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The Ferenczy Flash

FROM THE LAW OFFICES OF Ilene H. Ferenczy, LLC

The Latest Word in Employee Benefits . . .

THE CHILL IS ON - HOW TO TEMPORARILY FREEZE THE 3 PERCENT SAFE HARBOR 401(K) PLAN CONTRIBUTION

The IRS released new proposed regulations that grant relief to employers with safe harbor 401(k) plans that cannot continue to make the safe harbor contributions for their employees. These new regulations permit employers suffering from substantial business hardships to stop making the safe harbor contributions 30 days after appropriate notice is given to employees, assuming the plan is properly amended and other conditions are met.

Over the last few months, we have received numerous inquiries from plan sponsors and service providers asking, "How do we freeze or suspend a safe harbor 3% employer contribution during the middle of the plan year?" Until yesterday (May 18), the answer was, "You must terminate the plan." (The 401(k) rules allowed a mid-year suspension of the safe harbor match; it was only the 3% employer "non-elective" contribution that could not be frozen.) Of course, if the plan sponsor did terminate the plan, participants could no longer defer their own funds, the plan monies had to be distributed or rolled over, and a new plan could not usually be adopted until at least a year after the distributions would be completed. For a plan sponsor that wants only to suspend safe harbor employer contributions temporarily, this result created a Hobson's choice: get rid of the plan entirely or find a way to come up with money to make the contribution – sometimes at the cost of employee jobs.

Practitioners have been requesting for some time that the IRS take ameliorative measures to assist employers in this difficult economy. The IRS finally answered the call to action by issuing proposed regulations allowing a plan sponsor to suspend or reduce 401(k) safe harbor contributions if certain conditions are met:

- The Employer must have incurred a substantial business hardship. A "substantial business hardship" appears to be determined based on the facts and circumstances of each plan sponsor. To make this determination, the IRS will consider whether:

a. The business is operating at a loss;

- b. There is substantial unemployment or underemployment in the industry;
- c. The sales and profits of the industry are depressed or declining; and
- d. It is reasonable to expect that the plan will be continued only if the amendment is allowed.

(With the economy in its current state, we would not expect the burden of proof of financial hardship to be very high. However, we would discourage a company that is not suffering any hardship from using these rules as an excuse to preemptively eliminate the employer contribution provision of its safe harbor plan.)

- Today, May 19, 2009, is the earliest date such an amendment can be adopted;
- All eligible employees must be provided a notice that includes the following information:
 - a. The consequences of the amendment (i.e., the 3% employer contribution will be made only in relation to compensation *paid* through the effective date of the amendment);
 - b. The procedure for changing salary deferral elections (e.g., provide a written election to the employer, call the toll-free number); and
 - c. The effective date of the amendment.
 - The amendment cannot be effective earlier than 30 days after the notice is provided and not earlier than the date the amendment is actually adopted (do not dawdle in adopting the amendment);
 - Eligible employees must be given a reasonable opportunity after the notice is provided and prior to the effective date of the change to modify their salary deferral elections;
 - The plan must satisfy the ADP and/or ACP test for the entire plan year using the current year testing method (which means that some highly compensated employees may receive refunds of salary deferrals early next year);
 - The employer must contribute the 3% safe harbor contribution on compensation paid through the effective date of the amendment; and
 - If the plan is top-heavy, the employer must meet the top-heavy rules for contributions.

Although these are only *proposed* regulations, plan sponsors may rely on these provisions to take action now. When final regulations are issued, plan sponsors will need to comply with the final regulations prospectively, but if such final regulations are more restrictive or onerous than the current proposed regulations, plan sponsors who relied on the current proposed regulations in the interim will be safe.

If you have a safe harbor plan and are struggling to make plan contributions during the current

economic crisis, the IRS' action may be just in the nick of time. If you want to take advantage of this relief, contact your plan consultants as soon as possible to get the notice disseminated to your employees and to start the 30-day countdown to your contribution freeze.

Call us if you have any questions or need assistance to implement a contribution freeze for your plan.

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