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Relief for Safe Harbor 401(k) Plans

The IRS proposed regulations earlier this week that will permit employers that sponsor a safe harbor 401(k) plan to modify safe harbor employer contributions mid-year. This news may be welcome relief to an employer experiencing cash flow difficulties.

Many 401(k) plans pass the nondiscrimination tests (known as "ADP" and "ACP" tests) by requiring the employer to make either safe harbor matching contributions or a safe harbor non-elective contribution. The safe harbor non-elective contribution must be at least 3% of compensation for all eligible employees, and must be fully vested.

In contrast to safe harbor *matching* contributions, where the IRS permitted an employer to reduce or suspend contributions mid-year, the IRS previously had required employers to sustain safe harbor *non-elective contributions* for the full 12-month plan year. An employer experiencing cash flow difficulties with a safe harbor non-elective contribution plan had only one option – to terminate the entire plan.

The IRS has stepped in with welcome relief. Effective May 18, 2009, employers may reduce or suspend safe harbor non-elective contributions in reliance on the proposed regulations. The relief is available only for an employer that suffers a "substantial business hardship." Factors indicating a substantial business hardship include that:

- 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.

An employer that has suffered a substantial business hardship may amend its 401(k) plan to reduce or suspend the employer's safe harbor non-elective contributions, in which case the plan must satisfy the mathematical ADP or ACP tests for the entire plan year (not just the remainder of the year), and employees must be given at least 30 days' notice of the amendment. Any such amendment should be accompanied by Board action documenting the existence of the substantial business hardship.

If you have any questions about how these new rules could affect your 401(k) safe harbor plan or any other aspect of your company's employee benefit plans, please contact a member of our Benefits Law Group.

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