December 12, 2016

IRS Notice Brings Resolution to Safe Harbor Plan Midyear Amendment Problem

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When retirement plan sponsors adopt a “safe harbor” 401(k) plan design, they are deemed to be compliant with the actual deferral percentage (ADP) and actual contribution percentage (ACP) nondiscrimination testing provisions of the Internal Revenue Code (IRS)—the federal tax Code.

The plan can avoid negative consequences from discrimination testing by either providing a minimum matching contribution for those participants who elect to make deferral contributions to the plan, or by providing every employee eligible to participate in the plan a minimum nonelective contribution.

In years that a plan fails the ACP or ADP testing rules, the employer has a choice to either make an additional contribution to certain nonhighly compensated employees (NHCEs), or return contributions made by highly compensated employees (HCEs)—or restrict contributions from the outset—until these testing requirements are met.

But plan sponsors that have adopted these types of safe harbor plan designs have discovered that they come with a cost. The U.S. Treasury regulations authorizing this plan design restrict the types of plan amendments that can be made without jeopardizing the plan’s safe harbor status to the middle of a plan year.

Midyear amendments to safe harbor 401(k) plans always have been permissible, but confusion in the industry about the scope of these amendments has been widespread. Fortunately, the IRS resolved the basis for most of this confusion in guidance issued in 2016.

Background on Preguidance Regulations

The safe harbor regulations provide that a plan will fail to be a safe harbor plan "unless plan provisions that satisfy the rules [making the plan a safe harbor plan] are adopted before the first day of the plan year and remain in effect for an entire 12-month plan year.In addition, except as provided in paragraph (g) of this section [regarding suspension of matching contributions] ***or in guidance of general applicability published in the Internal Revenue Bulletin*** . . . a plan which includes provisions that satisfy the rules of this section will not [be a safe harbor plan] if it is amended to change ***such provisions*** for that plan year." Treasury Regulation § 1.401(k)-3(e) (emphasis added).

The wording of this regulation (as well as informal comments by the IRS) has caused many practitioners and consultants to conclude that no amendments to any part of a safe harbor plan could be made midyear unless the IRS had specifically confirmed that a midyear amendment is permissible.

This broad reading of the regulation seemed at odds with the literal meaning of its purported scope, that amendments could not be made *to the provisions that make a plan a safe harbor plan*. The safe harbor regulations do not otherwise place any restrictions on other amendments to a plan that do not change "such provisions."

Basis for Confusion

Since the safe harbor regulations were issued, there have been occasions where Congress or the IRS has amended 401(k) plan compliance rules unrelated to safe harbor status, and still there was concern about whether a safe harbor plan could be amended midyear to include conforming amendments—whether permissible or required—without extinguishing a plan's safe-harbor status.

One concern: Although the change being made did not change the provisions that made a plan a safe harbor plan, it nevertheless caused a change in the information that was required to be included in the safe harbor notice prescribed by IRS Regulation 1.401(k)-3(d). While there was a reasonable basis for this concern, it could also lead to absurd results.

For example, did this mean that a plan could not be amended to change the plan's mailing address, because that information is required to be in the safe harbor notice? The IRS issued ad hoc guidance expressly blessing specific midyear amendments (for example, to add Roth-type contributions).

This led some people to conclude that these IRS-sanctioned amendments were the *only* permitted midyear amendments allowable for a safe harbor plan.Others argued (quite vociferously) that this was nonsense and was unsupported by regulations upon which taxpayers were entitled to rely.

IRS Notice 2016-16

The IRS provided some helpful guidance in January 2016, which now has quasi-regulation authority based on the first emphasized portion of the regulation quoted above, that the IRS

could provide additional guidance for guidance earlier published in the Internal Revenue Bulletin.

IRS Notice 2016-16 provides that midyear amendments to safe harbor plans are permissible as long as they are not one of four prohibited amendments (which is a specific listing of what "such provisions" referenced in the regulation are now are considered to be).

Amendments that do not change anything on the prohibited list but do change something that was required to be described in the safe harbor notice are permissible, provided that at least 30-days' notice is given and participants have a reasonable period of time to after the notice (30 days is deemed reasonable) to make or change an election.

Midyear amendments that change neither the prohibited list nor the information required to be in the safe harbor notice can be without 30-day advance notice or a reasonable election opportunity.

Open Questions Remain

While providing some helpful reliance, the guidance did not definitively resolve all questions. For example, it remains an open question whether changes to the eligibility requirements would require the advance 30-day notice.

Assume that a plan sponsor wanted to reduce its 1-year eligibility requirement to 6 months for a certain group of employees.Eligibility provisions are not specifically included on the list of notice content requirements in IRS Regulation 1.401(k)-3(d)(2).There is a general requirement that the safe harbor notice be "[s]ufficiently accurate and comprehensive to inform the employee of the employee's rights and obligations under the plan."

A plan's eligibility provisions are not something that is generally addressed in the safe harbor notice, because the notice is only required to be given to ***eligible*** employees, or to ineligible employees within a reasonable period of time before that person becomes an eligible employee. So, generally, eligibility is assumed by virtue of receiving the notice, and it is not necessary to describe those provisions in the safe harbor notice.

This means changes to the eligibility provisions should be able to be made midyear and without the advance notice or additional election opportunity required by IRS Notice 2016-16. This is supported by Example 7 of Notice 2016-16:

Example 7: The employer sponsoring Plan S, a safe harbor plan, makes a midyear amendment to change the entry date for commencement of participation of employees who meet the plan's minimum age and service eligibility requirements from monthly to quarterly. The amendment also changes plan rules regarding arbitration of disputes. The amendment is effective with respect to employees who are not already eligible to participate in the safe harbor plan. The safe harbor notice is not required to include the plan entry date or information on arbitration procedures; therefore, an updated notice and additional election opportunity are not required. The midyear change does not violate the provisions of §§ 1.401(k)–3 and 1.401(m)–3.

A plan entry date is not exactly the same as the reducing the 1-year eligibility requirement for a defined group of employees, but the analysis would likely be the same. Nevertheless, if a plan wanted to be 100% certain, it could provide notice of the change and an additional election

opportunity to the newly eligible employees with the general safe harbor notice 30 days before the change becomes effective. This would give the participants a reasonable period of time to make or change their election.

Conclusion

IRS Notice 2016-16 gives considerable certainty to plan sponsors seeking to make midyear plan revisions, but at the cost of providing additional notices. Nevertheless, the permissibility of some changes to plans may be unresolved. Understanding the evolution of this guidance may help in deciding the unresolved issues that remain in its wake.