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The Continuing Evolution of the Safe Harbor 401(k) Plan

The safe harbor 401(k) plan roared onto the scene in 1998 as a new design that allowed company owners and other highly compensated employees to maximize their salary deferrals even when other employees contributed at relatively low levels. Over the last 16 years, these plans have continued to evolve through a series of new laws and IRS pronouncements.

Background

In general, 401(k) plans are subject to annual testing designed to make sure highly compensated employees, or HCEs (those who own more than 5% of the company or earn more than $115,000, indexed for inflation), do not benefit too much more than non-HCEs. If there is too much of a spread between the groups, HCEs must either be refunded a portion of their contributions or the company must contribute additional amounts for non-HCEs. This test is referred to as the actual deferral percentage (ADP) test.

There is also the so-called top-heavy determination that requires the company to make a minimum contribution of up to 3% of pay to employees if certain owners and officers hold more than 60% of the total plan account balances.

Safe harbor 401(k) plans are exempt from the ADP test as long as they meet additional requirements which include agreeing to make a minimum company contribution and providing employees a notice each year that explains the safe harbor provisions. Safe harbor plans are also automatically considered not top heavy as long as the only allocations to participant accounts are employee deferrals and safe harbor contributions.

The company contribution must generally be immediately vested, although plans that also include automatic enrollment for deferrals may be able to apply a two year vesting schedule. The contributions can be either a fixed matching contribution (safe harbor match) on behalf of only those who defer or a fixed profit-sharing-type contribution (safe harbor nonelective) that is made on behalf of all eligible participants.

Tried it but didn't like it

What happens when a plan sponsor has a safe harbor 401(k) plan but no longer wants it? The general rule is that safe harbor features must remain in effect for a full 12-month plan year, so a calendar year plan could amend to remove those features any January 1st. One exception is for plans that are being completely terminated and allows for the elimination

of the safe harbor provisions concurrent with that termination.

There was also a provision that allowed for the mid-year elimination of a safe harbor matching contribution as long as the match was funded through the date of elimination and the plan passed the normal tests for the year; however, there was no corresponding "out" for those that used the safe harbor nonelective contribution… until the recent recession.

The IRS recognized that the economic downturn meant that some companies could no longer afford the mandatory contribution, so they proposed new rules in 2009 allowing for the mid-year elimination of a safe harbor nonelective contribution. But, unlike the match, the new rules were only available for companies that could demonstrate a substantial business hardship as defined by IRS rules.

While this was welcome relief, the IRS received feedback that the rules should be the same for both types of safe harbor contributions. In late 2013, the Service finalized the regulations to provide the requested consistency. Under these new rules, a company can eliminate either a safe harbor matching or safe harbor nonelective contribution mid-year, if:

- They are operating at an economic loss (an easier standard to meet than the "substantial business hardship" standard from the 2009 regulations); or
- The safe harbor notice provided to employees before the start of the year specifically notes the possibility that the contribution might be suspended during the year.

In both scenarios, the plan must still pass the ADP test and comply with the top-heavy requirements, but at least there is now a uniform set of requirements that is easy to understand.

What is the moral to this story? Sponsors of safe harbor plans should consider whether it makes sense to include the "possibility of suspension" language in all safe harbor notices going forward, even if there are no current discussions of eliminating the contribution. Even if never used, including that language preserves the ability to amend the plan to reduce or eliminate the safe harbor contribution should unforeseen circumstances arise.

Tried it, like it, but want to make a few changes

There are many reasons an employer might want to tweak its plan. Maybe the goal is to make it easier for new employees to join; maybe it is to allow plan loans; or maybe the company wants to change the way it allocates profit sharing contributions. These changes can usually be easily accomplished by simply amending the plan. While safe harbor plans can be amended just like any other, there are restrictions on the timing.

Back in 2007, the IRS published an announcement saying that it is acceptable for safe harbor plans to adopt mid-year plan amendments to add a Roth deferral option or to permit hardship distributions, as long as the plan sponsor provided a supplemental safe harbor notice to describe the change.

