## Mid-Year Changes to Safe-Harbor 401(k) Plans: New Rules Under IRS Notice 2016-16



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Craig P. Hoffman, Esq., APM General Counsel and Director of Regulatory Affairs American Retirement Association

## What We Will Cover

- Overview
- Document and Notice Requirements
- Mid-year Changes Under IRS Notice 2016-16
- Exiting and Terminating Amendments
- "Maybe" Notice Alternative



## **Overview**



#### Safe Harbor Plans

- Safe harbor 401(k) plans first became available for the 1999 plan year.
- They have become very popular over the years because of their attractive design features.
- However, once the plan year of a safe harbor plan has begun, the ability to make changes to the terms of the plan is more restricted than in a normal profit sharing or 401(k) plan.



### Advantages of a Safe Harbor 401(k) Plan

- Free pass on ADP/ACP tests.
- Provides certainty on deferrals for HCEs.
- Simplifies plan design



## Advantages of a Safe Harbor 401(k) Plan

- Can qualify for an exemption from the top-heavy rules under IRC §416(g)(4)(H).
  - Contributions must be limited to only safe harbor contributions, elective deferrals, and matching contributions based on a formula within certain parameters.
  - Matching formula must provide that:
    - No match for deferrals in excess of 6% of compensation
    - Matching rate doesn't increase as the deferral rate increases
    - No single HCE gets a higher rate of match than any single NHCE and
    - Discretionary match (if any) limited to 4% of compensation.
    - "Triple-stacked" match design utilizes this exemption.



### **ADP Safe Harbor Requirements**

- $\checkmark\,$  Safe harbor employer contribution
- ✓ Notice requirement
- ✓ 12-month plan year
- ✓ Plan documentation



### Safe Harbor Contribution

- Requires either a non-elective contribution OR one of two types of fixed matching contributions.
- Non-elective equal to at least 3% of compensation.
- Matching
  - <u>Basic</u>: 100% match on deferrals not exceeding 3% of compensation and 50% on deferrals between 3% and 5% of compensation.
  - <u>Enhanced</u>: At least as valuable at every level of deferral, matching rate may not increase as the deferral rate goes increases. Common formula is 100% match up to 4% of compensation.



# Plan Document and Notice Requirements



### **Plan Documentation**

- A safe harbor 401(k) plan must generally include the safe harbor language, ON OR BEFORE THE BEGINNING OF THE PLAN YEAR.
- The only exceptions:
  - The "maybe" notice design and
  - Mid-year adoption of safe harbor language by an employer that is not already sponsoring a 401(k) plan.



### **Plan Documentation**

- Safe harbor language must address:
  - Satisfaction of ADP test safe harbor
  - Special vesting, distribution rules for ADP safe harbor contributions, and no allocation conditions
  - "Compensation" for allocation of deferrals and safe harbor contributions, including periodic or true-up of match.



### Plan Documentation (Continued)

- Plan must specify which safe harbor contribution the plan will ۲ provide.
- If ER intends to provide for "other" matching contributions that will qualify under ACP test safe harbor, plan must include provisions that limit matching formulas.



### Plan Documentation (Continued)

- All plan provisions need to be in place before the beginning of the plan year
- Safe harbor notice CANNOT be used to "turn on" the safe harbor provisions for a year. But same flexibility can be achieved for non-elective safe harbor contribution designs with "maybe" notice.



### **Safe Harbor Notice**

- The ER must also provide a written "safe harbor" notice to each eligible participant to satisfy the ADP and ACP test safe harbors.
- The notice must be:
  - Accurate and timely
  - Understandable to the average participant.



## **Notice Content (Full Notice)**

- Type of safe harbor contribution
- Other contributions to the plan
- Plan receiving safe harbor contribution
- Compensation that is subject to deferral
- Deferral requirements (how, when, etc.)
- Distribution and vesting provisions
- Where a participant may obtain additional plan information (contact information)



## **Notice Content (Full Notice)**

- QACA Notice additional content:
  - Explanation of the auto enroll/auto escalation deferral amount
  - Explanation of the employee's right to elect a different amount or NOT to have elective deferrals withheld
  - If employee may direct investments, an explanation of how elective deferrals (and other contributions if applicable) will be invested if no investment election is made (*i.e.*, the QDIA).



