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November 26, 2013 www.groom.com

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Long-Awaited IRS Guidance Provides Uniform Rules for Mid-Year Suspension of Safe Harbor Contributions

The Internal Revenue Service (IRS) recently issued final safe harbor plan regulations that (1) provide uniform rules for suspending/reducing employer matching and non-elective contributions mid-year, and (2) pave the way for upcoming guidance on permissive mid-year changes that will not impact the safe harbor status of the plan. 78 FR 68735 (Nov. 15, 2013).

Although the final regulations largely track the 2009 proposed regulations, they do permit plan sponsors to add language to their annual safe harbor notices to reflect the ability to make employer contribution changes mid-year, and thereby avoid having to demonstrate that the employer has a financial hardship in order to permit the change. While some employers with non-elective contributions undoubtedly will take advantage of the new rules to make mid-year suspensions, the economic pressures that were present when the proposed rules were published in mid-2009 have lessened.

Importantly, for plans with non-elective contributions, the new rules create an immediate need to expand 2014 safe harbor notices if a plan sponsor wants to keep its options open for next year (and avoid the hardship requirement), as the regulations do not extend the December 2 safe harbor notice deadline.

A summary of the prior rules and the final regulations is set forth below, along with action steps.

I. <u>Background</u>

Both traditional safe harbor plans (Code secs. 401(k)(12), 401(m)(11) or 403(b) plans) and plans with Qualified Automatic Contribution Arrangements (Code secs. 401(k)(13), 401(m)(12) or 403(b) plans) require employer contributions (either matching or non-elective contributions) to be made for the entire 12-month plan year. The IRS regulations have historically permitted employers to suspend matching contributions with 30-days advance notice to participants (and then perform the applicable discrimination testing), but did not address changes to non-elective contributions.

In 2009, the IRS issued proposed regulations that would also permit suspension of non-elective contribution, but added a financial hardship condition (following sec. 412(c)) that did not apply to changes to matching contributions. Under Code section 412(c) – which is part of the rules governing waivers of the minimum funding requirements for DB plans – an employer is required to establish "substantial business hardship" to the IRS and obtain a ruling to that effect. This “facts and circumstances” test includes (but is not limited to) factors such as the employer is operating at an economic loss, there is substantial unemployment or underemployment in the trade or business and in the industry concerned,

the sales and profits of the industry are depressed or declining, and it is reasonable to expect that the plan will be continued only if the waiver is granted.

The proposed regulations also clarified that, if safe harbor employer contributions – matching or non-elective – are suspended mid-year, the section 401(a)(17) compensation limit must be prorated, and the plan will become subject to the top-heavy rules (along with discrimination testing). In general, proration of the compensation limit may well impact contributions already made (e.g., if the person was approaching or possibly reached the maximum limit ($260,000 in 2014) by the time of the suspension) requiring forfeiture and reallocation of some amounts.

II. Final Regulations

To provide uniformity in these rules, the final regulations require the following process for making mid-year suspension/reduction of safe harbor matching or non-elective contributions.

Hardship or Notice Alternatives – The employer must either –

- be operating at an economic loss, as described in Code section 412(c)(2)(A) for the plan year. Fortunately, this prong no longer takes into account the other factors under Code section 412(c) set forth above, as this change was intended to address concerns that employers needed certainty that they satisfied the hardship requirements; or
- provide a safe harbor notice that includes a statement that the plan may be amended during the plan year to reduce or suspend safe harbor non-elective or matching contributions, as applicable, and that the reduction or suspension will not apply until at least 30 days after all eligible employees are provided notice of the reduction or suspension.

Additional Requirements – Consistent with the prior regulations, the following rules must also be satisfied –

- provide 30-days advance notice of the amendment to participants, explaining: (a) the consequences of the amendment that reduces or suspends future safe harbor contributions, (b) the procedures for making changes in their cash or deferred elections and, if applicable, their employee contribution elections, and (c) the effective date of the amendment;
- provide a reasonable opportunity, after notice is provided, for participants to change salary deferral elections;
- continue contributions through the effective date of the amendment (reduction or suspension cannot be effective earlier than the later of the date the amendment is adopted or 30 days after eligible employees are provided the supplemental notice); and
- meet the ADP and ACP test, as applicable, for the entire plan year on a "current year" testing basis.

Other Clarifications – The final rules clarify a number of other issues, as described below.

Impact of Other Mid-Year Changes. The final regulations were expanded to provide the IRS with authority to develop rules to address special circumstances under which a mid-year change to a safe harbor plan is appropriate, such as an

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amendment to the plan in connection with a mid-year corporate transaction. This same flexibility extends to mid-year changes to safe harbor plans under Code sections 401(k) and 401(m).

Plan Terminations. The final regulations extend the suspension rules to a safe harbor plan termination – allowing a plan termination mid-year if:

- The above requirements are met, treating the plan termination as a suspension of contributions, except notice of the amendment or hardship requirement is not required and the reasonable opportunity requirement does not apply; or
- The plan termination is in connection with a transaction described in Code section 410(b)(6)(C) (e.g., corporate merger/reorganization) or the employer incurs a substantial business hardship, comparable to the hardship described in Code section 412(c) (as described above).

Impact on Code Section 401(a)(17). The preamble to the final regulations confirms the IRS position that a pro rata compensation limit applies with a mid-year reduction/suspension of safe harbor contributions, but provides no additional guidance.

Existing Contingent Notice Rules Remain Unchanged. The rules regarding the ability of a safe harbor plan to use a contingent notice (as described in Treas. Reg. § 1.401(k)-3(f)(2)) before the beginning of the plan year, where the contingent notice indicates that the plan may be amended during the plan year to include safe harbor non-elective contributions and that, if the plan is amended, a follow-up notice will be provided, remains unchanged.

III. Applicability Date and Action Steps

With respect to mid-year changes of non-elective employer contributions, the final regulations provide that employers may rely on them for amendments adopted after May 18, 2009, the date the proposed regulations were published in the Federal Register. (Any provision in the final regulations, which are generally effective November 15, 2013, that is more restrictive will apply prospectively.) With respect to mid-year changes of matching contributions, these more restrictive regulations do not apply until the 2015 plan year; therefore, employers that change safe harbor matching contributions in 2014 will not be subject to the new hardship requirement – regardless of whether or not the annual notice for 2014 includes the new disclosure language.

Going forward, all employers offering safe harbor plans should add the above notice language to their safe harbor notices in order to provide maximum flexibility to make mid-year changes to the employer contributions (and avoid the financial hardship requirement). Importantly, for plans with non-elective contributions, employers need to act fast to take advantage of this provision for the 2014 plan year. (There is no rush for plans with matching contributions because this new hardship requirement is not effective until the 2015 plan year.) Although employers generally want to preserve maximum flexibility, we note that those employers with a "linked" nonqualified deferred compensation plan may have trouble making mid-year changes to the safe harbor plan without creating potential 409A issues in the linked nonqualified plan.

Plan sponsors and administrators should stay tuned for IRS guidance covering other permissible mid-year changes to safe harbor plans, including those unrelated to contributions.

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