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View From Groom: Helpful IRS Guidance on Mid-Year Changes to Safe Harbor 401(k) and 403(b) Plans

BY ELIZABETH DOLD AND KENDALL W. DAINES

IRS Notice 2016-16 (Feb. 16 *IRS Bulletin*) provides long-awaited guidance clarifying the extent to which a safe harbor 401(k) plan (either a traditional safe harbor plan or a qualified automatic contribution arrangement ("QACA")) may be amended mid-year (20 PBD, 2/1/16). Prior to this guidance, the IRS presumption had been that a mid-year change to a safe harbor plan was not permitted unless IRS guidance expressly permitted the change – and the list of permissible mid-year changes was very short. Under this new guidance, effective for mid-year changes on or after January 29, 2016, the presumption is reversed so that a mid-year change is permitted unless it is on a list of prohibited mid-year changes in the Notice, provided certain participant notice and election requirements are met. This guidance also applies to 403(b) plans that apply the section 401(m) safe harbor rules pursuant to Code section 403(b)(12). In addition, although this guidance does not expressly apply to an eligible automatic contribution arrangement ("EACA"), it seems that it should because the EACA rules generally follow the QACA rules. However, the IRS has requested comments as to whether additional guidance is necessary to address EACAs, so this is not entirely clear.

Elizabeth Dold (edold@groom.com) is a principal at Groom Law Group, Chartered. Her practice focuses on the tax laws impacting a wide variety of retirement, health and welfare and other compensation matters, including employment taxes and other reporting and withholding requirements.

Kendall W. Daines (kdaines@groom.com) is an attorney at Groom Law Group, Chartered. She has over 25 years of experience advising clients on a wide range of tax issues affecting tax-qualified retirement plans.

Background

Pre-tax contributions to a 401(k) plan are tested for nondiscrimination by means of the actual deferral percentage test ("ADP Test"), a complex numerical test that generally compares the rate of pre-tax 401(k) contributions made by highly compensated employees with the rate of pre-tax 401(k) contributions made by non-highly compensated employees. A plan can avoid performing the ADP Test by implementing a safe harbor design, which requires that the plan sponsor provide a certain level of matching or nonelective contributions ("Safe Harbor Contributions").

IRS regulations provide that a safe harbor plan design generally must be adopted before the start of a plan year and remain in effect for a 12-month plan year, and that the safe harbor plan design cannot be amended or changed during the plan year. The regulations provide several exceptions to this prohibition, for example, the regulations permit Safe Harbor Contributions to be reduced or suspended during a plan year provided certain requirements are met. In addition, the IRS has issued specific guidance permitting the mid-year addition of Roth contributions, as well as the mid-year change to a hardship withdrawal feature to permit withdrawals on account of a hardship for a primary beneficiary, and changes to the spousal definition following *U.S. v. Windsor*.

In order to meet the safe harbor requirements, participants must receive a notice describing key elements of the plan design within a reasonable period (generally 30 days) before the start of the plan year. (Special timing rules apply for employees who become eligible during the plan year.) In addition, participants must have a reasonable opportunity (generally 30 days) after receipt of the safe harbor notice to make or change a deferral election.

Permissible Mid-Year Changes

Before the new IRS guidance, the fact that the regulations required that the safe harbor plan design be in effect for a 12-month plan year – as well as the fact that the safe harbor notice describing the plan features had to be provided to participants before the start of the plan year – indicated that mid-year changes were not permissible. The concerns included, first, a change would mean that the original feature was not effective for a 12-month plan year; and second, a change might be inconsistent with the safe harbor notice provided before the plan year. The new guidance provides that a mid-year change – defined as (i) a change that is first effective during a plan year, but not effective as of the beginning of the plan year, or (ii) a change that is effective as of the beginning of the plan year, but adopted after the beginning of the plan year – is permissible, provided the requirements described below are met.

Notice and Election May Be Required. – If the mid-year change affects the information required to be included in the safe harbor notice, the following notice and election opportunity conditions must be satisfied:

- an updated safe harbor notice that describes the mid-year change and its effective date must be provided to each employee to whom the safe harbor notice is required within a reasonable period (generally 30 days) before the effective date of the change. If it is not practicable to provide the notice within this time-frame (for example, because the change is effective retroactively), the notice must be provided as soon as practicable, but not later than 30 days after the date the change is adopted; and

and

- each employee to whom the notice is required to be provided must have a reasonable opportunity (30 days is deemed reasonable) before the effective date of the change (or as soon as practicable after the notice is provided for retroactive changes, but no later than 30 days after adoption) to change the employee's deferral election.

Importantly, no updated notice or election opportunity is required if the change does not affect the information that the regulations require to be included in the safe harbor notice (even if the notice includes such other information that is being changed).

Prohibited Changes. — The change may not be one of the following prohibited changes (unless required to be made mid-year, for example, a statutory change):

- a mid-year change to the vesting schedule applicable to Safe Harbor Contributions under a QACA to increase the number of year of service required for a fully vested account;
- a mid-year change to exclude a group of employees from eligibility for Safe Harbor Contributions (although it would be permissible to change the service/entry date requirements for individuals who are not already eligible to receive safe harbor contributions as of the date the change is either effective or adopted);
- a mid-year change in the type of safe harbor plan, for example, a change from a traditional safe harbor plan to a QACA; and
- a mid-year change to (a) modify (or add) a formula used to determine matching contributions (or the definition of compensation used to determine matching contributions) if the change increases the amount of matching contributions, or (b) to permit discretionary matching contributions, unless the change in (a) or (b) is made, and an updated safe harbor notice and election period are provided, at least 3 months prior to the end of the plan year, and the change is made retroactively effective to the first day of the plan year.

The mid-year changes already addressed in the regulations are not subject to these new provisions, but must meet the requirements included in the regulations. These include (i) the adoption of a short plan year or change to the plan year; (ii) the adoption of safe harbor plan deign on or after the beginning of the plan year; and (iii) the reduction or suspension of safe harbor contributions or changes from safe harbor plan status to non-safe harbor plan status. In addition, other applicable laws may affect the ability to make mid-year changes, for example, the anti-cutback prohibition, nondiscrimination restrictions, and anti-abuse provisions, which still apply.

The guidance also includes several examples to help illustrate these rules.

Next Steps

This very welcome first step addresses a historic limitation for safe harbor plans and provides much-needed plan design flexibility, which should be reviewed whenever a mid-year change is being considered. The IRS has requested comments as to whether additional guidance is needed to address mid-year changes, specifically whether guidance is needed to address mid-year changes relating to plan sponsors involved in mergers and acquisitions or to plans that include an eligible automatic contribution arrangement under section 414(w). Comments must be submitted in writing no later than April 28.

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