## **Minimizing Notice Content (Short Form)**

- Notice may cross-reference to SPD for the following items:
  - Other contributions
  - Plan receiving safe harbor contributions and
  - Compensation that is subject to deferral.



## **Timing of SH Notice**

- The safe harbor notice must be provided a reasonable period of time before the beginning of each plan year (or a reasonable period of time before an employee first becomes eligible).
- The timing rule is deemed satisfied:
  - If given at least 30 and no more than 90 days before the beginning of the plan year or
  - For newly eligible participants, no more than 90 days before and no later than the employee's eligibility date (although okay if given before first deferrals are withheld).



## **Timing of QACA SH Notice**

- A QACA safe harbor notice must be provided sufficiently early so that the employee has a reasonable period of time after receipt to make a different (or no) deferral election and/or a different directed investment election.
- Notwithstanding the foregoing, the auto enroll or default investment election must be effective no later than the earlier of:
  - The pay date for the second payroll period that begins after the date the notice is given and
  - The first pay date that occurs after the notice is given.



## Mid-year Amendments to Safe Harbor Plans



- The 401(k) final regulations (at §1.401(k)-3(e)) specifically provide:
  - "[P]lan provisions that satisfy the rules of this section [must be] adopted and remain in effect for an entire 12-month plan year. In addition, ...a plan that includes provisions that satisfy the rules of this section will not satisfy the requirements of §1.401(k)-1(b) if it is amended to change such provisions for that plan year."
- The IRS had previously interpreted this regulation to prohibit almost any amendment that modifies any provision of the safe harbor plan during the plan year.



- The underlying principle espoused by the IRS was that participants receive a safe harbor notice before the year begins and they should be able to rely on its content for the entire year.
- The result had made it quite difficult to operate a safe habor plan since, effectively, no changes could be made once the planyear had begun.



- The IRS acknowledged that there was a need for guidance on the types of mid-year amendments that are permissible.
- IRS Announcement 2007-59 specifically asked for public comment on this topic.



- ASPPA GAC filed numerous comment letters:
  - November 16, 2007
  - June 6, 2010
  - November 11, 2011
  - June 1, 2012
  - October 10, 2013.



- Until the most recent guidance was released, the only midyear amendments/changes clearly permitted were:
  - Mid-year adoption of safe harbor provisions under a "maybe" notice type of plan design
  - Mid-year adoption of a Roth contribution program
  - Expansion of hardship withdrawals to add the PPA '06 provisions



- Mid-year amendments/changes clearly permitted (continued):
  - Amendments to conform with the Windsor case (same gender) marriages)
  - Amendments to suspend safe harbor contributions ("exiting") and
  - Amendments to change the plan year (if certain requirements) are satisfied)
  - Amendments to terminate the plan.



### **IRS Notice 2016-16**

- IRS Notice 2016-16 now significantly expands the types of amendments/changes that safe harbor plan sponsors can adopt mid-year.
- The new guidance was effective January 29, 2016.



## **IRS Notice 2016-16**

- The new rules now permit most mid-year amendments/changes if certain requirements are satisfied (with limited exceptions).
- A mid-year amendment/change is defined as a change:
  - "That is first effective during a plan year, but not effective as of the beginning of the plan year or
  - Effective as of the beginning of the plan year, but adopted after the beginning of the plan year."



### **IRS Notice 2016-16**

- In cases where there is mid-year change relating to the information covered by the safe harbor notice (whether in the plan or not), the new rules require timely distribution of an updated notice.
- The "update" requirement would also apply in circumstances where the notice information is cross-referenced to the SPD and would therefore require an SMM, an updated SPD, or an updated notice with the changes being provided in a timely fashion.



