401(k) Safe Harbor Plan Design Options

There are four options to choose from when considering a safe harbor 401(k) plan: a basic safe harbor matching contribution, an enhanced safe harbor matching contribution, a safe harbor non-elective contribution and an automatic enrollment safe harbor contribution.

1. Safe Harbor Match Contribution – The first option is the basic safe harbor match contribution. The basic safe harbor match contribution has a required minimum formula that matches 100% of the first 3% of employee deferrals plus 50% of the next 2% of employee deferrals. This would be a maximum safe harbor match of 4% of pay annually. An employee would need to contribute at least 5% of their pay to receive the maximum match. This is 100% immediately vested. This contribution may be funded per pay period or annually.

2. Enhanced safe harbor matching contribution – This option matches 100% of the first 4%, 5% or 6% deferred. The employer chooses from the three percentages. The safe harbor enhanced matching contribution is immediately 100% vested. This contribution may be funded per pay period or annually.

3. Safe Harbor Non-Elective Contribution – This is the third safe harbor contribution option that is available. This contribution is a 3% of pay contribution to all eligible employees regardless of whether they are contributing to the plan or not. This is 100% immediately vested. This can also be made each pay period but must ultimately equal 3% of the employees eligible compensation.

4. Qualified Automatic Contribution Arrangement (QACA) – This is a safe harbor arrangement with an automatic enrollment setup. The employer chooses the automatic enrollment percentage it wishes to implement. The minimum automatic deferral percentage must be 3%. If 3% is selected, then the employer must use a minimum escalation schedule. Under that schedule for plan years of participation 1-2 the employee is automatically enrolled at 3%. Starting with the 3rd year that automatic deferral percentage increases by 1% until the 5th year of participation when the participant reaches 6%. That is the statutory minimum schedule that must be provided for the escalation. The schedule can continue past the 5th year but cannot exceed 10% ultimately. The employer can choose to avoid the escalation feature by setting the automatic deferral rate at 6%. The most common safe harbor match formula associated with this arrangement is the QACA basic safe harbor match. This formula matches 100% of the first 1% deferred and then 50% of the next 5% deferred for a maximum match of 3.5%. An employee would have to defer 6% to get the full 3.5% match. The employer can also make a safe harbor non-elective contribution equal to 3% of eligible compensation as outlined in #2 above. These contributions can be subject to a two-year vesting schedule whereby the participant must be 100% fully vested after 2 years of service. The contribution can be made per payroll or on an annual basis.

5. Advantages of being Safe Harbor – There are several advantages to having a safe harbor 401(k) plan. First, your Highly Compensated Employees (HCEs) can contribute to the IRS deferral maximums without worrying about receiving refunds of their contributions because the plan is deemed to pass the ADP/ACP testing of employee deferrals and employer matching contributions. An HCE is anyone that is a greater than 5% owner, any of their lineal ascendants/ descendants that are employed, and any other employee who made greater than $135,000 in 2021. In a non-safe harbor 401(k) plan when you have HCEs the amount they can contribute may be restricted due to the ADP/ACP compliance testing of the employee deferrals and employer matching contributions. If the HCE average exceeds acceptable IRS thresholds refunds are typically made to the HCEs to bring the test back into a passing state. The advantage of going with a safe harbor plan with either the match or the non-elective contribution is that it will be deemed to pass this test allowing your HCEs to contribute to the IRS maximums of $20,500 for 2021 or $27,000 for 2022 for those employees who are 50 or older during the plan year. This can be an excellent employee retention tool for your company.

   The second advantage is that your plan would also be deemed to not be top-heavy, which is another annual compliance test that is required. A plan is top heavy when the Key employees as of the last day of the plan year have greater than 60% of your plan's total assets. A Key employee is any employee who is a greater than 5% owner, or an employed relative as stated above, any officer of the company that makes greater than $200,000, indexed annually, and any owner that has greater than 1% but less than 5% ownership and makes at least $150,000. In a traditional 401(k) Plan if the top-heavy test fails and a Key employee has made or received contributions to the plan during a top heavy plan year, then the employer would be required to make a top heavy minimum contribution equal to the greatest Key employee contribution rate up to a 3% of pay maximum. The top-heavy test is always determined as of the last day of the plan year but applies to the next following plan year. For example, if the plan is determined to be top heavy at 12/31/22, the top-heavy year would be the 2023 plan year. In the first plan year, the 12/31/22 date will be used for the first plan year and second plan year.

6. Summary – To summarize, the advantages of going with a safe harbor plan are that it allows your HCEs/Keys to contribute to their maximum, potentially helps in retention of employees, avoids ADP/ACP testing refunds, and avoids being required to make up to a 3% top-heavy minimum contribution during the plan year.