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Mid-Year Suspension of 401(k) Safe Harbor Employer Contribution (QNEC) Arrangements Allowed for Substantial Business Hardship

Proposed Relief for Mid-Year Cessation of Safe Harbor Employer Contribution. The IRS proposed rules on May 18, which may be relied on immediately, allowing an employer experiencing substantial business hardship the ability to stop making safe harbor employer contributions (QNECs) to a 401(k) plan mid-year as long as the ADP / ACP nondiscrimination tests are satisfied for the year. Proposed Amendments to Regulations §§ 1.401(k)-3 and 1.401(m)-3, 74 Fed. Reg. 23134 (May 18, 2009), <http://www.smartpdf.com/register/2009/may/18/E9-11481.pdf>.

Background - Safe Harbor 401(k) Plans. 401(k) plans are deemed to satisfy the “ADP” and “ACP” nondiscrimination rules as well as the § 416 top-heavy rules if either:

- the employer makes specified qualified matching contributions (QMACs) to all non-highly compensated employees (“NHCEs”) who defer, which are fully vested matches of at least 100% of the first 3% of deferrals and 50% of the next 2% of deferrals; or
- the employer makes qualified non-elective employer contributions (QNECs) to all NHCEs which are fully vested 3% contributions regardless of whether they make salary deferrals under the plan. Internal Revenue Code §§ 401(k)(12) and 401(m)(11).

Notice at least 30 days in advance of the plan year is required. Treas. Reg. § 1.401(k)-3(d). A variation of the safe harbor match exists for qualified automatic contribution arrangements (QACAs) that provide for certain negative elections for salary deferrals, where the nondiscrimination rules are deemed to be met if there is for all NHCEs a 100% match on the first 1% of deferrals and a 50% match on the next 5%. Code §§ 401(k)(13) and 401(m)(12).

Mid-Year Changes. Under existing regulations, a 401(k) plan can switch **into** a safe harbor non-elective employer contribution (QNEC) arrangement mid-year if adequate notice is given. See Treas. Reg. §§ 1.401(k)-3(f) & 1.401(m)-3(g). This does not apply to safe harbor matching arrangements. The regulations also allow a 401(k)

plan to switch **out of** a safe harbor match (QMAC) arrangement mid-year, eliminating the safe harbor match prospectively, as long as at least 30 days advance notice is given, participants have an opportunity to change their elections and the plan is amended to provide that the ADP / ACP nondiscrimination tests must be met for the entire plan year (using the current year testing method). Treas. Reg. §§ 1.401(k)-3(g) & 1.401(m)-3(h). However, under existing regulations, a 401(k) plan can not switch out of a safe harbor non-elective employer contribution (QNEC) arrangement mid-year, unless the plan terminates during the year.

Proposed Regulations Allow Employers With Substantial Business Hardship to Switch Mid-Year Out of Safe Harbor Employer Contribution (QNEC) Arrangement. The IRS proposed rules, 74 Fed. Reg. 23134 (May 18, 2009), which can be relied on immediately for plan amendments adopted after May 18, 2009, allow an employer experiencing a “substantial business hardship” to reduce or amend the 401(k) safe harbor non-elective employer contribution (QNEC) arrangement mid-year, provided: (i) notice is given 30 days in advance of the change; (ii) participants have an opportunity to change their elections; and (iii) the plan is amended to provide that the ADP / ACP nondiscrimination tests must be met for the entire plan year (using the current year testing method). Proposed amendment to Treas. Reg. §§ 1.401(k)-3(g)(i) & 1.401(m)-3(h)(ii). The § 416 top heavy rules will also need to be satisfied for the entire plan year. See Preamble.

“Substantial business hardship” is defined in Code § 412(c)(8) by reference to § 412(d)(2), which provides that the factors taken into account in determining substantial business hardship 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.

Comments.

- This proposed amendment gives the employer the flexibility to not be locked into fixed contributions when there is a business downturn. The employer may therefore be more predisposed to put in a safe harbor fixed contribution in the first place, thus benefiting the employees.
- Employers cannot wait until the end of the plan year to suspend contributions because of the 30 day notice requirement.

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