Safe Harbor 401(k) Plans: What you need to know

A safe harbor 401(k) plan is a type of 401(k) plan that allows employees to save for retirement while also protecting the plan from failing certain IRS tests. In essence, safe harbor plans protect employers and employees from penalties, unexpected tax liability, and even refunded 401(k) contributions.

What is a safe harbor 401(k) plan?

There are many different types of 401(k) plans available. A safe harbor 401(k) is simply one of the available options.

However, there are a few differences between a safe harbor plan and a traditional 401(k) plan:

- Employer contributions to a safe harbor plan must be fully vested when they're made.
- Safe harbor plans aren't subject to IRS nondiscrimination testing. They are called "safe harbor" plans because they can't fail the nondiscrimination testing, unlike traditional 401(k) plans.

What is nondiscrimination testing?

Congress wants to make sure that all employees, regardless of income, have equal opportunity to contribute to a 401(k) plan. Over the years, they have implemented a series of tests to ensure that 401(k) plans don't discriminate against lower salary employees. These tests are commonly referred to as "nondiscrimination tests," and they are performed annually.

For nondiscrimination testing purposes, employees are grouped into two categories: highly compensated employees (HCE) and non-highly compensated employees (NCHE).

Highly Compensated Employee Thresholds:
For plans enacted in 2019, the threshold for HCEs is $120,000, based on 2018 earnings. That number increases to $125,000 for 2020 plans, based on 2019 earnings. Anyone who earns less than this threshold is considered a NCHE. In addition, employees with a 5 percent or higher interest in the company are considered HCE. Certain family members of these employees may also be considered HCE.

The plan may use an alternative method, marking the top 20 percent of paid employees as HCEs and the remaining 80 percent as NHCEs.

The Actual Deferral Percentage (ADP) Test:
The actual deferral percentage test is based on employee deferrals (contributions) for the year. It does not include catch-up contributions, however. The specifics are complicated, but this test compares the deferrals of HCEs to those of NHCEs.

The Actual Contribution Percentage (ACP) Test:
The actual contribution percentage test is similar to the ADP test. However, it includes employer contributions as well as employee deferrals when comparing HCE 401(k) participation to NHCE participation.

The Top-Heavy Test:
The IRS guidelines state that, “A plan is top-heavy when, as of the last day of the prior plan year, the total value of the plan accounts of key employees is more than 60% of the total value of the plan assets.”

In other words, if key employees hold more than 60 percent of the total plan assets, the 401(k) plan is considered “top-heavy,” and fails the test.

What happens if a 401(k) plan fails a nondsicrimination test?

There are different outcomes depending on which test is failed and other criteria. In some situations, the employer must make corrections, which usually include making additional contributions for NHCEs. Obviously, these adjustments will require additional paperwork and man hours, as well. If corrections aren’t possible or aren’t completed correctly, the plan may be required to refund 401(k) contributions for HCEs, which can create unexpected tax liabilities for both the employer and employees.

Obviously, these tests are complicated, and the penalties for failure can be hugely detrimental. A safe harbor 401(k) plan isn’t subject to the nondiscrimination tests, making it a better option for many employers.

How does a safe harbor 401(k) plan work?

Safe harbor plans function similarly to traditional 401(k) plans. However, because they aren't subject to nondiscrimination tests, there are a few additional requirements and restrictions.

Safe Harbor 401(k) Plan Requirements:

These guidelines were established to ensure all employees benefit equally from the plan.

1. The employer must make contributions, and these contributions must be immediately vested. The contributions may be based on "matching," where a certain percentage of each employee's deferral is "matched" by the employer. Or, the employer can simply contribute 3 percent or more of each employee's salary, regardless of the employee's own contributions.

2. The employer must provide notice to all employees within a reasonable time period before the plan starts. "Reasonable" time period is usually at least 30 days in advance, but no more than 90 days in advance. (You can find more details about what must be included in the notice here.)

Safe Harbor Deadlines:

New safe harbor 401(k) plans must start by October 1. However, the 30-day notice must be sent by September 1, which means the plan must be set up by August 30.

A safe harbor provision may be added to an existing 401(k) plan. This provision must go into effect on January 1, and the 30-day notice should be sent no later than December 2. You should request the safe harbor provision addition no later than November 30.

Certain changes may be made during the plan year, but the employer must notify employees at least 30 days beforehand.

Safe Harbor 401(k) Contribution Limits:

The employee deferral limits for a safe harbor plan are the same as a traditional 401(k) plan. For 2020, these limits are $19,500 for those under 50, and $26,000 for those over 50 (including catch-up contributions).

Who should consider a safe harbor 401(k) plan?

Safe harbor 401(k) plans are ideal for certain employers. Consider using this type of plan if you:

- Already plan to match at least 3 percent of employee contributions
- Don't want to worry about passing nondiscrimination tests
- May fail nondiscrimination tests (or have failed in the past)
- Have low NHCE 401(k) plan participation
- Want to help ensure your employees prepare for retirement

Final Thoughts

Obviously, the cost of contributions is the largest deterrent to utilizing a safe harbor 401(k) plan. However, many employers feel that the cost is well worth the benefit of exemption from nondiscrimination testing. In addition, you may rest easier knowing your employees are better prepared for retirement.

If you have any questions about safe harbor plans or would like to discuss your specific situation, please give us a call. Our tax experts are here to help

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