Summary of Safe Harbor Contributions

The employer must make either a safe harbor matching contribution or a safe harbor nonelective contribution to satisfy the ADP safe harbor contribution requirement. This is true both for the 401(k) safe harbor and the QACA safe harbor. The employer is permitted to make both, but is only required to satisfy one of these requirements in order to eliminate the ADP test. The safe harbor contribution must apply to at least all eligible NHCEs (subject to the exception regarding otherwise excludable employees). The plan may, but is not required, to provide the safe harbor contribution to the eligible HCEs.

A matching contribution will satisfy the ADP safe harbor contribution requirement if it is no less than the contribution determined under the "basic" formula prescribed by the applicable statutory requirement. The safe harbor matching contribution may be determined on a plan year basis, or under a payroll period method. The match may be reduced or discontinued during the plan year, provided the ADP and ACP tests are run instead.

Safe harbor match under the 401(k)(I2) safe harbor. The safe harbor match under IRC §401(k)(12)(B) may be met by using the basic formula in the statute, or under an "enhanced" formula illustrated below.

BASIC MATCHING FORMULA UNDER THE 401 (K)(12) SAFE HARBOR

The basic formula provides the following match:

100% match on the first 3% of compensation deferred

Plus

50% match on the next 2% of compensation deferred

Example. Paul and Rhonda are participants in a safe harbor 401(k) plan that provides the basic match to satisfy the ADP safe harbor. Each employee's compensation for the plan year is $40,000. Paul defers 2% of compensation, or $800, and Rhonda defers 4% of compensation, or $1,600. Paul's match is $800, because Paul's deferral rate is less than 3% (Paul's deferral rate is 2%), and the first 3% of compensation deferred is matched dollar-for-dollar. Rhonda's match is $1,400. For Rhonda, the first 3% of compensation deferred ($1,200 in her case) is match dollar-for-dollar, but the next 1% of compensation she deferred ($400 in her case) is matched only 50-cents-on-the-dollar, for an additional match of $200 on that portion of her deferrals.

<u>MAXIMUM BASIC MATCH IS 4% OF COMPENSATION</u>

The maximum match that is made under the basic formula is 4% of compensation. A match of that amount would apply to any participant who defers at least 5% of compensation.

Enhanced matching formula under the 401(k)(l2) safe harbor. An enhanced formula satisfies the ADP safe harbor contribution requirement so long as the matching contribution at each level of deferral *is* no less than the matching contribution determined under the basic formula. To test whether a formula is satisfactory, look to the level of match that is made on each level of deferral up to 5% of compensation, and compare the matching contribution under the formula with the matching contribution that would be made at that deferral level under the prescribed formula.

Example: Flat rate match meeting the 401(k)(l2) safe harbor. The matching formula under a safe harbor 401(k) plan is 100% match on the first 4% of compensation deferred, with no additional match on higher levels of deferral. This formula satisfies the enhanced formula requirement, because the match is no less valuable than the basic formula. If this formula is in effect in the plan described in the example above, Paul's match would be the same ($800), but Rhonda's match would be $1,600 rather than $ l,400.

Example: Matching rate exceeding 100%. The matching formula under a safe harbor 401(k) plan is 150% of the first 3% deferred. This, too, satisfies the enhanced formula requirement. If this formula were in effect in the plan described in the example above, Paul's match would be $1,200 and Rhonda's match would be $1,800. In Paul's case, his entire deferral amount is multiplied by 150% because his deferral rate is less than 3%. In Rhonda's case, only the first 3% deferred ($1,200) is subject to the match, but it is multiplied by 150% under this formula. In each case, the match is greater than the match that would be available under the basic formula, as shown in the example above.

The "Safe Harbor" matching contribution must be 100% vested. This contribution also wears multiple hats:

1. **automatic pass of ADP**
2. **automatic pass of ACP**
3. **satisfies Top-heavy minimum provided there is NO profit sharing contribution**

SAFE HARBOR NONELECTIVE CONTRIBUTION

A nonelective contribution will satisfy the ADP safe harbor contribution requirement if it equals at least 3% of the employee's compensation.

Note that the formula requirement is the same under the 401(k)(l2) safe harbor and the QACA safe harbor. So, in the case of the QACA safe harbor, Congress was willing to provide a reduced contribution incentive for the employer to adopt an automatic enrollment feature in its 401(k) plan that meets the QACA definition, but only if the plan is providing a safe harbor matching contribution and not if the plan is providing a safe harbor nonelective contribution. As with the match, the nonelective contribution need only be provided to the eligible NHCE’s. However, the plan may provide that the HCEs also receive the nonelective contribution allocation. A contribution greater than 3% is also permitted. An eligible NHCE must receive the allocation of the nonelective contribution regardless of whether he chooses to make deferrals under the section 401(k) arrangement, and, in the case of the QACA safe harbor, regardless of whether the employee is enrolled under the automatic enrollment feature, enrolls by affirmative election, or affirmatively elects not to enroll to avoid automatic enrollment. Some employers prefer the nonelective contribution because it guarantees at least some retirement savings, even for those employees who do not choose to, or are unable to afford to, make elective deferrals to the 401(k) plan.

