

One of the more frustrating aspects for the business maintaining a 401(k) plan is satisfying the special nondiscrimination requirements. The tests require adequate participation by "non-highly compensated employees" (NHCEs) in order for the "highly compensated employees" (HCEs) to maximize their own salary deferrals. Failure to satisfy the tests requires a correction which often means the painful process of returning salary deferrals to the HCEs.

For a number of years, employers have had the option to simplify this process and avoid the tests altogether by providing a "safe harbor" contribution for NHCEs. Also, plans that use automatic enrollment have a somewhat more flexible, safe harbor option.

To help those employers still struggling with the nondiscrimination tests or for those who have chosen a safe harbor design and would like to consider the new option, we will review the various safe harbor options that are available, as well as discuss automatic enrollment as a method of solving testing problems.

Testing Requirements

Absent a safe harbor contribution, a 401(k) plan must satisfy the Average Deferral Percentage ("ADP") test each plan year. This requires calculating each eligible participant's deferral percentage and comparing the ADP of the HCEs to the ADP of the NHCEs. HCEs are employees who:

- Owned more than 5% of the employer in the current or previous year, or
- Earned more than a specified limit in the previous year (\$125,000 for 2019)
- Ownership due to family attribution (i.e. lineal decedents such as spouse, children, etc.)

Employer matching contributions and after-tax employee contributions must satisfy a similar ACP test. Failure to satisfy either test requires either returning excess deferrals or contributions to the HCEs (within 2 ½ months of the end of the plan year) or making additional employer contributions (within 12 months after the end of the plan year).

In addition, a "top heavy plan" (more than 60% of the balances under the plan belong to "key employees") must satisfy special contribution requirements. Even if the sponsor makes matching contributions, additional top heavy contributions may have to be made to ensure that all non-key participants receive the required contribution which, in most cases, is 3% of compensation.

"There is a lot of consideration when analyzing plan design for our clients because there are a lot of moving parts! No two companies are alike and their plans shouldn't be either. - MVP"

Safe Harbor Provisions

- If a qualifying safe harbor contribution is made to a 401(k) plan, the plan is deemed to satisfy the ADP test. This means the HCEs may make the maximum allowable deferral of compensation (\$19,000 plus \$6,000 catch up contribution if age 50 or over – 2019 limitations).

- In most cases the ACP test is also avoided and the plan is deemed to have satisfied the top heavy requirements.
- The safe harbor contributions must be 100% vested and are not available for hardship or other in-service withdrawals before age 59 ½.
- The employer must adopt a safe harbor provision prior to the beginning of the plan year. Also, participants must be notified of the employer's intent to make safe harbor contributions within 30 to 90 days prior to the beginning of the plan year. There are several types of employer contributions that can satisfy the safe harbor.

Traditional Safe Harbor Options

Non-elective Safe Harbor Contributions

One option is to make a 3% non-elective contribution for all NHCEs eligible to participate in the plan. Contributions must be made for all eligible participants regardless of whether the participant has worked 1,000 hours during the year or was employed on the last day of the plan year and whether or not they actually contribute to the plan themselves (401k or Roth election). So if the participant met the eligibility requirements of the plan, they would be eligible to receive the non-elective safe harbor contribution.

Safe Harbor Matching Contributions

1. The employer can make a basic matching contribution for all eligible NHCEs who choose to make salary deferrals at the following rate: 100% of the first 3% of compensation deferred, plus 50% of the next 2% deferred. Therefore, if the participant contributed (401k or Roth) up to 5% of their pay, the safe harbor match under this option would be equal to 4% of their pay.
2. As an alternative, the sponsor may contribute an "enhanced" match equal to at least the amount of the basic match (e.g., 100% of the first 4% deferred). Under the enhanced match, the contribution rate cannot increase as an employee's deferral rate increases, and the contribution rate for HCEs cannot exceed the contribution rate for the NHCEs.

Qualified Automatic Contribution Arrangement (QACA)

A "qualified automatic contribution arrangement (QACA) that acts as an additional type of safe harbor design (meaning the plan automatically satisfies the ADP and ACP tests as well as top heavy requirements).

