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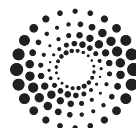

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Setting sail to a safe harbor

IS A SAFE HARBOR 401(K) PLAN RIGHT FOR YOU?

A safe harbor 401(k) plan is a 401(k) that automatically satisfies the nondiscrimination testing rules for elective deferrals and matching contributions. The IRS will consider your plan a safe harbor plan if it satisfies certain contribution, vesting and notice requirements. Safe harbor 401(k)s differ from traditional 401(k)s in ways that are attractive to both employers and employees.

Understanding the differences

So what are the differences between safe harbor and traditional 401(k) plans? First, the IRS doesn't require the typical nondiscrimination testing required for traditional 401(k)s for safe harbor 401(k)s. This can be enticing to employers because it allows them to maximize contributions to owners and not have to worry about actual deferral percentage (ADP) and actual contribution percentage (ACP) testing and correcting testing failures.

Second, unlike traditional 401(k)s, safe harbor 401(k)s *require* plan sponsors to make a safe harbor contribution, either in the form of a matching contribution or nonelective contribution. The basic matching contribution is 100% of the amount of the participant's elective deferrals up to 3% of the participant's compensation, plus 50% of the amount of the participant's elective deferrals between 3% and 5% of the participant's compensation.

The IRS doesn't require the typical nondiscrimination testing required for traditional 401(k) plans for safe harbor 401(k)s.

If you choose instead to use nonelective contributions, they must be a minimum of 3% of the employee's compensation and go to all eligible participants, whether deferring or not. The safe harbor employer contribution is immediately 100% fully vested. This benefit can encourage employee participation in the plan and also help retain current employees and attract new ones.

Setting up a safe harbor plan

Employers can add a safe harbor feature to an existing profit sharing or traditional 401(k). But you must amend your plan before Oct. 1 for a calendar year plan (or 90 days before the end of the plan year for a fiscal year plan). The safe harbor feature is then effective the first day of the next plan year. You can't add a safe harbor feature that is effective in the current plan year.

A new 401(k) plan must have at least three months remaining in the short plan year to immediately start a safe harbor. Otherwise, you'll have to wait until the next plan year to add it, and it won't be effective until the following plan year. The only exception to the three-month rule is for a completely new business. In this situation, you may establish a safe harbor plan with as little as one month left in the plan year.

The minimum requirement for safe harbor 401(k) eligibility is a minimum age of 21 and one year of service, with 1,000 hours worked. You must distribute an annual notice to all eligible employees and participants before Dec. 1 explaining the details and any updates to the safe harbor plan.

Learning more about safe harbor plans

Employers can deduct employer contributions up to 25% of the compensation of all eligible participants. Participants can exclude their elective deferrals from their income for federal income tax purposes.

As with traditional 401(k)s, the IRS applies a 10% penalty to all early distributions (before the age of 59½) from a safe harbor 401(k). Also, participants cannot withdraw safe harbor money for in-service distributions before age 59½ or for hardship distributions.

If you choose to stop safe harbor matching contributions and safe harbor nonelective contributions, you can do so at any time during the year. You must first amend your plan document to remove the safe harbor provision. You'll need to give participants notice of the discontinuance 30 days in advance and allow them to make changes to their deferrals during that period. Because the plan is no longer a safe harbor 401(k), ADP/ACP testing will apply for the entire year.

Don't get top heavy

Safe harbor 401(k) plans can easily become top heavy because key employees can receive maximum contributions. If a plan becomes top heavy (and a key employee defers or receives an allocation of 3% or more), the employer must provide an allocation of 3% to all eligible nonkey employees.

If the plan is making a nonelective contribution of 3% to all employees, it automatically satisfies the top-heavy contribution requirement. If the plan is making a safe harbor matching contribution (and it's not considered exempt), you'll need to make extra contributions of 3% for the eligible employees who aren't deferring and for the participants who are deferring less than 3%.

