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Legal ALERT!

Achieving Cost Savings by Mid-Year Reduction of Retirement Plan Contributions. IRS Authorizes Mid-Year Suspension of “Safe Harbor” Contributions

The economic downturn has forced many employers to focus on cost savings, including reducing contributions to their defined contribution retirement plans. The IRS recently issued proposed regulations that permit sponsors of “safe harbor” 401(k) plans that satisfy the safe harbor by providing non-elective contributions to suspend or reduce those contributions if the employer is experiencing substantial business hardship. This Alert discusses when and how an employer may make mid-year adjustments to retirement plan contributions.

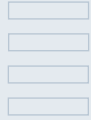
Review the Plan and Written Communications to Employees. Whether an employer can reduce contributions in the middle of a plan year is determined first by the terms of the plan. If the plan leaves the amount of the contribution to the discretion of the employer, the employer is generally free to change the contribution rate at any time. If the plan specifies a certain contribution rate (e.g. 10 percent of compensation), the plan may still permit the employer to change that contribution mid-year by adopting a plan amendment. Whether the employer may do so and to which participants the change would apply depends on whether participants have already accrued a right to a specific contribution. For example, if the plan provides that participants must be employed by the employer on the last day of the plan year to receive the contribution, employees have not accrued a right to that contribution until the last day of the plan year. Therefore, the employer generally may amend the plan at any time before the last day of the plan year to reduce the contribution. With respect to matching contributions, an employer generally may amend the plan at any time to change the matching contribution rate prospectively (i.e. effective for post-amendment pay periods).

Notwithstanding the terms of the plan, an employer may find itself facing a claim from employees for failure to provide promised contributions if it has provided any written statement to employees (e.g. in an employee manual or benefits booklet) that can be construed as a promise to contribute to the plan at a certain rate. In most such cases, this liability can be avoided simply by providing participants advance notice of the amendment. (ERISA does not otherwise require a sponsor of a defined contribution plan to provide participants notice of reduced contributions).

Special Rules for Safe Harbor 401(k) Plans. The recent IRS proposed regulations relate to “safe harbor” 401(k) plans that satisfy the employer contribution requirement through non-elective (i.e. profit-sharing) contributions. A “safe harbor” plan is exempt from non-discrimination rules otherwise applicable to employee elective deferral contributions (and in some cases, non-discrimination rules applicable to employer matching contributions). Safe harbor 401(k)

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plans must provide for special minimum matching contributions or non-elective contributions.

Employers whose 401(k) plans include safe harbor matching contributions have always been permitted to suspend matching contributions mid-year, upon providing notice to plan participants. However, prior to the issuance of the proposed regulations, employers whose 401(k) plans include safe harbor non-elective contributions have not been allowed to suspend contributions.

Under the proposed regulations, an employer may suspend or reduce non-elective contributions if it is experiencing "substantial business hardship." Substantial business hardship is determined using a number of factors, including whether the employer is operating at a loss, whether there is substantial unemployment in the employer's industry, whether the sales and profits of the industry are depressed or declining; and whether it is reasonable to expect the plan to continue after the planned reduction or suspension.

Employers wishing to suspend or reduce non-elective contributions must adopt a plan amendment that satisfies the proposed regulations and must comply with certain notice and timing requirements. Participants must be notified at least 30 days prior to the suspension or reduction of contributions and must be given an opportunity to change their elections before the reduction or suspension.

Because of the notice requirements, an employer that wants to reduce or suspend safe harbor contributions during a plan year cannot wait until the end of the plan year to implement the change. The plan amendment must be adopted and participants must be notified prior to the suspension or reduction. The plan must also satisfy the safe harbor non-elective contribution requirements for the portion of the year prior to the suspension or reduction of contributions, and must satisfy nondiscrimination testing requirements using the current year testing method for the entire plan year.

Plan sponsors may rely on these proposed regulations immediately.

Of course, counsel should always be consulted before making any amendment to a plan document. ■

The principal authors of this Alert are Kathryn A. Lisandrelli and Raymond N. McCabe. Please contact Ms. Lisandrelli or Mr. McCabe or any member of our Labor and Employment Practice Area if you have any questions about how this decision affects the administration of your qualified plans.

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