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Suspending 401(k) match raises compliance issues (updated)

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As the effects of the COVID-19 pandemic continue to ripple through the economy, financially stressed employers are scrambling to control costs and keep their businesses afloat. Many of these employers may be considering temporarily suspending 401(k) matching contributions as a cost-saving measure. While companies evaluating this option have to consider the impact on employee morale and retirement adequacy, they may overlook some less obvious compliance issues. This article identifies a number of technical compliance issues for employers to consider before reducing or suspending a 401(k) match, including ERISA's anti-cutback protections, the actual deferral percentage (ADP) and actual contribution percentage (ACP) safe harbor requirements, and the Internal Revenue Code's $285,000 cap on plan compensation. Updates to this article incorporate guidance from IRS Notice 2020-52 on suspending or reducing safe harbor contributions during the pandemic.

IRS issues new guidance on suspending or reducing safe harbor contributions

Notice 2020-52 clarifies the following:

- During the COVID-19 pandemic, an employer can suspend or reduce safe harbor matching or nonelective contributions, even if it isn't operating at an economic loss or its safe harbor notice didn't mention the possibility of suspending or trimming contributions. This relief is available to employers that adopt a plan amendment suspending or reducing contributions between March 13 and Aug. 31, 2020.

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- Employers suspending or reducing safe harbor nonelective contributions have until Aug. 31 to provide a supplemental notice explaining the change and procedures for participants to change their deferral elections. Without this relief, this notice is usually due at least 30 days before the suspension or reduction takes effect. The relief doesn't apply to employers suspending or trimming safe harbor matching contributions.

- Employers can maintain their plans' safe harbor status by suspending or reducing contributions only for highly compensated employees (HCEs), since contributions to HCEs aren't safe harbor contributions. But employers taking this action still must follow the ordinary notice and election requirements for midyear changes to safe harbor plans.

Amending the plan

An employer will need to amend its plan to suspend matching contributions if they are required by plan terms — as is usually the case. If the plan gives the employer discretion to make matching contributions, an amendment may be unnecessary. However, even if the contributions are entirely discretionary, employers still might want to review past employee communications for any statements that could be interpreted as promising a match, since the expectation of a match likely influenced some employees' deferral elections.

Anti-cutback issues

ERISA's anti-cutback rules generally require employers implementing a suspension to fund matching contributions based on deferrals and compensation through the amendment's adoption date (or effective date, if later). However, an exception may apply to plans that condition the match on employees satisfying a service condition — for example, completing 1,000 hours or being employed on the last day of the year. Sponsors of these plans may be able to eliminate the match retroactively to the start of the plan year for employees who haven't yet satisfied the service condition, which arguably means they haven't accrued a right to receive a matching contributions. Employers taking this approach assume some legal risk and should consult with legal counsel. In addition, however unpopular a match suspension will be with many employees, employers may face the most backlash from employees for whom the change is retroactive to the start of the year, since they presumably made deferrals with the expectation of a match.

Notice to employees

Employers with safe harbor plans must notify employees at least 30 days in advance of a match suspension (as discussed in the next section). The law doesn't specify notice timing for nonsafe harbor plans, but employees should receive notice sufficiently in advance of the suspension's effective date to have a reasonable amount of time to change their deferral elections.

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Additional considerations for safe harbor plans

The Section 401(k) regulations allow midyear suspension of safe harbor matching contributions if employers satisfy either of the following requirements:

- The annual safe harbor notice included a statement that the plan might be amended during the year to reduce or suspend safe harbor contributions, and the reduction or suspension wouldn't apply until at least 30 days after all eligible employees receive notice of the reduction or suspension.
- The employer is operating at an economic loss for the plan year, as described in Section 412(c)(2)(A).

An employer that suspends safe harbor contributions midyear effectively opts out of the safe harbor for the year. This will require the plan to pass the ADP and ACP nondiscrimination tests for the year. The plans could also become subject to top-heavy testing because exemptions for safe harbor plans will no longer apply.

Pandemic relief. Notice 2020-52 relaxes these requirements for employers affected by the COVID-19 pandemic. IRS will not treat employers that amend their plans between March 13 and Aug. 31, 2020, to suspend or reduce safe harbor contributions as failing to satisfy these requirements. However, these employers still must follow the steps for suspending safe harbor contributions described below.