A safe harbor 401(k) that has only elective deferrals and safe harbor matching contributions is exempt from being top heavy. A safe harbor 401(k) with matching contributions isn't exempt from being top heavy if:

- The plan allows for a discretionary nonelective contribution to be made and one is actually made,
- Forfeitures are allocated to participants in the same manner as nonelective contributions, or
- Employees can defer immediately, but aren't eligible for a matching contribution until after one year of service is completed — this isn't common.

Be safe

Not having to meet the discrimination testing requirements is an attractive proposal for some plan sponsors. But be sure you understand all the requirements of a safe harbor 401(k) plan before you jump ship.

Upcoming compliance deadlines:

10/3* Deadline for setting up a SIMPLE for 2012
10/17* Extended deadline for filing 2010 Form 5500
10/17* Extended deadline for filing 2010 individual tax returns
11/1 2012 SIMPLE notice due to current SIMPLE participants
12/1 2012 safe harbor plan notice due to participants

** This date reflects a two-day extension of the normal deadline, which falls on a Saturday this year.*

Looking for money

WHAT YOU NEED TO KNOW ABOUT PLAN LOANS

Generally, participants can't access the money in their qualified retirement plan accounts until they reach age 59½. But they can take a loan from their plan account if the plan allows for participant loans. Does your plan allow for plan loans and, if so, what are the rules?

How much participants can borrow

Government regulations set the amount of money that a participant can take as a loan. Participants can't borrow more than 50% of their vested account balance, and the dollar amount of the loan cannot be more than $50,000.

The plan may set additional limitations, such as a minimum amount that participants can borrow or the number of outstanding loans a participant may have at one time. Plans that don't set limits in these areas may find themselves overwhelmed with repeated requests and an administrative burden.

How to pay it back

The Department of Labor (DOL) requires payback within five years. However, the DOL makes an exception to the five-year term if the participant uses the loan to purchase a primary residence.

Participants must make payments at least quarterly, in substantially equal amounts and at a reasonable rate of interest. The interest the participant pays goes back into their account, not to the plan sponsor.

Loans are most commonly set up to be repaid by payroll deduction, with payments automatically withheld from the participant's pay. It's up to the employer to transmit these deductions back to the plan in a timely manner. Be careful: The IRS treats participant loan payments like employee 401(k) deferrals when it comes to the seriousness of timely remittance to the plan.

How to handle defaults

If a participant is still employed and stops making payments, the loan is in default. The balance will be a taxable distribution to the participant that he or she must report on his or her individual tax return. Because there's no actual cash distributed at the time of this "deemed" distribution, no tax

is withheld. This may cause personal tax consequences for the participant.

Where the participant is no longer an employee and stops making payments, and the entire balance in the account is going to be distributed, the 20% mandatory withholding is paid out of the remaining cash proceeds prior to distribution of the account. The participant has the option of paying off the loan on termination, which would allow for a rollover of the entire balance into an IRA or other qualified plan. The distribution and taxation rules are complex, so contact your benefits specialist for more information.

The plan may set additional limitations, such as a minimum amount that participants can borrow or the number of outstanding loans a participant may have at one time.

How to start the process

The DOL requires retirement plans that allow loans to have a written loan program. The program must spell out how much money participants can borrow, how they'll pay the loan back and what happens if they don't. The summary plan description (SPD) must tell participants whether this option is available. The SPD should detail the process and provisions specific to your plan.

If a participant determines that taking a loan from his or her retirement account is the right choice, start the process with a loan application. This will allow the participant to specify the amount to borrow and set the payment terms. Generally, the plan administrator must approve the application. He or she will make sure the loan complies with both DOL regulations and any other plan document requirements.

Some companies also have a relationship with an outside plan professional, either a third-party administrator (TPA) or certified public account (CPA), who assists in these matters. The TPA or CPA can assist with preparing the necessary paperwork, as well as requesting the funds according to the completed loan application. Plans generally choose to pass the fees charged for these services to the participant. Most plans allow participants to pay those fees personally or from their retirement plan account.

Making the decision

If your plan has an optional loan feature, make sure your participants are aware of this benefit. Remind them that, just as with any loan, they must follow the terms and make scheduled payments. By providing detailed and clear information to participants, they'll be able to determine whether it's a realistic option before finalizing the decision and signing the forms.

