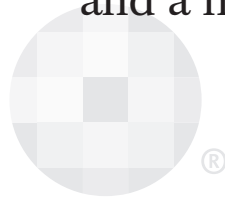


401(k) Plans in Challenging Economic Times: Reducing or Eliminating Employer Contributions Midyear

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In today's economic climate, employers are faced with difficult decisions regarding their 401(k) employer contributions.

In this article, the authors discuss how proposed regulations and a new safe harbor option may help employers keep their options open.



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Recent months have left many companies struggling with significant declines in profits as a result of the overall weakening of the economy. Faced with unprecedented economic pressures, and a strong need to cut costs, many employers are considering reducing or suspending employer contributions to their 401(k) plans. Any midyear change to a 401(k) plan employer contribution must be carefully evaluated prior to implementation. The reduction or suspension of employer contributions is an especially complicated matter for employers sponsoring “safe harbor” 401(k) plans. The benefits of maintaining safe harbor plans include the avoidance of annual nondiscrimination testing and, in some cases, an opportunity for greater savings by highly compensated employees (HCEs). However, the regulatory

hurdles for suspending or reducing employer safe harbor contributions are numerous—and can result in the loss of a plan's qualified status if not navigated correctly. Careful consideration and understanding of the effects of reducing or suspending contributions by plan sponsors of 401(k) plans (and other defined contribution plans) can save a plan the pain of costly, unintended consequences.

401(k) Plan Basics

Generally, 401(k) plans are required to be tested annually to ensure that they do not, disproportionately, benefit HCEs (at present, a HCE is an employee who had annual compensation of \$105,000 or more for 2008). This nondiscrimination testing is comprised of two separate tests: the “actual deferral percentage” test (ADP), which tests employee pre-tax contributions, and the “actual contribution percentage” test (ACP), which tests employer matching contributions and employee after-tax contributions. With respect to

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both tests, the average percentage contributed by or on behalf of a plan's HCEs cannot exceed certain limits, based on the average percentage contributed by or on behalf of non-highly compensated employees (NHCEs).¹ This test is performed based on either the current or prior year's compensation and contribution data, as required by the terms of a plan. If a plan fails one of the nondiscrimination tests, the excess deferrals or excess contributions made by or on behalf of HCEs must be corrected. This is most often accomplished through refunds, forfeitures, or additional employer contributions.²

Nondiscrimination testing can create significant administrative burdens for employers, especially if the tests are failed. Although the testing is generally performed by a third-party administrator, an employer sponsoring a plan is often responsible for determining how the failure will be corrected, communicating with employees on corrective refunds and forfeitures, and revising Form W-2 reporting if amounts previously deferred must later be included in income. Employers may also face employee relations challenges presented by unhappy HCEs who need to revise their tax reporting and/or pay additional taxes as the result of refunds and forfeitures. These challenges may be especially acute in difficult economic times, as refunds and forfeitures (and the resulting consequences for HCEs) may have a greater impact on employees than in other years.

To simplify the administration of their plans, and to avoid the pitfalls of nondiscrimination testing, many employers have chosen to convert their 401(k) plans to safe harbor plans in recent years. Safe harbor 401(k) plans automatically satisfy the requirements of the ADP and ACP tests, as well as the top-heavy test, if certain notice, contribution, vesting, and allocation conditions are met.³ A plan is generally required to be operated as a safe harbor plan for an entire plan year, although a new 401(k) plan may take advantage of the ADP safe harbor if its initial plan year is at least three months long.⁴ Safe harbor 401(k) plans can be divided into two categories: traditional safe harbor 401(k) plans and qualified automatic contribution arrangement safe harbor 401(k) plans.

Traditional Safe Harbor Plans

To satisfy the traditional safe harbor 401(k) notice requirements, each employee must be provided with a safe harbor notice within a reasonable period before the beginning of the plan year. The notice is deemed timely if it is distributed at least 30 days (and no more than 90 days) prior to the beginning of a plan year.⁵ The safe harbor notice must contain participants' rights and obligations under the plan. A notice is not considered sufficient unless it describes the type of safe harbor contribution being offered, the plan to which the contributions are to be made, any other contributions to be made, procedures for making deferral elections, and the plan's withdrawal and vesting provisions, as well as other information about the plan and safe harbor contributions as specified in the regulations.⁶

