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INFORMATION MEMO
EMPLOYEE BENEFITS LAW

FEBRUARY 2016

IRS Issues Helpful Guidance Regarding Mid-Year Amendments To Safe Harbor Plans

In Notice 2016-16, the Internal Revenue Service issued helpful guidance to employers that sponsor so-called safe harbor 401(k) and 403(b) plans. The guidance significantly expands the types of amendments that may be made to a safe harbor plan during a plan year, without jeopardizing the plan's safe harbor or tax-favored status.

Background

Sponsors of Internal Revenue Code Section 401(k) plans (401(k) Plans) that provide for employee elective deferrals are generally required to perform the complex actual deferral percentage (ADP) test. A similar test, the actual contribution percentage (ACP) test, must be performed in the case of 401(k) Plans that provide for employee after-tax contributions (other than Roth contributions) or employer matching contributions. An Internal Revenue Code Section 403(b) plan (403(b) Plan) is not subject to ADP testing, but is subject to ACP testing if the 403(b) Plan provides for employee after-tax contributions (other than Roth contributions) or employer matching contributions.

The ADP and ACP tests generally compare the deferrals and contributions made and received by eligible highly compensated employees to the deferrals and contributions made and received by eligible non-highly compensated employees. If the deferrals and/or contributions made and received by eligible highly compensated employees exceed those made and received by eligible non-highly compensated employees by more than a limited percentage, then the plan sponsor must take corrective action, which can include making additional contributions for non-highly compensated employees and/or refunding "excess" amounts to affected highly compensated employees.

To avoid the complexities of the ADP and ACP tests, and the potential for objectionable corrective action, some plan sponsors design their plans to satisfy the safe harbor rules of the Internal Revenue Code. A plan that satisfies the safe harbor rules is not subject to ADP or ACP testing (unless the plan provides for employee after-tax contributions (other than Roth contributions), in which case ACP testing is still required).

To qualify as a safe harbor plan, a 401(k) Plan or Section 403(b) Plan must (among other requirements) provide for a minimum level of employer matching contributions or employer non-elective contributions. The contribution scheme generally must be fixed, and communicated to eligible employees, before the start of each plan year and must remain unchanged for the entire ensuing plan year. Mid-year changes to the employer's contribution "commitment" are generally prohibited.

Prior to the release of Notice 2016-16, the Internal Revenue Service had indicated that almost all other mid-year changes to a safe-harbor plan were also prohibited, even those changes that had no impact on a plan's contribution features. The few formal exceptions to the general prohibition on mid-year amendments included amendments that implemented a Roth contribution program, amendments that authorized hardship withdrawals under circumstances affecting a participant's designated beneficiary, and amendments that implemented changes related to same-sex spouses.

New Specific Prohibited Amendment Categories

Rather than add to the list of permitted mid-year amendments, Notice 2016-16 provides the following four new categories of specifically prohibited mid-year amendments:

- A mid-year change to increase the number of completed years of service required for an employee to have a nonforfeitable (i.e., vested) right to the employee's account balance attributable to a safe harbor qualified automatic contribution arrangement (known as a QACA).
- A mid-year change to reduce the number or otherwise narrow the group of employees eligible to receive safe harbor contributions.
- A mid-year change to the type of safe harbor plan; for example, a change from a traditional or basic safe harbor plan to a safe harbor plan with automatic contribution features.
- A mid-year change (i) to modify (or add) a formula used to determine matching contributions (or the definition of compensation used to determine matching contributions) if the change increases the amount of matching contributions, or (ii) to permit discretionary matching contributions. However, this prohibition will not apply if, at least 3 months prior to the end of the plan year, the change is adopted and the updated safe harbor notice and election opportunity are provided (see below), and if the change is made retroactively effective for the entire plan year.

Together with the preexisting prohibitions[1], there are now seven specific categories of prohibited mid-year amendments. Subject to the notice and election period requirements described below, almost any mid-year amendment that is not specifically prohibited apparently may now be adopted without adversely affecting a plan's safe harbor status.[2] Common examples include changes to a plan's qualified default investment alternative, changes in distribution features, and changes required by applicable law to be made mid-year.

Notice and Election Period Requirements

One of the conditions for establishing and maintaining a plan's safe harbor status is that eligible employees must receive a detailed "safe harbor notice" at least 30 days prior to the start of each plan year. Among other things, the required safe harbor notice must provide details on eligibility, contributions, vesting and distributions.

Notice 2016-16 provides that an otherwise permissible mid-year amendment is subject to the plan sponsor's satisfaction of the following notice and election conditions:

- An updated safe harbor notice that describes the mid-year amendment and its effective date must be provided to each employee otherwise required to be provided a safe harbor notice within a reasonable period before the effective date of the amendment. This timing requirement is deemed to be satisfied if the updated safe harbor notice is provided at least 30 days (and not more than 90 days) before the effective date of the amendment. If it is not practicable for the updated safe harbor notice to be provided before the effective date of the change (for example, in the case of a mid-year change to increase matching contributions retroactively for the entire plan year), the notice is treated as provided timely if it is provided as soon as practicable, but not later than 30 days after the date the amendment is adopted.

1 Unless the applicable regulatory conditions corresponding to each specified change are satisfied, a plan cannot be treated as or qualify as a safe harbor plan if the plan is amended to (i) change the plan year, (ii) adopt safe harbor features after the beginning of the plan year, or (iii) reduce or suspend safe harbor contributions or change from safe harbor status to non-safe harbor status.

2 General limitations on plan amendments, like the so-called anti-cutback rule, could also limit a plan sponsor's ability to make a mid-year amendment (even if an amendment is not specifically prohibited under the safe harbor rules).

- Each employee required to be provided an updated safe harbor notice under the preceding paragraph must be given a reasonable opportunity (including a reasonable period after receipt of the updated notice) before the effective date of the mid-year amendment to change the employee's cash or deferred election (and/or any after-tax employee contribution election). For this purpose, a 30-day election period is deemed to be a reasonable period. If it is not practicable for the election opportunity to be provided before the effective date of the amendment, an employee is treated as having a reasonable opportunity to make or change an election if the election opportunity begins as soon as practicable after the date the updated notice is provided to the employee, but not later than 30 days after the date the change is adopted.

The foregoing notice and election requirements also apply if there is a mid-year change in any of the information required to be included in a plan's safe harbor notice, even if the change is not a result of a formal plan amendment (e.g., a change in deferral election procedures or a change in contact information for the plan). The special notice and election requirements do not apply in the case of a mid-year change to information that is not required to be included in a plan's safe harbor notice, even if that information is provided (voluntarily) in a plan's safe harbor notice.

Impact on Plan Sponsors

Sponsors of safe harbor plans will now be permitted to make substantially more mid-year changes to their plans without concern about the plans' continued safe harbor status. This should be welcome relief to most sponsors of safe harbor plans. Sponsors of 401(k) Plans and 403(b) Plans that have not elected safe harbor status for their plans (perhaps due to previously limited flexibility) may now want to reconsider whether safe harbor status may make sense for their plans. Eliminating the need to perform ADP and/or ACP testing, and eliminating the need to take corrective action when the tests cannot be satisfied, are substantial benefits that can be gained by adopting and satisfying the safe harbor standards.

If you have any questions about this memorandum, please contact any member of our Employee Benefits and Executive Compensation Practice Group listed below.

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