IRS ISSUES FINAL REGULATIONS ON MID-YEAR REDUCTION OR SUSPENSION OF SAFE HARBOR CONTRIBUTIONS

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On November 15, 2013, the Internal Revenue Service ("IRS") issued final regulations regarding how a plan sponsor is permitted to exit a safe harbor 401(k) feature in the middle of the current plan year ("Final Regulations"). These rules both clarified and supplemented the existing operational rules regarding safe harbor 401(k) matching and non-elective (commonly referred to as "profit sharing") "full year" contribution requirements.

Background

As you may know, one design feature available to a sponsor of a 401(k) plan is a "safe harbor employer contribution" component. The main advantage to such a feature is that it generally permits a plan sponsor to avoid the application of the "actual deferral percentage" ("ADP") and "actual contribution percentage" ("ACP") tests that serve to limit the amount of elective deferral and matching contributions that may be made by or the behalf of "highly compensated employees". In addition, in certain circumstances, proper employment of a safe harbor 401(k) feature can avoid the application and/or impact of the "top-heavy" test which restricts the amount of total plan assets that may accrue within the trust of a plan for the benefit of certain "key employees". However, the advantages of a safe harbor 401(k) feature come at a cost.

In order to gain the advantage of avoiding the ADP, ACP and top-heavy tests ("Tests"), a plan sponsor who elects to employ a safe harbor 401(k) feature must satisfy several requirements which include, but are not limited to, both employer contribution and administrative aspects. The most noteworthy of these requirements involve a 100% fully vested employer contribution of up to four (4) percent of each eligible employee's compensation (in the case of a safe harbor matching contribution) and an annual participant notification requirement. Most plan sponsors understand those two obligations from the outset of their election to "go safe harbor". However, many plan sponsors are less aware of the restrictions that apply to the ability of a plan sponsor to exit their 401(k) plan's safe harbor design feature; particularly if the desire to eliminate the feature occurs in the middle of the current plan year. The remainder of this article discusses both the prior and new IRS guidance on how to exit a 401(k) safe harbor contribution feature "mid-year".

Prior Guidance

Prior to the issuance of the Final Regulations, a plan sponsor could fully terminate a safe harbor plan midyear or eliminate a safe harbor *matching* contribution feature mid-year for any reason if the plan at issue provided advance notification of the elimination of the feature, funded the safe harbor contribution through the effective date of its elimination and applied the Tests in relation to the full plan year.

However, plan sponsors were only permitted to exit a safe harbor *non-elective* contribution feature mid-year if such sponsor satisfied the criteria set forth above and experienced a "substantial business hardship" as defined under the Internal Revenue Code. For this purpose, a substantial business hardship required a finding that: (i) the plan sponsor was operating at an economic loss, (ii) substantial unemployment

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or underemployment existed in the plan sponsor's trade or business, (iii) sales and profits of the plan sponsor's industry were depressed or declining, and (iv) it was reasonable to expect that the plan would only be continued if relief was granted.

As one might anticipate, the satisfaction of all four of the substantial business hardship criteria set forth above severely limited the ability of any plan sponsor to exit mid-year from a safe harbor non-elective contribution feature. In addition, the effective impact of the rules was to require not just a business hardship on the part of the individual plan sponsor but a finding that the entire industry within which such plan sponsor operated was experiencing a substantial hardship. Many practitioners believed that requiring a hardship on the part of the entire industry was unnecessary and too restrictive. Based on the form of the Final Regulations, the IRS agreed.

Final Regulations

As noted above, the manner by which a safe harbor 401(k) contribution could be eliminated mid-year under the old guidance depended upon whether the safe harbor 401(k) contribution at issue was a safe harbor match or a safe harbor non-elective contribution. However, there did not seem to be any justification for such a distinction. Therefore, it should be no surprise that the Final Regulations provide identical rules for the mid-year elimination of either a safe harbor match or a safe harbor non-elective contribution feature.

Under the Final Regulations, there are two circumstances under which a plan sponsor may stop a safe harbor contribution requirement:

1. the plan sponsor is operating at an economic loss; or
2. the plan sponsor included specific language in the annual safe harbor notice explaining that the plan *may* be amended during the plan year to eliminate the safe harbor contribution feature.

The first item listed above reflects the elimination of three (3) of the four (4) criteria that were previously required in order to satisfy the economic hardship component necessary under the prior guidance with regard to the mid-year elimination of a safe harbor non-elective feature. Obviously, this will make it easier for a plan with a safe harbor non-elective component to qualify for this type of relief but more difficult for a plan with a safe harbor match which did not previously have to satisfy any such requirement. Notwithstanding, the second item's grant of an ability to every plan sponsor to include "magic" language within its safe harbor notice that permits a plan sponsor to accomplish the same safe harbor elimination goal is much more permissive. Therefore, presumably, such language will become standard "boilerplate" language included within all future safe harbor participant notices prepared not only by Legacy Retirement Solutions but by all plan service providers.

If the plan sponsor meets one of the circumstances that permit the mid-year elimination of a safe harbor contribution, it then must satisfy several administrative requirements in order to effectuate that intent. Specifically:

1. all eligible employees must be provided with a supplemental notice that informs them about such elimination including its effective date and how to change their deferral elections;
2. the elimination of the safe harbor contribution must be effective no earlier than the later of the date the amendment is adopted or 30 days after all eligible employees are provided with the supplemental notice referenced above;
3. all eligible employees must be granted a reasonable opportunity (including a reasonable period after receipt of the supplemental notice) to change their deferral elections before the elimination of the safe harbor contribution;
4. the plan must be amended to provide that the Tests will be satisfied for the entire plan year in which the elimination occurs; and
5. the plan sponsor must fund the safe harbor contribution through the effective date of the amendment that eliminates it.

With regard to the mid-year elimination of a safe harbor 401(k) match features, the above referenced changes are effective for plan years beginning on or after January 1, 2015. However, with regard to safe harbor 401(k) non-elective features, the Final Regulations are technically effective retroactively to May 18, 2009 but, practically, are effective immediately.

For more information about this issue please contact our marketing department at 484-483-1044 or your administrator at Legacy.

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