

401(k) Safe Harbor Design Overview

Introduction

One of the most popular current plan designs for closely held businesses and professional entities is a tax-qualified retirement plan that offers “Safe Harbor” protection for 401(k). A Safe Harbor 401(k) Plan provides for employer contributions that ensure that the plan’s “highly-compensated” employees, as defined by IRS, are able to maximize their 401(k) contributions without restrictions from traditional 401(k) non-discrimination testing.

Traditional 401(k) Rules

One of the most burdensome aspects of a traditional 401(k) plan for small employers is the requirement that the plan comply annually with non-discrimination testing, known as the ADP test. The required testing is based on the amount of elective 401(k) contributions made by each eligible employee as a ratio to income. Eligible employees are broken down into two groups:

- highly-compensated group (HCEs); and
- non-highly compensated group (NHCEs).

The individual rates are averaged for each group and then the averages are compared to one another. Generally, the difference between the two groups cannot exceed two percent, i.e. the average contribution rate of the HCEs cannot exceed more than 2% of the NHCE average. There are additional restrictions if the NHCE average is either below 2% or above 8%.

HCEs are generally defined as business owners (including direct family members) and any employee whose prior year compensation with the employer exceeds \$160,000 (2025 limit used for 2026 testing). Typically, these are the people that want to maximize their 401(k) contributions up to the annual limit. However, often small employers find that their plans cannot meet the annual test requirements because many of the NHCEs contribute at a lesser rate or they do not contribute at all. The plan is then forced to limit the amount of 401(k) contributions of the HCEs throughout the year if projected testing is done, or refund the excess contributions after testing is completed at the close of the year. Neither of these options is attractive.

Why Adopt Safe Harbor

Beginning in 1999, the introduction of “safe harbor” 401(k) plans offered a solution to eliminate these problems. A safe harbor 401(k) plan that meets certain annual requirements would no longer be required to perform nondiscrimination testing of elective or matching contributions [IRC §§ 401(k)(12) and 401(m)(11)]. To be within the safe harbor, a 401(k) plan would have to meet certain employer contribution requirements, and would generally have to provide for 100% immediate vesting of these contributions.

More specifically, by adopting a safe harbor 401(k) plan, a plan sponsor can avoid actual deferral percentage (ADP) testing of elective 401(k) contributions and actual contribution percentage (ACP) testing of employer matching contributions. The ADP and ACP tests are used to determine whether the amount of elective contributions and matching contributions discriminates in favor of the HCE group. The obvious advantages of avoiding these nondiscrimination tests must be weighed against the following:

- For a Safe Harbor Match, the plan must satisfy the annual notice requirement to employees at least 30 days prior to the beginning of each plan year;
- Safe Harbor contributions must be contributed for all eligible employees, even if they separate from service during the year; and
- Safe Harbor contributions must be fully and immediately vested (unless paired with a Qualified Automatic Contribution Arrangement, which allows for 2-year vesting schedule).

Safe Harbor Employer Contribution Options

Under the safe harbor design options, a 401(k) plan can provide either of the following contributions:

- A Matching contribution that meets either:
 - **Basic Safe Harbor Match** of dollar-for-dollar on elective contributions up to 3% of compensation plus a 50 cents-on-the-dollar match on elective contributions between 3% and 5% of compensation for those eligible employees who make an election for 401(k) payroll deduction; or
 - **Enhanced Safe Harbor Match** of dollar-for-dollar on elective contributions up to a cap of between 4% and 6% of compensation.
- A 3% of compensation non-elective contribution for each eligible employee, regardless of the employee's participation in 401(k).

Alternative match formulas are allowable provided that the match at any given rate of elective contributions is at least equal to the aggregate amount of matching contributions that would be made under the basic matching formula. An alternate formula will only satisfy the safe harbor if the rate of matching contribution does not increase as the rate of elective contribution increases. And, of course, the rate of matching contributions that applies to HCEs may not be greater than the rate of match that applies to NHCEs.

If the plan provides for a **Qualified Automatic Contribution Arrangement**, the match may be structured as a dollar-for-dollar match on elective contributions up to 1% of compensation plus a 50 cents-on-the-dollar match on elective contributions between 2% and 6% of compensation.

Whether an employer chooses the matching option or the non-elective contribution option typically depends on other plan design factors, including the employer's Top Heavy status (a plan is Top Heavy when at least 60% of the plan's assets belong to Key employees). The 3% of pay non-elective option, in addition to satisfying the 401(k) tests, also satisfies the top heavy minimum contribution requirement, and can be used in the non-discrimination testing for additional employer discretionary contributions, as well. Therefore, most small employers who either need to meet the additional top heavy minimum, or who combine the 401(k) Safe Harbor features with a Cross-Tested Profit Sharing Plan, typically choose the non-elective contribution route.

Safe Harbor plans that utilize the match option can also satisfy the top heavy minimum contribution requirement, as long as there are no other employer contributions under the plan. Non-top heavy plans typically prefer the match option, since their contributions will reward contributing plan members only. However, for budget purposes, the match option can be more expensive depending on the level of employee participation (4% of pay match v. 3% of pay non-elective contribution).

Safe Harbor Annual Notice Requirement

For a Safe Harbor Match Plan

For each plan year that an employer elects to use the Safe Harbor Match, a notice must be given to eligible employees prior to the beginning of the plan year. For an *existing 401(k) plan*, the deadline for a final decision on Safe Harbor Match status must be made prior to December 1st of the year before the safe harbor match provisions can take effect. A *new plan* or an *existing profit sharing only plan* (without 401(k) provisions) may elect safe harbor match status in the current year provided that notice is given and the plan is implemented or amended prior to 3 months before the close of the year. Employees must be given the opportunity to make elections for 401(k) payroll deduction at least 3 months prior to the close of the year.

For a Safe Harbor Non-Elective Plan

Effective January 1, 2020 under the SECURE Act, there is no notice requirement for Safe Harbor Non-Elective plans— unless the plan also has a discretionary match that falls within the ACP Safe Harbor rules. Additionally, a Safe Harbor Non-Elective provision can be adopted for an existing 401(k) profit sharing plan any time up to 30 days before year-end. The 30-day deadline can be advanced to the end of the following plan year if the Safe Harbor Non-Elective contribution rate is increased from 3% to 4%.