

## Employee Benefits & Executive Compensation Client Service Group

To: Our Clients and Friends

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### New Proposed 401(k) Regulations Permit Reduction or Suspension of Safe Harbor Non-Elective Contributions

The IRS recently issued proposed regulations permitting the suspension or reduction of non-elective contributions under safe harbor 401(k) plans in certain circumstances. Under prior law, safe harbor 401(k) plan sponsors were permitted to reduce or suspend matching contributions mid-plan year, but were not able to do the same to non-elective contributions. If a plan sponsor wanted to reduce or suspend non-elective contributions under a safe harbor 401(k) plan mid-plan year, a plan termination was necessary. However, the proposed regulations provide some much anticipated relief to plan sponsors suffering a "substantial business hardship." These proposed regulations are effective for plan amendments adopted after May 18, 2009.

#### Background

Section 401(k) of the Internal Revenue Code requires, among other things, that elective contributions under a 401(k) plan must not discriminate in favor of highly compensated employees. A plan can fulfill this requirement by satisfying the Average Deferral Percentage test ("ADP test"), or by satisfying certain safe harbor design alternatives. One permissible safe harbor design requires the plan sponsor to make a qualified matching contribution on behalf of all eligible non-highly compensated employees equal to 100% of the first 3% of compensation deferred by the employee, and 50% of the contributions on the next 2% of compensation. An alternative safe harbor design allows the plan sponsor to simply make a qualified non-elective contribution ("QNEC") equal to 3% of compensation for all eligible non-highly compensated employees.

With respect to automatic contribution arrangements, an additional safe harbor design alternative provides the plan sponsor a choice between a matching contribution and a QNEC. This alternative match requires a 100% match on up to 1% of compensation and 50% up to 6% of compensation. Or, the QNEC of 3% of compensation may be used to satisfy ADP test requirements.

Any 401(k) plan that provides a matching contribution is required to satisfy a form of discrimination testing known as the Actual Contribution Percentage test ("ACP test"). The ACP test is similar to the ADP test, and generally will be deemed to have been satisfied if the plan passes the ADP test. Like the ADP test, a 401(k) plan can be deemed to satisfy the ACP test if it complies with the aforementioned safe harbor designs.

Another requirement for the safe harbor 401(k) plans is that they generally must be adopted before the beginning of the plan year and maintained throughout a full 12-month plan year. Therefore, if, at the beginning of a plan year, a plan commits to an allocation schedule making it a safe harbor plan, it generally cannot be amended to revert to the ADP test or other testing for that plan year. However, an exception to this rule permits a 401(k) plan utilizing the safe harbor matching contribution to be amended during the plan year to reduce or suspend those matching contributions on future elective deferrals as long as certain requirements are met. Until now, the same had not been true with respect to QNECs.

## **New Rules**

The proposed regulations permit an employer sponsoring a safe harbor 401(k) plan to reduce or suspend safe harbor QNECs mid-plan year if the employer incurs a “substantial business hardship.” Whether an employer endures a substantial business hardship will be determined by taking into account, among other things, the following factors:

- The employer is operating at an economic loss;
- There is substantial unemployment or underemployment in the trade or industry concerned;
- The sales or profits of the industry concerned are depressed or declining; and
- It is reasonable to expect that the plan will only be continued if the QNECs are reduced or suspended.

If a plan sponsor incurs such a substantial business hardship, it may be able to reduce or suspend its non-elective contributions. In order to do so, it must:

- Provide notice to all eligible employees of the reduction or suspension;
- Not permit the reduction or suspension earlier than the later of 30 days after the eligible employees are provided notice and the date the amendment is adopted;
- Give eligible employees a reasonable opportunity prior to the reduction or suspension to change their compensation deferral elections;
- Ensure that the plan satisfies ADP testing for that plan year using the current plan year method; and
- Satisfy the safe harbor requirements with respect to safe harbor compensation paid through the effective date of the amendment.

Note that with the exception of the need for a substantial business hardship, the above list represents the same requirements plan sponsors have needed to comply with in order to reduce or suspend safe harbor matching contributions prior to the proposed regulations.

## **Conclusion**

Although the proposed regulations will come as a relief to a number of struggling businesses, they are quite narrow in their scope and do not provide the level of flexibility that was desired by many employers hoping to reduce or suspend QNECs. It is important that plan sponsors seeking to reduce or suspend their QNECs take steps to ensure that (1) they are eligible for the relief provided by the regulations, and (2) the reduction or suspension is accomplished in a compliant manner.

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