401(k) Plans

Sailing from Safe Harbor to Perfect Storm

With the economy becoming more volatile in recent months, many employers sponsoring safe harbor 401(k) plans have found themselves unable to satisfy their contribution obligations. The Treasury Department's proposed regulations offer some flexibility to sponsors that would otherwise have only one option: terminate the plan.

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It seems that every week there are more stories in the financial press describing employers that are reducing or eliminating contributions to their retirement plans. While many profit sharing and 401(k) plans include language affording plan sponsors the discretion as to the amount to be contributed, regulations addressing safe harbor 401(k) plans offer less flexibility. Until the Treasury Department issued proposed regulations on May 18, 2009, certain safe harbor plans had only one option to suspend or reduce employer contributions—plan termination.

The Safe Harbor

The regulations under Internal Revenue Code ("IRC") Section 401(k) provide for several plan designs that are deemed to satisfy some of the otherwise applicable nondiscrimination tests. Generally, employers that meet certain minimum contribution and vesting requirements and provide required notices to participants are deemed to satisfy the Actual Deferral Percentage ("ADP") Test that may limit the amounts the plan's Highly Compensated Employees ("HCEs") can defer. The minimum employer contribution may be made in the form of a matching contribution [Treas. Reg. § 1.401(k)-3(c)] or a nonelective contribution [Treas. Reg. § 1.401(k)(b)], neither of which is discretionary. IRC § 401(k)(13) also provides safe harbor match and nonelective contribution formulas as part of a Qualified Automatic Contribution Arrangement. If matching contributions made to plans with an ADP-related safe harbor contribution fall within prescribed limits, the plan is deemed to also satisfy the Actual Contribution Percentage ("ACP") Test. Further, to the extent the contributions to the plan consist solely of elective deferrals and safe-harbor contributions for a given year, the plan is deemed to satisfy all top-heavy requirements for that year.

Plan sponsors wishing to implement a safe harbor plan must generally do so as of the first day of a plan year and must provide notice to all eligible participants within a reasonable time prior to the beginning of that plan year. They must also amend their plan document to add the safe harbor provisions prior to the start of the year in which the design will first be effective.

The Winds of Change—Here Comes the Storm

As the economy has become more volatile in recent months, many employers sponsoring safe harbor 401(k) plans have found themselves unable to satisfy their contribution obligations. However, because both the match and nonelective varieties of safe harbor contributions are not discretionary, such sponsors have faced the dilemma of making difficult financial decisions or maintaining noncompliant plans.

Safe Harbor Matching Contributions

Plans utilizing the safe harbor matching design have some flexibility to eliminate or reduce the amount of the match midyear, i.e., after the notice has already been provided to participants. Treas. Reg. § 1.401(k)-3(g) describes the steps a sponsor must follow:

- *Supplemental Notice:* All employees must be provided a supplemental notice explaining (1) the impact of the amendment on their future contributions, (2) the procedure for changing their

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deferral election, and (3) the effective date of the amendment [Treas. Reg. §§ 1.401(k)-3(g)(1)(i) and 1.401(k)-3(g)(2)].

- *Effective Date:* The reduction or suspension of the safe harbor matching contribution cannot be effective any earlier than the later of the date on which the plan sponsor adopts the amendment or 30 days following the date on which eligible employees are provided the supplemental notice described above [Treas. Reg. § 1.401(k)-3(g)(1)(ii)].
- *Election Changes:* Because it is possible, if not likely, that participants made their deferral elections based on the expectation of a fully vested matching contribution, the employer must provide eligible employees with a reasonable opportunity to change their salary deferral elections prior to the effective date of the reduction or suspension [Treas. Reg. § 1.401(k)-3(g)(1)(iii)].
- *ADP Testing and ACP Testing:* The plan must satisfy the ADP test and the ACP test for the entire year using the current year testing method [Treas. Reg. §§ 1.401(k)-3(g)(1)(iv), 1.401(m)-3(h)(1)(iv)]. This is true even if the plan was a safe harbor plan for the majority of the year.
- *Employer Contributions:* The employer must fund the safe-harbor contribution from the beginning of the plan year through the effective date of the amendment [Treas. Reg. § 1.401(k)-3(g)(1)(v)]. Generally, the employer has until the due date (with extensions) of the company tax return to deposit the contribution. However, plans that provide for the calculation of the safe harbor match on a pay period basis must fund the contribution by the end of the plan-year quarter following the quarter to which the contribution relates [Treas. Reg. § 1.401(k)-3(c)(5)(ii)].