Under a QACA, an eligible employee automatically has a specified percentage of compensation withheld unless he makes an affirmative election either not to participate or to change the amount of the default election. A QACA can allow automatic deferrals of up to 10% of compensation but, as a minimum, the plan must require automatic deferral of 3% the first year, 4% the second, 5% the third and 6% thereafter.

The employer can make either:

- A 3% non-elective contribution for each NHCE, or
- A match contribution of 100% of the first 1% deferred and 50% of the next 5% deferred.

Unlike the traditional safe harbor design, contributions do not have to be fully vested until an individual has earned two years of service.

QACA is similar to a traditional safe harbor design in several respects. Contributions are required to be subject to withdrawal restrictions and cannot be restricted to those meeting an eligibility requirement (1,000 hours of service or employment on the last day of the plan year). Also the same rules apply concerning the timing of the plan amendment and annual notice to participants about the safe harbor contributions.

There is also an annual required notice about the automatic enrollment feature that must notify participants of:

- The level of elective contributions under the default;
- The employee's right to elect out of or change the amount of the deferral election; and
- How contributions will be invested in the absence of an employee investment election.

Choosing a Safe Harbor Option for the First Time

A Plan Sponsor struggling with testing issues should seriously consider one of the safe harbor designs. An employer reluctant to make the required contributions should also consider automatic enrollment (without a safe harbor contribution) as a method to increase participation and thereby improve test results.

Automatic Enrollment

Automatic enrollment is proven to increase participation, sometimes significantly, the Pension Protection Act ("PPA") included several automatic enrollment options to encourage this practice. The concept is simple: automatic enrollment brings in those who fail to participate simply because of inertia. This is likely to have the biggest impact on the young, a group that benefits the most from compounding returns over an accumulation period of 30 years or more.

An "eligible automatic contribution arrangement" (EACA), can be an effective approach that does not require a safe harbor contribution. With an EACA, the sponsor sets the default deferral percentage at any level and does not have to increase it each year as under a QACA. MVP would help with this decision process and make recommendations on setting the desired percentage.

The program requires the use of a qualified default investment arrangement ("QDIA"), and the sponsor has the option to allow new enrollees the option to withdraw contributions within 90 days of enrollment. The EACA has one other advantage: the 2 ½ month correction period under the ADP and ACP tests is extended to 6 months.

Electing a Safe Harbor Design

Other employers will want to consider adopting either a traditional safe harbor or QACA. It's important to understand that each of these options provides the sponsor design flexibility. In addition to the safe harbor contribution, the sponsor can make an additional discretionary matching contribution and still avoid the ACP test as long as certain requirements are met.

It can also be meaningful that the safe harbor options, in most cases, eliminate the complication of any top heavy problems. However, if the plan uses a matching contribution to satisfy the safe harbor and any other employer contributions are made, the plan must still demonstrate compliance with the top heavy rules.

When selecting one of the safe harbor options there are several clear differences between the traditional options and QACA. First, the QACA does not require immediate full vesting two years of service can be required. Second, the maximum required matching contribution is effectively 3.5% of compensation and not 4%. This can reduce the employer's contribution cost somewhat, but this advantage may be offset by a higher rate of participation under a plan that has automatic enrollment.

Plans Currently Using a Safe Harbor Design

If an employer is currently using a traditional safe harbor design with the 3% non-elective contribution, a QACA with a non-elective contribution is a good alternative. The contribution cost is the same, but added participation means more retirement security. Some employers will appreciate the ability to have a vesting provision, although changing the vesting provision does complicate administration.

As discussed above, a QACA with a matching contribution may be more or less expensive than the current safe harbor, depending upon the circumstances. If the safe harbor plan currently has a high level of participation or if it is not expected that automatic enrollment will have much of an impact on participation levels then the QACA safe harbor contribution will cost less than the traditional approach. Even if the cost is a bit more, due to increased participation, an employer motivated by the other benefits of automatic enrollment may still choose to switch.

Finally, note that an employer that appreciates the benefits of automatic enrollment but is satisfied with the current safe harbor can also choose to add an automatic enrollment feature and maintain the current safe harbor design.



Let's Talk

Sounds like a good time to strike up a conversation about MVP and services we offer. You can get in touch with us by calling us at 1-866-687-6877 or by emailing us at sales@mvp401k.com.