provide another notice (no later than the first day of the 12th month of the plan year) indicating that safe harbor status has been elected and that the NEC is being given. If the NEC is made, discrimination testing of elective deferrals (ADP) is not required. If the NEC is not given, elective deferrals must be tested for discrimination using the ADP test.

Matching Contribution Options

The alternative to the nonelective safe harbor contribution is the employer matching contribution. Again, there are two options: basic or enhanced match.

The *basic safe harbor matching contribution* is a 100% match on the first 3% of deferred compensation plus a 50% match on deferrals between 3% and 5%.

The *enhanced safe harbor matching contribution* must be equal to or greater than the amount of the basic match (for example, 100% of the first 4% deferred). The enhanced matching contribution rate may not increase as the deferral percentage goes up. And the rate of match for the HCE group may not exceed the rate of match for the non-highly compensated employee (NHCE) group.

As with the 3% NEC, the type of safe harbor matching contribution selected must be described in the plan document and in the annual notice to eligible participants.

Additional Matching Contributions

A safe harbor plan may make additional matching contributions without losing safe harbor status. However, if an additional matching contribution is discretionary, the contribution may not exceed 4% of compensation. Furthermore, matching contributions may not be made on more than 6% of compensation. And the rate of match for any HCE may not be more than that of any NHCE.

Stopping Safe Harbor Contributions Midyear

An employer that chooses the guaranteed 3% NEC option *must* make a contribution — regardless of subsequent financial reverses during that plan year. That requirement has made the flexible NEC a more popular safe harbor plan design choice.

An employer that chooses a safe harbor *matching* contribution may stop making contributions midyear by providing a written notice to the employees at least 30 days before the contributions are to be stopped. If this occurs, employee deferral (ADP) and matching contribution (ACP) tests must be performed for the entire plan year.

Adopting a Safe Harbor Plan Midyear

Safe harbor 401(k) plans must generally be established for the entire plan year before the plan year starts. Midyear adoption *is* possible, however, for either a new 401(k) plan or a profit sharing plan that adds a 401(k) feature during the year. Generally, there must be at least three months remaining in the plan year for a new plan or a converted plan to allow elective deferrals. However, a plan sponsored by a new

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ADP SAFE HARBOR CONTRIBUTIONS

(NO ADP TEST REQUIRED)

NONELECTIVE CONTRIBUTION

1. No allocation requirements may be imposed, such as requiring participants to work 1,000 hours during the year or be employed on the last day of the year.
2. Contributions are 100% vested.
3. Not available for in-service withdrawal before age 59½, even for hardship.
4. Can be used to satisfy top-heavy minimum contribution.
5. Can be used towards satisfying cross-testing gateway.
6. Cannot be used to satisfy permitted disparity.
7. Available in guaranteed or flexible formula.
 - a. **Guaranteed nonelective formula** provides required 3% each year.
 - b. **Flexible nonelective formula** allows employer to decide each year.

OR

MATCHING CONTRIBUTION

1. No allocation requirements may be imposed, such as requiring participants to work 1,000 hours during the year or be employed on the last day of the year.
2. Contributions are 100% vested.
3. Not available for in-service withdrawal before age 59½, even for hardship.
4. Can be used to satisfy top-heavy minimum contribution.
5. Available in basic or enhanced formula.
 - a. **Basic match formula** is 100% of first 3% deferred plus 50% of next 2% deferred.
 - b. **Enhanced match formula** must be at least as generous as the basic formula, and the rate of match may not increase as deferral percentage increases.

NOTE: The top-heavy minimum contribution is waived for plans using either the safe harbor basic or enhanced matching formula, provided there is no allocation of any other employer contributions, including the reallocation of forfeitures. Such a plan would actually be exempt from the top-heavy rules. See accompanying article for details.

ACP SAFE HARBOR CONTRIBUTIONS

(NO ACP TEST REQUIRED)

1. One of the above safe harbor contributions must be provided.
2. Once the safe harbor contribution is provided, any non-safe-harbor matching formula will satisfy the ACP safe harbor *if* it meets these requirements:
 - a. Allocation of any discretionary matching contribution cannot exceed 4% of compensation.
 - b. Deferrals in excess of 6% of compensation may not be matched.
 - c. Rate of match does not increase as deferral percentage increases.
 - d. Non-safe-harbor additional match does not need to be 100% vested.
 - e. May permit in-service withdrawals.
3. Under the 401(k) proposed regulations, a plan cannot have a 1,000-hour or last-day allocation requirement for any discretionary match. It is not clear whether this is the case for contributions made before the effective date of the final regulations.

Top-heavy Rules for Safe Harbor Plans

Small business owners commonly select a safe harbor 401(k) retirement plan design. These same employers often see their plans become top heavy. A plan is considered top heavy when more than 60% of the aggregate value of the plan accounts belongs to key employees — the owners and officers of the business.

Coordinating Contributions

If a plan becomes top heavy and any key employee has had an allocation of 3% or more, then the employer must provide an allocation of 3% to *all* eligible employees. However, if it is a safe harbor 401(k) plan, the employer is already providing a contribution, so there are special top-heavy rules that apply to safe harbor plans.

