The Safe Harbor Solution For Your 401(k) Plan

Another year of failed 401(k) testing? Once again having to refund salary deferrals – to yourself and possibly select highly-paid employees? Avoid year-end testing disasters and taxable refunds with a safe harbor 401(k) plan. By adding a "safe harbor" feature to your 401(k) plan, the special 401(k) test – the one that limits your deferrals based on the amount your employees' defer – no longer must be met, allowing you to contribute the maximum deferral amount permitted by law.

<u>401(k) Test vs. Safe Harbor Contribution</u>

In exchange for avoiding the annual 401(k) test, employees must receive a certain level of fully vested employer contributions. Because of this required contribution, is it still beneficial to add the safe harbor feature? Consider the following example which illustrates a traditional 401(k) plan that has failed the annual 401(k) test. The example lists possible test corrections, including either a taxable refund to the owner or fully vested contributions to employees. Alternatively, if the plan was a 3% of pay safe harbor 401(k) plan, no refund of deferrals ($7,400 plus earnings) would be needed, and the employees' total safe harbor contributions ($1,200) would be less than if the corrective contribution ($1,600) was made to fix the failed test. The safe harbor 401(k) plan is hands-down the better option!

	Compensation	Deferral	Possible Taxable Refund	Possible Corrective Contribution	SH Plan Design Alternative
Owner	$185,000	$18,500	$7,400	$0	$5,550
Employee 1	$22,000	$1,100	$0	$880	$660
Employee 2	$18,000	$540	$0	$720	$540
Total	$225,000	$20,140	$7,400	$1,600	$6,750

<u>Safe Harbor Nonelective Contribution</u>

A fully vested "nonelective" contribution of at least 3% of compensation must be made to all non-highly-paid participants regardless of whether they defer – although it can also be provided to owners and "highly-paid" participants as well. The plan document must specify the contribution that will be made, and this information must be provided to participants before the beginning of each plan year.

- ❖ An alternative to the required "fixed" nonelective contribution is the "maybe" option, as follows:
- ❖ The plan is designed as a plan subject to traditional 401(k) testing, with the possibility that the plan will be amended into a safe harbor plan at least 30 days before the end of the plan year.
- ❖ The test can be run near year-end to see if it will fail and safe harbor provisions should be added.
- ❖ The initial notice to participants must explain that the plan may or may not operate as a safe harbor 401(k) plan, and a supplemental notice must be provided if the safe harbor is adopted.

The safe harbor feature works best in a plan with low employee participation, resulting in frequent testing failures. If that describes you, with careful plan design, you may be able to avoid complex 401(k) testing and maximize your annual salary deferrals. And that's just one of the advantages of a safe harbor 401(k) plan!

Please contact us for more information on safe harbor 401(k) plans and how we can help you take advantage of this opportunity to use your 401(k) plan more effectively.

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Design Alternative – A safe harbor 401(k) plan can instead be designed with a required matching contribution. Only participants who defer would receive the matching contribution.

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