The traditional safe harbor 401(k) contribution requirement is met if the employer makes a fully vested nonelective contribution or an employer matching contribution meeting the safe harbor requirements. To constitute a safe harbor nonelective contribution, an employer contribution must be equal to three percent of each eligible employee's compensation for the year, regardless of whether the employee makes elective contributions.⁷ The matching contribution requirements

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are satisfied if matching contributions are made on behalf of each NHCE equal to 100 percent of the employee's elective contributions (up to the first three percent of compensation deferred and a 50-percent match on the employee's elec-

tive contributions between three percent and five percent).⁸ However, in no event may the matching contributions on behalf of any employee be in excess of six percent of the employee's compensation.⁹ The matching contribution requirement is also satisfied by other matching formulas, provided that the rate of the match does not increase as the percentage of deferrals increases and the aggregate matching contribution is at least equal to the aggregate matching contribution at each tier of the basic match formula.¹⁰ Regardless of the matching formula utilized, the rate of the matching formula for any HCE may not exceed the rate of match for any NHCE.¹¹

Qualified Automatic Contribution Arrangement Plans

The Pension Protection Act of 2006 (P.L. 109-280) introduced a new safe harbor design, which is paired with the automatic enrollment of plan participants, effective for plan years beginning on or after January 1, 2008. This new design, referred to as a qualified automatic contribution arrangement (QACA), provides a somewhat greater degree of flexibility for employers because of its lower required employer matching contribution percentage and two-year vesting schedule.¹² Like a traditional safe harbor plan, a QACA plan is exempt from nondiscrimination testing and top-heavy testing.¹³

Under the QACA plan rules, all eligible employees are automatically enrolled in the plan, unless an employee affirmatively declines participation in the plan. Upon enrollment, a percentage of the employee's compensation is automatically deferred to the plan. Generally, an employee who did not affirmatively decline participation in the QACA plan is required to defer three percent of his or her compensation. The deferrals start on the date the participant was enrolled and continue to the end of the plan year. The three-percent deferral will automatically increase by one percent for each of the next three years, until it reaches a maximum deferral percentage of six percent.¹⁴

To qualify for the safe harbor, the plan must provide for either minimum nonelective or matching contributions. The minimum nonelective contributions for a QACA are the same as those for the traditional safe harbor (generally three percent of each eligible employee's compensation).¹⁵ The minimum matching contribution percentage, however, is lower than the requirement for a traditional safe harbor plan. Generally, minimum matching contributions under a QACA must equal 100 percent of employee contributions up to one percent of pay and 50 percent of employee contributions above one percent and up to six percent of pay.¹⁶ Unlike the traditional safe harbor, an employer's nonelective or matching contributions can be subject to a two-year vesting requirement.¹⁷ Sponsors of a QACA generally must provide a safe harbor notice to all eligible employees at least 30 days, but no more

than 90 days, before each plan year.¹⁸ In addition to information required under the traditional safe harbor, the notice must explain (1) an employee's right to elect not to have elective contributions or to elect a different deferral amount or percentage and (2) describe how contributions made under the automatic contribution arrangement will be invested if the employee does not choose the investment.¹⁹

Midyear Reduction or Suspension of Employer Contributions to Safe Harbor Plans

As the economy has continued to decline, many employers have been forced to examine their benefit programs as potential areas for cost savings. Some employers have come to the conclusion that the guaranteed employer contributions required for safe harbor plans do not allow them the flexibility they need to respond to adverse economic condi-

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tions. Simply put, these employers have determined that the benefits of a safe harbor plan are not significant enough to outweigh the need to have discretion as to how much they contribute to their 401(k) plans.

It is clearly permissible (and relatively straightforward) to withdraw a plan from the safe harbor for a future plan year. Although it is possible to remove a plan from the safe harbor during a plan year, the process must be carefully planned to ensure that the changes to employer contributions comply with the safe harbor requirements. Furthermore, it is necessary to ensure the plan is prepared for nondiscrimination testing for that plan year. Employers who unilaterally cease or reduce employer contributions risk a plan's qualified status, as well as liability for breach of fiduciary duty to plan participants. It is, therefore, vital for plan sponsors to understand and comply with the strict regulations regarding the midyear amendment of a safe harbor plan.

