The Safe Harbor Option

The allure of a safe harbor plan is that it is exempt from the ADP and ACP tests which are two nondiscrimination tests that 401(k) plans must satisfy every year.

The ADP and ACP tests are designed to make sure higher-paid employees don't contribute too much more than lower-paid employees. In effect, they limit the salary deferrals of all those who fit the definition of highly paid (those who own more than 5% of the firm or had prior-year earnings over $115,000).

In past years, nearly one-half of all U.S. 401(k) plans have had to adjust the contributions of higher-paid employees. About 50% of the plans distributed taxable refunds to those who over-contributed, while the others limited the amount that highly paid employees could put into the plan in the first place.

So it's easy to see where safe harbor fits. Using this design, employers avoid those unpalatable adjustments and refunds. In fact, owners and highly paid employees can set aside up to $17,500 from their salary each year ($23,000 if age 50 or older (as indexed)), regardless of what other employees do. In return, employers must make a minimum contribution to employees' accounts, which has the added appeal of being a great recruiting tool.

Safe Harbor Plan Options

Employers establishing a safe harbor 401(k) have two options for making contributions to employees' accounts. Under either option, the contributions are fully vested.

Matching option: The employer matches dollar for dollar the first 3% of pay an employee defers, plus 50 cents per dollar on the next 2% of pay the employee defers.

- An employee deferring 5% of pay receives a 4% match, while an employee making no deferrals receives no match.

Nonelective option: The employer contributes 3% of pay for all eligible employees whether or not they contribute themselves.

At least 30 days and not more than 90 days before each year begins, the employer must notify employees of their opportunity to participate in the plan and the type of employer contribution that will be provided. And, while the employer has the flexibility to decide annually which contribution option to use, the plan must be amended for any changes before the year begins.

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Employers are also free to make contributions beyond the safe harbor amounts.

The Matching Option

The majority of employers establishing a safe harbor plan choose the matching option. This may be an especially good choice for a firm with many workers who are unlikely to contribute. With a traditional 401(k), the owners could not contribute much for themselves because of the ADP test restrictions. But with a safe harbor match, these restrictions disappear.

For more information, or to discuss a retirement plan opportunity with one of our consultants, call today.

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CPI Qualified Plan Consultants, Inc. is a member of CUNA Mutual Group, a leading insurance and financial services organization based in Madison, WI.

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