A Timely Analysis of Legal Developments

ASAP®

In This Issue:

May 2009

The IRS has issued proposed regulations that allow for the suspension or reduction of safe harbor nonelective contributions under certain 401(k) safe harbor plans.

New Safe Harbor 401(k) Guidance Helps Economically Distressed Employers

By Lisa A. Taggart

The Internal Revenue Service issued proposed regulations on May 18, 2009 which allow for the suspension or reduction of safe harbor nonelective contributions under certain 401(k) safe harbor plans.

A safe harbor 401(k) plan is a 401(k) plan that requires an employer to make certain levels of plan contributions for nonhighly compensated employees. In exchange, the plan is exempt from the regular 401(k) plan requirement to have annual nondiscrimination testing performed. Employer contributions under a safe harbor 401(k) plan are made in the form of either matching contributions or nonelective contributions.

In general, a safe harbor 401(k) plan must maintain its status as a safe harbor plan for a full, 12-month plan year. There are, however, two exceptions to this general rule:

- A safe harbor plan may be amended to reduce or suspend safe harbor matching contributions on future employee deferrals for a plan year.
- A safe harbor plan may be terminated during the plan year.

Under the proposed regulations, a plan may also reduce or suspend safe harbor nonelective contributions if the employer sponsoring the plan experiences a "substantial business hardship." Some factors that are considered in determining whether a substantial business hardship exists are:

- the employer is operating at an economic loss;
- there is substantial unemployment or underemployment in the trade or business and in the industry concerned; and
- the sales and profits of the industry concerned are depressed or declining.

Once the existence of a substantial business hardship is determined, the following requirements must be met in order to reduce or suspend safe harbor nonelective contributions for the plan year:

- the plan must be amended before the end of the plan year to permit the reduction or suspension;

- all eligible employees must be provided with a supplemental notice describing the consequences and effective date of the amendment, as well as the plan's procedures for modifying employee elections;
- the reduction or suspension must be effective no earlier than the later of 30 days after eligible employees are provided with the supplemental notice or the date on which the amendment is adopted;
- all eligible employees must be given a reasonable period of time (including a reasonable period after receipt of the supplemental notice) prior to the reduction or suspension to change their deferral elections;
- the plan must be amended to provide that the average deferral percentage test and the actual contribution percentage test (as applicable) are satisfied for the entire plan year in which the reduction or suspension occurs, based upon current year testing;
- the plan must satisfy the safe harbor nonelective contribution requirement for compensation paid through the effective date of the amendment; and
- the plan must satisfy the top-heavy requirements.

The proposed regulations are effective for amendments adopted after May 18, 2009, and they may be relied upon pending the release of final regulations.

Conclusion

The proposed rules may not provide the level of flexibility to reduce or suspend safe harbor nonelective contributions that employers and practitioners desired. Nonetheless, they offer an alternative to plan termination for certain plan sponsors should business necessity dictate that safe harbor contributions be suspended or reduced.

Plan sponsors facing economic difficulty should consult with their benefits counsel to discuss whether they can utilize this option.

Lisa A. Taggart is an Associate in Littler Mendelson's Philadelphia office. If you would like further information, please contact your Littler attorney at 1.888.Littler, info@littler.com, or Ms. Taggart at lataggart@littler.com.