Safe Harbor 401(k) Match vs. Non-Elective: Two Words for the Same Thing or Two Different Options?

Facts

I recently got a promotion at work, and one of my new job responsibilities is to help manage our company's retirement plan. It is a safe harbor 401(k) plan. A number of our employees are about to become eligible for the plan, and they are asking me questions about the company matching contribution. From what I can tell, we make a contribution for everyone who is eligible even if they are not contributing for themselves.

Question

Since the company contribution goes to everyone, is it really a match?

Answer

In general, there are two broad categories of company contributions to a 401(k) plan – a match and a nonelective (a/k/a profit sharing) contribution – and it is not uncommon for the two terms to be used interchangeably even though the contribution types are quite different. We've heard all of them referred to as matching contributions, all as profit sharing contributions, and even the all-encompassing "profit sharing match" contribution. We're here to help you set the record straight.

When it comes to safe harbor 401(k) plans, the company contribution can be in the form of either a match or a nonelective contribution (also referred to as a NEC – because acronyms). Based on the facts you have provided, you're already on the right track to understanding the primary difference. While a nonelective contribution goes to all employees who are eligible for the plan, a matching contribution only goes to those who contribute out of their paychecks. That is actually true of all 401(k) plans, not just safe harbor plans.

Choosing The Best Option

You may now be wondering whether one type of safe harbor contribution is better or worse than the other. The answer really depends on what the company is hoping to achieve with its retirement plan as well as the budget for making contributions.

If the company philosophy is more paternalistic, seeking to ensure that all eligible employees receive a benefit, then the NEC is probably the way to go. In addition, the safe harbor NEC coordinates well with what is referred to as a new comparability profit sharing formula. On the other hand, the match may be the better option if the company is trying to encourage participants to save for themselves.

From a budget standpoint, employee contribution rates are a significant driver. The minimum required NEC is 3% of compensation, while the minimum required match formula yields a match of 4% of pay for any employee who defers 5% or more of pay from his or her paycheck. If not that many employees defer or they defer at lower rates, the matching contribution will generally be the less expensive option.

Lower deferral amounts = lower matching contributions. However, if most participants defer at a rate that entitles them to the maximum match (or close to it), the 3% NEC will be less expensive. In terms of cash flow more than budget, safe harbor matching contributions are sometimes (depending on other plan features) required to be deposited at least quarterly, while the outside deadline to deposit the NEC is the last day of the following year.

Switching Contribution Types

You may be wondering whether it is possible to switch from a safe harbor match to a NEC or vice versa. The short answer is yes, but it wouldn't be a 401(k) plan if there wasn't a longer answer to go with that.

Making the change requires a formal plan amendment, which can only be effective as of the start of a subsequent plan year. In other words, once the year has started using one type of contribution or the other, the contribution type can no longer be changed for that year. In addition, participants must be notified of the change between 30-90 days before it takes effect.

A word of caution is in order. We have seen situations when companies have chosen to switch from a safe harbor NEC to a match, thinking their participants' low deferral rates would make the match less expensive. However, as soon as the participants realized they could receive a larger company contribution by increasing their deferrals, many did just that, resulting in a higher overall cost to the company. Again, if the goal was to encourage savings, this would have been a huge success. But with the goal of cost-savings, making the change did not produce the desired outcome.

If you aren't sure which option is best for your company, give us a call. We are available to review your current plan design and run some cost/benefit projections to illustrate the impact of different options.

Related Resources

- What are the Different Types of 401(k) Contributions?
- What is a True-Up Matching Contribution?

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