



Legal Alert: When a Safe Harbor becomes Unsafe

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The Internal Revenue Service this week issued proposed regulations that would permit the reduction or suspension of safe harbor nonelective contributions (SHC's) by an employer that sponsors a "safe harbor" 401(k) plan if the employer incurs a "substantial business hardship" (as described in the proposed regulations). This gives an employer an alternative to terminating its safe harbor plan just because it cannot afford to make a contribution. The proposed regulations would allow for the reduction or suspension of safe harbor nonelective contributions and safe harbor matching contributions under substantially identical rules. Under the proposed regulations, reducing or suspending safe harbor nonelective contributions will not cause the plan to fail to satisfy section 401(k), provided that the following five conditions are satisfied:

- all eligible employees must receive a supplemental notice of the suspension or reduction, as the case may be;
- the suspension or reduction must be effective no sooner than 30 days after the supplemental notice is provided *and* no earlier than the date the plan amendment is adopted;
- eligible employees have a reasonable period after receiving the supplemental notice, and before the suspension or reduction of SHC's becomes effective, to revoke or modify their salary-reduction elections;
- the plan is amended (if necessary) to provide that the current-year testing method will be used in performing the ADP test for the plan year in which the suspension or reduction occurs; and
- the plan satisfies the safe harbor requirements with respect to the SHC's made, and safe harbor compensation paid, through the effective date of the amendment.

The proposed regulations would also provide that the supplemental notice requirement is satisfied by a notice that explains: (1) the effects of the plan amendment reducing or suspending SHC's; (2) the effective date of the amendment; and (3) the procedure for changing salary-reduction elections. (The proposed regulations also apply the same rules and requirements to safe harbor plans under §1.401(m)-3, providing safe harbor matching

contributions, except that references in the above requirements to the ADP test, or nonelective contributions are applied to the ACP test and matching contributions.) As mentioned above, an amendment suspending or reducing safe harbor contributions can only be made if the employer is enduring a "substantial business hardship." For this purpose, "substantial business hardship" is intended to have the same meaning as when applied by the PBGC for purposes of applying funding standards to a restored defined benefit plan. That is, the determination would be made on the basis of the following, and other similar, factors:

- whether the plan sponsor and its controlled group (if any) are operating at a loss;
- whether there is substantial unemployment in the industry or business of the sponsor;
- whether profits in the industry(ies) are depressed or declining; and
- the degree to which a suspension or reduction can be expected to benefit the financial condition of the sponsor.

Because a reduction or suspension of safe harbor contributions cannot be effective less than 30 days after the supplemental notice is provided to all eligible employees or before the plan amendment is adopted, an employer who wants to reduce or suspend safe harbor contributions during a particular year cannot merely adopt an amendment at the end of the plan year. In addition, if a plan is amended during a plan year to reduce or suspend safe harbor contributions (whether nonelective contributions or matching contributions) the otherwise-applicable compensation limit under section 401(a)(17) of the Code must be prorated as if the year of the suspension or reduction were a short plan year. Finally, if safe harbor contributions are reduced or suspended, so that the full amount is not made for a plan year, the plan will not be a "safe harbor" plan for the plan year, and will be subject to the top-heavy rules under section 416 of the Code, as well as discrimination testing.

The proposed regulations are to be effective with respect to any plan amendments adopted after May 18, 2009 (the date of publication). The proposed regulations may be relied upon pending the issuance of final regulations, and to the extent that final regulations are more restrictive than the proposed regulations, the final regulations will be applied prospectively. The Notice of Proposed Rulemaking, including the text of the proposed regulations, can be found at <http://edocket.access.gpo.gov/2009/pdf/E9-11481.pdf>. If you have any questions regarding the proposed regulations, you can contact the author of this Alert, Jeffrey Ashendorf, at 212-453-5926, jashendorf@fordharrison.com, or any member of Ford & Harrison's [Employee Benefits practice group](#).