It was initially thought that these were just examples of allowable amendments that made a plan more generous to employees. However, the IRS later clarified that because of the rule requiring safe harbor plans to remain in effect for a full 12-month plan year (described above), adding Roth and/or hardship provisions are the only changes that can be made to a safe harbor plan once the year has started. In other words, any other type of change can only be made at the beginning of the next plan year, no matter how much more generous the change might be to participants.

What is the moral to this story? Towards the end of each year, it is important to consider what changes might be warranted or preferred in the subsequent year so that amendments can be prepared and signed timely. In addition, since plan provisions must generally be incorporated in the annual safe harbor notice, confirming any plan changes prior to the December 1st notice deadline for calendar year plans (30 days before the start of the plan year) is strongly recommended.

Forfeitures…be careful when and how you use them

When a participant who is partially vested terminates employment and takes a distribution, the non-vested portion of his or her account that stays behind is called a forfeiture. Most plans specify that such amounts can be used in one of three ways:

- Pay allowable plan expenses;
- Offset any company contributions; or
- Allocate to remaining participants as additional contributions.

Forfeited amounts must be used each year and cannot be carried from one year to the next. If the forfeitures are not used for one of the first two options listed above, then they must be allocated as additional contributions.

For a safe harbor plan, the option that probably comes to mind is to use the forfeitures to fund the safe harbor contributions. Although that would be an easy solution, unfortunately, the IRS does not permit the use of forfeitures for this purpose.

The reason is that safe harbor contributions must be fully vested at the time they are deposited. Since forfeitures arise from non-vested contribution sources, such as non-safe-harbor match or profit sharing, they couldn't possibly meet that requirement.

That leads to another challenge. If forfeitures cannot be used to pay for the safe harbor contribution and there are not enough plan expenses to absorb them, the only other choice is to allocate them as additional contributions.

However, if the accumulated forfeitures are not "discovered" until a future year, the only option is to allocate them as profit sharing contributions. This risks the loss of the plan's exemption from the top-heavy rules since there would be an allocation to participant accounts other than deferrals and safe harbor contributions.

What is the moral to this story? If your plan has accumulated accounts that are subject to vesting, it is important to monitor forfeiture activity on an ongoing basis. That allows any forfeited amounts to be applied to fees as soon as possible.

Oops! Forgot to provide the safe harbor notice!

Retirement plans have many moving parts, and business owners and managers often have quite a few competing demands on their time beyond managing the company 401(k) plan. The result? Accidents will happen despite everyone's best intentions.

The IRS does have a correction program for such accidents. It is called the Employee Plans Compliance Resolution System (EPCRS), and it includes sample corrections for some of the more common oversights that arise. One oversight it does not address is how to correct a situation when an employer either does not provide a safe harbor notice at all or provides it after the deadline.

In its recent e-newsletter, *Retirement News for Employers*, the IRS provided some rather pragmatic guidance on addressing this issue. The newsletter does indicate that if the lack of notice meant that a participant was deprived of his or her ability to defer, the employer likely needs to make corrective contributions to make up for the missed opportunity. However, if employees were otherwise provided with adequate information about the plan and were given ample opportunity to take advantage of all its features, the IRS suggests that the oversight can be treated as an administrative error and that the plan sponsor must revise its procedures to make sure future notices are provided timely.

What's the moral to this story? EPCRS can generally only be used to self-correct if the plan sponsor had existing policies and procedures in place that were designed to prevent the failure being corrected, and the newsletter's reference to revising procedures is further confirmation that there must have been a procedure there in the first place. As a result, it is highly recommended that employers confirm they have internal controls in place in order to preserve the ability to self-correct if accidents happen.

Conclusion

As you can see, the safe harbor 401(k) plan continues to evolve. There are certainly many advantages to this design and there are additional restrictions as well. If you have a safe harbor plan or are thinking of adding the feature, the moral to this story is that working with an experienced provider who can help you plan ahead is a great way to build in added flexibility.

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