Steps to suspend safe harbor contributions

To exit the safe harbor, an employer must take the following steps:

- At least 30 days before the amendment takes effect, send a notice to all eligible employees explaining the amendment's consequences, its effective date, and the procedures for changing deferral elections (and after-tax contribution elections, if applicable).
- Provide employees a reasonable amount of time after receipt of the notice to change deferral elections.
- Adopt a plan amendment to suspend the match no later than the effective date of the change.
  - Since exiting the safe harbor subjects the plan to ADP/ACP testing, the amendment must state that the plan will satisfy ADP/ACP testing for the entire plan year, using the current-year testing method.
- Satisfy all safe harbor rules (including funding the safe harbor match) for amounts deferred before the amendment takes effect.

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Safe harbor nonelective contributions

Employers suspending safe harbor nonelective contributions generally use the same procedures discussed above, but with one small wrinkle: For plan years starting after Dec. 31, 2019, the Setting Every Community Up for Retirement Enhancement (SECURE) Act (Pub. L. No. 116-94) eliminated the safe harbor notice requirement for employers making safe harbor nonelective contributions. If a company not operating at an economic loss doesn't provide a safe harbor notice for a plan year, can the employer suspend safe harbor nonelective contributions?

This is a moot point for employers suspending safe harbor nonelective contributions for the COVID-19 pandemic. IRS is allowing an employer that timely amends its plan to suspend or reduce these contributions midyear, even if the employer isn't operating at an economic loss or the safe harbor notice didn't mention the potential for this change. However, until IRS issues additional guidance, this remains an area of uncertainty for employers that suspend safe harbor nonelective contributions in future years.

Pandemic exception to 30-day notice requirement. Notice 2020-52 also relaxes the requirement to provide at least 30 days' advance notice of a midyear suspension or reduction of safe harbor nonelective contributions during the pandemic if the following conditions are met:

- The employer provides a supplemental notice explaining the change to employees by Aug. 31, 2020.
- The amendment to suspend or reduce safe harbor contributions is adopted between March 31 and Aug. 31, 2020, and before the suspension takes effect.

The exception to the advance notice requirement does not apply to a suspension of safe harbor matching contributions, since the matching level directly affects employees' deferral decisions.

Safe harbor 403(b) plans

Section 403(b) plans aren't subject to ADP testing. However, nongovernmental and nonchurch 403(b) plans that offer matching and/or after-tax contributions are subject to ACP testing. Sponsors of these plans can provide safe harbor matching contributions to satisfy the ACP testing requirements. These sponsors can exit the ACP safe harbor midyear by following the same procedures outlined above. This will require the plan to pass ACP testing for the entire year, using the current-year testing method.

Reducing safe harbor contributions

Employers that reduce safe harbor contributions this year (instead of suspending them entirely) must follow the same procedures for suspending contributions, since either change causes a plan lose its safe harbor status. This is true even for employers switching from an "enhanced" safe harbor match to a "basic" match midyear, since a safe harbor formula must be adopted before the start of the plan year and remain in effect for all 12 months of the plan year.

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> Example. An employer currently offers a safe harbor match of 100% on contributions up to 5% of pay. Effective July 1, the employer wants to substitute a basic safe harbor match — 100% on contributions up to 3% of pay, plus 50% on contributions that exceed 3% of pay but do not exceed 5% of pay. Because the reduction will occur midyear, the plan will lose its safe harbor status, and the employer should follow the steps outlined above for suspending a match.

Suspending or reducing contributions only to HCEs

Notice 2020-52 clarifies that contributions to HCEs aren't safe harbor contributions, so suspending or reducing contributions only for HCEs has no impact on a plan's safe harbor status. The notice doesn't state that this position is an temporary exception for the COVID-19 pandemic. So employers apparently can suspend or reduce contributions only for HCEs in any year and still maintain their plans' safe harbor status.

Employers suspending matching contributions to HCEs still need to provide the affected HCEs an updated safe harbor notice (since this is a midyear change to the notice's required content) and an opportunity to change their deferral elections. In a footnote, IRS says the guidance doesn't address the impact of the SECURE Act's elimination of the safe harbor notice for employers making safe harbor nonelective contributions. This apparently means employers suspending safe harbor nonelective contributions only for HCEs midyear don't have to provide an updated safe harbor notice. But these employers still might want to notify the affected HCEs.

Prorating the 401(a)(17) compensation limit

A plan may not base allocations on compensation exceeding the Section 401(a)(17) compensation limit — $285,000 for 2020. Under the 401(a)(17) regulations, the limit must be prorated if "compensation for a period of less than 12 months is used for a plan year" (subject to certain exceptions). When an employer suspends its match midyear, the match earned prior to the suspension is based on less than a full year's compensation. In the preambles to the 2009 proposed and 2013 final regulations on midyear suspensions of safe harbor contributions, IRS took the position that the limit must be prorated in this circumstance. The same rule presumably applies to suspensions of nonsafe harbor contributions.

