

Safe Harbor 401(k) Plans - 2009

Background

A 401(k) plan permits employees to elect to contribute a portion of their compensation (an “elective deferral”) to the employer’s retirement plan rather than receiving the compensation. Deferring compensation to the plan postpones state and federal income tax on the deferrals and also permits the elective deferrals to grow on a pre-tax basis in the plan. Like all qualified retirement plans, 401(k) plans cannot discriminate in favor of Highly Compensated Employees (“HCEs”); generally those who own more than 5% of the company, their parents and children, and employees who make more than a certain amount in the prior year (\$105,000 for 2008) In order to prove that it is not discriminatory, a 401(k) plan must pass the Actual Deferral Percentage (ADP) test with respect to employee deferrals and the Actual Contribution Percentage (ACP) test with respect to any employer matching contributions. The benefit of the Safe Harbor 401(k) plan is that the employer does not need to perform the tricky “ADP” and “ACP” tests on an annual basis. In addition, the employer does not need to make an extra contribution to the Non-Highly Compensated Employees (NHCEs) or refund some of the elective deferrals of HCEs, which has to be done if a regular 401(k) plan fails these tests. Consequently, any HCEs, subject to certain limitations, may contribute the full 401(k) plan annual dollar amount (\$16,500 for calendar year 2009), without regard to the amount any NHCE defers.

As in all 401(k) plans, the maximum amount the company may contribute and deduct is 25% of eligible participants’ compensation, and each participant is limited to total employer and employee contributions of the lesser of 100% of compensation or \$49,000. For ERISA purposes, compensation is limited to \$245,000 for plan years beginning in 2009.

Two Alternative Employer Contribution Options

The “cost” of this automatic compliance with the ADP and ACP tests is the employer must provide a minimum contribution which is *either* (1) a flat, “non-elective” employer contribution of 3% of pay for all participants, *or* (2) an employer matching contribution, but not both. Either of these minimum contributions *may* include the HCE group, but is not required to do so. These contributions must also be 100% vested.

1. **The 3% Non-Elective Contribution** - The required non-elective contribution is a 3% employer contribution for each employee eligible to make elective deferrals, regardless of whether they are employed on the last day of the plan year or have a minimum number of hours of service. The 3% option is satisfied by providing an employer contribution on behalf of all eligible non-highly compensated participants equal to at least 3% of pay regardless of whether or not the employees make elective deferrals into the 401(k) plan. In addition to satisfying the contribution requirement, this 3%-of-pay contribution will satisfy the minimum contribution requirements in top-heavy plans. It can also be used as part of a “tiered” or “new comparability” contribution formula designed to maximize contribution for executives. It cannot, however, be used for purposes of Social Security integration.

2. **Employer Safe Harbor Matching Contribution** - The required employer safe harbor matching contribution, if used, may take several forms. A plan must provide a safe harbor matching contribution that is at least as favorable as dollar-for-dollar on the employee elective deferrals up to 3% of pay and 50¢ per dollar on the next 2% of pay. Compensation can be defined to include the entire plan year, or only from participant’s entry into the plan. Thus, an employee must defer 5% of pay to get the maximum employer safe harbor matching contribution of 4%.

Alternatively, the employer safe harbor matching contribution may be simplified to a dollar-for-dollar match on the first 4% of pay deferred by the employee. Under this structure, an employee must defer just 4% of pay to get the maximum safe harbor employer matching contribution of 4%.

Where this employer matching safe harbor is used, an employee who defers nothing gets no employer matching contribution.

Neither an employment on the last day of the plan year condition nor minimum hours of service test can be used as a condition for a safe harbor match for an employee who has met the plan’s eligibility requirements.

Additional Matching Contributions

If the employer makes additional matching contributions over and above the safe harbor matching contribution above, the following **additional** requirements apply:

Match Rate - The rate of matching contribution for any HCE cannot exceed the rate for any NHCE making the same level of employee deferrals. This makes it unlikely that a service-weighted matching formula will qualify for the safe harbor. Also, the rate of employer matching contribution cannot increase as the rate of employee deferral increases.

Employee Deferral Limit - No other employer match (regardless of the formula) may be made on employee deferral contributions greater than 6% of the participant’s compensation. The match itself can be more than dollar-for-dollar, such as \$2.00 for each \$1.00 of deferral, but deferrals in excess of 6% of pay must be disregarded. (For example, an employee earning \$50,000 defers \$4,000, which is 8% of pay. Any matching contribution must be based only on the first \$3,000 deferred, which is 6% of pay).

Fixed Match with 3% Safe Harbor - A fixed match of a lesser amount can be used if the 3% non-elective safe harbor is used. For example, a plan that uses the 3% non-elective safe harbor may also match a percentage of employees’ elective deferral contributions up to 6% of their pay.

Additional Discretionary Match - Additional employer discretionary matching contributions can also be made. Again, employee deferral contributions greater than 6% of pay may not be matched, and the overall amount of the discretionary match must be limited to 4% of pay.

Timing of Deposits

Safe harbor “employer matching” contributions done on a “per pay period” basis must be deposited at least quarterly during the plan year. Specifically, the deposit should occur by the end of the month following the quarter to which they apply. If the safe harbor “employer matching” contribution is made late, the plan could jeopardize the safe harbor status and thus be subject to compliance testing for that specific plan year.