### **Updated Safe Harbor Notice**

- Generally, the new notice must be given a "reasonable period of time before the effective date of the change."
- This standard is deemed satisfied if the notice is given at least 90 days and no less than 30 days before the effective date of the change.



### **Updated Safe Harbor Notice**

- In certain circumstances, it may not be "practicable" to give the notice before the effective date. In such cases, the new notice must be given "as soon as practicable" but no later than 30 days after the change is adopted.
- An example would be where the matching contribution rate is increased retroactively to the beginning of the plan year.



### **Updated Safe Harbor Notice**

- If a new safe harbor notice is required, then each eligible employee must be given a "reasonable opportunity" to change their deferral election after receiving the updated notice.
  - After receiving the updated notice, an election period of at least 30 days before the effective date of the change is deemed reasonable.
  - If not "practicable" to provide for an election period before the effective date of the change, then the election period must begin as soon as practicable after the date the updated notice is given but no less than 30 days after the date the change was adopted.



- A mid-year amendment that results in any of the following is not permitted:
  - An amendment to increase the completed number of years of service to vest in a "QACA" safe harbor contribution (that can be subjected to a two-year cliff vesting schedule)
  - A change in the type of safe harbor plan (e.g., a change from a traditional safe harbor plan to a QACA safe harbor plan)



- Prohibited mid-year amendments (continued):
  - An amendment to reduce or narrow the group of employees eligible to receive safe harbor contributions. This would seemingly prohibit the prospective reduction of matching contributions that fit within the parameters for the ACP safe harbor)
  - Prohibition doesn't apply to entry date or service crediting amendments with respect to employees not already eligible as of the date the amendment is either made effective or adopted



- Prohibited mid-year amendments (continued):
  - An amendment that modifies (or adds) a formula used to determine matching contributions (or the definition of compensation used to determine matching contributions) if the change increases the amount of matching contributions or
  - Adding a "discretionary" matching contribution.



- Prohibited mid-year amendments (continued):
  - The prohibition on matching contribution changes, described in the previous slide, doesn't apply if:
    - The change is adopted at least three months before the end of the plan year
    - Is made retroactively effective for the entire year (which would also require revocation of a payroll period based limitation for the year, if applicable) and
    - The safe harbor notice and new election opportunity are provided.



#### **Prohibited Mid-year Amendments**

- Prohibited mid-year amendments (continued):
  - Any mid-year amendment that otherwise violates other applicable IRC provisions, such as:
    - The anti-cutback rules of IRC §411(d)(6)
    - The nondiscrimination rules of IRC § 401(a)(4)
    - The "anti-abuse" provisions in Reg. §1.401(k)-1(b)(3).



#### Notice 2016-16

- Needless to say, Notice 2016-16 is good news.
- It represents a significant loosening of the rules from what had been the informal position of the IRS.
- The Notice solicits comments on what additional guidance in • this area may be needed such as with respect to plans with automatic enrollment features or sponsors involved in merger and acquisition transactions.



# Exiting/Terminating Safe Harbor 401(k) Plans Mid-Year



#### Exiting/Terminating Safe Harbor Mid-year

- The new guidance does not change the rules that apply to plan sponsors who wish to suspend their participation in a safe harbor plan.
- Those rules were modified under regulations (proposed 2009, finalized 2013) issued as a result of the "great recession."



## Exiting/Terminating Safe Harbor Mid-year

- Two possibilities exist for getting out of a safe harbor plan midyear:
  - Apply the "exiting" rules or
  - Terminate the plan.



# Exiting/Terminating Safe Harbor Mid-year

- Under the "exiting" rules, the plan continues but:
  - Loses its safe harbor status and
  - Must apply ADP/ACP tests using current year testing to remain qualified.
- Under the midyear termination rules, plan goes out of existence but it's still possible to preserve safe harbor status in the year of termination depending on the reason for the termination.



