Is a Safe Harbor Plan the Right Move?

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This alternate approach can save headaches, but at a price.

Do you worry each year about whether your highly compensated employees (HCEs) will have “excess” salary deferrals returned to them due to the plan failing the actual deferral percentage / actual contribution percentage (ADP/ACP) discrimination tests? Most small plan sponsors take advantage of “safe harbor” rules that nearly always eliminate the need to worry about passing these tests. But there are risks to this approach as well.

What are the test formulas?

Currently, the threshold for HCE status is an annual salary of $120,000, or at least 5% company ownership.

Using the ADP test, you first calculate your HCEs’ average deferral rates, including employees eligible to participate in the plan but who choose not to. For example, if you have only two HCEs, and one deferred 5% and another 6%, the average is 5.5%. Also suppose, using the same calculation method, that your non-highly compensated employees’ (NHCEs’) average deferral rate is 4.5%.

Although the HCEs’ ADP exceeded the NHCEs’, you’d pass the test because, when the NHCE average deferral rate is between 2% and 8% (as is typical), the HCEs’ ADP can exceed the NHCEs’ by up to two percentage points. That is, the NHCEs’ average deferral could have been as low as 3.5%, and you’d still pass. (Different formulas kick in when the NHCEs’ average deferral rate is below 2% or above 8%.)

The ACP test is similar, but also includes employer matching contributions and after-tax employee deferrals.

What if you don’t pass?

If you’re consistently failing those tests by a wide margin, a safe harbor plan design could look attractive. The rules provide two safe harbor formula categories to choose from to avoid ADP/ACP testing, as well as top-heavy testing:

- **Minimum matching contribution formulas.** This requires plans to either:
  - Match 100% of the first 3% of deferred compensation and 50% on deferrals between 3% and 5% (which means the maximum you’d contribute is 4% of employee compensation), or
  - Match 100% on the first 4% deferred.

- **Nonelective contribution rate.** The company must contribute 3% of the eligible employee’s compensation, regardless of how much or little NHCEs save on their own.

All safe harbor contribution amounts must vest immediately with the employee.

How about a QACA?

A qualified automatic contribution plan (QACA) is also a form of safe harbor plan. With this approach, you must auto-enroll employees into the plan and a qualified default investment option such as a target date fund. A QACA must have a minimum initial deferral rate of 3% and annual deferral rate increases of at least 1%, until the deferral rate reaches at least 6%, but no more than 10%.

In addition, the plan must match 100% of deferrals on the first 1% deferred, and at least 50% on incremental deferrals up to 6%. (The net result is a maximum required match of 3.5%.) A two-year cliff vesting formula is permissible.

Where to next?

Starting a safe harbor plan takes some planning. If you want to establish a new one, you must do so by October 1 for calendar year plans. Existing 401(k) plans have until January 1 to start as a safe harbor plan.

You must provide participants a notice of intent to be a safe harbor plan for the coming year at least 30 days prior to the new plan year. If you currently have a 401(k) plan, check your plan documents to ensure you can amend them to add a safe harbor plan.

Should you do it?

Going the safe harbor route is the path of least resistance, but it can also be the more expensive one. (See “And the cost is… ”) Set a time to discuss the pros, cons and applicable documentation with your benefits advisor. He or she can review the ADP/ACP discrimination tests with you, as well as determine whether a safe harbor plan would work for your organization.
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