Automatic enrollment plans may want to consider the nonelective contribution on the 401(k)(12) safe harbor rather than under the QACA safe harbor. If the employer is going to make the 3% nonelective contribution, it may want to consider using the 401(k)(12) safe harbor rather than the QACA safe harbor, even if the plan has an automatic enrollment feature. By using the 401(k)(12) safe harbor, the automatic enrollment feature would not have to meet the qualified percentage rules for the default deferral rate, including the automatic increasing of that rate if it doesn't start at 6% or higher. The only thing the employer would be giving up here is the ability to use a 2 year vesting schedule on the safe harbor contribution, rather than immediate 100% vesting. Avoiding the automatic increasing of the default deferral rate will simplify administration of the automatic enrollment feature.

The 3% "Safe Harbor" nonelective contributions, which must be 100% vested, wears three hats:

1. **automatic pass of ADP**
2. **satisfies Top-heavy minimum**
3. **may be used in 401(a)(4) nondiscrimination testing of employer profit sharing contribution**

EMPLOYER’S CONTRIBUTION COST IS MORE PREDICTABLE

When the employer provides the safe harbor nonelective contribution, its contribution costs are more predictable than they are under the safe harbor matching contribution formula. With the nonelective contribution, all eligible employees (or at least all eligible NHCEs) will receive the contribution allocation, so the employer will have to budget a fixed contribution cost of 3% of compensation for those employees. With the matching contribution, only those eligible employees who actually defer under the 401(k) arrangement (whether by affirmative election or, if the plan includes an automatic enrollment feature, by default enrollment) will receive the allocation. The employer's contribution cost under the safe harbor matching contribution, if the basic formula is adopted, could be as high as 4% of compensation for the eligible employees under the 401(k)(12) safe harbor (or 3.5% of compensation for the eligible employees under the QACA safe harbor), but could be much less than the cost of the nonelective contribution if a significant portion of the eligible employees do not make 401(k) deferrals. In general the 3% nonelective safe harbor is a more effective plan design when the employer is confident that a profit sharing contribution will be made. The safe harbor matching contribution may encourage more employees to participate and the employer will increase unexpectedly.

Effect of automatic enrollment of participation rates should be taken into account when evaluating the safe harbor match. An employer considering the QACA safe harbor should also consider that one effect that an automatic enrollment feature has in many situations is to increase the participation rates of the NHCEs. Thus, even though the safe harbor match requirement under the *QACA* safe harbor is less than the safe harbor match requirement under the 401(k)(l2) safe harbor, it is also probable that a greater percentage of the NHCEs will be enrolled in the plan because of the automatic enrollment feature which might increase the employer’s overall matching contribution costs. On the other hand the cost of the safe harbor nonelective contribution is unaffected by the level at which eligible employees are deferring under the 401(k) arrangement.

PREREQUISITES FOR THE QACA SAFE HARBOR

In order to rely on the ADP safe harbor under IRC §401 (k)(13) the plan must include a 40l(k) arrangement, and the plan must include an automatic enrollment feature that satisfies the definition of a qualified automatic contribution arrangement (QACATo be a QACA, the plan's automatic enrollment feature must meet minimum requirements, as explained below. In addition, the plan must satisfy a matching or nonelective contribution requirement, the vesting and withdrawal requirements and a notice requirement. If these requirements are met, the plan is deemed to pass the ADP test.

Permissible features: Any feature listed above as a permissible feature in a 401(k)(12) safe harbor plan is also a permissible feature in a QACA. Note, however that automatic enrollment feature is listed as a permissible feature in a 401(k)(12) safe harbor plan, but a QAC would have to have an automatic enrollment feature that meets conditions described below.

AUTOMATIC DEFERRAL REQUIREMENTS FOR A QACA

To be a QACA, the automatic contribution arrangement under the plan must meet the requirements of IRC §401 (k)(l3)(C). The default election under the QACA must be equal to the qualified percentage. In addition, the QACA must otherwise meet the “baseline" definition of an automatic contribution arrangement. The arrangement must be a cash or deferred arrangement and a default must apply under which the employee is treated as having made an election to have a specified contribution made on his or her behalf under the plan. The default contribution percentage must satisfy uniformity requirements prescribed by the regulations.

Qualified percentage: As a general rule, the default contribution percentage must be uniform for all employees, not exceed 10% of compensation and satisfy the minimum deferral percentage requirements.