If a safe harbor 401(k) 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. If a nonelective contribution of 3% or more is made to a top-heavy plan, that contribution will generally satisfy the top-heavy contribution requirement.
2. If a plan that is top heavy calls for making a safe harbor matching contribution (and is not exempt as described below), then the safe harbor contribution will count towards satisfying the top-heavy minimum contribution for those employees who receive it. For example, if a participant defers 2% and receives a 2% safe harbor match, when the employer makes the top-heavy contribution, that employee would need to receive only 1% to satisfy the 3% top-heavy contribution.
3. In 2004, the IRS clarified the circumstances under which a safe harbor 401(k) plan would be exempt from the top-heavy rules. Basically, to be exempt, there cannot be *any* employer contributions to the plan other than

elective deferrals and contributions that satisfy the ADP and ACP safe harbor. Thus, there can be no profit sharing contributions. Forfeitures generally may not be allocated as additional contributions. There is an exception that permits discretionary matching contributions provided they stay within the ACP safe harbor requirements of being less than 4% of compensation and not matching deferrals that exceed 6% of compensation.

An Annual Determination

Top-heavy status is determined on a yearly basis. If a profit sharing contribution was made in 2004, for example, the plan cannot be exempt from the top-heavy rules in 2004. However, if no profit sharing contributions are made in 2005 and no employer contributions are made (other than the employer safe harbor contribution), then the plan will be exempt from the top-heavy rules for 2005.


A safe harbor 401(k) matching contribution plan is *not* exempt from top-heavy rules if:

1. The employer makes a discretionary nonelective contribution;
2. Forfeitures are allocated to participant accounts in the same manner as nonelective contributions;
3. Employees are eligible to make elective deferrals when they are hired but are not eligible for the employer match until one year of service is completed. For example, if a plan permitted employees to make elective deferrals after three months of service but required one year of service to be eligible for the safe harbor matching contribution, that plan would not be eligible for the top-heavy exemption; or
4. A plan is designed to use only compensation that was earned while a participant was eligible instead of using a full year's compensation. 

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business entity may have an initial plan year as short as one month. Employee notice may be made at the time the safe harbor design is adopted.

Safe harbor plan designs are ideal for many employers because they eliminate testing and permit highly compensated employees to maximize their contributions. However, some employers may be reluctant to abandon their vesting schedules and the 1,000-hour/last-day rules in favor of matching or nonelective contributions. Clearly, each employer's expectations, finances, and demographics are unique and should be carefully weighed before committing to a safe harbor plan. 

SAFE HARBOR 401(k) IMPLEMENTATION

1. New safe harbor 401(k) plan issues:
 - a. A safe harbor 401(k) feature may not be added to an existing profit sharing plan with less than three months remaining in the plan year.
 - b. A brand new 401(k) plan must have at least three months remaining in the short plan year to immediately start a safe harbor (by October 1 for a calendar year plan, for example).
 - c. An exception to the three-month rule exists for a new business entity that may establish a safe harbor plan with one month remaining in the plan year.
2. A safe harbor feature may not be added to an existing 401(k) plan during the plan year. The plan may be amended to add the safe harbor as of the next plan year.
3. A safe harbor notice must be provided each year between 30 and 90 days before the next plan year begins. If a flexible nonelective safe harbor contribution will be made, a second notice must be provided 30 days before the end of the plan year.
4. A safe harbor match may be discontinued during the year upon 30 days advance notice to employees. However, ADP and ACP testing will apply for the entire year.

Each employer's goals, plan design, contribution sources, and demographics form a unique scenario that the employer should discuss with his or her plan provider before finalizing the decision to go with a safe harbor 401(k) plan in 2005.

Examples of Safe Harbor 401(k) Formulas

Acronyms Used Below: **SH** = Safe harbor; **\$/\\$** = Dollar-for-dollar match; **50%/\\$** = 50¢/dollar match; **25%/\\$** = 25¢/dollar match

| The Plan's Allocations | Testing or No Testing | Comments/Other |
|---|---|--|
| Plan 1 Elective Deferrals — 50% Limit SH Match — Basic Formula | No ADP Test No ACP Test Exempt from Top-heavy Test | NA |
| Plan 2 Elective Deferrals — 60% Limit SH Nonelective — 3% | No ADP Test No ACP Test Exempt from Top-heavy Test | NA |
| Plan 3 Elective Deferrals — No Limit SH Match — Basic Formula Discretionary Employer — 2% | No ADP Test No ACP Test Top-heavy Test Required | Only a safe harbor plan with no employer allocations is exempt from the top-heavy test. |
| Plan 4 Elective Deferrals — No Limit SH Match — Basic Formula Forfeiture Allocation Contribution | No ADP Test No ACP Test Top-heavy Test Required | Only a safe harbor plan with no employer allocations is exempt from the top-heavy test. Even a forfeiture allocation is considered an employer allocation. |
| Plan 5 Elective Deferrals — No Limit SH Nonelective — 3% Discretionary Match — $$/\$$ to 3% | No ADP Test No ACP Test Top-heavy Test Required | A safe harbor 3% NEC also satisfies the ACP test, provided discretionary match does not exceed 4% of compensation and further provided the matching is not made on deferrals above 6%. |
| Plan 6 Elective Deferrals — 40% Limit SH Enhanced Match — $$/\$$ to 5% Discretionary Match — 50%/\\$ to 5% | No ADP Test No ACP Test Exempt from Top-heavy Test | The discretionary match need not be tested, provided it does not provide more than 4% of compensation and provided it does not match deferrals over 6%. |
| Plan 7 Elective Deferrals — No Limit SH Nonelective — 3% Discretionary Match — 25%/\\$ to 8% | No ADP Test ACP Test Required Top-heavy Test Required | The discretionary match exceeded the 6% deferral limit, which would not allow the ACP safe harbor to be satisfied and, thus, requires testing. |

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