Employer Matching Contributions in Safe Harbor Plans

A plan providing for safe harbor contributions based on a matching formula, including a QACA with a matching contribution, may be amended

during a plan year to reduce or suspend safe harbor matching contributions on future elective deferrals if certain requirements are met. The employer must provide a supplemental notice to all employees notifying them of the change to the matching contribution, including a description of the consequences of the change and the effective date of the change. The notice must also contain information regarding how employees may change their deferral elections. The reduction or suspension of the matching contribution may be effective no earlier than the later of 30 days after eligible employees are provided the supplemental notice or the date the amendment is adopted. Eligible employees must also be given a reasonable opportunity, before the reduction or suspension of safe harbor matching contributions, to change their cash or deferred elections and, if applicable, their employee contribution elections.²⁰

Of course, because the plan is no longer eligible for a safe harbor, it is now subject to nondiscrimination testing for the plan year in which the change was made. As safe harbor plans generally do not contain nondiscrimination testing provisions, the plan document will likely have to be amended to require that the plan satisfy the nondiscrimination test for the entire plan year using current year testing.²¹ It is important to note that amounts contributed prior to the effective date of the amendment removing the plan from the safe harbor are not exempt from nondiscrimination testing.²²

Employers may also want to consider what employee communications or plan documents require revision following a change or suspension of a safe harbor matching contribution. This would include items such as new hire packets, summary plan descriptions, and employee handbooks.

Nonelective Employer Contributions in Safe Harbor Plans

Until very recently, there was no guidance permitting a midyear suspension of safe harbor nonelective contributions. The effect of this lack of information was that an employer could not suspend or reduce safe harbor nonelective contributions in a traditional safe harbor plan or a QACA. The only option available to an employer that wished to eliminate its obligation to make a safe harbor nonelective contribution midyear was to terminate the plan.

Recognizing that the current “contribute or terminate” structure was detrimental to both financially

distressed employers and plan participants, the IRS recently issued proposed rules that allow employers to reduce or suspend their safe harbor nonelective contributions midyear in the case of a “substantial business hardship.”²³ These proposed rules are applicable to amendments made after May 18, 2009.²⁴ Although it is not clear from the text of the rules, which refer to traditional plans, presumably the proposed rules also apply to nonlective contributions made under a QACA.

The proposed regulations define a “substantial business hardship” as “comparable to” the substantial business hardship standard that applies to a request for a minimum funding waiver for a defined benefit plan under Code Sec. 412(c) of the Internal Revenue Code.²⁵ The factors taken into account by the IRS under Code Sec. 412(c) include the following: whether the employer is operating at an economic loss; whether there is substantial unemployment or underemployment in the employer’s trade or business and in the industry concerned; and whether the sales and profits of the industry concerned are depressed or declining.²⁶ Although there is no reporting obligation associated with the suspension of a safe harbor nonelective contribution, employers wishing to suspend a nonelective contribution because of business hardship should consider documenting the circumstances and evidence leading them to conclude that they have suffered a business hardship permitting a midyear suspension in the event of an audit.

The proposed rules mirror the existing rules applicable to the suspension or reduction of safe harbor matching contributions. An employer who has experienced a substantial business hardship and wishes to terminate the safe harbor nonelective contribution must provide all eligible employees with a supplemental notice that explains the consequences of the amendment reducing or suspending future safe harbor nonelective contributions, the procedures for changing cash or deferred elections and, if applicable, employee contribution elections and the effective date of the amendment. Again, as required under the rules for suspending safe harbor matching contributions, the reduction or suspension of the nonelective contributions may be effective no earlier than the later of 30 days after eligible employees are provided the supplemental notice and the date the amendment is adopted, and eligible employees must be given a reasonable opportunity (including a reasonable

period after receipt of the supplemental notice) prior to the reduction or suspension of the safe harbor nonelective contributions to change their cash or deferred elections and, if applicable, their employee contribution elections.²⁷

Finally, the plan must be amended to provide that the nondiscrimination test will be satisfied for the entire plan year in which the reduction or suspension occurs, using the current year testing method, and the plan must satisfy the safe harbor nonelective contribution requirement with respect to safe harbor compensation paid through the effective date of the amendment. As discussed above with respect to the suspension of employer matching contributions, an employer may also want to examine its employee communications, including summary plan descriptions, to determine if changes to these documents are necessary.

