



Important Information

Plan Administration and Operation

April 2000*

Improved ADP and ACP Safe Harbor Plan Designs

WHO'S AFFECTED This information applies to defined contribution plans with a 401(k) feature or employer matching contributions that must satisfy the actual deferral percentage (ADP) or actual contribution percentage (ACP) test each year.

BACKGROUND AND SUMMARY The Small Business Job Protection Act of 1996 (SBJPA) created a new "safe harbor" 401(k) plan design that eliminated the need to perform the ADP test if certain contribution requirements are met. SBJPA also created a safe harbor design that would automatically satisfy the ACP test with respect to employer matching contributions.

In late 1998, and early 2000, the IRS provided guidance for designing plans to meet the safe harbor requirements. This issue of *Pension Analyst* summarizes these requirements.

ACTION AND NEXT STEPS You should review this guidance carefully and compare it with your current plan design before making any decisions. In addition, you should also compare the costs of your current plan design to the cost of the safe harbor plan design, including the associated administrative costs. After your analysis, if you are still interested in a safe harbor plan design, you should contact your Prudential Retirement Representative who will discuss your plan design options with you.

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Improved ADP and ACP Safe Harbor Plan Designs

To simplify nondiscrimination testing rules that apply to 401(k) plans, the Small Business Job Protection Act of 1996 (SBJPA) introduced safe harbor plan designs for these plans. A plan that uses a safe harbor design does not need to perform the annual actual deferral percentage (ADP) and actual contribution percentage (ACP) tests as long as it also meets specific plan document and participant notice requirements.

ADP Safe Harbor

Plans Eligible to Use ADP Safe Harbor Design

In general, a 401(k) plan may use the ADP safe harbor design to avoid ADP testing only if it:

- Has a full 12-month plan year; and
- Provides one of the permissible safe harbor contributions.

In the case of a new 401(k) plan, the initial plan year does not have to be 12 months long to take advantage of the ADP safe harbor, but does have to be at least three months long. This exception to the 12-month plan year requirement also applies where an existing profit sharing plan adds a 401(k) feature. *For example, a profit sharing plan with a calendar plan year may add a safe harbor 401(k) feature effective October 1, 2000.*

In general, the plan document must be amended before the first day of the applicable plan year to specify that the safe harbor design will be used. In addition, the plan sponsor must distribute notices to participants before the first day of the plan year to tell them this design is in effect.

However, a plan that uses the current year ADP testing method may be amended as late as 30 days before the end of the plan year to instead provide the safe harbor nonelective contribution for that entire year. *For example, a 401(k) plan with a calendar plan year may be amended as late as December 1, 2000, to provide the safe harbor nonelective contribution instead of performing the ADP test.* To take advantage of this special rule, the plan sponsor must distribute notices to participants before the first day of the plan year, explaining that the plan *may* be amended during the upcoming year to adopt the safe harbor nonelective contribution. The plan sponsor must then provide a supplemental notice, no later than 30 days before the end of the plan year, stating that this contribution will be made. For administrative ease, this supplemental notice may be provided as part of the safe harbor notice for the following plan year.

ADP Safe Harbor Contributions

To qualify for the ADP safe harbor, a 401(k) plan must provide one of the following types of employer contributions:

- A matching contribution, using either
 - The Basic Matching Formula, or
 - An Enhanced Matching Formula; or
- A nonelective contribution equal to at least 3% of compensation.

The "Basic Matching Formula" is a formula that matches 100% of Elective Contributions up to 3% of Compensation plus 50% of Elective Contributions from 3% to 5% of Compensation.

An "Enhanced Matching Formula" is a formula that provides:

1. A rate of matching contributions that does not increase as the employee's rate of pre-tax deferral contributions increases; and
2. At any rate of deferral contributions, a total matching amount equal to at least the total amount of match that would have been provided under the Basic Matching Formula.

The ADP safe harbor contribution must also be:

- Required to be made under the terms of the plan document. A discretionary contribution does not count as a Safe Harbor contribution. In addition, if these contributions are made to a profit sharing plan, the plan must not require the existence of profits for the contribution to be made. However, unlimited additional discretionary contributions may be made to the plan, in excess of those required to meet the safe harbor design rules.
- 100% immediately vested.
- Subject to the 401(k) withdrawal rules and therefore not available for hardship withdrawals.
- Based on a nondiscriminatory definition of compensation. This may be a safe definition or one that requires compensation nondiscrimination testing. The plan may not limit the amount of compensation on which the contribution is based, except in accordance with the annual adjusted \$150,000 compensation limit. The plan may limit the compensation

measurement period to the period during which the employee is eligible to participate in the plan.

