Employee Benefits Corner

IRS Issues Favorable Guidance on Mid-year Safe Harbor Changes

By Elizabeth Thomas Dold and David N. Levine

Long-awaited IRS guidance was recently issued in the form of Notice 2016-16[1] that permits a wide variety of mid-year safe harbor plan changes, subject to certain participant disclosures, but still lists a few changes that are not permitted to be adopted or effective after the first day of the plan year. The guidance is effective for mid-year changes made on and after January 29, 2016, and applies to traditional safe harbor 401(k) plans, QACAs (qualified automatic contribution arrangements) and safe harbor 403(b) plans.

We first review the applicable IRS regulations that restrict mid-year changes, and then we take a look at the guidance below. Plan sponsors should keep this guidance in mind when considering mid-year changes to their safe harbor 401(k) or 403(b) plans.

Background

Under the Internal Revenue Code ("the Code"), benefits under or contributions to a qualified plan must be nondiscriminatory in amount. This results in 401(k) plans being subject to discrimination testing—which includes actual deferral percentage (ADP) testing, which applies to elective deferrals under Code Sec. 401(k), and actual contribution percentage (ACP) testing that applies to matching contributions and after-tax employee contributions pursuant to Code Sec. 401(m).

Importantly, this testing can be avoided if the plan sponsor adopts a safe harbor plan under Code Sec. 401(k)(12) (traditional 401(k) safe harbor), Code Sec. 401(a)(13) (QACA 401(k) safe harbor) and Code Sec. 401(m)(11) (traditional safe harbor match) and Code Sec. 401(m)(12) (QACA safe harbor match).

However, in order to maintain the safe harbor status of the plan, and maintain compliance with the plan terms, the safe harbor regulations require that certain plan provisions remain in effect for a 12-month plan year (subject to limited exceptions), and that the annual safe harbor notices be provided to plan participants, and that participants have a reasonable opportunity after receipt of the notice to make or change a cash or deferral election under the plan.[2]

Regarding the 12-month plan year requirement, Reg. §1.401(k)-3(e)(1) provides that a plan will fail to satisfy the requirements of Code Secs. 401(k)(12) and 401(k)(13), and the regulations thereto unless plan provisions that satisfy the safe harbor plan rules of Reg. §1.401(k)-3 are adopted before the first day of

ELIZABETH THOMAS DOLD is a Principal at Groom Law Group, Chartered in Washington, D.C.

DAVID N. LEVINE is a Principal at Groom Law Group, Chartered in Washington, D.C.

the plan year and remain in effect for an entire 12-month plan year. It also provides that a safe harbor plan that includes provisions that satisfy the safe harbor plan rules of Reg. §1.401(k)-3 will not satisfy the nondiscrimination requirements for 401(k) plans for a plan year if the safe harbor plan is amended to change those provisions during the plan year. Reg. §1.401(m)-3(f) includes similar provisions for matching safe harbor plans.

In sum, this is very welcome first step to providing additional flexibility to plan sponsors that offer safe harbor plans and may well encourage more plan sponsors to reconsider this plan design feature.

There are limited exceptions to these rules in the Regulations for (i) a short first plan year, (ii) a change in the plan year, (iii) a short final plan year, (iv) a delayed adoption of safe harbor plan nonelective contributions (if notice of this possibility is provided before the beginning of the plan year) and (v) a mid-year reduction or suspension of safe harbor contributions (which results in loss of safe harbor plan status). There are also a few additional exceptions that the IRS has provided over the years, including most recently the *Windsor* amendment (regarding same sex marriages), adding a hardship withdrawal for a primary beneficiary, and adding a Roth 401(k) feature to the plan.

