



Retirement Plan Update

Relief is Here for Sponsors of Safe Harbor 401(k) Plans

The IRS Proposes Rules Allowing Employers to Suspend Three Percent Safe Harbor 401(k) Contributions During Plan Year.

In these tough economic times, many employers are finding it hard to fund their plans' safe harbor contributions. Previously, if a Plan Sponsor with a fixed 3% safe harbor contribution plan was unable to fund the employer contribution the only option was to terminate the plan. Plan Sponsors who elected to keep the plan had little choice on how to reduce costs during the plan year. Only Plan Sponsors with safe harbor match or "maybe" safe harbor 401(k) plans had alternatives.

There is a solution now:

The IRS has issued proposed regulations that would allow employers to amend plans to reduce or suspend their §401(k) or §403(b) fixed 3% safe harbor contributions mid-year in the case of a *substantial business hardship*. There is a 30-day advance employee notice requirement and a requirement that employees be allowed to change their salary deferral elections in advance of the plan change.

The proposed regulations are effective for plan amendments after May 18, 2009. Plans may rely on them pending issuance of final regulations.

Background on Prior Regulations

A 401(k) plan can satisfy the safe harbor rules (and thereby avoid the need to satisfy ADP/ACP testing or make refunds) under three options. All of the solutions involve employer contributions. The options are:

- 1) Fixed 3% pay contribution to all eligible participants
- 2) Match of up to 4% pay to eligible participants deferring
- 3) Optional 3% of pay contribution to all eligible participants, but elected at year-end – the "maybe" safe harbor

Previously, if an employer could not continue the safe harbor contributions, those contributions could be stopped mid-year if the plan used Option 2, the match safe harbor. For those using Option 3, the "maybe" safe harbor, the Plan Sponsor could always elect to make or not to make safe harbor contributions at year-end. Option 3 has always offered the most flexibility, which is why we usually recommend this safe harbor option to Plan Sponsors choosing a safe harbor 401(k) plan.

Either option 2 or 3 (suspend the match or elect out of the "maybe" contribution) do, however, require full ADP and ACP testing for that specific year.

Plans that elected the fixed 3% contribution provision (option 1) could eliminate the employer contribution for the remainder of the year only by terminating the plan – a rather harsh option as it eliminated each employee's opportunity to contribute his or her own elective deferrals.

Proposed Regulations

The proposed regulations extend the option to reduce or suspend safe harbor contributions for plans with the 3% fixed contributions (option 1) during the plan year provided the plan sponsor has incurred a *substantial business hardship* (this is not a requirement for plans suspending the safe harbor match or “maybe” contribution provisions). Factors taken into account to make this hardship determination include whether:

- The business is operating at a loss;
- There is substantial unemployment or underemployment in the industry;
- The sales and profits of the industry are depressed or declining; *and*
- It is reasonable to expect that, after the employer is permitted to reduce or suspend safe harbor fixed contributions, the plan will continue and not be terminated.

While it appears that many plan sponsors would meet the first three criteria, the last factor may not apply in many cases and, absent further guidance, we don't know how much weight the IRS will give it. Hopefully, additional IRS guidance will be forthcoming.

In addition to the requirement for an employer to have a substantial business hardship, an employer must satisfy the following conditions under the proposed regulations – similar to those governing the suspension of safe harbor matching contributions:

- Provide all eligible employees notice of the reduction or suspension at least 30 days before the safe harbor contribution requirement is suspended;
- Execute the plan amendment at least of 30 days before the employee notice is provided;
- Provide eligible employees a reasonable opportunity after the notice is provided and prior to the effective date of the change to modify their salary deferral elections (this may require additional wording to the amendment);
- Satisfy the ADP and/or ACP test for the entire plan year using the current year testing method (which means that some highly compensated employees may receive refunds of salary deferrals early next year);
- Contribute the 3% safe harbor contribution on compensation paid through the effective date of the amendment; and
- If the plan is top-heavy, meet the top-heavy rules for contributions. *This is the most problematic issue.* It may be that the required top-heavy contribution is larger than the safe harbor fixed contribution, due to plan provisions for safe harbor versus mandated top-heavy rules. This requires careful analysis, which we will perform for our clients.

If you have a 401(k) plan with the safe harbor fixed 3% of pay contribution provision and are not finding it economically feasible to make plan contributions during the current economic crisis, the IRS' proposed regulations may provide just the welcome relief you need. Contact our compliance team at (619) 696-7284 if you want to take advantage of this relief.