Prorating the compensation limit can result in a forfeiture of excess matching contributions (plus earnings) allocated during the portion of the year before the suspension. Consider the following example:

> Example. A calendar-year plan matches 100% of deferrals up to 6% of base pay. Jane earns $360,000 in annual base pay ($30,000 a month) and elects to defer 6% of base pay ($1,800 per month). During the first half of 2020, Jane earns $180,000, defers $10,800 and is credited with $10,800 in matching contributions. The plan sponsor suspends matching contributions effective July 1, 2020. The

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401(a)(17) pay cap must be reduced from $285,000 to $142,500. As a result, Jane's maximum match is only $8,550 (6% x $142,500). Jane must forfeit the excess match of $2,250 ($10,800 – $8,550).

Impact on ADP/ACP testing

Reducing matching contributions will directly affect the ACP test and may also indirectly affect the ADP test for pretax deferrals. Here are some factors to consider in evaluating the testing consequences:

- The lack of a match might lead to lower deferral rates, particularly among nonhighly compensated employees (NHCEs), causing the plan to fail the ADP test.

- Plans that traditionally "borrow" from matching contributions to help pass the ADP test will have less match to borrow, again leading to ADP test failures. However, any safe harbor matching contributions made before the suspension are still "qualified matching contributions" that can be used to help pass the ADP test.

- Plans using the current-year testing method might get better ADP/ACP results under the prior-year testing method (which relies on NHCEs' contribution percentages from the previous year). However, plans must meet certain eligibility conditions to switch to prior-year testing (for example, a five-year history of using current-year testing). Eligible plans must formally adopt an amendment changing the test method by the end of the testing year. This option is unavailable to employers suspending a safe harbor match, since the regulations require the plan to pass ADP testing in the year of the suspension, using the current year testing method.

What if the plan fails ADP/ACP testing? Plans failing the ADP/ACP tests must refund or recharacterize excess contributions to HCEs if the employer is too cash-strapped to make qualified nonelective employee contributions (QNECs). To avoid a 10% excise tax, corrective distributions and/or recharacterization must occur within 2-1/2 months after the end of the plan year (or six months after plan year-end for certain auto-enrollment plans).

Match 'true up'

Some plans provide a year-end true-up match to ensure employees don't lose out merely because the match formula applies each pay period, rather than on an annualized basis. Employers suspending their match must consider how they want to determine the true-up and carefully draft a plan amendment suspending the match to avoid unintended true-ups.

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Nonqualified 'mirror' plans

Employers maintaining nonqualified mirror plans for HCEs should consider how suspending the match would affect accruals under the nonqualified plan. In particular, employers should assess whether any shift between the plans raises concerns under Section 409A.

To treat all employees equally, employers might want to suspend the mirror plan's match when the qualified plan's match is suspended. While this generally should be permissible under 409A, some employees may be contributing to the mirror plan only to earn the match. Allowing these employees to suspend their contributions to the mirror plan when the match is suspended would violate 409A and give rise to substantial tax penalties. This outcome may frustrate employees.

Trade groups asking Congress, regulators for relief

Plan sponsor groups, including the ERISA Industry Committee, have been asking policymakers for help navigating many of these issues. These groups urged Congress and the Treasury Department to waive the requirement that employers seeking to suspend safe harbor matching contributions have to meet the "economic loss" test or had to provide a safe harbor notice with the requisite language in late 2019. Treasury granted this relief in Notice 2020-52.

Employers could still benefit from additional relief, such as the ability to prospectively suspend safe harbor matching contributions without prorating the Section 401(a)(17) limit for the presuspension period. In addition, the groups have asked for a two-year extension of the period for making corrective QNECs after a failed ADP test triggered by a suspension of nonsafe harbor matching contributions. The outlook for this additional relief is not clear, but these provisions are in the mix as Congress considers "Phase 4" economic rescue legislation in the weeks ahead.

Related resources

Non-Mercer resources

- Notice 2020-52 (IRS, June 29, 2020)
- Letter to Senate Finance Committee requesting retirement plan relief (ERISA Industry Committee, March 19, 2020)
- Issue snapshot: Treatment of 401(a)(17) limitation in defined contribution plan in a short plan year (IRS, Nov. 18, 2019)
- Final regulations: Reduction or suspension of safe harbor contributions (Federal Register, Nov. 15, 2013)

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- Delving into CARES Act relief for retirement plan participants (April 10, 2020)
- SECURE, CARES acts change rules on required minimum distributions (April 7, 2020)
- Stimulus bill gives 2020 DB funding relief, access to DC savings (March 26, 2020)

Other Mercer resources

- Stay informed on the coronavirus (regularly updated)

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