Maximizing Your 401(k) Contributions Through a Safe Harbor Plan

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As the popularity of 401(k) Plans increase, more and more business owners are finding themselves with a difficult dilemma. Originally, the owner may have decided to implement a 401(k) as much for his own tax and retirement planning benefits as for his employees. While the company remained small, and a high percentage of the employees participated in the plan by deferring their own income, the owner was able to contribute a healthy sum on his own behalf to the plan.

As companies grow, however, it is often more difficult to maintain a high percentage of employee contribution to the plan. Even in companies with high participation but a large number of employees, the same ultimate problem can result – the owner and other highly compensated employees become exceedingly limited in the amounts of personal income they can defer into the plan. This occurs because traditional 401(k) plans are structured in such a way that the average deferral allowed on the part of the highly compensated group is dictated by the average deferral of the non-highly compensated group.

There is a way for the highly compensated employees to defer the maximum $17,500 or $23,000 if age 50 or older (2013) to a 401(k) through the use of a Safe Harbor 401(k) Plan. For some, the new Safe Harbor Plans are ideal. Others find them to be too expensive and believe they provide too little incentive for the employees to contribute toward their own retirement and to remain employed with the company.

In summary, Safe Harbor 401(k) Plan allows all highly compensated employees to maximize their personal contribution to the plan ($17,500 in 2013). The catch, however, is this. The employer must decide between two Safe Harbor formulas that mandate employer contributions. The first is the 3% non-discretionary formula where every eligible employee receives the 3% of salary contribution whether they are deferring into the plan or not. The other formula – Safe Harbor Match – requires an employer contribution for only those employees actually deferring. This formula calls for 100% of the first 3% plus 50% of the next 2%. In essence, if an employee defers 5% of their salary, the employer contributes 4%. All Safe Harbor contributions are always 100% vested.

For some employers, it is easy to transition into the Safe Harbor provisions, but for most it is a difficult jump. Those who have plans that are already top-heavy, requiring them to make the 3% mandated annual contribution, will not experience much change from a cash flow standpoint. Their only obstacle might be the fact that now the 3% contribution will not be subject to a vesting schedule. However, these employers often find the vesting issue to be a small price to pay in order to enable them to significantly increase their personal pre-tax contribution amounts.

On the other hand, those employers who have been matching with a maximum out of pocket expense of 1% or 2% for only those employees participating in the 401(k) Plan, may find it to be a stretch to contribute 3% for all employees. Some also take issue with the immediate vesting of their 3% contributions, not wanting to give an extra benefit to those who may not remain employed with the company beyond their first year of employment.

To obtain a proposal for or additional information on Safe Harbor 401(k) Plans, please contact us.