

IRS Proposes Reduction or Suspension of 401(k) Safe Harbor Nonelective Contributions by Financially Distressed Employers

For the last several months, news reports have been filled with stories about employers reducing or eliminating matching or other employer contributions to their 401(k) plans in order to cope with the economic downturn. This alternative, however, has not been readily available to certain employers that make safe harbor contributions to their 401(k) plans.

The Internal Revenue Code and IRS regulations allow employers to avoid annual non-discrimination testing that is generally required for 401(k) plans if they make specified minimum guaranteed employer contributions to their plans. These may take the form of either matching contributions (i.e., based on employee pre-tax or after-tax contributions) or nonelective contributions (i.e., based on compensation, whether or not employees contribute to the plan). In either case, an employer using the safe harbor generally must decide and provide written notice to all participants before the beginning of the plan year, and maintain the safe harbor arrangement throughout the plan year.

The IRS regulations offer an exception to this plan year requirement for employers that use safe harbor matching contributions. An employer can amend its 401(k) plan to reduce or eliminate safe harbor matching contributions mid-year if it gives participants thirty (30) days' advance written notice of the change, provides an opportunity for employees to modify their contribution elections before the reduction or elimination, and amends the plan to require satisfaction of nondiscrimination testing rules for the entire plan year. Thus, employers using safe harbor matching contributions face minimal restrictions in responding to the current economic climate.

By contrast, the IRS regulations have not permitted mid-year reduction or elimination of safe harbor nonelective contributions. Financially distressed employers could alter such contributions mid-year only by completely terminating the entire 401(k) plan.

The IRS has now proposed regulations offering relief to these employers. The proposed regulations permit mid-year reduction or elimination of safe harbor nonelective contributions under conditions similar to those that apply to safe harbor matching contributions. Participants must be given thirty (30) days' advance written notice and an opportunity to change their contribution elections before the reduction or elimination, and the plan must satisfy non-discrimination testing requirements for the entire plan year. This relief is available, however, only to employers experiencing a "substantial business hardship." Satisfaction of this standard appears to be based on all the facts and circumstances, including but not limited to whether or not (i) the employer is operating at an economic loss, (ii) there is substantial unemployment or underemployment in the business and the industry concerned, (iii) the sales and profits of the industry concerned are depressed or declining, and (iv) it is reasonable to expect that the plan will be discontinued if safe harbor nonelective contributions are not reduced or eliminated.

This relief is immediate and applies to any 401(k) plan amendments adopted after May 18, 2009. In addition, employers may rely on the guidance in these proposed regulations, even if final regulations are more restrictive.

If you have questions or would like additional information about this relief for safe harbor 401(k) plans, please feel free to contact Brian Dougherty at (215) 587-5919 or bdougherty@postschell.com.

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