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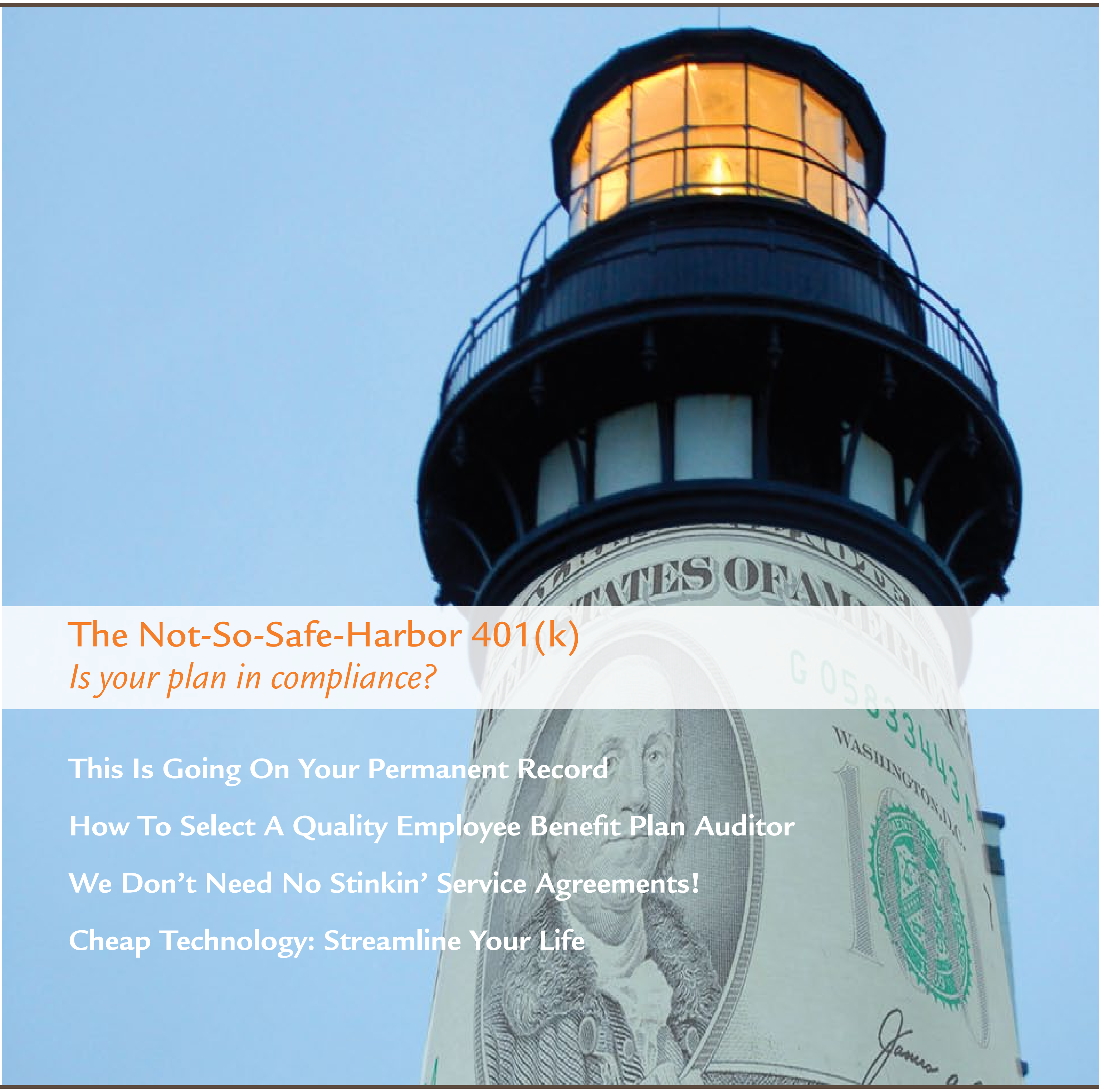

The Not-So-Safe-Harbor 401(k)

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The Not-So-Safe-Harbor 401(k) Plan

By Adam C. Pozek, ERPA, QPA, QPFC

The Safe Harbor ("SH") 401(k) Plan can be an effective tool to allow business owners to maximize their benefits; however, it comes with a few strings attached. Recently, the head of the IRS plan audit division announced that it has come to IRS attention that a number of Safe Harbor 401(k) plans may have gotten some of those strings tangled and that they are planning an audit initiative to investigate the matter.

