Is It Possible to Split Eligibility to Allow for Deferrals but to Postpone Safe Harbor Contributions?

Facts

We allow new employees to join our 401(k) plan on the first of the month after they are hired. They become eligible to make deferrals and also receive the company safe harbor contribution at that time. We don't have high turnover, but employees who leave often do so within the first year of joining us. We don't mind allowing new hires to contribute to the plan out of their own paychecks, but since safe harbor contributions must be immediately vested, it feels like we are wasting company money by giving a contribution to someone who might leave in a relatively short timeframe.

Question

Is it possible to split eligibility so that new hires can make 401(k) deferrals right away but postpone eligibility for safe harbor contributions until they have been with me for a year?

Answer

So, the cringeworthy answer is…you guessed it…it depends. We know, that's not much help as you try to navigate the options available, so don't worry, we're not going to leave you hanging.

TL;DR

Technically, as long as the provisions are set in your plan document, there is no issue with having a different eligibility for 401(k) deferrals, safe harbor contributions, and / or discretionary employer contributions like matching and profit sharing. If your document allows this "split eligibility" between money types and you're following your document, you're good to go.

The Details

If that sounds too simple and you were waiting for the "but," here we go! There are usually two reasons that companies implement safe harbor provision:

- ADP/ACP Test Safe harbor plans enjoy a free pass on the ADP test and, as long as certain conditions are met, on the ACP test as well. This allows the highly compensated employees to defer up to the maximum regardless of how much the non-HCEs contribute.
- Top Heavy Plans that include only deferrals and safe harbor contributions are deemed to automatically satisfy the top heavy rules.
- Splitting the eligibility requirements between 401(k) and safe harbor generally does not affect your ADP/ACP test, but it can absolutely affect the impact of the top heavy requirements and create a real and quite unpleasant "gotcha moment." Here's why.

When a plan is top heavy, the company must provide a minimum contribution (generally equal to 3% of pay) for each non-key employee who is *eligible to make 401(k) deferrals* and employed on the last day of the plan year. As long as all non-key employees who are eligible to make deferrals receive the safe harbor contribution (assuming they actually defer, in the case of the safe harbor match), the plan is deemed to satisfy the top heavy requirements even some end up receiving less than 3% of pay.

You can probably guess where this is going. As soon as eligibility is split, a subset of employees (shorter service ones, in this case) are eligible to defer but not to receive the safe harbor contribution. That means the free pass on the top heavy requirements is blown with respect to those participants.

What does this mean to you as a plan sponsor? You can still choose to split your plan's eligibility requirements; however, the thing you'll want to keep in mind to avoid that gotcha moment is that those individuals who are eligible to defer but are not yet eligible for safe harbor contributions must still receive a top heavy minimum contribution (even if they choose not to make 401(k) deferrals into the plan). Theoretically, that could mean one of those short service employees who does not defer could end up receiving a bigger benefit than a longer service employee who chooses to defer a small amount. Yikes! Probably not the result you were hoping to achieve.

The need to provide a top heavy contribution isn't necessarily a bad thing as long as you know it might be coming. Unlike safe harbor contributions, top heavy contributions can be subject to a vesting schedule so that anyone who leaves before completing two years of service forfeits those dollars (i.e. that money goes to the forfeiture account and you can use it to fund future contributions or plan expenses). In this case, the vesting schedule allows you to ensure that only those employees who are with you a year or more actually get to take employer contributions with them when they leave; this is true despite the fact that you begin making contributions on their behalf as soon as they are eligible for 401(k) deferrals.

Bottom line here? Even those questions that may seem straightforward have the potential for a few extra twists and turns to consider. If you have questions on plan design changes or the potential impact of a plan provision, your DWC Team is here to help!

Related Resources

- Nondiscrimination Testing: Top Heavy vs. ADP

Want to get articles just like this one delivered to your inbox weekly?

Subscribe to receive regular updates from the DWC 401(k) Q&A blog.

Helpful insights without the junk, delivered on your schedule.