

May 26, 2009

TCRS 2009-04: Proposed Regulations Relating to Suspension or Reduction of Safe Harbor Nonelective Contributions

On May 18, 2009, the Internal Revenue Service published proposed regulations that would provide relief to employers who sponsor a safe harbor plan providing for nonelective contributions and who incur a substantial business hardship, if certain conditions are satisfied. The proposed regulations would permit such employers the option of amending their plan during the plan year to reduce or suspend nonelective contributions instead of terminating their plan. The proposed regulations are effective for amendments adopted after May 18, 2009.

Considering the current economic climate, the proposed regulations provide a viable alternative to plan termination and welcome relief from the nonelective safe harbor funding requirement.

Background

Under existing safe harbor rules, generally, a safe harbor plan must be adopted before the beginning of a plan year and be maintained throughout a full 12-month period. Limited exceptions apply. A 401(k) plan that provides for safe harbor matching contributions may be amended during the plan year to reduce or suspend matching contributions if certain conditions are satisfied.

Prior to the issuance of these proposed regulations, there was no corresponding provision that permitted the reduction or suspension of safe harbor nonelective contributions during the plan year. Therefore, if an employer needed to reduce or suspend safe harbor nonelective contributions, it had to wait to amend its plan effective for the following plan year. For an employer that could not afford to wait, the only alternative was to terminate the plan.

Scope of Proposed Regulations

The proposed regulations apply to 401(k) plans (including those that have a Qualified Automatic Contribution Arrangement (QACA)) that provide for safe harbor nonelective contributions (3% of compensation) and 403(b) plans that provide for similar contributions.

Substantial Business Hardship

According to the proposed regulations, some of the factors taken into account to determine if a substantial business hardship exists include, but are not limited to, the following:

- whether the employer is operating at an economic loss,
- whether there is substantial unemployment (or underemployment) in the trade or business of the employer, its controlled group members (if applicable) and in the industry to which the employer belongs, and
- whether the sales and profits of such industry are depressed or declining.

Conditions for Reducing or Suspending Safe Harbor Nonelective Contributions

- The employer must incur a substantial business hardship.
- The plan must be amended before the end of the plan year and the amendment must be adopted after May 18, 2009.
- Eligible employees must be given a written supplemental notice that explains (1) the reduction or suspension of *future* nonelective contributions and the consequences of the reduction or suspension, (2) the effective date of the amendment and (3) the procedures for changing deferral (and employee after-tax contribution, if applicable) elections.
- The reduction or suspension must occur no earlier than the later of (1) 30 days after providing eligible employees the supplemental notice and (2) the date the amendment is adopted.

- The amendment must provide that the ADP test and ACP test (if applicable) must be satisfied for the entire plan year in which the reduction or suspension occurs using the current year method.
- Eligible employees must be given the opportunity within a reasonable period after the supplemental notice is provided and before the reduction or suspension to change their deferral and, if applicable, their after-tax contribution elections.
- The nonelective contributions must be funded through the effective date of the amendment using safe harbor compensation paid through that date.

Effect On Other Plan Provisions

The proposed regulations provide that:

- the same rules that apply to the reduction or suspension of safe harbor nonelective contributions also apply to safe harbor matching contributions, except for the substantial business hardship rule.
- a plan that is amended to reduce or suspend safe harbor contributions (whether nonelective or matching) must prorate the otherwise applicable compensation limit (\$245,000 for 2009) under Code section 401(a)(17).
- a plan that is amended to reduce or suspend safe harbor nonelective contributions will be subject to the top-heavy rules for the entire year of the reduction or suspension. The proposed regulations do not provide relief from the top-heavy minimum contribution requirement in the case of substantial business hardship.

Reliance On Proposed Regulations

Pending issuance of final regulations, the proposed regulations may be relied upon for guidance. If final regulations are more restrictive with respect to any provision in the proposed regulations, the corresponding provision of the final regulations will be applied without retroactive effect.

Reliance on the proposed regulations allows employers who incur a substantial business hardship to act quickly in order to limit their safe harbor nonelective contribution liability for the current year. However, before adopting the amendment, employers are urged to first consider the implications (financial or otherwise) of reducing or suspending safe harbor nonelective contributions on the top-heavy status of their plan and on other plan requirements.

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