Right about now, you may be asking, "So, what? SH plans get a free pass, what compliance issues are there to worry about?"

The reality is that while Safe Harbors do provide a free pass on the ADP test and sometimes the ACP test and top-heavy requirements, there are other rules that can actually be more stringent than those that apply to regular plans. Let's take a look.

Mandatory Safe Harbor Contribution

One of the fundamental requirements of SH plans is that the employer is required to make either a matching or non-elective contribution on behalf of eligible non-highly compensated employees, and the formula must follow what is written in the plan document. This means no cutting back during slow economic times and no trueing-up matching contributions for owners who front load their deferrals when the plan calls for a pay period match.

The Safe Harbor rules require contributions to be deposited no later than the last day of the year to which the contributions relate, e.g. December 31, 2013, for the 2012 Safe Harbor contributions. However, for SH match plans that calculate the match each pay period (or on any frequency other than annually), the match must be deposited no later than the end of the quarter following the quarter to which it relates. Deposits made after these deadlines represent compliance failures that can subject the plan to penalties.

Top Heavy Minimum Contribution

Generally speaking, SH plans are deemed to satisfy the top-heavy requirements that could otherwise require a plan sponsor to make additional contributions for employees. A common misperception is that this is absolute. There are some common fact patterns in which a top heavy contribution may still be due. Consider two quick examples.

- A top heavy plan provides for immediate eligibility to make deferrals but requires a waiting period for SH eligibility. Those eligible to defer but not to receive the SH contribution are not covered by the top heavy relief, so the employer must make the 3% top heavy contribution for those short-service employees.

- A top heavy SH plan includes a profit sharing provision. The top heavy relief is conditioned on the only contributions being deferrals and SH contributions. If the plan sponsor makes a profit sharing contribution, the relief is lost for the entire plan.

These issues typically arise with SH match plans when participants who defer less than 3% of pay don't receive an employer contribution of at least 3%. However, there can be issues even with higher deferral rates and with SH non-elective plans. The reason is that plans can use alternative definitions of compensation, e.g. compensation from an employee's eligibility date, to calculate the SH contribution, but the top heavy contribution is required to be calculated using full-year compensation.

Forfeitures

Most plans allow the use of forfeitures to offset company contributions. Unfortunately, that does not apply to SH contributions. The reason is that IRS rules require the SH amounts to be fully vested when contributed to the plan. Since forfeitures result from non-vested balances, such amounts couldn't have been vested at the time of contribution.

Forfeitures can usually be used to pay certain plan expenses, but there is a bit of a conundrum when forfeitures exceed those expenses. A separate set of rules requires any forfeitures remaining at the end of the year to be allocated as additional contributions. If a plan with leftover forfeitures is top heavy and those forfeitures must be allocated, it can trigger additional top heavy contributions as described above. Quite the tangled web of overlapping rules, I know, but those are the rules nonetheless.

Amendments

When amending SH plans, timing is critical. A few years ago, the IRS published guidance indicating that it is ok to amend a SH plan mid-year to add a Roth feature or to provide for hardship distributions. Some interpreted this as being a partial list and believed that other types of changes were also permitted as long as they made the plan more generous. However, the IRS has since "clarified" that the guidance on adding Roth and hardships is pretty much an exclusive list, meaning that no other changes are permitted once the year begins. No accelerating eligibility requirements; no increasing the deferral limit or adding catch-up contributions; no changing your safe harbor match from pay period to annual. Nothing.

Conclusion

The SH design works well for many companies; however, there may also be other designs that are equally as effective without all the additional rules.

To those who might be tempted to skip the annual compliance review on a safe harbor plan, please be reminded of the adage that an ounce of prevention is worth a pound of cure. The IRS may be coming to a safe harbor plan near you. Avoiding problems is certainly preferable, but fixing any problems on your terms is much better than waiting for the IRS to show you that your safe harbor plan isn't quite as safe as you thought.

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