- Made to each eligible Non-Highly Compensated Employee (NHCE). The plan may not require the NHCE to be employed on the last day of the plan year to receive the contribution.

In addition, if the plan provides a safe harbor matching contribution, the rate of matching contributions for any Highly Compensated Employee (HCE) cannot be greater than the rate of matching contributions for any NHCE with the same rate of pre-tax deferral contributions.

ADP safe harbor contributions must be made to a defined contribution plan but do not have to be made to the same plan to which the employee pre-tax deferral contributions are made. They may even be made to a money purchase pension plan or to an employee stock ownership plan (ESOP). However, if the safe harbor contributions are made to another defined contribution plan:

- Each employee who is eligible for the 401(k) plan must be eligible to participate under the other plan under the same terms and conditions;
- Both the 401(k) plan and the other plan must have the same plan year; and
- The safe harbor contribution may not be used to satisfy the safe harbor requirements under more than one plan.

Restrictions on Deferral Contributions Under the ADP Safe Harbor

A 401(k) plan that wants to use the ADP safe harbor design may impose the following restrictions on NHCEs' pre-tax deferral contributions:

- The plan may limit the frequency and duration of periods in which eligible employees may make or change cash or deferred elections. *For example, a plan may permit employees to change deferral elections only twice per plan year.* However, employees must have at least 30 days after receipt of the required annual notice to make or change such election for the plan year.
- The plan may require employees to make their deferral elections in whole percentages of compensation or whole dollar amounts.
- The plan may limit the amount of elective contributions that an employee may make. *For example, the plan may limit deferrals to 15% of compensation.* However, each eligible NHCE must be able to make elective deferrals in an amount sufficient to receive the maximum available amount of match and must be able to elect to make any lesser amount of pre-tax contributions.
- The plan may limit the types of compensation that may be deferred as long as each eligible NHCE may make elective contributions under a "reasonable" definition of compensation. This definition of compensation does not have to be a nondiscriminatory definition of compensation and can be different from the compensation on which the matching or nonelective contribution is based.

- The plan may limit the amount of deferral contributions to comply with the annual elective deferral limit (\$10,000 for 1999) or the annual additions limit or on account of a suspension due to a hardship withdrawal.

All other standard 401(k) rules apply to a plan that uses the ADP safe harbor design. *For example, benefits other than matching contributions may not be contingent on an employee's election to make pre-tax contributions.*

Ability to Abandon an ADP Safe Harbor Design

In general, once a plan sponsor has decided to provide ADP safe harbor contributions and has provided the required participant notices, the plan is committed to this design for the entire plan year. However, if a plan begins the year with a safe harbor matching contribution, it may be amended during that year to reduce or eliminate the matching contributions, provided certain requirements are met.

To abandon a safe harbor matching contribution, the plan sponsor must provide a supplemental notice to all eligible employees, which:

- Explains the consequences of the amendment;
- Identifies the effective date of the reduction or elimination of matching contributions; and
- Provides employees with a reasonable opportunity to change their pre-tax deferral and, if applicable, employee post-tax contribution elections.

This notice may be provided as a written paper document or through an electronic medium (such as e-mail, an internet/intranet site, or an automated telephone system). The rules for providing electronic notices are discussed later in this publication.

The plan document must be amended to reflect this change, which may be effective no earlier than the later of:

- 30 days after the supplemental participant notice is provided; or
- The amendment adoption date.

The amendment must provide that the ADP test (and, if applicable, the ACP test) will be performed and satisfied for the *entire* plan year, using the current year testing method.

For example, a 401(k) plan with a calendar plan year may begin the 2000 plan year with an ADP safe harbor Enhanced Matching Formula. On May 1, 2000, the plan sponsor decides that it is too expensive to continue providing this contribution and will take its chances with performing the ADP and ACP tests on a current year basis. If eligible employees are provided with the required supplemental notice by May 15, 2000, and the required plan amendment is also adopted on May 15, 2000, the amendment may be effective no earlier than June 14, 2000.

While a safe harbor nonelective contribution may be added mid-year, the nonelective contribution may not be abandoned mid-year.