Safe Harbor Nonelective Contributions

Employers using the safe harbor nonelective option are somewhat more restricted. In fact, prior to May of 2009, regulations simply did not provide a mechanism to reduce or eliminate a safe-harbor nonelective contribution without completely terminating the plan and distributing benefits to participants. This led several companies that found themselves in difficult financial straits in the early months of 2009 to terminate their 401(k) plans entirely as the only means to put a limit on the safe harbor contribution for this year.

Effective May 18, 2009, the Treasury Department issued proposed amendments to Treas. Reg. §§ 1.401(k)-3 and 1.401(m)-3 to provide relief to certain businesses impacted by the economic downturn. Specifically, plan sponsors that incur a substantial business hardship (as described in IRC § 412(c)) are now permitted to amend their plans to reduce or eliminate the safe harbor nonelective contribution. Whether a substantial business hardship exists is a "facts and circumstances" determination. IRC § 412(c)(2) notes that factors such as whether the employer is operating at an economic loss, has declining or depressed sales, and the levels of profits and substantial unemployment/underemployment in the employer's industry should be considered.

The steps required to eliminate or reduce the safe harbor nonelective contribution are essentially the same as those described above with regard to eliminating or reducing the match. There is, however, one additional requirement related to the funding of the nonelective contribution through the effective date of the amendment. The compensation limit under IRC § 401(a)(17) must be prorated for the portion of the year during which the safe harbor remained in effect when calculating the nonelective contribution.

Example

A calendar year plan that uses the safe harbor nonelective design is amended to eliminate the nonelective contribution effective September 30, 2009. The amount of the nonelective contribution is three percent of compensation. The compensation limit is prorated to $183,750 (9/12 x $245,000); therefore, the maximum nonelective contribution is three percent of that amount, or $5,512.50.

Potential Holes in the Lifeboat

While the regulations do provide welcome relief, there are several potential issues that could cause your plan to "take on water." Plans that eliminate or reduce the safe harbor contribution are required to satisfy the ADP/ACP tests for the entire year. One of the primary reasons for implementing a safe harbor plan is to allow HCEs to make elective deferrals up to the IRC § 402(g) limit ($16,500 for 2009) without concern for test failures and refunds. After the notices, amendments and partial year funding, it may feel like a bucket of cold water to the face if employers learn for the first time at the end of the year that their plans also fail their ADP and/or ACP tests and have to take corrective actions, especially if the plan was initially established as a safe harbor and has never been through the testing process. As such, it is worthwhile to remind plan sponsors of the testing requirements

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and to suggest a projected test to determine what, if any, steps may be taken to prevent a year-end failure.

A second and potentially more costly concern comes into play with plans that are top-heavy. A plan is top-heavy when more than 60 percent of the plan's assets are in the accounts of key employees (generally owners and officers). Such plans require a minimum contribution (generally three percent of compensation) on behalf of all nonkey employees. Safe harbor 401(k) plans that include only elective deferrals and safe harbor contributions for a given year are deemed to satisfy the top-heavy minimum contribution requirement for that year. As soon as a plan sponsor eliminates or reduces the safe harbor contribution, the top-heavy "exemption" evaporates and the employer may be left with a required top-heavy minimum contribution equal to or greater than the amount of the safe harbor contribution it just eliminated. If the plan fails its ADP test also, the perfect storm can quickly become a category five hurricane.

While no one can predict when our economy's volatility will subside, the recently amended regulations provide some measure of relief to financially strained plan sponsors. With the appropriate planning, consultation and documentation, there is a mechanism for troubled safe harbor plans to return to smooth sailing. ■

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