Midyear Reduction or Suspension of Employer Contributions to Non-Safe Harbor 401(k) Plans

Although non-safe harbor 401(k) plan designs may offer greater flexibility in terms of changing employer matching and nonelective contributions, plan sponsors must still be wary of potential regulatory requirements. First and foremost, plan sponsors must consider whether a formal amendment to the plan is necessary and whether such amendment violates the anticutback rule, which prohibits any reduction in an accrued benefit by plan amendment.²⁸ Additionally, a plan sponsor must consider the effects of such changes on its nondiscrimination testing, especially when the plan is highly utilized by HCEs or has historically struggled with passing the non-discrimination test. Even if a plan has sufficient NHCE participation (such that no testing issues may be readily apparent), employers should be mindful that a reduction or suspension of employer matching contributions may cause a decrease in contributions by NHCEs, resulting in the plan failing the nondiscrimination test. This may be especially troublesome in difficult economic times when employees may be hesitant to continue making contributions without the incentive of employer matching contributions.

Another general consideration includes providing sufficient notice for participants to change deferral

elections before the reduction or suspension of employer contributions takes effect. It is generally recommended that a plan sponsor provide 30 days notice in the event of a reduction or suspension of employer matching contributions to accommodate any changes in deferral elections by participants. Plan sponsors should also review whether any contractual obligations might prevent the reduction or suspension of employer contributions, such as a collective bargaining agreement. Moreover, plan sponsors should review prior communications with employees, including all plan documents, and consider whether these communications provide that employer contributions are discretionary or may be interpreted as promising to continue to provide contributions.

Although suspending employer contributions often negatively impacts employee participation and contribution rates, such action can provide much-needed financial relief to employers. Employers who have concerns about passing the nondiscrimination tests (and who may have pursued safe harbor status to alleviate these concerns) may wish to explore other methods of encouraging participation by NHCEs through communication of the benefits of saving for retirement in a tax-qualified plan, automatic enrollment, and other measures.

Looking Ahead

With careful planning, a 401(k) plan meeting the safe harbor with an employer matching contribution can be successfully amended midyear to reduce or eliminate the match. The situation is more complicated with respect to plans utilizing a nonelective employer contribution. Although the recent IRS guidance was a welcome relief to employers in severe economic straits, the proposed rules do not aid those employers who are not operating at an economic loss and wish to suspend nonelective contributions to avoid sustaining a business hardship.

Despite the fact that the list of employers suspending employer contributions continues to grow, many companies have indicated that they hope to restore employer contributions once their economic situation improves. During these difficult economic times, the reduction or suspension of contributions, in lieu of other cost-cutting measures such as layoffs and salary freezes, will continue to become more common among companies as a short-term solution as fiscal results underscore the need for immediate action.

ENDNOTES

- ¹ Code Sec. 401(k)(12); 401(m)(11).
² Code Sec. 401(k)(8)(A)-(B).
³ Code Sec. 401(k)(12)(A); 401(k)(12)(E)(i).
⁴ Reg §1.401(k)-3(e)(1)-(2).
⁵ Reg. §1.401(k)-3(d)(3)(ii).
⁶ Reg. §1.401(k)-3(d)(3)(ii).
⁷ Code Sec. 401(k)(12)(C).
⁸ Code Sec. 401(k)(12)(B)(i).
⁹ Code Sec. 401(m)(11)(B)(i).
¹⁰ Code Sec. 401(k)(12)(B)(iii).
¹¹ Code Sec. 401(k)(12)(B)(ii).
¹² Act Sec. 902 of the Pension Protection Act of 2006 (P.L. 109-280).
¹³ Reg. §§1.401(k)-2, 1.401(k)-3, 1.401(m)-2 and 1.401(m)-3.
¹⁴ Code Sec. 401(k)(13)(C)(3).
¹⁵ Code Sec. 401(k)(13)(D)(i)(II).
¹⁶ Code Sec. 401(k)(13)(D)(i)(I).
¹⁷ Code Sec. 401(k)(13)(D)(iii)(I).
¹⁸ Code Sec. 401(k)(13)(E).
¹⁹ *Id.*
²⁰ Reg. §1.401(k)-3(g)(1).
²¹ Reg. §1.401(k)-3(g)(1)(iv).
²² Reg. §1.401(k)-3(g)(1)(v).
²³ Prop. Reg. §§1.401(k)-3 and 1.401(m)-3.
²⁴ Prop. Reg. §§1.401(k)-3(g)(1)(ii) and 1.401(m)-3(h)(1)(ii).
²⁵ *Id.*
²⁶ Code Sec. 412(c)(2).
²⁷ *See supra* at note 24.
²⁸ Code Sec. 411(d)(6)(B).

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