



JENNINGS LAW FIRM

memorandum

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“SAFE HARBOR” 401(k) PLANS

Virtually every employer who maintains a 401(k) plan has had to refund to one or more of its highly compensated employees (HCEs) part of their 401(k) contributions because the plan failed the ADP test. [In general, the level of 401(k) contributions that the HCEs can make is determined by the 401(k) contributions made by the non-HCEs. If the Non-HCEs do not contribute, neither can the HCEs. The ADP test is the test that determines if the HCEs over contributed.] The ADP test has been a significant impediment to many employers, particularly closely held employers, establishing 401(k) plans.

Congress has responded and created what is called the “safe harbor” 401(k) plan. If the employer makes one of two kinds of “safe harbor” contributions, then the plan automatically passes the ADP test. In fact, the employer does not even have to run the ADP test. If the employer offers a matching contribution, the employer can automatically pass the test on those contributions (called the ACP test) as well.

What is a safe harbor 401(k) plan?

A safe harbor 401(k) plan is a 401(k) plan to which the employer makes either of the following contributions:

1. A fully vested contribution equal to 3% of pay for each Non-HCE employee who is eligible to make a 401(k) contribution for the plan year, or
2. A fully vested matching contribution for each Non-HCE of (a) 100% of the employee’s 401(k) contribution up to 3% of pay, and (b) another 50% matching contribution on 401(k) contributions between 3% and 5% of pay.

The employer is also required to provide a special annual written notice to each plan participant that describes the safe harbor contribution being made and certain other information.

What if the plan is “top-heavy”?

The safe harbor contribution counts towards the employer’s top-heavy contribution.

Can the employer make other contributions to the plan?

Yes.

What if the plan is age-weighted (or cross-tested)?

The 3% of pay safe harbor contribution is counted as part of the employer’s age-weighted contribution. The matching contribution is not.

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When does the annual written notice have to be given?

The employer has to furnish the written notice at least 30 days before the beginning of the plan year. If the employer establishes a new 401(k) plan, the notice can be given when the plan is established.

What if an employer does not presently maintain a retirement plan?

An employer may establish a new safe harbor 401(k) plan at any time during the year.

What kinds of employers are the best candidates for a safe harbor 401(k) plan?

Employers with a top-heavy plan should very definitely consider a safe harbor 401(k) plan. The safe harbor contribution counts toward the employer's top-heavy minimum contribution and guarantees each HCE can contribute up to their full 401(k) dollar limit (\$15,500 in 2007, not counting the "catch-up contribution").

Employers with an age-weighted plan should consider adding a safe harbor contribution. Allowing HCEs to make 401(k) contributions could reduce the amount the employer has to contribute for Non-HCEs under the age-weighted formula.

How do I determine if my company should establish a safe harbor 401(k) plan?

Our firm will review your existing plan at no cost and discuss with you how a safe harbor plan would benefit your company. If you do not presently have a plan, we can discuss how a qualified retirement plan can benefit your company.

A tax qualified retirement plan is one of the best tax shelters available to the owner of a business. Properly established and maintained, the IRS will never disallow the deduction for contributions and all earnings will be tax deferred until distributed.

If you would like additional information about retirement plans in general or safe harbor 401(k) plans, please call Lee T. Jennings in our office at 312.332.7733.

Please visit our website at www.danaconsulting.com