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Should a 401(k) Plan Be a Safe Harbor 401(k) Plan?

By Scott M. Feit

MARCH 2007 - A safe harbor 401(k) plan can be an attractive alternative for companies that might have difficulty satisfying antidiscrimination testing, or whose owners might be unable to maximize their contributions due to low employee contributions. If, however, the majority of employees are contributing to the 401(k) plan, or if highly compensated employees do not want to maximize their contributions, then a safe harbor plan may require significantly higher contributions from an employer than is necessary. Therefore, a safe harbor 401(k) plan may not be suitable for all employers.

Safe Harbor 401(k) Plans

Safe harbor 401(k) plans are very attractive because if the plan satisfies four conditions, then the 401(k) antidiscrimination test is deemed satisfied. Then the company's owners and other highly paid employees can contribute the maximum to the 401(k) portion of the plan and not worry about receiving a refund at the end of the year. The four conditions are—

- a required contribution,
- 100% vesting for the required contribution,
- annual notice to all participants, and
- withdrawal restrictions.

A safe harbor 401(k) requires that an employer make either a contribution of 3% of compensation or a matching contribution (e.g., 100% of deferrals up to 4% of compensation). There are no accrual requirements for the safe harbor contribution; therefore, the plan can't require the participant to be employed on the last day of the plan year or satisfy an hours-of-service requirement to receive the safe harbor contribution. If an employer's 401(k) plan would have no difficulty passing the 401(k) antidiscrimination test and the employer prefers to allocate company contributions to active participants, then a safe harbor 401(k) plan would not be in the company's best interest. The employer could reduce the amount of the required company contributions by not having a safe harbor plan.

The safe harbor 401(k) contribution must be 100% vested immediately. The plan may still have a vesting schedule for company contributions other than the safe harbor contribution. A safe harbor plan is not the solution if an employer's 401(k) plan can easily pass the 401(k) antidiscrimination testing and if the employer, for example, wants participants to work for a specific number of years before receiving all of the company contributions. There can be any number of other reasons not to implement a 401(k) safe harbor plan; an employer should conduct a careful assessment before deciding.

A safe harbor 401(k) also requires participants to receive a notice explaining their rights under the plan. It must disclose certain information, including which safe harbor contribution will be made (3% of pay or match) for the year. The notice must be given on an annual basis within a reasonable time before the first day of the plan year. The final safe

harbor requirement is the distribution restrictions on the safe harbor company contributions. For example, safe harbor employer contributions are not eligible for hardship withdrawal.

The fundamental question with regard to the establishment of a 401(k) plan is whether, based on the goals of the employer, a plan should be a safe harbor plan or a non–safe harbor plan. Safe harbor 401(k) plans are great for some, but other employers would do better without them.

Examples

The following examples will help illustrate whether a safe harbor 401(k) plan is cost effective.

Example 1

	Salary	Deferrals	401(k)%
Owner	$225,000 $15,500 6.89%		
Employee 1	50,000 0 0.00		
Employee 2	30,000 500 1.67		
Employee 3	45,000 500 1.11		

In this example, the average 401(k) percentage for the employees is 0.93%. Without going into detail of the 401(k) testing requirements, the employee average would have to be at least 4.89%. This particular plan would fail the 401(k) test. Generally, the owner would have two choices: Take a refund from the plan of approximately $11,318, or make a qualified nonelective contribution (QNEC) to the employees of approximately $5,000. If the company had a safe harbor match where the company promised 100% of every dollar deferred up to a maximum of 4% of pay, then it would cost the employer $1,000 for the employees ($500 for Employee 2 and $500 for Employee 3). In addition, the owner would be able to receive a safe harbor match of $9,000 (4% x $225,000). In this example, a safe harbor plan allows the owner to receive $24,500 [$15,500 401(k), plus $9,000 match] while allocating only $1,000 to the employees.

Example 2

	Salary	Deferrals	401(k)%
Owner	$225,000 $15,500 6.89%		
Employee 1	50,000 4,000 8.00		
Employee 2	30,000 1,000 3.33		
Employee 3	45,000 3,000 6.67		

In this example, the average 401(k) percentage for the employees is 6%. Again, the employee average would have to be at least 4.89%, so this particular plan would easily pass the 401(k) test. Therefore, it would be in the best interest of the owner to establish a 401(k) plan without the safe harbor feature.

Crucial Preparation

It is crucial for a business owner to review a detailed 401(k) analysis before determining the type of 401(k) to establish. Many investment companies and third- party recordkeepers are quick to set up safe harbor 401(k) plans because they are easier to administer, but a safe harbor plan may not always be the best choice.

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