


Should You Consider a Safe Harbor 401(k)?



A safe harbor design allows a 401(k) plan to avoid annual nondiscrimination testing of employee elective contributions and employer matching contributions. If you are thinking of implementing a safe harbor 401(k) plan, the overview that follows may prove useful in your decision-making.

The Safe Harbor Design Advantage

A 401(k) plan generally must undergo actual deferral percentage (ADP) and actual contribution percentage (ACP) testing each year. In addition to allowing a 401(k) plan to avoid the administrative burden of conducting these tests, a safe harbor design may enable highly compensated employees (HCEs) to contribute more to the plan than they could if the plan were subject to nondiscrimination testing. Employers that might benefit most from a safe harbor 401(k) plan include:

- Firms with highly paid employees who are not able to maximize their plan deferrals because of the low participation rates of lower paid employees
- Companies already making employer contributions at or near the levels required to meet the safe harbor requirements
- Employers required by law to make top-heavy minimum contributions

Contribution Requirements

Employers that choose a safe harbor plan design must satisfy certain employer contribution requirements. There are two basic options:

- Make nonelective contributions of at least 3% of compensation on behalf of each nonhighly compensated employee who is eligible to participate in the plan
- Match 100% of employee elective contributions up to 3% of compensation and 50% of elective contributions between 3% and 5% of compensation

Sponsors may also use an enhanced matching formula. With an enhanced match, the aggregate amount of matching contributions at any given deferral rate must at least equal the aggregate amount of matching contributions made under the basic matching formula.

Whether the plan provides for matching or nonelective contributions, they must be fully vested when made.

Required Notices

A safe harbor plan must provide written notice of rights and obligations under the plan to eligible employees between 30 and 90 days before the beginning of each plan year. For employees who become eligible after the beginning of the plan year, the notice generally must be provided within the 90-day period ending on the employee's entry date. Plans that provide for immediate eligibility and permit employees to begin deferrals on

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the date they become eligible may provide the notice as soon as possible thereafter.

Converting to a Safe Harbor Plan

Both new and existing retirement plans can use the safe harbor design. To convert an existing 401(k) plan, the employer must adopt an amendment converting the plan before the plan year the conversion will take effect. A newly established 401(k) safe harbor plan's first plan year must be at least three months long (or less if the plan is established soon after the employer comes into existence).

Midyear Amendments

Once a 401(k) safe harbor plan is in place, employers have some flexibility to amend their plans during the year. Under IRS Notice 2016-16, a midyear change will not violate the safe harbor rules merely because it is a midyear change, provided it does not violate a list of specifically prohibited changes, and, in the event the change affects the plan's required safe harbor notice content, applicable notice

and election opportunity conditions listed by the notice are satisfied.

Specifically prohibited midyear changes include the following:

- Increasing the number of years of service required for vesting in a qualified automatic contribution arrangement (QACA) plan
- Reducing the number of employees currently eligible to receive safe harbor contributions
- Changing the type of safe harbor plan (e.g., from a traditional safe harbor to a QACA or vice versa)

Also prohibited is changing the formula for matching contributions if it increases the amount of matching contributions or adds discretionary matching contributions. But the IRS allows increasing the match if the change is retroactively applied for the entire plan year and it's based on compensation for the full year. In addition, the change must be adopted and participants must be given notice and an opportunity

to change their deferrals at least three months prior to the plan year-end.

If the midyear change affects the required information in the safe harbor notice, the sponsor must then provide an updated safe harbor notice with a description of the midyear amendment and its effective date. Generally, a sponsor has between 30 and 90 days before the change becomes effective to provide notice to participants.

Reducing or Eliminating Contributions

Generally, for plan years beginning on or after January 1, 2015, a sponsor may reduce or stop making safe harbor matching or nonelective contributions if (1) the employer is operating at an "economic loss" or (2) the safe harbor notice states that the plan may do so and that the reduction or elimination will not apply until at least 30 days after the notice is provided. (Additional requirements apply.) ADP and ACP testing will apply to all elective and matching contributions (including safe harbor matching contributions) made during the plan year.

Documenting Hardship Distributions

The IRS recently published a memorandum outlining new audit procedures for use by agents verifying whether a plan has followed proper substantiation procedures for safe harbor hardship withdrawals. Plan sponsors may want to review these procedures to anticipate later possible objections to their hardship withdrawal programs.

According to the memorandum, the auditor must determine whether the sponsor — to substantiate the hardship — relied on specific source documents (such as estimates, contracts, bills, etc.) or a "summary" of information on those documents. If source documents were used, the auditor is to determine whether they substantiate the hardship. In the latter case, the auditor is further required to determine whether the summary information obtained from the employee conforms to the requirements set forth in the Attachment.

The Attachment lists information that must have been provided to the employee, such as notification that the distribution is taxable, that it may not exceed the amount of the immediate and heavy financial need, and that the employee agrees to maintain the underlying source documents and provide them upon request.

The Attachment also identifies the specific, detailed information that the IRS deems necessary to substantiate particular types of safe harbor hardship distributions. For example, for funeral and burial expenses, the summary must include the name of the deceased, his or her relationship to the participant and date of death, and the name and address of the service provider. Similar lists are provided for the other five types of safe harbor hardship withdrawals.



Using EPCRS To Fix Plan Errors

The IRS developed the Employee Plans Compliance Resolution System (EPCRS) to help plan sponsors avoid plan disqualification by making it easier for them to correct a wide variety of retirement plan qualification failures. If plan sponsors follow the established guidelines, they may be able to bring their plans back into compliance without losing valuable tax benefits.

