



Consultants, Actuaries and Administrators of Pension
and Profit Sharing Plans Since 1970

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401(k) Safe Harbor Design

with Class Based Discretionary Contributions

Introduction

One of the most popular current plan designs for closely held businesses and professional entities is a tax-qualified retirement plan that combines 401(k) features plus employer contributions that are allocated on a cost-efficient basis between principals and employees.

This type of plan is designed to allow for three levels of contributions:

- Voluntary 401(k) contributions through payroll deduction, which can be either pre-tax or post-tax under the 401(k) Roth provisions (regardless of income level).
- Safe Harbor Employer contributions that can be structured as either Matching or Non-Elective (not based on an employee's 401(k) election).
- Additional Discretionary Contributions (or Profit Sharing) that are allocated at different rates based on an employee's job classification (known as Class Based or New Comparability). This type of plan allows for various levels of contributions for separate classifications of employees, allowing a plan sponsor to favor (in a non-discriminatory way) owners, management, or other select groups. Like a defined benefit pension plan, it can offer greater benefit potential in a relatively short period of time for older, higher paid employees. And, like a traditional profit sharing plan, it allows year-to-year contribution flexibility.

For 2012, individual annual contributions can be as high as \$55,500 for principals (\$50,000 for those under age 50) with lower percentages of pay allocated to other groups of employees (a minimum of 4.5% to 5% of pay is typically required for employees when business owners want to maximize their own contributions).

It's the combination of annual flexibility from year to year and selected contribution levels that make New Comparability profit sharing plans so unique and valuable. When combined with 401(k) Safe Harbor features, it typically is the most cost efficient way for business owners to save for their own retirement and provide a valuable benefit for their employees at a reasonable cost.

Traditional 401(k) Rules

One of the most burdensome aspects of a traditional 401(k) plan for small employers is the requirement that the plan comply annually with non-discrimination testing. The required testing is based on the amount of elective 401(k) contributions made by each eligible employee. Eligible employees are broken down into two groups: the highly compensated group (HCEs) and the non-highly compensated group (NHCEs). The average contribution rate of each group is calculated and then compared to one another. Generally, the difference between the two groups cannot exceed two percent, i.e. the average contribution rate of the HCEs cannot exceed more than 2% of the NHCE average. There are additional restrictions if the NHCE average is either below 2% or above 8%.

HCEs are generally defined as business owners and any employee whose prior year compensation exceeds \$115,000 (as indexed). Typically, these are the people that want to maximize their 401(k) contributions up to the annual limit. However, often, small employers find that their plans cannot meet the annual test requirements because many of the NHCEs contribute at a lesser rate or they do not contribute at all. The plan is then forced to limit the amount of 401(k) contributions of the HCEs throughout the year if projected testing is done, or refund the excess contributions after testing is completed at the close of the year. Neither of these options is attractive.

Why Adopt Safe Harbor

Beginning in 1999, the introduction of "safe harbor" 401(k) plans eliminated these problems. A safe harbor 401(k) plan would no longer be required to perform nondiscrimination testing of elective or matching

contributions [IRC §§ 401(k)(12) and 401(m)(11)]. To be within the safe harbor, a 401(k) plan would have to meet certain employer contribution requirements, and would have to provide for 100% immediate vesting of these contributions.

More specifically, by adopting a safe harbor 401(k) plan, a plan sponsor can avoid actual deferral percentage (ADP) testing of elective 401(k) contributions and actual contribution percentage (ACP) testing of employer matching contributions. The ADP and ACP tests are used to determine whether the amount of elective contributions and matching contributions discriminates in favor of the HCE group. The obvious advantages of avoiding these nondiscrimination tests must be weighed against the following:

- In any safe harbor plan year, the employer must make the required contributions (unless safe harbor status is revoked prospectively);
- The plan must satisfy the annual notice requirement to employees at least 30 days prior to the beginning of each plan year;
- Safe Harbor contributions must be contributed for all eligible employees, even if they separate from service during the year; and
- Safe Harbor contributions must be fully and immediately vested.

Safe Harbor Employer Contribution Options

Under the safe harbor design options, a 401(k) can provide either of the following contributions:

- A dollar-for-dollar match on elective contributions up to 3% of compensation plus a 50 cents-on-the-dollar match on elective contributions between 3% and 5% of compensation for those eligible employees who make an election for 401(k) payroll deduction; or
- A 3% of compensation non-elective contribution for each eligible employee, regardless of the employee's participation in 401(k).