Plan document vs. summary plan description

While employers and plan sponsors strive to be consistent with the retirement plan information given to participants, on rare occasions a conflict in information may exist. In a recent case, plan participants sought to enforce the language of a misleading summary plan description (SPD) that didn't agree with the terms of the plan document. But the U.S. Supreme Court, in *CIGNA Corp. v. Amara*, reinforced the rule that the plan document controls the benefits and held that courts cannot change the benefits provided by the plan document.

The background

The case originated when CIGNA converted its pension plan into a cash balance plan. Before the conversion, CIGNA provided retiring employees with a defined benefit annuity that was "calculated on the basis of preretirement salary and length of service." After converting to a cash balance plan, retiring employees received a lump-sum cash payment that was "calculated on the basis of a defined annual contribution from CIGNA as increased by compound interest." Various features of the new plan meant that some employees, in fact, received fewer benefits than they would have under the pre-1998 defined benefit plan.

CIGNA didn't explain that the employees would receive fewer benefits in its descriptions of the new plan. Instead, it told employees that the new plan provided "an overall improvement in retirement benefits" and guaranteed that retiring employees would receive at least as much as the benefits to which they were entitled as of the conversion date.

The participants sued, claiming that CIGNA didn't satisfy ERISA disclosure requirements during the transition to the cash balance plan. The District Court agreed and "reformed" the new plan and ordered CIGNA to pay benefits under the reformed plan. On appeal, the Second Circuit Court of Appeals agreed. CIGNA then appealed to the Supreme Court.

The Supreme Court rejected the argument that the participants had to only show "likely harm" to pursue their claim and found that they must suffer actual harm.

The Court speaks

The Supreme Court found that ERISA only grants courts the ability to enforce plan terms, not to change them. This meant that the District Court couldn't modify the plan's terms. Also, the participants couldn't base their claim for ERISA benefits on incorrect information in summary documents,

such as an SPD or a summary of material modifications. Instead, they could base their claim for benefits only on what the plan document provides. The Supreme Court also rejected the argument that the participants had to only show "likely harm" to pursue their claim and found that they must suffer actual harm.

But it wasn't all bad news for the participants. The Supreme Court found that "equitable remedies" under ERISA might include monetary damages or equitable estoppel. Even though the District Court couldn't reform the plan, it could use some other form of remedy to compensate the plaintiffs — just not plan benefits. So while this case affirms that ERISA doesn't provide specific relief for misrepresentations, it does allow courts to re-evaluate what equitable remedies might be available in these situations.

Be clear

If your plan has a separate SPD and plan document, now would be a good time to review them. Make sure the plan document actually provides the benefits you think it provides — and that the SPD is consistent with the plan document.

Final IRS hybrid plan regulations now a reality

Hybrid retirement plans combine features of defined contribution and defined benefit plans. The IRS recently issued final hybrid plan regulations reflecting the changes made by the Pension Protection Act of 2006. Generally, the final regulations apply to plan years beginning on or after Jan. 1, 2011.

Here are highlights of some of the provisions in the final regulations:

3-year vesting requirement. If the plan determines any portion of an accrued benefit is using a statutory hybrid benefit formula, it must vest participants with 100% of their accrued benefit after three years of service. Also, the regulations subject the entire benefit to this vesting requirement, not just the portion determined by the statutory formula.

Safe harbor for age discrimination. A participant's accumulated benefit (as of any date) can't be less than any similarly situated younger participant's accumulated benefit. An individual is similarly situated to another if they're identical in every way (other than age) that's relevant in determining their vested accrued plan benefit. Also, to satisfy the safe harbor, you must compare the benefits using the same formula.

Conversion protection. Any plan converting from a traditional defined benefit plan to a hybrid plan must provide a benefit that is, at minimum, equal to the benefits accrued through the date of conversion, plus the benefits earned after the conversion date. An alternative approach requires the plan to establish an opening hypothetical account balance. You must then separately account for the opening hypothetical account balance and related interest, and the postconversion hypothetical contributions and related interest.

Market rate of return. The rate at which the plan credits interest can't be more than the market rate of return. Plans must specify how they determine interest credits and how often they make them (at least annually).

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