

REPTECH

Customized Employee Benefits Administration

IRS GUIDANCE ON SAFE HARBOR 401(K)

The Safe Harbor 401(k) is Introduced.

In both 1996 and 1997, Congress passed legislation touted as “simplification” of the pension (including 401(k)) rules. By this time in 1999, these new provisions have become part of our daily lives, though the complexity of “simplification” is mystifying. Why can't they make it easier? This question is repeated so often, yet the answer remains the same: They can; they just don't.

One exception to this growing cynicism is a provision of the Small Business Job Protection Act of 1996 (“SBJPA”) which became effective just last month. For plan years beginning on or after January 1, 1999, a 401(k) plan that meets one of the “safe harbor” designs will not have to perform the Actual Deferral Percentage (“ADP”) test which compares

the average elective deferrals of the group of highly compensated employees (“HCEs”) to the average elective deferrals of the group of nonhighly compensated employees (“NHCEs”). Under the ADP test the average percentage of the HCE group is limited to the lesser of two times the average percentage of the NHCE group or two percentage points greater than the average percentage of the NHCE group.

What is a Safe Harbor Plan?

IRS Notice 98-52 defines a safe harbor 401(k) plan. A plan is a “safe harbor” 401(k) plan if the employer: (1) commits (by amending the plan) to either a specific matching formula or a floor nonelective contribution to every eligible NHCE; **and** (2) gives a timely notice to the affected employees. **The notice must be provided on or before March 1, 1999 in order for a**

calendar year plan to use the safe harbor relief for the 1999 plan year.

Sample notices are included with this Newsletter. If you intend to use the safe harbor rules for the 1999 calendar year, you must fill out one of these notices and deliver it to each affected employee. Posting it on the bulletin board is not adequate.

The plan provisions need not actually be amended to add the selected formula, however, until the end of the remedial amendment period (generally 12/31/99), unless the period is extended by the IRS.

The Matching Approach.

The basic matching formula must guarantee in writing that the employer will match 100% of the first 3% of compensation that an employee elects to defer, and that the employer will

match 50% of the next 2% of compensation that an employee elects to defer. Thus, the employer commits to a matching contribution of up to 4% of payroll of those employees who are eligible to participate in the plan. Of course, rarely does a plan achieve 100% participation, so the actual cost of the matching contribution will likely be less than the 4% maximum.

An alternative to using the above matching formula is to use the “enhanced matching formula.” A richer matching formula may be used if the rate of the employer's matching contribution does not increase as an employee's rate of elective deferrals increases, and the formula provides matching contributions on behalf of each NHCE who is an eligible employee in a manner, at any rate of elective contributions, that provides an aggregate amount of matching contributions at least equal to the aggregate amount of matching contributions that would have been proven under the basic matching formula.

For example, assume that beginning January 1, 1999, an employer maintains Plan L covering all employees except union employees and

nonresident aliens who have no U.S. income. Plan L contains a 401(k) arrangement and provides a required matching contribution equal to 100% of each eligible employee's elective contributions up to 4% of compensation. All matching contributions are 100% immediately vested (another requirement of use of the safe harbor rules), and such contributions are subject to the normal 401(k) withdrawal restrictions. Plan L is a safe harbor 401(k) plan with an enhanced matching formula. Remember the basic formula is 100% of the first 3% and 50% of the next 2%; however, the formula in the above example meets the requirements because each NHCE who is an eligible employee receives matching contributions at a rate that, at any rate of elective deferrals, provides an aggregate amount of matching contributions at least equal to the aggregate amount of matching contributions that would have been received under the basic matching formula, and the rate of matching contributions does not increase as the rate of an employee's elective contributions increase. The example assumes that Plan L provided a timely notice to the employees.

The Nonelective Floor Approach.

An employer who prefers to simplify the process even further may commit (by amending the plan) to a contribution of 3% of each NHCE's compensation. This is known as a “3% nonelective” contribution. This nonelective contribution would be due to each eligible NHCE even if they make no elective deferrals of their own. The good news is that this 3% nonelective contribution not only satisfies the ADP safe harbor, but also satisfies the minimum contribution requirement of a “top-heavy” plan. Matching contributions used in a safe harbor 401(k) plan do not satisfy the top-heavy minimum contribution requirement. The third role the 3% nonelective contribution plays is to assist in meeting the nondiscrimination test under Code §401(a)(4). Thus, the 3% nonelective approach is not only simpler, but also performs triple duty with respect to testing for nondiscrimination. A fourth duty it performs is the elimination of a need to make any matching contribution; it therefore eliminates both the Actual Contribution Percentage (“ACP”) test and the Multiple-Use test which no one really

understands anyway (more of that complicated "simplicity").

Involuntary Cash-Out Threshold Raised to \$5,000

Old law required consent of a participant before a distribution could be made if at any time their vested account balance in the plan exceeded \$3,500. For plan years beginning in 1998, the administrator may elect to cash-out any participant whose vested account balance is \$5,000 or less without the consent of the participant. The plan document need not be amended now because the IRS has determined that this provision may be added later as part of the amendments due before the end of the 1999 plan year **so long as the effective date of the amendment is made retroactively and the plan is operated in a manner consistent with the anticipated amendment. See below.**

1999 Limits.

The elective deferral limit of Code §402(g) remains at \$10,000; the compensation limit remains at \$160,000; and the Social Security Wage Base was increased to \$72,600. The highly compensated employee definition continues to be

employees who earn more than \$80,000 in the previous plan year or 5% owners in either the current plan year or the previous plan year. The definition of "key" employees for purposes of top-heavy plans changes only slightly to officers who earn more than \$65,000, 5% owners, 1% owners who earn more than \$150,000, and one of the 10 largest owners (owning at least 1/2 %) who earn more than \$30,000. Why aren't the "key employee" and the "highly compensated employee" definitions the same? Go figure! And while you have your calculator out, call your Congressperson.

AMENDMENTS

Amendments to plan documents to reflect the changes in qualification provisions of GATT, USERRA, SBJPA '96, and TRA '97 are not required until the last day of the 1999 plan year, unless the plan is terminated in which case the amendments must be in effect on the date of termination. Plans must be operated in accordance with the new rules and then amended retroactively to cover the period affected by the change in the law. It has also been clarified that changes

in the law that are "integrally related" to a qualification provision (those that are permitted to be incorporated into the plan, but not required to be) are covered under the extended "remedial amendment period." For example, a plan sponsor may operate its plan as if the family aggregation provisions had been deleted even though the amendment actually changing the plan provision may not be adopted until the end of 1999.

The changes in the law over the last two and one half years will require a complete restatement of all qualified plans in the 1999 plan year, with corresponding republishing of the SPD, and submission of the plan to the IRS for a new determination letter, unless the plan is allowed to rely on the notification letter issued to REPTECH (e.g., standardized plans).

QUESTIONS?

Contact:

Ralph W. Shaw (ext. 15)

Eileen A. Baldwin (ext. 16)

Denver: 303-292-4015

Toll Free: 1-877-291-4015