Sample ADP Safe Harbor Designs

Assuming that the plan amendment and participant notice requirements are met along with all other basic design requirements described above, the following contribution formulas would meet the ADP safe harbor rules:

- A matching contribution of 100% of the employee's pre-tax deferral contributions up to 4% of compensation. This design uses an Enhanced Matching Formula.
- A matching contribution of 150% of the employee's pre-tax deferral contributions up to 3% of compensation. This design also uses an Enhanced Matching Formula.

ACP Safe Harbor

Plans Eligible to Use ACP Safe Harbor Design

A plan may use the ACP safe harbor design to avoid ACP testing if it:

- Provides employer matching contributions;
- Uses an ADP safe harbor design;
- Has a full 12-month plan year; and
- Provides one of the permissible safe harbor contributions.

Here too, there is an exception to the 12-month plan year requirement for new plans, as long as the initial plan year is at least three months long. However, there is no exception for the addition of a matching contribution feature to an existing 401(k) plan.

As in the case of the ADP safe harbor, the plan document must be amended before the first day of the applicable plan year to specify that the safe harbor design will be used. In addition, the plan sponsor must distribute notices to participants before the first day of the plan year to tell them this design is in effect.

Restrictions on the Use of the ACP Safe Harbor Design

Due to the eligibility requirements noted above, the ACP safe harbor design may be unavailable or unattractive to a plan that permits or requires employee post-tax contributions:

- A plan that has employee post-tax contributions that are subject to the ACP test, but does not provide employer matching contributions, may not use the ACP safe harbor design.
- A plan that provides employer matching contributions and also requires or permits employees to make employee post-tax contributions, may use the ACP safe harbor design, but will still have to perform an ACP test on the employee post-tax contributions.

In addition, the ACP safe harbor design is not available to:

- A 401(k) plan that actually performs the ADP test; or
- A plan that does not permit employee pre-tax deferrals (*for example, a non-401(k) profit sharing plan that matches employee post-tax contributions*).

ACP Safe Harbor Contributions

To qualify for the ACP safe harbor, a plan must meet both of the following requirements for the entire plan year:

- Each eligible NHCE is also an eligible employee under a 401(k) plan that satisfies the ADP safe harbor requirements; and
- The plan satisfies the Matching Contribution Limitations, described below.

The Matching Contribution Limitations require the plan to provide one of the following types of matching contributions:

- ADP Safe Harbor Basic Matching Formula contributions. The plan may provide no other matching contributions.
- ADP Safe Harbor Enhanced Matching Formula contribution that matches deferrals not exceeding 6% of compensation. The plan may provide no other matching contributions.
- Matching contributions that meet all of the following requirements:
 - The rate of matching contributions does not increase as the rate of employee pre-tax or post-tax contributions increases;
 - At any rate of employee pre-tax or post-tax contributions, the rate of matching contributions for any eligible HCE does not exceed the rate applicable to an eligible NHCE with the same rate of employee pre-tax or post-tax contributions.
 - There is no match on employee pre-tax or post-tax contributions that in total exceed 6% of an employee's compensation.
 - The plan imposes on employee pre-tax and post-tax contributions only those restrictions permitted under the ADP safe harbor design and discussed above.

A plan would look to this design option to meet the ACP safe harbor if it:

- Meets the ADP safe harbor by making a 3% (or greater) nonelective contribution; or
- Meets the ADP safe harbor using either the Basic Matching Formula or an Enhanced Matching Formula and makes additional discretionary matching contributions; or
- Meets the ADP safe harbor using an Enhanced Matching Formula that matched deferrals exceeding 6% of compensation.

Under this design option, matching contributions may be subject to a vesting schedule and may be eligible for hardship withdrawals.

In general, an ACP safe harbor plan may make discretionary matching contributions only to the extent they do not exceed a dollar amount equal to 4% of any employee's compensation.

Participant Notice Requirements

Method of Delivery

A plan sponsor must notify all eligible employees if it intends to use a safe harbor plan design or if it wants to be able to switch from a current year ADP testing basis to the safe harbor nonelective contribution during the upcoming plan year. This notice may be provided as a written paper document or through an electronic medium (such as e-mail, an internet/intranet site, or an automated telephone system). If the notice is provided electronically:

- The electronic medium must be reasonably accessible to the employee.
- The medium used must provide the notice in a manner that is no less understandable to the employee than a written paper document.
- At the time the notice is provided, the employee is notified that he may request and receive a written paper notice at no charge.
- The plan sponsor must, in fact, provide the written notice at no charge, upon request from an employee.

