

Client Advisory | June 2009

IRS Rules Allow Suspension or Reduction of Safe Harbor 401(k) Non-Elective Contributions Upon Substantial Business Hardship

On May 18, 2009, the Internal Revenue Service issued proposed regulations that permit employers sponsoring safe harbor 401(k) plans to suspend or reduce safe harbor non-elective contributions after the start of the plan year if certain conditions are satisfied.



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A safe harbor 401(k) plan to which the employer makes specified levels of employer matching contributions or non-elective contributions is deemed to satisfy certain annual nondiscrimination tests. Contributions to a safe harbor 401(k) plan generally must be maintained throughout the plan year for the plan to satisfy the nondiscrimination tests. However, plans using safe harbor matching contributions to satisfy the nondiscrimination requirements can reduce or suspend the level of such contributions during the plan year if certain conditions are met without jeopardizing the tax-qualified status of the plan. Prior to this May guidance, plans using safe harbor non-elective contributions were not entitled to this relief, leaving termination of the plan as the only alternative for an employer who was financially unable to meet the safe harbor contribution requirements.

The proposed regulations allow safe harbor non-elective contributions to be suspended or reduced mid-year if the employer has incurred a “substantial business hardship” and certain other conditions are met. Whether an employer has incurred a “substantial business hardship” depends on a number of factors including whether:

- The employer is operating at an economic loss;
 - There is substantial unemployment or underemployment in the trade or business and in the industry of the employer;
 - The sales and profit of the employer’s industry are depressed or declining; and
 - It is reasonable to expect the plan will be continued only if the relief is granted.
- An employer that has incurred a “substantial business hardship” may reduce or suspend safe harbor non-elective contributions mid-year if the following requirements are met:
- The plan is amended before the end of the plan year to reduce or suspend the non-elective safe harbor contributions;
 - All eligible employees are provided a written “supplemental” notice that explains the consequences of the amendment to reduce or suspend future safe harbor contributions, the procedures for changing their salary deferral elections and the effective date of the amendment.
 - The reduction or suspension of the contributions cannot be effective earlier than 30 days after the later of the date the eligible employees are given the supplemental notice or the date the amendment is adopted;
 - All eligible employees are given a reasonable opportunity (including a reasonable period after receipt of the supplemental notice) to change their salary deferral elections before the safe harbor non-elective contributions are suspended or reduced;
 - The plan is amended to provide that the actual deferral percentage (ADP) test and actual contribution percentage (ACP) test will be satisfied for the entire plan year in which the safe harbor non-

elective contributions are suspended or reduced by using the current year testing method; and

- The plan must satisfy the safe harbor non-elective contributions requirement for compensation paid through the effective date of the amendment.

Additional consequences may result from suspending or reducing safe harbor 401(k) matching or non-elective contributions mid-year. If the plan does not pass the ADP/ACP tests for the year, the employer may need to make additional contributions to the plan or may be required to reduce contributions made on behalf of highly compensated employees. The compensation limit under Code Section 401(a)(17) (\$245,000 for 2009) must be prorated.

This rule could prove problematic for an employer that made contributions for the portion of the year prior to the reduction or suspension of the safe harbor contributions based on compensation greater than the prorated compensation limit. Safe harbor plans are deemed to satisfy the top-heavy rules of Code Section 416, and discontinuing safe harbor contributions mid-year will cause the plan to lose this exemption. If the plan is determined to be top-heavy, minimum contributions may need to be made to the plan to meet the top-heavy requirements.

The proposed regulations are effective for amendments adopted after May 18, 2009, and may be relied upon pending the release of final regulations.

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