Safe Harbor for All? Not so Fast! There is More Than One Way to Fix a 401(k) Plan

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One of the 401(k) plan complaints I have heard in my career from plan sponsors is that they don't like to have to take, or give refunds of salary deferral contributions to their Highly Compensated Employees (HCEs). Usually, if a refund is required, it is either to the business owner, or some of their most valuable employees. Most don't understand why a refund is being given to them, and it makes them think the plan is not working.

In 1999, the "safe harbor" plan design became effective to help solve this problem for plan sponsors. Since then, they have been sold as the only answer to failed Average Deferral Percentage (ADP) tests. There have been so many times that I look at a plan design and ask the question: Why do you have a safe harbor design? Only about 1 in 10 can say it was to solve this problem. The rest simply don't know. It was the advice they were given at the time — and seemed like a good idea.

Too many times, I have seen a safe harbor plan design that is unnecessary. The only problem it solved was lack of knowledge on the part of the advisor who sold the plan. A safe harbor design means that the advisor never has to understand the intricacies of plan design, and never has to answer the question about why refunds are required. In short, it was easier for them to sell, but not necessarily better for the plan sponsor.

The truth is, there are many actions that can be taken to avoid failing test results. Safe harbor is only one of them, and has certain side effects that may be undesirable.

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Let's take a look at background information...

Before discussing actions to take, let's provide some background on the Average Deferral Percentage (ADP) Test itself. Each participant's 401(k) deferral (pre-tax and/or Roth) is divided by their compensation to determine their actual deferral percentage. This includes anyone eligible, even if they did not defer. The test then compares the average deferral rates of the Highly Compensated Employee (HCE) to the average deferral rates of the Non-Highly Compensated Employee (NHCE). These percentages are then compared; the rate of the HCEs cannot exceed the NHCE rate by defined amounts, as shown below:

NHCE ADP %	Maximum HCE ADP %
Less than 2%	2 x NHCE %
Between 2% and 8%	2% + NHCE %
Greater than 8%	1.25 x NHCE %

HCE – Someone who owns more than 5% of the company or is a spouse, ascendant or descendant of a 5% owner or any employee who earned more than $120,000 (2018 limit) in the prior year for the company.

NHCE – Someone who is not an HCE.

A similar test, called the Actual Contribution Percentage (ACP) test, is performed on Employer Matching Contributions. Both must pass or have some form of corrective action taken to maintain compliance.

A safe harbor design basically buys you a passing test result. It does NOT remove the requirement that you have to run the test, only that it will pass regardless of the math described above. This is important because most safe harbor plans don't ever run a test. One may think, why bother if it is going to pass anyway? The reason you should run the test is to know what the results are, and if there are better ways to pass it other than using a safe harbor design.

Safe harbor designs come with a few things that may not be desirable: a minimum contribution requirement, full and immediate vesting of that contribution, additional annual notice requirements to participants, and it limits the timing and types of plan amendments that can be made during the plan year. What many don't know is that there are ways to avoid the minimum contribution requirement in a safe harbor plan if they decide they don't have the money, or don't need to buy a passing test result.

All of that being said, let's take a look at a few steps to consider before committing to a safe harbor plan design.

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Education and Encourage Participation

A failing test is the result of not enough participation by Non Highly Compensated Employees (NHCEs). An educational campaign should be led by your plan's investment advisor to extol the virtues of saving for retirement, to explain the plan's benefits and to assist with investment decisions. Targeting those who refuse to defer or are deferring less than the average employee is a good place to start and can improve testing results quickly. At a minimum, it also provides some protection to the plan sponsor if these meetings are mandatory and sign-in sheets are maintained. This shows that the Plan has been communicated and that employees were offered the opportunity to save. Effective advisors can make a huge difference at these meetings.

Automatic Enrollment

The reason participation may be low is the enrollment process! Think about it: an employee gets a thick enrollment booklet, or nothing but an online enrollment code, and is expected to read and make many types of decisions. How much to contribute? Roth or pre-tax? Where to invest? Let's face it, the process can be very overwhelming to people.

Automatic enrollment changes the process. Instead of taking various steps to enroll, a participant only needs to take action if they DON'T want to enroll. The new default would be something like this…

You will be enrolled automatically at a deferral rate of 6%, and it will be invested in a target date fund based on your age and years to retirement. If you want to take more control and change your contribution percentage or investment allocation, don't worry, you can! If you don't want to contribute at all, you simply opt out, by signing the proper form to do so. Now, rather than take steps to get in, you simply take steps to get out. The reality is, in my opinion, people LOVE defaults! You can even set it up to automatically increase a participant's deferral percentage each year to get them saving more. When an automatic enrollment feature is used in a plan, it almost always solves the testing problem AND gets people saving who may not take the appropriate action to do so. It makes it easy, and they NEVER give up control. All they have to do is take action to engage in the process.

This may not be for every plan sponsor though, as the administrative requirements may be perceived to be too much of a burden, so what else can we do?

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Look to your Third Party Administrator to see if they are running available advanced testing techniques

An **effective Third Party Administrator (TPA) like Tycor** will perform the test with as much flexibility as the IRS Code permits or suggest solutions that may require a plan amendment but could result in improved outcomes. These options include:

- Disaggregating the Plan to reduce the number of NHCEs being included in the test.
- Identifying any mid-year participants and using eligible compensation to improve results.
- Considering if limiting the HCE group to the Top 20% is beneficial and amending the plan to use.
- Consider Current Year or Prior Year testing results for better planning.
- An alternative correction to simply refunding excess amounts to HCEs is to make booster contributions to the NHCEs.

If none of the above will work THEN look at the safe harbor design

There are three types of safe harbor plan designs to consider:

- **Safe Harbor Match:** Employee deferrals are "matched" by an Employer Contribution that is fully vested and as much as 4% of pay.
- **Safe Harbor Non-Elective:** Regardless of an Employee's Deferral, a 3% of Compensation contribution is made annually.
- **Qualified Automatic Contribution Arrangement (QACA):** Like Safe Harbor Match, but the matching formula is different; participants are automatically enrolled. It also allows for full vesting to occur after one year instead of immediately.

The QACA solution is not very popular as it has many details and moving parts that, for most sponsors, are not worth the extra effort.

If the Plan is making Profit Sharing Contributions, then the addition of a Safe Harbor Non-Elective can be a pretty easy choice.

To wrap up this discussion, the safe harbor design was a feature that was added by law back in 1999. It gave us as plan design professionals another tool to help the plan sponsor meet the objectives of the plan, but it was not intended to be the one-size-fits-all advice that it has become.

If you have clients who are still getting refunds as a result of failing an ADP test, or you have clients with a safe harbor plan that haven't reviewed it in a while, give Tycor a call at 610-251-0670! We will review and evaluate the plan to see if the design is optimized for their specific objectives.