SAFE HARBOR

Choosing the Right Safe Harbor Contribution for Your Firm

What you need to know

Many small businesses rely on safe harbor 401(k) plans to stay compliant with the IRS and to allow owners and key employees to maximize their salary deferrals while providing meaningful retirement savings for all participants. Plan sponsors may select a match or nonelective safe harbor contribution to achieve their individual goals. Employee demographics play a significant role in determining the appropriate safe harbor option.

Notable Safe Harbor Plan Features

- Safe harbor plans provide an automatic pass for ADP/ACP nondiscrimination testing and top-heavy requirements if the only employer contributions to the plan are safe harbor contributions.
- Employers may exclude highly compensated employees (HCEs) from safe harbor contributions.
- Safe harbor contributions generally require 100% immediate vesting and no allocation conditions.

Safe Harbor Options and Key Benefits

Safe harbor basic match

- In this scenario, the employer only contributes to participants who make employee deferrals. The basic formula is 100% match for the first 3% deferred, and an additional 50% match for the deferrals between 3% and 5%. The maximum match that any participant receives is 4% of eligible compensation.
- The most notable benefit to choosing the basic match option is that it only benefits employees who actively participate. The match typically costs less than alternative designs for larger employers with employees who are less likely to participate in the plan.
- This option is also appropriate for employers who would like to maximize owner and key staff salary deferrals of $22,500 ($30,000 for participants age 50 or over) but do not plan to make any new comparability profit sharing contributions.
- A safe harbor match formula typically works best for employer demographics with younger owners and owners with limited income.

Safe harbor enhanced match

- An alternative matching formula to the basic match formula.
- Employers can choose to provide a more generous match of up to 6% of eligible compensation.
- The enhanced match is at least as favorable as the basic match formula.
- The rate of match must not increase as an employee's deferrals increase.
- The rate of matching contributions for an HCE may not be greater than for any eligible nonhighly compensated employees (nonHCEs) at the same level of deferral.

Safe harbor 3% nonelective

- The employer makes a nonelective contribution of at least 3% of pay to all eligible nonHCEs, regardless of whether an employee actively defers from pay or not. It differs from a match because participants will receive this employer contribution whether or not they choose to make elective deferrals.
- The value of a 3% nonelective formula is that it can work double duty. It provides the automatic pass for an ADP test, and if a profit sharing contribution is made, the 3% safe harbor contributions are used to help satisfy the minimum contribution requirement (generally 5%).
  - Employers generally choose this safe harbor option when the owners and other key personnel are looking to maximize their own annual contributions at the current $66,000 limit ($73,500 for participants age 50 or over).
  - If owners and other key personnel are substantially older than most of the staff, they generally can receive 6% in profit sharing contributions (in addition to the 3% safe harbor) without additional contributions to the staff. This can translate to an extra $19,800 per owner each year, if compensation is at least $330,000.
- Further, consider an employer who must make a 5% contribution to staff in order to maximize contributions for owners and key personnel. The 3% safe harbor contribution counts towards the 5% needed, so the employer only needs to contribute an additional 2% at year end. In a safe harbor basic match, the owner would have to contribute up to 4% as a match ***plus*** 5% as a profit sharing contribution, resulting in potentially 9% to employees who receive the full match.
- This safe harbor appeals to employers who want to benefit all eligible employees and are likely to contribute profit sharing each year. Demographics impact the profit sharing component and favor older, higher-earning owners versus younger rank-and-file staff.

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