The notice must be written in a manner so it can be understood by the average eligible employee. It must also satisfy both content and timing requirements.

Content Requirement

The notice must be sufficiently accurate and comprehensive to inform the employee of his rights and obligations under the plan. In general, the notice must accurately describe:

- The Safe Harbor Matching or Nonelective Formula used, including a description of the levels of Match provided, if any, and state that these contributions (as well as the deferral contributions) are fully vested when made;
- Any other contributions under the plan (including the potential for discretionary Match) and conditions under which these conditions are made;
- The plan to which the Safe Harbor Contribution will be made (if other than the plan containing the cash or deferral arrangement);
- Type and amount of Compensation;
- How to make cash or deferred elections, including applicable administrative requirements;
- Periods available for making cash or deferred elections; and
- Withdrawal and vesting provisions applicable to plan contributions.

A shorter safe harbor notice may be provided if it cross-references an up-to-date Summary Plan Description for provisions describing:

- Non-Safe Harbor Contributions provided under the plan;

- The plan to which the Safe Harbor Contribution will be made;
- The type and amount of Compensation that may be deferred; and
- The withdrawal and vesting provisions applicable to plan contributions.

The shorter safe harbor notice must still accurately describe:

- The Safe Harbor Matching or Nonelective Formula used, including a description of the levels of Match provided, if any, and state that these contributions (as well the deferral contributions) are fully vested when made;
- How to make cash or deferred elections, including applicable administrative requirements; and
- The periods available for making cash or deferred elections.

It must also provide information that makes it easy for eligible employees to obtain information about the plan. This information may include telephone numbers, addresses and, if applicable, electronic addresses of individuals or offices who can provide the plan information.

Timing Requirement

In general, the plan sponsor must give the notice to employees within a reasonable period before the beginning of the plan year. For an employee who becomes eligible to participate in the plan after the beginning of the plan year, the employee must receive the notice within a reasonable period before the employee becomes eligible. A reasonable period is based on all relevant facts and circumstances.

However, a plan satisfies the timing requirement if the notice is given at least 30 days and no more than 90 days before the beginning of each plan year. In addition, if the employee becomes eligible after the 90th day before the beginning of the plan year, the timing requirement is satisfied if the notice is provided more than 90 days before the employee becomes eligible and no later than the date the employee becomes eligible.

If a plan sponsor adopts an ADP safe harbor design for the first time for a plan year beginning on or after January 1, 2000, and before June 2, 2000, a special notice deadline of May 1, 2000 applies.

Other Testing Requirements

Plans that use the ADP or ACP safe harbor designs must still satisfy other nondiscrimination tests such as coverage, top heavy, compensation, annual additions and, if applicable, nondiscriminatory availability of benefits, rights and features. However, if a plan satisfies both the ADP and the ACP safe harbor design rules and does not accept employee post-tax contributions, it does not have to perform a "Multiple Use" test.

Plan Document Considerations

If a plan sponsor chooses to use a safe harbor design, the plan must specify which of the alternatives it is using. If safe harbor matching contributions or nonelective contributions are made to another plan, the name of the other plan must be stated in the plan document. Generally, a plan sponsor that intends to use the safe harbor provisions for a plan year must adopt those provisions before the first day of that plan year. In addition, the other plan must also adopt, before the first day of that plan year, provisions specifying that safe harbor contributions will be made and provide for vesting and withdrawal restrictions.

However, if a plan sponsor wants to use the ADP or ACP safe harbor design for the 1999 or 2000 plan year, that amendment does not need to be adopted before the start of the year. Instead, it must be adopted by the SBJPA amendment deadline, which is generally the last day of the 2000 plan year, and must be effective retroactively to the first day of the appropriate plan year.

Next Steps

If you are interested in using the design-based safe harbor method for meeting ADP and ACP testing requirements, you should first compare your current plan design with the safe harbor method. This comparison also requires analyzing the current cost of your plan against the cost of implementing a safe harbor method.

After you have completed your analysis, if you wish to adopt a safe harbor design, you should contact your Prudential Retirement Representative who will discuss your plan design options with you.

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