IRS Creates Level Playing Field for Suspensions of 401(k) Safe Harbor Contributions

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Background

A safe harbor 401(k) plan eliminates the cost and uncertainty of some nondiscrimination testing. Qualifying conditions for this advantage include vested nonelective employer contributions equal to 3 percent of the compensation of all eligible employees or, alternatively, vested matching contributions equal to 100 percent of each employee's 401(k) deferral in an amount up to 3 percent of compensation plus 50 percent of the amount that the employee contributes between 3 percent and 5 percent of compensation. Although exceptions exist, these safe harbor contributions must generally be maintained for a full 12-month plan year and eligible participants must be notified of their rights and obligations under the arrangement within a reasonable period before the plan year begins.

Mid-Year Suspensions of Safe Harbor Matching Contributions

The plan year requirement presents a problem for employers looking to cut costs mid-year. However, current regulations allow a mid-year reduction or suspension of the safe harbor matching contribution under the following circumstances:

- Participants must receive a supplemental notice relating to the change at least 30 days before its effective date.
- Participants must be given a reasonable opportunity after receiving the supplemental notice (but before the safe harbor contributions stop) to change their deferral elections.
- The employer must adopt an amendment making the change effective no earlier than the later of the date the amendment is adopted or 30 days after the date participants receive the supplemental notice.
- The plan must be further amended to provide that the safe harbor testing method will no longer apply and must pass the applicable nondiscrimination tests for the entire year.
- Safe harbor contributions must be continued through the date of the amendment.

Special Business Hardship Rule for Safe Harbor Nonelective Contributions

The existing rules for mid-year changes were helpful, but there was a catch. The difficulty was that an additional, burdensome requirement applied to the suspension of safe harbor nonelective contributions. Thus, IRS regulations proposed in 2009 would have allowed mid-year suspensions of these contributions only if a plan sponsor incurred a substantial business hardship. The factors taken into account for this purpose would have been whether:

- The employer was operating at an economic loss;
- There was substantial unemployment or underemployment in the employer's trade or business and industry;
- Sales and profits in the employer's industry were in decline; and
- It was reasonable to expect that the plan would be continued only if the relief were granted.

This test for mid-year suspensions of nonelective contributions was criticized as being unnecessarily stricter than the test for suspending matching contributions. Moreover, applying the proposed additional factors made the result prone to uncertainty, because it required an employer to evaluate the general status of its industry and introduced a subjective element into the determination—specifically, whether it would be reasonable to expect the 401(k) plan's continuance.

New Final Regulations

On November 15, 2013, the IRS published final regulations that change the rules for mid-year suspensions of both nonelective and matching safe harbor contributions. The much-criticized substantial business hardship test that applied to nonelective contributions was replaced by giving employers a choice between two standards. The first of these will allow plan amendments to reduce or suspend safe harbor nonelective contributions if the employer is "operating at an economic loss ... for the plan year." The IRS does not say what it means by this phrase, but it arguably refers to a loss shown on the employer's financial statements for the year to date.

The alternative test will be satisfied if the notice provided to employees before the beginning of a plan year states that the plan may be amended during the upcoming year to reduce or suspend nonelective contributions but that this action will not apply until at least 30 days after notice of an actual reduction or suspension is provided. Thus, the initial notice in the plan year prior to the change must be followed up with a supplemental notice in the year the change occurs that spells out the consequences of the plan amendment reducing or suspending safe harbor contributions, the

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effective date of this change, and the procedures for employees to respond by changing their deferral elections. The new regulation makes a small change to the timing of the supplemental notice to clarify that the 30-day waiting period before a reduction or suspension can take effect is measured from the date the notice is furnished and not from the amendment's adoption date.

These rules will apply to plan amendments adopted after May 18, 2009, the date the current rules were proposed. Some commentators argued that any relaxation of the rules relating to the reduction or suspension of nonelective safe harbor contributions should apply to plan amendments adopted before this date. The IRS rejected this argument and took the position that such amendments constitute a violation of section 401(k) that should be corrected under the Employee Plans Compliance Resolution System.

Leveling the Field for Matching and Nonelective Contributions

The preamble to the new regulation indicates that the IRS now agrees that there is no policy reason for the distinction between matching and nonelective contributions that exists under the current rules. Therefore, for plan years beginning on or after January 1, 2015, this difference is eliminated so that the mid-year reduction or suspension of safe harbor matching contributions will also be subject to the requirement that the employer either be operating at an economic loss or have provided a notice in the year prior to a change of the possibility that the plan will be amended to reduce or suspend matching contributions. All of the other requirements for mid-year reduction or suspension of a match remain intact and will also apply to the mid-year reduction or suspension of safe harbor nonelective contributions.

Practical Steps

Employers wishing to utilize the new rules to make 2014 reductions or suspensions of nonelective contributions to a calendar-year safe harbor 401(k) plan without relying on the economic loss standard should have provided an updated safe harbor notice by the end of 2013. Since the new rules will apply to both matching and nonelective contributions for plan years beginning after 2014, it would be advisable for all employers who may wish to make a mid-2015 reduction to or suspension of their safe harbor 401(k) plans to provide the updated notice in 2014 unless it can confidently be predicted that the employer will be operating at an economic loss in 2015. ❖

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