Regarding the annual safe harbor notice requirement, 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.[3]

Lastly, regarding the election period, the safe harbor plan regulations provide that a safe harbor plan generally may limit the frequency and duration of periods in which eligible employees may make or change cash or deferred elections under the plan but require that an employee has a reasonable opportunity (including a reasonable period after receipt of a safe harbor notice) to make or change an election. For this purpose, a 30-day election period is deemed to be a reasonable period to make or change a cash or deferred election.[4]

The Guidance

The Notice divides the types of mid-year changes into one of three groups: (1) permissible under the original regulations, (2) new permissible changes, which may include a new notice and election opportunity and (3) prohibited changes, which we review in turn below.

Notably, a "mid-year change" is (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. Notably, this includes changes that impact the required safe harbor content even if no plan amendment is adopted (for example, a change in contact information).

Of course, any mid-year amendment must otherwise still comply with other applicable Code restrictions, such as anti-cutback restrictions under Code Sec. 411(d)(6), nondiscrimination restrictions under Code Sec. 401(a)(4) and anti-abuse provisions under Reg. §1.401(k)-1(b)(3).

Permissible Mid-year Changes Under the Regulations

The Notice does not alter the limited exceptions set forth under the Regulations regarding (1) adoption of a short plan year, (2) adoption of safe harbor plan status on or after the beginning of the plan year and (3) reduction or suspension of safe harbor contributions or changes from safe harbor plan status to nonsafe harbor plan status.

Other Permissible Mid-year Changes Under the Notice

A mid-year change (other than those permitted under the existing regulations or described as prohibited below) that alters the plan's required safe harbor notice content (which is information that is required by the safe harbor regulations to be set forth in the safe harbor notice) is permitted without jeopardizing the plan's safe harbor status, provided that the following notice and election opportunity conditions are met:

1. *Updated Safe Harbor Notice.* An updated safe harbor notice that describes the mid-year change and its effective date must be provided to each employee otherwise required to be provided a safe harbor notice under the Regulations within a "reasonable period" before the effective date of the change. This

"reasonable period" determination is based on all of the relevant facts and circumstances but is deemed satisfied if the updated notice is provided at least 30 days (and not more than 90 days) before the effective date of the change. If it is not practicable for the updated safe harbor notice to be provided before the effective date of the change (for example, in the case of a mid-year change to increase matching contributions retroactively for the entire plan year), the notice is treated as provided timely if it is provided as soon as practicable, but not later than 30 days after the date the change is adopted. Note that if the required information about the mid-year change and its effective date was provided with the pre-plan year annual safe harbor notice, an updated safe harbor notice is not required.

2. *Election Opportunity.* Each employee required to receive an updated safe harbor notice must be given a reasonable opportunity (including a reasonable period after receipt of the updated notice) before the effective date of the mid-year change to change the employee's cash or deferred election (and/or any after-tax employee contribution election). For this purpose, a 30-day election period is deemed to be a reasonable period. If it is not practicable for the election opportunity to be provided before the effective date of the change (for example, in the case of a mid-year change to increase matching contributions retroactively for the entire plan year), an employee is treated as having a reasonable opportunity to make or change an election if the election opportunity begins as soon as practicable after the date the updated notice is provided to the employee, but not later than 30 days after the date the change is adopted.

Importantly, to the extent that the mid-year change does not impact the required safe harbor notice content, even if the notice included such information, the mid-year change is permissible and no participant notice or election period is required.

Prohibited Mid-year Changes

The following changes are not permitted to be made mid-year, unless such a mid-year change is mandated by applicable law (*e.g.,* statutory law change or court decision):

1. A mid-year change to increase the number of completed years of service required for an employee to have a nonforfeitable right to the employee's account balance attributable to safe harbor contributions under a QACA pursuant to the safe harbor rules under Reg. §1.401(k)-3(k)(3) or §1.401(m)-3(a)(2).
2. A mid-year change to reduce the number or otherwise narrow the group of employees eligible to receive safe harbor contributions. However, this prohibition does not apply to an otherwise permissible change under eligibility service crediting rules or entry date rules made with respect to employees who are not already eligible (as of the date the change is either made effective or is adopted) to receive safe harbor contributions under the plan.
3. A mid-year change to the type of safe harbor plan, for example, a change from a traditional 401(k) safe harbor plan to a QACA safe harbor plan.
4. A mid-year change (i) to 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 (ii) to permit discretionary matching contributions. However, this prohibition does not apply if (A) at least three months prior to the end of the plan year, the change is adopted and the updated safe harbor notice and election opportunity are provided and (B) the change is made retroactively effective for the entire plan year (which may require a plan that provides for periodic matching contributions to be amended to provide for matching contributions based on the entire plan year).