If the “employer matching” is done annually after the plan year, similar to the flat 3% “employer” contribution, the total amount is due for deposit no later than the date the employer files its business income tax return.

Vesting and Other Safe Harbor Requirements

Either safe harbor contribution described above must be 100% vested. The safe harbor contribution also may not be subject to an ‘hour of service’ requirement or a ‘last day of the plan year employment’ requirement. However, the plan (1) may require an age 21 and “Year of Service” (normally at least 1,000 hours of pay in a 12 month period) for an employee to be eligible for the plan, and (2) may also provide additional employer profit sharing contributions, which may be subject to a vesting schedule and subject to ‘hour of service’ and employment on the last day of the year “accrual” requirements. Finally, the plan may not allow for distributions of the employer’s safe harbor contributions during employment, even for financial hardship, although employee deferral contributions can be withdrawn for financial hardship if the plan so provides.

Notice Requirements

Notices for new plans, as well as required annual notices for existing plans, must be given to all eligible participants within a reasonable time. Notices are presumed to be reasonable provided to employees at least 30 but no more than 90 days **prior** to the beginning of **each** plan year. A second notice is required at least 30 days but no more than 90 days before the end of the plan year *if* the employees received a notice before the beginning of the plan year stating that the employer *may* contribute a safe harbor 3% non-elective contribution during that plan year.

Annual Notice Requirements

Existing Plans - Generally required at least 30 days but not more than 90 days before first day of each plan year.

New Plans - may give notice up to effective date of the plan unless it is a “successor plan,” as discussed below. The 401(k) arrangement must be in effect for at least 3 months during the first plan year.

The addition of a 401(k) arrangement to existing non-401(k) plan is treated as new plan. As is the case with the establishment of a new plan, a safe harbor 401(k) arrangement may not be added to an existing non-401(k) plan unless the 401(k) arrangement will be in effect for at least 3 months of the plan year. See the discussion below about the amendment of an existing profit sharing plan to add safe harbor provisions.

Finally, any employee who becomes eligible after the notice period must receive the notice by the date of eligibility.

Successor Plans. A plan may not use the “new plan” rule if the plan is a “successor plan,” as the term is used in Notice 98-1. Under Notice 98-1, a successor plan is a 401(k) plan in which at least 50% of the eligible employees were eligible for another 401(k) plan maintained by the employer in the prior year. However, a SEP-IRA or Simple IRA is not considered a plan for this “successor plan” rule, so a safe harbor 401(k) plan that replaces either type of IRA plan is nevertheless a new plan.

Amendment of an Existing Profit Sharing Plan to Add Safe Harbor Provisions

Notice 2000-3 provides that the addition of a 401(k) arrangement to a non-401(k) plan is treated as a new plan for purposes of the safe harbor 401(k) rules. Thus, the employer may add the arrangement after the first day of the plan year, and the notice requirements can be satisfied as the first day that the 401(k) arrangement is in effect. As is the case with the establishment of a new plan, a safe harbor 401(k) arrangement may not be added to an existing non-401(k) plan unless the 401(k) arrangement will be in effect for at least three months during the first plan year. For example, suppose an employer maintains a calendar-year profit sharing plan. That employer may add a safe harbor 401(k) arrangement as late as October 1, 2009, so long as the safe harbor requirements are met from the effective date of the 401(k) arrangement to the end of that first year. The safe harbor notice would have to be given to employees no later than the effective date of the 401(k) arrangement, that is, October 1 in this example.

Flexibility

If an employer with a regular non-safe harbor 401(k) plan wants to wait to decide to provide the 3% non-elective contribution, a decision can be made as late as 30 days before the last day of the plan year whether to make the contribution. If the contribution is not made, nothing needs to occur. But the plan must be amended so as to provide for the 3% contribution if the employer decides to use that option, and such amendment could be limited for just that plan year in question, leaving open the option for the next year if the requisite notice is given before the next year begins. The notice must be given to employees before the beginning of the plan year in which the 3% safe harbor might be used that would simply indicate that the employer *may* decide to make the non-elective contribution. If the employer later decides to do so, a supplemental notice would be given (no later than 30 days before the end of the plan year).

Second, if the employer wants to do the safe harbor matching contribution instead of the non-elective contribution, the employees would have to be notified of that decision during the normal notice period (i.e., 30 to 90 days before the first day of the plan year), but the employer later could decide to discontinue the match during the plan year (with prior notice to employees) and opt to run ADP/ACP testing that year. The discontinuance of the match could take effect no sooner than 30 days after notice of such discontinuance is given to the employees.

Pension Protection Act of 2006

The Pension Protection Act of 2006 (PPA'06) became law in August of 2006 and covers a broad range of rules affecting qualified retirement plans in general, employers that sponsor those plans, and plan participants. Since many of the changes are complex, it is best for an employer to seek professional assistance to help best take advantage and comply with the new rules.

Please contact us if you have any questions regarding the safe harbor 401(k) plan or want to discuss the use of the safe harbor 401(k) plan option.

Please see our "Owner's Manual for Your 401(k) Plan – 2009" for additional information about the operation of 401(k) plans.

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