DOWNEAST PENSION SERVICES, INC.

SPECIALISTS IN

Company-Sponsored
Defined Contribution
Retirement Plans

401(k) Safe Harbor plan?

Why safe harbor?

A traditional 401(k) plan without a Safe Harbor feature requires discrimination testing. A company's census is divided between "highly compensated employees" (HCEs) and "non-highly compensated employees" (NHCEs). HCEs are employees who own more than 5% of the company. Certain family members who are related to 5% owners are also considered HCEs. Also, non-owners who earned more than $110,000 last year are considered HCEs this year.

The discrimination test takes the average rate of deferral (and match) for all the eligible NHCEs and compares that against the average of the HCE group. Generally speaking, the HCE group is allowed 2% more than the NHCE group.

> Example: Company XYZ has 100 employees, and imposes a one year wait and age 21 to become eligible. There is one owner who is employed, and that owner's spouse also works for the company. No other employee earned more than $110,000 last year, therefore there are only two HCEs. Of the 100 employees, only 50 are eligible, 2 HCEs and 48 NHCEs.
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> STEP 1: Determine the average deferral rate of the NHCE eligible group. Even those who are eligible but elect not to contribute to the plan need to be included in the average. Let's say the average deferral rate for the 48 eligible NHCEs is 3%.
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> STEP 2: Determine the average of the HCE group. Let's say the 2 HCEs defer the maximum and the average deferral rate is 11%.
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> STEP 3: Determine the maximum allowable HCE rate. That would be 3% (NHCE rate) + 2% = 5%.
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> STEP 4: The test failed and either refunds need to be made to the HCE group or a company contribution needs to be given to the NHCE group.
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> Typically the refund method would be used in this example, but may cause angst with the business owner. The whole purpose of the 401(k) plan is to allow for higher limits, yet the discrimination test makes it difficult for the owner to maximize deferrals.

To avoid discrimination testing, a plan can have a Safe Harbor feature. There are some choices, these contributions are all 100% vested:

1. **3% Safe Harbor Non-elective Contribution.** All eligible employees would receive a contribution equal to 3% of compensation. Example: Sally earns $10,000 and is eligible for the plan. The company would contribute $300 to her account, whether or not she defers any of her own paycheck into the plan.

2. **The basic Safe Harbor Match.** The company would match dollar for dollar on the first 3% of compensation deferred, plus $0.50 on the dollar for the next 2% of compensation deferred. Example: Sally earns $10,000 and defers $500 of her paycheck into the plan. The company would contribute a match of $400 for her ($300 + $100).

3. **Easier to understand Safe Harbor Match.** The company would match dollar for dollar on the first 4% of compensation deferred. Example: Sally earns $10,000 and defers $400 of her paycheck into the plan. The company would contribute a match of $400.

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