Types of Qualification Failures

Qualification failures may be of four types:

Plan document failures result from a plan provision (or its absence) that violates the requirements of Internal Revenue Code Section 401(a) or 403(a). A common cause of a plan document failure is not timely amending a plan to reflect required changes.

An *operational failure* is a qualification failure (other than an employer eligibility error) that occurs when a plan sponsor fails to follow terms stated in the plan document. An example of an operational failure would include improperly excluding eligible employees from plan participation.

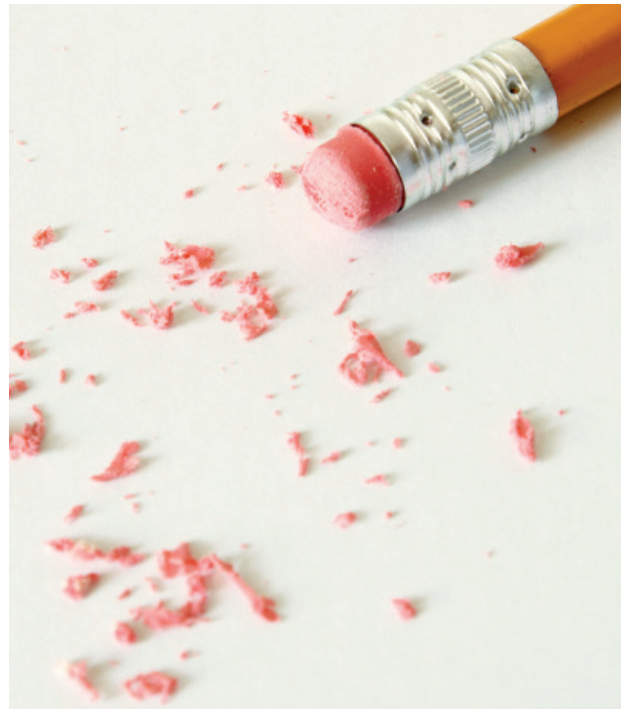
Demographic failures are those related to failure to follow nondiscrimination, minimum participation, or minimum coverage requirements (other than operational failures or employer eligibility failures). The correction of a demographic failure generally requires a corrective amendment to the plan that adds benefits or increases existing benefits.

Employer eligibility failures occur when the employer sponsoring the plan is not eligible to do so. Such failures do not include plan document, operational, or demographic failures.

Self-Correction Program (SCP)

The IRS has three programs available for resolving qualification failures. One of them is the SCP. This program allows a plan sponsor to correct plan failures without the involvement of the IRS or without paying a fee. Only operational failures (failing to follow the terms of a plan) may be corrected using the SCP. To be eligible for the SCP, plan sponsors must be able to demonstrate that they have established practices and procedures that show compliance with the law. A plan document alone is not sufficient.

The plan sponsor will need to follow the general correction guidelines listed in Revenue Procedure 2016-51, Section 6. According to the IRS, a plan that corrects a mistake listed in Appendix A or Appendix B of Revenue Procedure 2016-51 may be certain that its correction method is reasonable and



appropriate for the failure. In the event of an audit of the plan, a plan sponsor should maintain adequate records to show that the correction took place.

Voluntary Correction Program (VCP)

The VCP allows the plan sponsor to — at any time prior to an audit — pay a fee and receive IRS approval for the correction. All four types of qualification failures may be corrected with the VCP. When using this correction program, a plan sponsor identifies the mistakes to the IRS and suggests corrections using principles listed in Revenue Procedure 2016-51, Section 6.

Additionally, the plan sponsor pays a compliance fee and suggests changes it will make to its administrative procedures to avoid having the mistakes occur again. Subsequently, the IRS issues a Compliance Statement listing the plan sponsor's mistakes and the methods acceptable to the IRS for correcting them. The plan sponsor has 150 days from issuance of the Compliance Statement to correct the mistakes.

Audit Closing Agreement Program (Audit CAP)

Under the Audit CAP, a plan sponsor may pay a fine and correct a plan failure while the plan is under audit. Before entering a Closing Agreement, the plan sponsor makes corrections and pays a fine that is negotiated with the IRS. Fine amounts are based on all the facts and circumstances.



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Recent Developments

Workers Stressed About Retirement

A recent Employee Benefit Research Institute survey found that 31% of American workers feel very or somewhat stressed about preparing for retirement. Approximately 41% have tried to calculate how much they'll need to save for retirement. Other steps taken to prepare for retirement included estimating how much income they would need in retirement each month (38%), estimating their Social Security benefits (38%), and calculating retirement expenses (34%). About half of workers surveyed believe retirement planning (52%), financial planning (49%), or health care planning

(47%) educational programs would help boost their productivity at work.

Increase in Retirement Assets

According to the Investment Company Institute, employer-based defined contribution plan assets increased to \$7 trillion at the end of 2016, an increase of 1.3% from three months prior. Of the \$4.8 trillion held in 401(k) plans, mutual funds managed \$3 trillion. The most common types of mutual funds held in 401(k) plans were equity funds (\$1.8 trillion) and hybrid funds, including target date funds (\$835 billion). About two thirds of target date mutual fund assets at the end of 2016 were held in defined contribution plans.

IRS Clarification on Loan Amounts

The IRS has issued a clarification about the calculation of the maximum loan amount available to retirement plan participants who have received multiple loans during the one-year period prior to the date of the loan. Specifically, the IRS stated that the statutory language requiring that the maximum available be reduced by the "highest outstanding balance of loans" during the one-year period ending the day before the date of the loan may be properly interpreted in two ways: either as referring to the single highest unpaid balance of all loans taken during the one-year period or of each such loan added together.

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