Employee Benefits Corner

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IRS Issues Final Regulations to Allow Mid-Year Elimination of Safe Harbor Nonelective Contributions

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On November 15, 2013, the IRS issued final regulations to allow mid-year elimination of safe harbor nonelective contributions. These regulations have been in proposed form since May 2009, and provide much needed flexibility for employers adopting safe harbor plans—allowing mid-year suspension or elimination of safe harbor nonelective contributions. The history of this provision, along with a look at the final rules, and the changes from the proposed rules, are set forth below.

Background

In order for a 401(k) plan to meet nondiscrimination testing on a "safe harbor" basis, the employer is required to make either a matching or nonelective contribution. This is true whether the plan's safe harbor status is based on the traditional safe harbor[1] or the Qualified Automatic Contribution Arrangement (QACA)[2] design. Generally, a plan's status as a safe harbor plan, and the required employer contributions, must continue for the entire 12-month plan year. However, the existing IRS regulations have historically permitted an employer to amend its "safe harbor" 401(k) plan (or 403(b) plan) to suspend/eliminate matching contributions mid-year, provided certain requirements were met. These requirements included: (1) provide 30-day advance notice to participants; (2) matching contributions must continue to be made on employee contributions through the effective date of the amendment; (3) provide a reasonable opportunity after this notice is provided to change their salary deferral elections; and (4) the plan

must meet the ADP (and ACP) test for the entire plan year on a "current year" testing basis.

The existing regulations, however, do not address whether an employer may similarly suspend/eliminate its nonelective contributions mid-year. This silence raised concerns for employers that wanted to suspend their nonelective contributions mid-year to help meet financial needs. It appeared that the only way an employer could suspend its obligation to make safe harbor nonelective contributions during a year was to terminate the plan, a draconian step most employers wanted to avoid. Moreover, plan termination might not be a lawful option in this context. In this regard, the regulations provide that the requirement that a safe harbor 401(k) plan providing nonelective contributions be effective for a 12-month plan year does not apply if a plan is terminated mid-year, but only if the termination is in the context of a corporate transaction or if the employer "incurs a substantial business hardship comparable to a substantial business hardship described in section 412(c)."

Under Code Sec. 412(c)—which is part of the rules governing waivers of the minimum funding requirements—an employer is required to establish "substantial business hardship" to the IRS. This is a facts-and-circumstances test that includes (but is not limited to) factors such as:

- 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 waiver is granted.

Proposed Regulations

The IRS issued proposed regulations in May 2009 that permit an employer to suspend/reduce nonelective contributions to a safe-harbor 401(k) plan mid-year, but only if the employer incurs a "substantial business hardship (comparable to a "substantial business hardship" described in section 412(c)," *and* satisfies the same conditions that apply to a suspension of safe harbor matching contributions. Accordingly, in addition to the substantial business hardship, the employer must also (1) provide 30-day advance notice to participants, (2) continue nonelective contributions through the effective date of the amendment, (3) provide a reasonable opportunity after this notice is provided to change their salary deferral elections, and (4) meet the ADP (and ACP) test for the entire plan year on a "current year" testing basis.

This hardship standard tracks the same standard that applies to terminating a safe harbor 401(k) mid-year.[3] The effect of the proposed regulations was therefore limited—in that if an employer could meet the requirements to terminate its safe harbor plan mid-year, it may instead simply suspend nonelective contributions. The impact of the proposed regulations was likely that many employers were locked into making the nonelective contributions for the entire year, because they were unable to meet this strict hardship standard.

Notably, the proposed regulations also clarified that, if safe harbor employer contributions—matching or nonelective—are suspended mid-year, the Code Sec. 401(a)(17) compensation limit must be prorated, and the plan will become subject to the top-heavy rules. In general, proration of the compensation limit may well impact contributions already made (*e.g.,* if the person was approaching or possibly reached the maximum limit ($260,000 for 2014) by the time of the suspension) and require forfeiture and reallocation of some amounts.

