What a Safe Harbor 401(k) and Monopoly Have in Common

Any guesses? No, it's not the ability to trade and exchange real estate. We will save the topic of real estate in retirement plans for a different day. A safe harbor feature in a 401(k) is like everyone's favorite card in Monopoly—a "Get Out of Jail Free" card, only for 401(k) plans. It gives a free pass on a couple of important 401(k) non-discrimination tests and alleviates certain penalties associated with failing them (i.e., corrective contributions or corrective refunds).

A Pass from Testing

In order to retain their tax advantages, 401(k) plans undergo annual non-discrimination testing. These tests compare salary deferral and matching contribution amounts allocated to highly compensated employees (HCE) and non-highly compensated employees (NHCE). If the ratios fall within the thresholds specified by the Internal Revenue Code, the plan is in the clear. Otherwise, the plan "goes to jail" (i.e., fails the test) and the only way out is to refund some (and sometimes all!) of the deferrals made by the HCEs and/or make a special contribution to the NHCE population.

This is where the safe harbor comes in: ***401(k) plans that include a safe harbor provision satisfy these tests automatically.*** As a result, highly compensated employees are able to maximize their deferrals, regardless of the participation of the rank-and-file participants. This is true even if the rank-and-file participants do not make any salary deferral contributions.

A Special Contribution

Plans with a safe harbor feature promise a special contribution for plan participants; typically, it is either:

- *a match*: for instance, dollar-for-dollar up to 4 percent of compensation for those employees who make salary deferrals, **or**

- *a non-elective contribution:* at least 3 percent of pay to all eligible participants, whether or not they make deferrals into the plan.

More than Safety

The safe harbor feature brings a variety of other important benefits:

Peace of Mind: Testing failures require a cumbersome refund process or mandate additional contributions by the employer. Safe harbor plans automatically pass these tests, alleviating these concerns.

Higher Contribution: Safe harbor plans allow the highly compensated employees, typically the key players in a business, to defer the full 401(k) amount regardless of the NHCE employee participation levels.

Lower Cost: By adding a safe harbor 401(k) feature to an existing profit sharing plan, the employer may be able to reduce the total cost of mandatory contributions to the rank-and-file while maximizing contributions to key players. Since no complex deferral/match testing and corrections are required for a safe harbor 401(k), this feature significantly reduces plan expenses.

Top-Heavy Requirement: Since a great majority of small plans are considered top-heavy (more than 60 percent of plan assets belong to key participants), a safe harbor becomes a very helpful design feature: it helps satisfy the minimum contribution requirement for most top-heavy plans.

Reduce Profit Sharing Minimum**:** The 3 percent safe harbor contribution can be counted to satisfy the minimum contribution requirement for cross-tested profit sharing plans, reducing the mandatory funding component for non-owner employees while maximizing contributions for key players.

Some Rules

To benefit from the safe harbor provision, a plan must follow a few requirements:

Participant Notification: The IRS requires employers to provide a safe harbor notice to each eligible participant no less than 30 days and no more than 90 days prior to the beginning of the plan year.

Once Eligible, Always Eligible: Safe harbor 401(k) plans cannot require that an eligible participant be employed on the last day of the plan year or work a certain number of hours to receive a safe harbor contribution.

Full Vesting: Safe harbor contributions are usually 100 percent vested. Plans that utilize auto-enrollment can include a safe harbor match, which may be vested over a two-year period.

An Important Deadline

Tuesday October 1, 2013 is the last day to establish a new safe harbor 401(k) or add the safe harbor 401(k) feature to an existing profit sharing plan.

Who Are Safe Harbor 401(k) Candidates?

Small business owner clients and prospects with at least one rank-and-file employee:

- who are interested in a new 401(k) plan;
- who are setting up a defined benefit/cash balance and a 401(k) combination plan;
- who have an existing profit Sharing Plan and want to reduce the rank-and-file costs; or
- who have an existing defined benefit /cash balance plan and are interested in adding a supplemental 401(k) plan to increase their tax-deductible savings or make their plan design more efficient.

Increase Plan Contribution through Efficient Design

Calendar-year clients have until December 31 to establish their defined benefit plans for 2013. The latest regulations greatly expanded the ability of clients to **maximize plan savings** with a combination plan approach. The October 1 deadline will apply to those clients who want to add a safe harbor 401(k) plan to an existing defined benefit plan, or establish a combination 401(k)/defined benefit plan for the plan year ending December 31, 2013.

As always, your First Allied Retirement Services subject matter experts are ready to help. Call us at 888-926-0600 or send a message to pensions@firstallied.com .