retirement
plan news

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Ending a Nonelective Safe Harbor Contribution

The safe harbor 401(k) has been a very popular plan design since the late 1990s. Its popularity stems from the fact that when a plan is not otherwise able to pass the ADP and/or ACP nondiscrimination test, the employer may make a safe harbor 401(k) contribution, thus allowing the plan to avoid discrimination testing and highly compensated employees to maximize their deferrals.

Ending Safe Harbor Contributions. Safe harbor 401(k) contributions may be matching or nonelective (either guaranteed or flexible) and must be made for the entire 12-month plan year (unless operating during a short first plan year) to avoid ADP/ACP testing. Allocation provisions are written into the plan document.

The safe harbor *matching contribution* regulations contain an "escape clause" permitting an employer to stop making contributions midyear and, instead, perform the ADP and/or ACP test for the entire year. The *guaranteed nonelective contribution* (guaranteed NEC) option had no such midyear escape clause: Contributions were required for the full plan year. The only alternative to providing the guaranteed NEC for the entire plan year was to terminate the plan, which would punish participants. It is important to remember that when an employer terminates a 401(k) plan, there are limitations on adopting a replacement plan. **Note:** The *flexible NEC* method gives employers more options than the guaranteed NEC, but most employers chose the guaranteed method, thinking administration would potentially be easier.

Relief Needed. Due to the economic downturn and their inability to afford plan contributions, there was a loud outcry from employers with plans that provide the guaranteed NEC asking for a provision that would permit them to stop making contributions midyear. On May 18, 2009, the IRS attempted to answer this outcry with a proposed regulation permitting a safe harbor 401(k) plan with the guaranteed NEC to reduce or suspend the NEC *if* the business incurred a substantial business hardship (as described in Internal Revenue Code Section 412(c)).

Substantial Business Hardship. The factors taken into account in determining temporary substantial business hardship include (but are not limited to) whether or not:

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

- It is reasonable to expect that the plan will be continued only if the waiver is granted.

Additional Proposed Rules. Other than the hardship provision, the proposed rules are similar to the rules for stopping the safe harbor matching contribution. Specifically, the proposed rules provide that:

- All eligible employees be provided with a supplemental notice of the

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Kibble & Prentice
A USI Company

601 Union Street, Suite 1000
Seattle, Washington 98101-4064
206/441/6300 PH
206/441/6312 FX
www.kpcom.com

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reduction or suspension of the safe harbor NEC,

- The reduction or suspension be effective 30 days after the supplemental notice is provided,
- Eligible employees be given a reasonable opportunity after the notice is provided to change their deferral elections,
- The plan be amended to remove the safe harbor allocation and provide that the ADP and/or ACP test be satisfied for the entire plan year during which the reduction or suspension occurs using the current year testing method,
- The plan provide the safe harbor NEC through the *later of* the end of the 30-day notice period or the effective date of the amendment, and
- The compensation limit of $245,000 (IRC Section 401(a)(17)) be prorated.

The proposed regulations also provide that the supplemental notice requirement will be considered satisfied if it includes an explanation of the consequences of the amendment to reduce or suspend future safe harbor NECs, outlines the procedures for changing employee deferral elections, and provides the effective date of the amendment.

Compensation Cap. If a guaranteed safe harbor NEC is suspended, the safe harbor contribution must be calculated for the portion of the year that it was in force (i.e., from the beginning of the plan year until 30 days after the notice is provided) and the $245,000 compensation cap must be prorated. Here's an example.

An employer with a calendar-year plan decides to eliminate the guaranteed safe harbor NEC. The employer amends the plan, provides the supplemental notice to his employees, and, for the sake of this example, must provide a 3% NEC through June 30, 2009. When calculating the 3% NEC from January 1, 2009, until June 30, 2009, the compensation cap is prorated — six months out of 12 or 50% — resulting in a compensation cap of $122,500 (50% × $245,000).

The proration will also impact the test results for participants who front-loaded their contributions. Furthermore, because the safe harbor NEC was not made for a 12-month period, the plan will be subject to the top-heavy rules (IRC Section 416).

Top-heavy Issues. A top-heavy plan may be deemed to be exempt from the top-heavy rules for the year as long as the only contributions are deferrals and safe harbor permitted contributions. If the safe harbor contribution is suspended, then the plan is subject to the top-heavy rules for the year. If a key employee has made a deferral and/or received a safe harbor allocation to this top-heavy plan, the plan would be subject to a top-heavy allocation requirement for the year. Therefore, suspending the safe harbor NEC to save money may come with a cost — the cost of satisfying the top-heavy allocation.

In addition, the definition of compensation for the safe harbor NEC may be different from the definition of compensation for top-heavy purposes. The *safe harbor* definition may include only the compensation an employee receives while he or she is a participant and exclusions may apply. The *top-heavy* definition is a full year's compensation with no exclusions. Thus, it is important for an employer with a top-heavy plan to consider whether stopping the safe harbor NEC is more cost effective than making the top-heavy allocation. If the plan is top heavy, the employer may find that the only way to avoid making the top-heavy allocation is to terminate the plan.

