

RELIEF FOR SAFE HARBOR 401(k) CONTRIBUTIONS

401(k) plans are now perhaps the most prevalent form of qualified retirement plan. In order for a 401(k) plan to be qualified, it must satisfy a number of legal requirements. One of these is a special discrimination test called the Actual Deferral Percentage (ADP) Test.

A design-based safe harbor was added to the Internal Revenue Code under which a 401(k) plan is treated as satisfying the ADP test if the plan meets certain contribution and notice requirements. The employer can make either a safe harbor matching contribution or non-elective contribution. Generally, the plan must specify, before the beginning of the plan year, the type of safe harbor contribution that will be made for the year. Also, a safe harbor plan generally must be adopted before the beginning of the plan year and be maintained throughout a full twelve (12) month plan year.

An exception to these general requirements was provided for safe harbor matching contributions. A plan could be amended during the plan year to reduce or suspend safe harbor matching contributions on future 401(k) salary deferrals. A notice must be provided to all eligible employees and the reduction or suspension must be effective no earlier than the later of thirty (30) days after eligible employees are provided the notice and the date the amendment is adopted.

But, what if an employer elected safe harbor non-elective contributions? Is it possible to change this safe harbor contribution mid-year if the employer faces difficult financial circumstances? Under the initial regulations, the answer was “NO.” The regulations did not permit an employer to suspend or reduce the non-elective contributions. The only option available to the employer was to terminate the entire 401(k) plan. Obviously, this really was not a great alternative for a plan sponsor.

However, under new regulations, an employer may reduce or suspend safe harbor non-elective contributions under rules comparable to those for safe harbor matching contributions. An employer that incurs a substantial business hardship may reduce or suspend safe harbor non-elective contributions if:

- 1) all eligible employees are provided a supplemental notice;
- 2) the reduction or suspension is effective no earlier than the later of thirty (30) days after eligible employees are provided the supplemental notice and the date the amendment is adopted;
- 3) eligible employees are given a reasonable opportunity prior to the reduction or suspension to change their salary deferral elections;
- 4) the plan is amended to provide that the ADP test will be satisfied for the entire year using current testing method; and
- 5) the plan satisfies the safe harbor non-elective contribution requirement with respect to safe harbor compensation paid through the effective date of the amendment.

The regulations refer to Internal Revenue Code Section 412(c) for the determination of substantial business hardship. This section applies to the determination of business hardship for purposes of the waiver of minimum funding standards. The factors taken into account include:

- 1) employer operating at an economic loss;
- 2) there is substantial unemployment or underemployment in the trade or business and the industry concerned;
- 3) the sales and profit of the industry concerned are depressed or declining; and
- 4) it is reasonable to expect the plan will be continued only if the waiver is granted.

Safe harbor 401(k) plans have proven to be an excellent mechanism for key employees to maximize 401(k) salary deferrals while avoiding the pitfalls of the ADP test. However, recent economic times have forced many employers to reconsider decisions to implement 401(k) safe harbor designs. These new regulations insert flexibility into the implementation of safe harbor non-elective contributions, making it far more possible for employers to consider the 401(k) safe harbor.

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