

ALERT

IRS RELAXES SAFE HARBOR RULES

The Internal Revenue Service issued regulations on May 18, 2009, relaxing the 401(k) and 403(b) safe harbor rules.

Background

A safe harbor plan is exempt from the typical discrimination testing related to 401(k) salary deferrals and employer matching contributions (ADP/ACP) provided the employer commits to making either a matching contribution for those employees contributing to the plan or, a 3% contribution to all eligible employees whether or not they defer. Until yesterday, if an employer elected to make the 3% contribution prior to the start of the plan year the employer could not reduce or eliminate the 3% contribution during the year. The commitment could only be eliminated by termination of the plan.

New Regulation

The IRS will now permit elimination of the 3% contribution during the year provided the employer sponsoring the plan has incurred a substantial business hardship. A 30 day advance notice must be provided to employees in order to eliminate the 3% contribution.

It is important to note that the 3% contribution is still required for the portion of the year up to the date of discontinuance. Furthermore, the elimination of the 3% contribution must be carefully considered as there may be other implications.



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Implications

Once eliminated, the plan is subject to the ADP/ACP test and top heavy requirements for the entire year. Many employers elected the safe harbor provisions due to difficulties passing the ADP/ACP test and because they were top heavy.

The application of the ADP/ACP test could result in limiting the 401(k) deferrals of the highly compensated employees (in general, owners and those earning more than \$105,000). If the test fails, then 401(k) salary deferrals may be required to be returned to highly compensated individuals.

If a plan is top heavy then it may be subject to a required 3% contribution regardless, thereby making the elimination of the 3% safe harbor irrelevant. A plan is top heavy more than 60% of the plan assets belong to key employees (in general, 5% or more owners and, officers earning more than \$150,000). If any one key employee has contributed to the 401(k) plan during the year, the employer must contribute the same percentage to all eligible employees up to a maximum of 3% of compensation. Therefore, it is likely that an employer with a top heavy plan will still be required to make a 3% contribution for the year. Thus elimination of the 3% safe harbor will not result in any reduction of the employer contribution for the year.

Conclusion

While relaxation of the safe harbor rules is good news, careful consideration must be given prior to elimination of the safe harbor. The employer sponsoring the plan must have incurred a substantial financial hardship and the employer must consider the implications of applying the ADP/ACP test and top heavy tests.

If you have questions regarding the safe harbor rules or any retirement plan issues please call Catherine M. Beaver, Managing Director of the Retirement Plan Services Group at LBA directly at 904.396.4015 or CBeaver@TheLBAGroup.com.