Examples

The Notice also provides the following helpful examples to help work through these new rules:

Example 1. The employer sponsors a traditional safe harbor plan and makes a mid-year plan amendment to increase future safe harbor nonelective contributions from three percent to four percent for all eligible employees. This is a permissible change if the updated notice and election opportunity are followed.

Example 2. The employer sponsors a traditional safe harbor plan and makes a mid-year plan amendment to decrease safe harbor nonelective contributions from four percent to three percent for all eligible employees. This change must meet the original requirements of Reg. §1.401(k)-3(g) to be permissible.

Example 3. The employer sponsors a traditional ADP/ACP safe harbor plan with a calendar year plan year and match calculated on a payroll-period basis and makes a mid-year amendment on August 31 to increase the safe harbor matching contribution from

four percent to five percent retroactive to January 1 and to amend the plan to change from a payroll-period match calculation to an entire-plan-year match calculation. On September 3, the first date that an updated notice and additional election opportunity can practicably be provided, employees otherwise required to be provided a safe harbor notice are provided an updated notice and an additional 30-day election period starting September 3. This is a permissible mid-year change.

Example 4. The employer sponsoring a safe harbor plan and makes a mid-year amendment to add an age 591/2 in-service withdrawal feature. This is a permissible mid-year change if the updated notice and election opportunity are followed.

Example 5. The employer sponsors a QACA plan with multiple investment options and makes a mid-year change in the plan's default investment fund from Fund X to Fund Y. This is a permissible mid-year change if the updated notice and election opportunity are followed.

Example 6. The employer sponsors a traditional safe harbor plan and makes a mid-year amendment to change the design to a QACA safe harbor plan. This change is not permissible. However, if the employer had made a mid-year amendment to add an automatic contribution feature (but not an amendment changing the design to a QACA safe harbor plan), this is a permissible mid-year change if the updated notice and election opportunity are followed.

Example 7. The employer sponsors a safe harbor plan and makes a mid-year amendment to change the entry date for commencement of participation of employees who meet the plan's minimum age and service eligibility requirements from monthly to quarterly. The amendment also changes plan rules regarding arbitration of disputes. The amendment is effective with respect to employees who are not already eligible to participate in the safe harbor plan. The safe harbor notice is not required to include the plan entry date or information on arbitration procedures; therefore, an updated notice and additional election opportunity are not required, and the change is permissible.

Plans/Areas Not Covered

The guidance is expressly limited to safe harbor plans, so although EACAs (eligible automatic contribution arrangements) are subject to the same strict regulatory provisions that restrict mid-year changes, the IRS requested comments on whether additional guidance is needed for these plans.

Another area that is not covered is merger and acquisitions. The notice asks for comments on what additional guidance is needed with respect to mid-year changes to safe harbor plans in cases in which a plan sponsor is involved in a merger or acquisition. This has historically been of concern to the benefits community, so we anticipate the IRS receiving requests for additional relief in this M&A context.

Conclusion

In sum, this is very welcome first step to providing additional flexibility to plan sponsors that offer safe harbor plans and may well encourage more plan sponsors to reconsider this plan design feature.

ENDNOTES

1 Notice 2016-16, IRB 2016-7, 318.
2 *See* Reg. §§1.401(k)-3 and 1.401(m)-3.
3 *See* Reg. §§1.401(k)-3(d), 1.401(k)-3(k) and 1.401(m)-3(e).
4 *See* Reg. §§1.401(k)-3(c) and 1.401(m)-3(c).