

Needed Relief for Suspension of Safe Harbor Nonelective Contributions Arrives—With a Catch

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The Internal Revenue Service (IRS) issued proposed regulations that provide some needed relief regarding the suspension of employer contributions under safe harbor 401(k) plans. *See* 74 Fed. Reg. 23,134 (proposed May 18, 2009). Review the proposed guidance at <http://edocket.access.gpo.gov/2009/pdf/E9-11481.pdf>. However, there is a catch if employers want to suspend their safe harbor *nonelective* contributions, but that catch does not apply if employers want to suspend their safe harbor *matching* contributions. This guidance is proposed to be effective for amendments adopted after May 18, 2009. Because this guidance has been issued in proposed form, it is subject to changes and finalization by the IRS, but plan sponsors may rely on this guidance until it is finalized.

Due to the current economic downturn, many plan sponsors have been forced to look for ways to cut costs, and many have considered and/or implemented reducing or suspending employer contributions under their 401(k) plans. If the plan is not a safe harbor 401(k) plan (and does not involve unionized employees), this may be as easy as amending the plan to reflect the reduction (followed by timely notice to participants). However, if the plan is a safe harbor 401(k) plan, the issue becomes more complicated.

A “safe harbor 401(k) plan” is a plan that is deemed to satisfy certain nondiscrimination tests because employer contributions satisfy the safe harbor rules. Two types of employer contributions may be used to satisfy these rules: matching contributions or nonelective contributions. Matching contributions are a specified percentage of participants’ salary deferrals, while nonelective contributions are a flat percentage of participants’ compensation, similar to a profit-sharing contribution.

Contributions under safe harbor 401(k) plans generally need to be maintained for the entire plan year. However, rules allowing for the reduction of safe harbor *matching* contributions (as opposed to nonelective contributions) after the beginning of the plan year have been around for years. But, previous to the May IRS guidance, there was no authority that allowed safe harbor nonelective contributions to be reduced midyear. This took a lot of employers by surprise this year when they wanted to reduce their safe harbor nonelective contributions but then realized that, due to a simple design choice, they could not reduce their contributions until next year.

The guidance provides that safe harbor nonelective contributions may now be suspended after the beginning of the plan year, provided certain rules are met. These rules are generally similar to the rules

governing the suspension of safe harbor matching contributions, with one major exception. The “catch” is that safe harbor nonelective contributions can only be suspended if a plan sponsor incurs what the IRS guidance calls a “substantial business hardship,” while safe harbor matching contributions can be suspended regardless of whether a substantial business hardship has occurred.

The guidance does not describe what would constitute a “substantial business hardship,” but it does refer to the use of the term in another context. In this other context (a request for a waiver of the minimum funding requirement under section 412(c)), the factors taken into account in determining if a substantial business hardship has occurred include (but are not limited to) whether or not—

- the employer is operating at an economic loss;
- there is substantial unemployment or underemployment in the trade or business and in the industry concerned;
- the sales and profits of the industry concerned are depressed or declining; and
- it is reasonable to expect that the plan will be continued only if the relief is granted.

While it appears likely that many plan sponsors would meet the first three criteria during these turbulent economic times, the last factor may not apply in many cases and, without further guidance, we do not know how much weight the IRS will give it. In fact, in a recent newsletter discussing the May guidance, the IRS does not list this last factor at all. Perhaps the IRS will provide further insight on the importance of this last factor in connection with finalizing this guidance.

The IRS sets out another significant rule in the introduction to the proposed guidance that will affect any suspension of safe harbor contributions, regardless of whether they are matching contributions or nonelective contributions. If safe harbor contributions are reduced or suspended during the plan year, the compensation limit under section 401(a)(17) of the Internal Revenue Code (\$245,000 for 2009) will have to be prorated. This would mean, for instance, if safe harbor contributions were discontinued exactly halfway through the plan year, the limit on compensation that could be considered in determining safe harbor contributions would be one half of \$245,000, or \$122,500. Implementation of this rule this year could prove problematic for plan sponsors that make contributions periodically throughout the plan year and that decide to eliminate safe harbor contributions after the effective date of the guidance since contributions might already have been made to the plan based on the full compensation limit.

The following rules must be met in order to reduce or suspend safe harbor nonelective contributions after the beginning of the plan year:

- the employer must incur a substantial business hardship;
- eligible employees must be provided with a supplemental notice;
- the reduction or suspension cannot be effective earlier than 30 days after the supplemental notice is provided or, if later, the date the amendment is adopted;
- employees must be given a reasonable opportunity prior to the reduction or suspension to change their deferral elections; and
- the plan must be amended to provide that the actual deferral percentage (ADP) test, or actual contribution percentage (ACP) test, if applicable, will be satisfied for the entire plan year using the current year’s testing method.

The supplemental notice must explain:

- the consequences of the amendment;
- the procedures for changing deferral elections; and
- the effective date of the amendment.

Overall, this guidance provides needed relief for the suspension of 401(k) safe harbor contributions, although the IRS has added some unexpected complexity. In addition, if a plan does not pass the ADP/ACP tests for the year, the plan sponsor may need to make additional contributions to the plan or perhaps reduce contributions made on behalf of highly compensated employees in order to satisfy these tests. And while some safe harbor plans are deemed to satisfy the top-heavy rules, these plans would lose this exemption if safe harbor contributions are suspended or reduced during the plan year. Given this, a plan sponsor that is considering exiting safe harbor should consider the additional costs that may be involved in meeting the nondiscrimination and top-heavy tests as well as the additional administrative burden associated with running these tests.

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