LEGAL UPDATE

Mid-Year Amendments to Safe Harbor 401(k) Plans Made Easier

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The Internal Revenue Code (IRS) authorizes employers to adopt a safe harbor design for a 401(k) plan that automatically enables the plan to pass the ADP and ACP tests if it makes safe harbor contributions for the benefit of nonhighly compensated employees and meets certain notice requirements. This design eliminates the cost and uncertainty of nondiscrimination testing, but requires the plan sponsor to make either a nonelective contribution equal to three percent of the participant's compensation or a matching contribution that equals 100 percent of the participant's elective deferrals up to three percent of compensation plus 50 percent of elective deferrals exceeding three percent of compensation, but only up to five percent of compensation.

Perceived Prohibition of Most Mid-Year Changes. IRS regulations require that these safe harbor provisions be adopted before the first day of the plan year to which they will apply and that they remain in effect for an entire 12-month year. With respect to the plan year requirement, the regulations stipulate that the plan's safe harbor provisions may not be amended mid-year. Unfortunately, informal IRS guidance obscured the correct interpretation of the plan amendment restriction and implied that mid-year changes were permissible only for such plan features as the implementation of Roth contributions or the addition of hardship withdrawals. IRS Announcement 2007-59 requested comments as to whether additional guidance was needed with respect to mid-year changes to a safe harbor plan, and in January 2016, the IRS finally responded by revoking the Announcement and issuing Notice 2016-16 which significantly liberalizes the rules, but also provides specific limitations on the circumstances in which mid-year changes can be made. The new rules apply to mid-year changes made on or after January 29, 2016.

Conditions for Mid-Year Changes. The scope of the relief contained in the new guidance is broader than mid-year amendments to a safe harbor plan, and also applies to mid-year changes in the information to be included in the plan's safe harbor notice. This notice informs participants of their rights and obligations under the safe harbor arrangement and must be delivered 30 to 90 days before the plan year begins. Under the new rules, however, the occurrence of a mid-year change that would necessitate modifying the required content of this notice triggers the obligation on the part of the plan to furnish an updated notice and provide affected participants a reasonable opportunity after receipt of the notice, but before the effective date of the mid-year change, to revise the participant's cash or deferred election and/or any after-tax contribution election.

Certain plan amendments clearly constitute a plan change affecting information that must be included in the safe harbor notice, such as a change to the plan's withdrawal or vesting provisions. The safe harbor notice regulations require plans so amended to provide a revised notice and election opportunity, but not all mid-year amendments to a safe harbor plan may involve such information and, in this case, providing the notice and election opportunity would not be necessary. Thus, mid-year changes to the plan's entry date provisions or to rules concerning arbitration would not require following these procedures.

Timing of Notices and Election Opportunities. Generally speaking, when a mid-year plan change necessitates providing notice of the change, the requirement will be met if the notice is given at least 30 days, but not more than 90 days, before the effective date of the change. However, if the notice requirement cannot be timely met because the change is retroactive, it will suffice if the notice is furnished as soon as practicable, but not more than 30 days after the date the change is adopted.

There is a similar rule for the election opportunity. For the purpose of enabling a participant to make or revise his or her elections, a 30-day election period is deemed reasonable. However, in those cases where a mid-year plan amendment is retroactive and it will not be practical (or possible) for a participant to revise his or her elections before the effective date of the change, the rules will be satisfied if the election opportunity begins as soon as practicable after the date the updated notice is provided to the participant, but not more than 30 days after the date the amendment is adopted. Of course, many 401(k) plans now allow daily changes to deferral elections, and these plans should find it easy to meet the election opportunity requirement.

Prohibited Changes. There are several mid-year changes to a safe harbor plan that remain prohibited under the new guidance. Thus, imposing a more rigorous vesting standard on matching contributions under a so-called safe harbor QACA (qualified automatic contribution arrangement) by increasing the number of years of service needed by a participant in order to vest in safe harbor contributions will have to wait until the next plan year. It should be remembered that in an ordinary safe harbor 401(k) plan, safe harbor contributions, whether in the form of nonelective or matching contributions, must be fully vested from the start, so that this restriction will not apply to these plans. In a QACA, however, matching contributions can be subject to a two-year vesting period, and it continues to be the case that the terms for meeting this vesting requirement must be established in advance of the plan year for which the matching contribution is made.

Another banned mid-year change also involves QACAs and prevents plans from converting from a traditional 401(k) safe harbor plan to a QACA safe harbor plan.

A third mid-year change that continues to be barred is increasing the eligibility requirements for receiving a safe harbor contribution, thereby reducing the number of employees who qualify to receive them. However, this restriction does not apply to mid-year changes permitted under eligibility service crediting rules or entry date rules in so far as they may affect employees who have not yet become eligible as of the date the change is adopted or becomes effective.

Finally, increasing safe harbor matching contributions mid-year by changing the match formula or modifying the definition of safe harbor compensation continues to be prohibited, presumably, because a participant could be misled by an initially low rate of match to which he or she responds by declining to elect deferrals under the plan or electing a lower level of deferrals than the participant would have elected if it were known that a higher match would be introduced. However, this prohibition does not apply if the change is adopted at least three months before the end of the plans year and the increased matching contribution applies to the entire year and is made retroactive to its beginning.

Summary. Notice 2016-16 represents welcome relief for sponsors of safe harbor 401(k) plans who may have felt they were required to delay making desirable or needed plan changes until the beginning of the next plan year. The new notice eliminates the ambiguity the IRS had allowed to develop in this regard.

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