The proposed regulations provided that employers may rely on them for amendments adopted after May 18, 2009, and any provision in the final regulations that is more restrictive will apply prospectively.

Final Regulations

The final regulations provide welcome relief in this area by eliminating the substantial business hardship requirement for suspending nonelective contributions, in favor of a new notice option. Moreover, they provide uniform rules that apply equally to safe harbor matching and nonelective contributions. Specifically, effective for amendments adopted after May 18, 2009, for nonelective contributions, and effective for plan years beginning on or after January 1, 2015, for matching contributions, the following requirements must be met to reduce/suspend safe harbor employer contributions:

1. The employer:
    - is operating at an economic loss, as described in Code Sec. 412(c)(2)(A) for the plan year, *or*
    - includes in the safe harbor notice a statement that the plan may be amended during the plan year to reduce or suspend safe harbor nonelective or matching contributions, as applicable, and that the reduction or suspension will not

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apply until at least 30 days after all eligible employees are provided notice of the reduction or suspension.

2. Provide 30-day advance notice to participants of the amendment. This notice must explain (a) the consequences of the amendment that reduces or suspends future safe harbor contributions, (b) the procedures for changes to their cash or deferral elections and, if applicable, their employee contribution elections, and (c) the effective date of the amendment.
3. Provide a reasonable opportunity after this notice is provided to change their salary deferral elections.
4. Continue contributions through the effective date of the amendment.
5. Meet the ADP and ACP test for the entire plan year on a "current year" testing basis.

This approach tracks the existing rules (which remain unchanged) regarding the ability of a safe harbor plan to use a contingent notice (as described in Reg. §1.401(k)-3(f)(2)) before the beginning of the plan year where the contingent notice indicates that the plan may be amended during the plan year to include safe harbor nonelective contributions and that, if the plan is amended, a follow-up notice will be provided.

Moreover, the final regulations extend these same rules to a safe harbor plan termination—allowing a plan termination mid-year if:

- the requirements set forth above are met—by treating the plan termination as a suspension of contributions, except the requirements (1) and (3) noted above do not apply; or
- the plan termination is in connection with a transaction described in Code Sec. 410(b)(b)(6)(C) (*e.g.,* corporate merger/reorganization) or the employer incurs a substantial business hardship, comparable to the hardship described in Code Sec. 412(c) (as described above).

Also, the preamble to the regulations confirms the IRS position that a *pro rata* 401(a)(17) compensation limit applies with a mid-year reduction/suspension of safe harbor contributions, but declines to provide additional guidance.

Importantly, the regulations were also expanded to provide the IRS with authority to develop rules to address special circumstances under which a mid-year change to a safe harbor plan is appropriate, such as an amendment to the plan in connection with a mid-year corporate transaction. This same flexibility extends to mid-year changes to safe harbor plans under Code Sec. 401(k) and (m).

Action Steps

Now that the rules appropriate align for matching and nonelective safe harbor contributions, all employers offering safe harbor plans should add the language set forth in (1)(b) above to their next safe harbor notices in order to provide maximum flexibility in order to make mid-year changes to the employer contributions. Failure to do so results in the need to demonstrate that the employer is operating at a loss to permit the amendment; the other factors that showed a financial hardship (as outlined above) are no longer relevant. (Note that this change was intended to address concerns that the employers needed certainty that they satisfied the hardship requirements.) We also note that those employers with a "linked" nonqualified deferred compensation plan could, depending on the terms of the linked plan, have trouble making mid-year changes to the safe harbor plan without creating potential 409A issues in the linked nonqualified plan.

And stay tuned for an additional wave of long-anticipated IRS guidance outlining various mid-year changes to safe harbor plans that are permissible.

Endnotes

[1] Code Sec. 401(k)(12).
[2] Code Sec. 401(k)(13).
[3] Reg. §1.401(k)-3(e)(4)(ii).

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