

Client Alert

Don't Terminate That 401(k) or 403(b) Safe Harbor Plan Just Yet: IRS Proposes New Rules Allowing Employers Experiencing Substantial Business Hardship To Reduce Non-elective Contributions Mid-Year

Introduction

On May 18, 2009, the Internal Revenue Service (the "IRS") issued new proposed regulations that allow plan sponsors of Internal Revenue Code ("Code") Section 401(k) or 403(b) safe harbor plans to reduce or suspend non-elective contributions mid-year if they are experiencing a "substantial business hardship." Prior to the proposed regulations, a plan sponsor could suspend non-elective contributions under a safe harbor plan only by terminating the plan. The proposed regulations apply to both traditional safe harbor plans and those that qualify as "qualified automatic contribution arrangements" (QACAs), a type of automatic enrollment plan introduced under the Pension Protection Act of 2006 for plan years beginning in or after 2008. The proposed regulations mirror current regulations that allow sponsors of plans with safe harbor matching contributions to reduce or suspend such contributions mid-year.

Plan sponsors may rely on the proposed regulations immediately (*i.e.*, effective for amendments adopted after May 18, 2009) pending issuance of final regulations. If the final regulations are more restrictive

than the proposed regulations, the final regulations will only apply prospectively.

"Substantial Business Hardship"

To obtain the relief provided in the proposed regulations, a plan sponsor must first determine if it has incurred a "substantial business hardship." The determination as to whether an employer has experienced a substantial business hardship is based on all of the relevant facts and circumstances. Factors taken into account in making this determination include whether:

- the employer is operating at an economic loss;
- there is substantial unemployment or underemployment in the trade or business and in the industry concerned; and
- the sales and profits of the industry concerned are depressed or declining.

Requirements under the Proposed Regulations

Under the proposed regulations, an employer that experiences a substantial business hardship may amend its plan to reduce or suspend safe harbor non-elective contributions if all of the following requirements have been satisfied:

1. all eligible employees are provided a "supplemental notice" that explains the consequences of the prospective reduction/suspension of safe harbor non-elective contributions, the procedures for changing their salary deferral elections (and, if applicable, their employee after-tax elections), and the effective date of the amendment;
2. the reduction or suspension of safe harbor non-elective contributions takes effect no earlier than 30 days after eligible employees are provided the supplemental notice or the date the amendment is adopted, whichever is later;

3. eligible employees are given a reasonable opportunity (including a reasonable period after receipt of the supplemental notice) prior to the reduction or suspension to change their salary deferral elections (and, if applicable, their employee after-tax elections);
4. the plan is amended to provide that the actual deferral percentage (ADP) test and/or the actual contribution percentage (ACP) test, as applicable, will be satisfied for the entire plan year using the current year testing method;
5. the plan satisfies all of the other safe harbor non-elective contribution requirements with respect to safe harbor compensation paid through the effective date of the amendment; and
6. the plan must prorate the otherwise applicable compensation limit found in Section 401(a)(17) of the Code (\$245,000 for 2009) to reflect the shortened safe harbor contribution period.

A 401(k) plan that reduces or suspends safe harbor non-elective contributions under the proposed regulations also will be no longer exempt from the top-heavy testing rules under Code Section 416 for the year of the reduction or suspension.

Full Text

The full text of the proposed regulations is available at: <http://edocket.access.gpo.gov/2009/pdf/E9-11481.pdf>.

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