Safe Harbor 401k Plans: Answers To Common Questions

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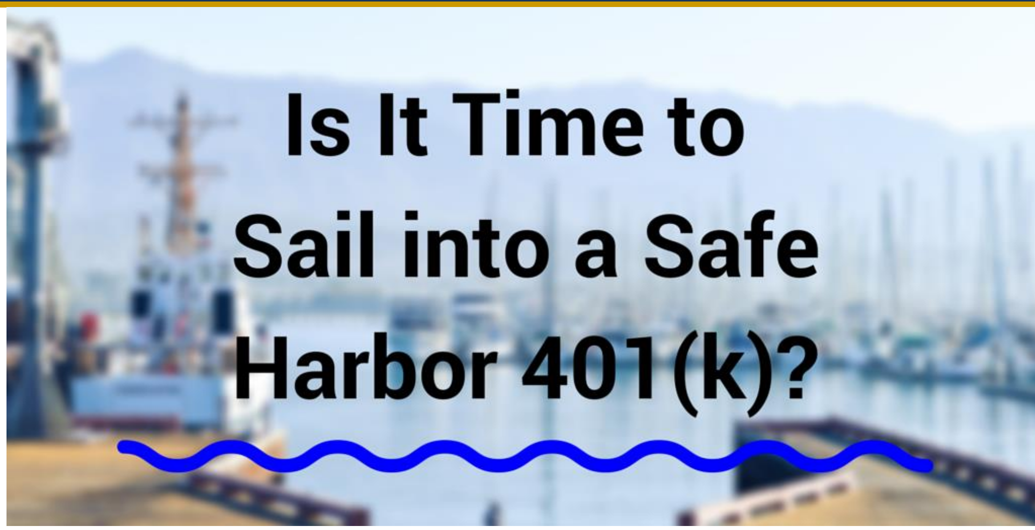

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"Safe harbor" 401k plans are the most popular type of 401k used by small businesses today. They automatically pass annual ADP/ACP and top heavy tests and allow business owners to maximize contributions to the plan. To achieve safe harbor status, owners are required to make a contribution on behalf of participating employees. For many employers, that trade-off is well worth the cost. Here's why.

When 401k testing fails, it's usually business owners that bear the brunt of the consequences. And small businesses tend to fail more because business owners generally have a larger percentage of plan assets. They often receive the largest 401k refunds when the ADP/ACP test fails and they must generally make a 3% contribution to non-owners when the top heavy test fails.

Given these consequences, it's little wonder why business owners find safe harbor 401k plans attractive. They allow business owners to maximize their 401k contributions without the risk of refunds, while generally costing the same as a top heavy 401k plan.

However, safe harbor 401k plans aren't for everybody. They are subject to special contribution and vesting requirements that can make them more expensive for small businesses than a traditional 401k plan.

We get a lot of questions from business owners trying to weigh the benefits of a safe harbor 401k plan vs. any additional cost. Below is a FAQ with answers to the most common questions we receive. If you are a small business owner, you can use this FAQ to help decide whether a safe harbor 401k plan is right for your company

What are the employer contribution requirements for a safe harbor 401k plan?

Safe harbor 401k plans require an employer to make either an eligible matching or non-elective contribution to participants:

Safe harbor matching contribution – 2 options are available:
Basic match - 100% match on the first 3% of deferred compensation plus a 50% match on deferrals between 3% and 5% (4% total).
Enhanced match – Must be at least as much as the basic match at each tier of the match formula. A common formula is 100% match on the first 4% of deferred compensation.
Safe harbor nonelective contribution – 3% (or more) of compensation, regardless of 401k deferrals.
These contributions can be limited to just non-Highly-Compensated Employees (HCEs). They must be 100% immediately vested.

What’s a Qualified Automatic Contribution Arrangement (QACA)?

A QACA is a newer type of safe harbor 401(k) plan. They include an automatic enrollment feature that automatically enrolls any eligible employee that fails to make an affirmative enrollment election in the plan at a specified deferral rate. These plans include the following special rules:

The QACA safe harbor matching contribution formula is a 100% match on the first 1% of compensation deferred and a 50% match on deferrals between 1% and 6% (3.5% total).
A Qualified Default Investment Alternative (QDIA) must be offered to invest participants that fail to make affirmative investment election.
The plan’s default deferral rate must start at no less than 3% and increase at least 1% annually to no less than 6% (with a maximum of 10%).
QACA safe harbor contributions can be subject to up to a 2 year cliff vesting schedule
Can a discretionary profit sharing contribution be made to a safe harbor 401k plan? If yes, is it subject to testing?

Yes. Regardless of a 401k plan’s safe harbor status, profit sharing contributions must satisfy 401(a)(4) testing. “Pro-rata” or “permitted disparity” allocations generally pass this test automatically, while “new comparability” allocations must pass 401(a)(4)’s general test.

Can a discretionary matching contribution be made to a safe harbor 401k plan? If yes, is it subject to testing?

Yes. A discretionary matching contribution is exempt from the ACP test just like a safe harbor match when two conditions are satisfied:

The match formula cannot be based on more than 6% of deferred compensation.
The match cannot exceed 4% of compensation in total.
For example, a discretionary 50% match on the first 6% of deferred compensation (3% total) would be exempt from the ACP test

Are safe harbor 401k plans always exempt from top heavy testing?

No. Safe harbor 401k plans become subject to top heavy testing for plan years in which one or more of the following conditions apply:

401k deferrals are subject to shorter eligibility requirements than safe harbor contributions.
A discretionary profit sharing contribution (including forfeiture reallocations) is made by the employer.
A discretionary match that’s not exempt to ACP testing is made by the employer.
Non-Roth after-tax contributions are made by participants.
When a safe harbor 401k plan fails the top heavy test, any employer contributions made to the plan count towards satisfying the 3% top heavy minimum contribution.

Know your options!

Safe harbor 401k plans can be a great choice for small businesses that have trouble passing 401k testing. However, they are not for everybody – they can be more expensive than traditional 401k plans. Small business owners should weigh the pros and cons of these plans before choosing one for their company.

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