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Good News for Many Safe Harbor 401(k) Plans

A number of plan sponsors and plan advisors have inquired about the obligation to a safe harbor 401(k) plan in the event the down turn in the economy requires the company to suspend the safe harbor contribution. Until now, only a safe harbor 401(k) plan which utilizes a matching safe harbor contribution was permitted to suspend the matching contribution and continue to operate the plan. A plan which utilizes the nonelective safe harbor contribution (typically a 3% fully vested contribution to all eligible employees) was not permitted to suspend the 3% contribution during the year without terminating the plan.

Fortunately, on May 18, 2009, the Internal Revenue Service ("IRS") published proposed amendments to certain Treasury Regulations to provide an employer incurring a "substantial business hardship" an alternative to terminating the 401(k) safe harbor plan. An employer meeting certain requirements can reduce or suspend a required safe harbor nonelective contribution without losing their plan's qualified status.

I. Background.
A 401(k) plan is a qualified retirement savings plan which allows eligible employees to make a cash or deferred election with respect to their wages. In order to qualify under federal income tax laws, a qualified 401(k) plan must satisfy certain nondiscrimination requirements. A 401(k) plan must pass either the "actual deferral percentage" ("ADP") test or one of the safe harbors. A plan that that intends to be a safe harbor 401(k) plan must meet the following requirements:

a. adopt a safe harbor 401(k) plan that specifies whether the employer will make a safe harbor matching or nonelective contribution;

b. maintain the safe harbor 401(k) plan throughout a full plan year subject to certain exceptions (explained below);

c. notify each eligible employee within a reasonable period before the beginning of each plan year of rights and obligations under the plan; and

d. make either matching or nonelective contributions at least as great as the rates required by its safe harbor.

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There are exceptions to the general requirement that an employer continue a safe harbor 401(k) plan throughout a full plan year. First, a new 401(k) plan may have a short plan year for the first plan year only. For any other safe harbor 401(k) plan, an employer may either:

a. amend a plan to reduce or suspend safe harbor matching contributions on future employee elective contributions for a plan year, or

b. terminate its safe harbor plan during the plan year.

II. Substantial Business Hardship.
Under the proposed regulations an employer that experiences a "substantial business hardship" may amend its safe harbor plan to reduce or eliminate the plan's safe harbor nonelective contribution. First, the plan must be amended prior to the end of the plan year to reduce or suspend the safe harbor nonelective contribution. Second, following the amendment, the plan must provide that the ADP test (and any other nondiscrimination requirements) will be satisfied for the entire plan year in which the safe harbor nonelective contribution is reduced or suspended.

All eligible employees must be given a "supplemental notice" that explains the reduction or suspension of any remaining safe harbor nonelective contribution and its consequences, the procedures for changing employee elections and the effective date of the amendment. The reduction or suspension of the safe harbor nonelective contribution can occur no earlier than 30 days after giving eligible employees the supplemental notice and the amendment's adoption date, if later. All eligible participants must be given a reasonable period of time after they receive the supplemental notice to change their salary deferral elections prior to the reduction or suspension of the safe harbor nonelective contributions.

Plans which eliminate the safe harbor nonelective contribution must prorate the annual compensation limit ($245,000 in 2009) over the shorter period. Also, the Plan will have to satisfy any top heavy requirements, if applicable.

These proposed regulations are effective for amendments adopted after May 18, 2009, but plans may rely on them pending issuance of final regulations. The IRS has stated that, to the extent the final regulations are more restrictive than these proposed regulations, they will not be applied retroactively.

If you have questions about this procedure for eliminating a safe harbor contribution during the year, contact the author, Jeff Dixon of Firm's Employee Benefits and ERISA practice team at jdixon@mwlaw.com or 501-688-8823.

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