Alternative match formulas are allowable provided that the match at any given rate of elective contributions is at least equal to the aggregate amount of matching contributions that would be made under the basic matching formula. An alternate formula will only satisfy the safe harbor if the rate of matching contribution does not increase as the rate of elective contribution increases. And, of course, the rate of matching contributions that applies to HCEs may not be greater than the rate of match that applies to NHCEs.

The following conditions must be met in order to satisfy the safe harbor matching contribution requirements:

- The plan provides a safe harbor match using the basic matching formula and no other match is provided under the plan; or
- The plan provides a safe harbor match using an enhanced matching formula under which matching contributions are made only with respect to elective contributions that do not exceed 6% of the employee's compensation and no other match is provided under the plan. For example, an enhanced match formula that would meet this requirement would be a dollar-for-dollar match on elective contributions anywhere from 4% to 6% of compensation.

Matching contributions in excess of these limitations would be subject to annual compliance testing under standard ACP rules.

Whether an employer chooses the matching option or the non-elective contribution option typically depends on other plan design factors, including the employer's Top Heavy status (a plan is Top Heavy when at least 60% of the plan's assets belong to Key employees). The 3% of pay non-elective option, in addition to satisfying the 401(k) tests, also satisfies the top heavy minimum contribution requirement, and can be used in the non-discrimination testing for additional employer discretionary contributions, as well. Therefore, most small employers who either need to meet the additional top heavy minimum, or who combine the 401(k) Safe Harbor features with a Class Based Profit Sharing Plan, typically choose the non-elective contribution route.

Safe Harbor plans that utilize the match option can also satisfy the top heavy minimum contribution requirement, as long as there are no other employer contributions under the plan. Non-top heavy plans

typically prefer the match option, since their contributions will reward contributing plan members only. However, for budget purposes, the match option can be more expensive depending on the level of employee participation (4% of pay match v. 3% of pay non-elective contribution).

Safe Harbor Annual Notice Requirement

Generally, for each plan year that an employer elects to use the safe harbor, a notice must be given to eligible employees prior to the beginning of the plan year. An existing plan may elect safe harbor status in the current year provided that notice is given and the plan is amended prior to 3 months before the close of the year. Employees must be given the opportunity to make elections for 401(k) payroll deduction at least 3 months prior to the close of the year.

The deadline for a final decision on safe harbor can be as late as one month prior to the close of the year provided that:

- A “maybe” notice was given to employees prior to the beginning of the plan year indicating that the employer might elect safe harbor status for the year;
- The employer uses the 3% non-elective contribution rather than the matching contribution to satisfy the safe harbor requirements; and
- A final notice is given by December 1st to announce the final decision and the plan is appropriately amended by that date as well.

Class Based Plan Rules

The theory behind class based plans is based on the method by which a plan meets the non-discrimination standards imposed by law. Normally a profit sharing plan is tested for non-discrimination on a contribution basis. Such a plan passes by virtue of its design, i.e. everyone receives the same rate of contribution, except for the differences allowed for social security integration (the only permitted disparity allowed in traditional defined contribution plans).

For non-discrimination testing under a class based plan, the contribution allocated to each employee is projected to age 65 and converted to a benefit. The benefit is expressed as a percentage of pay. This is known as the employee's "accrual rate." It is this accrual rate that is then tested by comparing the various rates between HCEs and NHCEs.

As long as the projected accrual rates for each group are "comparable" based on the IRS regulations, the contribution allocation rates will be deemed to be non-discriminatory. For example, a 15% of pay contribution for a 50 year-old, will result in a lower projected benefit rate than a 5% of pay contribution for a 30 year-old. Therefore, contribution levels between groups can vary dramatically with this type of design, as long as the plan meets testing. Minimum contributions for NHCEs generally must be at least one-third the rate of HCEs, unless employees receive a 5% of pay minimum (including the 3% of pay the employee receives under the Non-Elective Safe Harbor rules). When providing that level of contribution to employees, an HCE's allocation rate can be higher than the 3-to-1 ratio.

Under the right circumstances, this design can be very advantageous to a small employer. However, the continued success of this type of plan design depends on annual testing. For small employers, test results can vary when age demographics of employees change from year to year. Therefore, it is critical to discuss these issues with a pension professional prior to the establishment of any type of plan that tests non-discrimination on an age-basis.

Please note that this Safe Harbor and Class Based Profit Sharing description is intended to be a general overview and should not be considered as tax advice.