Effective Date. The proposed regulations are effective immediately (as of May 18, 2009) and may be relied upon until the final regulations are issued. A public hearing on the proposed regulations is scheduled for September 23, 2009. Written comments are due by August 19, 2009. ❖

A profit sharing plan may not treat highly compensated employees (HCEs) more favorably than nonhighly compensated employees (NHCEs). Thus, the plan must have a definitely determinable allocation formula that passes nondiscrimination testing and is spelled out explicitly in the plan document and/or board resolution.

Allocation Options. There are two allocation methods that are routinely used to automatically satisfy nondiscrimination and do not require testing. The first is a pro rata allocation based on compensation that provides every eligible employee with a pro rata portion of the allocation based on each person's compensation as a ratio of total compensation. To determine pro rata allocations, each employee's compensation is divided by the total of all eligible employees' compensation and the resulting number is then multiplied by the employer's total allocation. Compensation is limited (by Internal Revenue Code Section 401(a)(17)) to $245,000 for 2009. When an eligible employee's compensation exceeds the limit, the compensation used in the allocation formula would be $245,000 (for 2009).

The other allocation method is known as permitted disparity (or Social Security integration). This is also a pro rata allocation method based on compensation. However, with this method, eligible employees who earn more than the Social Security wage base ($106,800 in 2009) receive an additional allocation based on the amount of earnings above the wage base (up to the $245,000 compensation limit) because the employer is not contributing to Social Security on that amount. Theoretically, under this approach, an employer contributes the same percentage of preretirement compensation to both the public and private retirement systems on behalf of its employees.

Cross-testing Allocation Method. An alternative allocation method (used since the early 1990s) is a "new comparability approach," also known as a cross-tested plan, which allows an employer to create separate groups and provide each group with a different allocation. HCEs may receive a higher allocation rate than NHCEs, provided the nondiscrimination tests are passed. The cross-tested approach works by converting the defined contribution allocation to a defined benefit accrual rate and performing the nondiscrimination test on a benefits basis. Certain demographics are more favorable. For cross-testing to pass, the NHCEs should generally be younger and further away from retirement than the HCEs, giving the NHCEs a longer time horizon for their benefits to accrue than the older HCEs have. This does not have to be true for every employee for this design to work.

The cross-test involves passing two tests. The first is the gateway test, which ensures a minimal allocation for all NHCEs. The second is the nondiscrimination test. If the gateway test is not satisfied, the cross-test fails and there is no need to perform the other test.

Gateway test. There are two common ways of satisfying the gateway test. One method is to provide a *5% gateway allocation* to all NHCEs. The other method is the *three times allocation* method, which restricts the highest allocation any HCE may receive to no more than three times the lowest allocation (other than zero) provided to any NHCE. For example, if the lowest allocation rate to any NHCE is 2%, then the highest allocation rate to any HCE is 6%. There is also the *broadly available allocation* method.

Nondiscrimination test. There are a number of complex steps in the nondiscrimination testing process of converting the allocations to an equivalent benefit accrual rate (or EBAR) and determining that the benefit accrual for each employee passes nondiscrimination. Furthermore, just because this annual test passes in the current year, there is no guarantee that it will pass in future years as employee demographics change.

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recent developments

Amendment for Pension Plans with an NRA of 55 to 61. IRS Notice 2007-69 (August 2007) offered relief for defined benefit pension plans, money purchase plans, and target benefit plans that have a normal retirement age (NRA) of 55 to 61. These plans must comply with final regulations that call for an amendment to increase NRA to at least 62 years of age, unless the NRA for the industry can be proven to be ages 55 to 61. The first plans affected by this requirement are those with plan years starting July 1, 2008. Employers must adopt an interim amendment by the *later of* (a) the last day of the first plan year beginning after June 30, 2008, or (b) the due date (including extensions) for filing the employer's income-tax return for the employer's taxable year that includes the first day of the first plan year beginning after June 30, 2008.

Plan Audit Questionnaires Available. The IRS is helping keep qualified plans compliant by distributing internal IRS questionnaires to employers to help them understand what agents would ask if an employer's plan was chosen for examination. The questionnaires address many important areas of plan administration including the transmittal of data from the employer to the recordkeeper, payroll file processing accuracy and record retention, operational errors, and the determination process for eligibility and vesting. Employers would be wise to make sure they can successfully answer questions applicable to their plan(s) *before* being selected for an audit. The questionnaires may be found at *www.irs.gov/retirement/article/0,,id=206492,00.html.* ❖

A Cross-testing Primer

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One of the most common causes of test failure in later years is the hiring of an HCE's child. Family attribution of ownership from the parent will make the child an HCE. As a general rule, adding a young HCE to a cross-test calculation will cause it to fail. Employers thinking about this design may want to exclude their children from the plan.

Continued Flexibility. Cross-tested allocations are usually discretionary contributions determined annually by the employer. The plan's rate groups and allocations may be changed from year to year, providing employers with flexibility as employee demographics change. ❖

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