# Terminating a Safe Harbor Plan



#### **Plan Termination**

- Normal termination rules apply.
  - Plan has to fully vest all participant accounts.
    - Safe harbor contributions (other than in a QACA) and deferrals are already fully vested so perhaps not a big deal.
  - Plan document would need to be updated for current law as of its termination date.
  - Plan assets would need to be distributed within a "reasonable period of time" after plan's termination date. Within one year after plan termination date is deemed reasonable under Rev. Rul. 89-87.



#### **Mid-year Plan Termination**

- Special rules apply if termination is for:
  - Substantial business hardship or
  - 410(b)(6)(C) transaction (e.g., merger, acquisition, etc.).
- Result:
  - Plan gets to retain safe harbor status
  - No 30-day notice mandate and
  - Still must fund contributions to termination date.



#### **Substantial Business Hardship**

- Defined in 412(c)(2) for funding waivers of minimum funding:
  - The factors taken into account in determining . . . substantial business hardship . . . shall include (but shall not be limited to) whether or not:
    - The employer is operating at an economic loss
    - There is substantial unemployment or underemployment in the trade or business and in the industry concerned
    - The sales and profits of the industry concerned are depressed or declining and
    - It is reasonable to expect that the plan will be continued only if the waiver is granted.



# **Mid-year Plan Termination**

- Termination for any other reason (i.e., no business hardship or 410(b)(6)(C) transaction) then the following conditions apply:
  - Give at least 30 day's advance notice to eligible employees
  - Terminate plan
  - Fund to termination date and
  - Must pass current year ADP/ACP tests.
- Result:
  - Plan still qualified, but loses safe harbor status
  - Plan is now subject to top-heavy rules.





- In February 2009, in the midst of the "Great Recession," ASPPA GAC wrote a comment letter urging the IRS to issue guidance that would permit plan sponsors to suspend nonelective safe harbor contributions mid-year without having to formally terminate the plan.
- In May 2009, the IRS issued proposed regulations that permitted suspension on 30 day's notice, but only if the employer had incurred a "substantial business hardship (comparable to a substantial business hardship described in section 412(c))."



- On November 15, 2013, the IRS issued final regulations that revised and superseded the 2009 proposal. Under the final regulations, safe harbor contributions of either flavor (matching or non-elective) may be reduced or suspended under the following conditions:
  - The plan is affirmatively amended to reduce or suspend contributions
  - At least 30 days ahead of the reduction or suspension, employees are given a supplemental notice explaining the consequences of the change, procedures for making new deferral elections, and the effective date of the reduction or suspension.



- "Exiting" conditions (continued):
  - Employees are given a reasonable opportunity to change their deferral elections and
  - Safe harbor contributions must continue at the existing level to the reduction or suspension date (which can be no earlier than the later of: the adoption date of the amendment; or 30 days after eligible employees receive the supplemental notice).



- In addition, under the new regulations, suspension or reduction will only be permitted if:
  - The plan sponsor is operating at an "economic loss" or
  - The annual safe harbor notice that was given out before the beginning of the plan year **included language informing** participants of the possibility that safe harbor contributions could be reduced or suspended during the year. (The "maybe" not notice.)
- This change means that the "exiting" rules for plans with matching contributions will now be more restrictive because of the new wording that must be added to the annual notice to allow for reduction or suspension for reasons other than operating at an "economic loss."



- The proposed regulation had required the plan sponsor to have incurred a "substantial business hardship" in order to exit a safe harbor non-elective plan.
- Under the final regulations:
  - The same "exiting" rules apply both non-elective and matching contribution safe harbor plans
  - "Economic loss" has replaced "substantial business hardship" as the "exiting" standard that must be met by all types of safe harbor plans in the absence of the "maybe not" language in the annual notice and
  - The IRC §401(a)(17) limit must be prorated, but it is not entirely clear what is meant by this and no guidance has been provided.



- In recognition that the "maybe not" wording in the annual notice is a new requirement for matching plans, there are bifurcated effective dates:
  - For non-elective contribution plans retroactive to May 18, 2009 (the date the proposed regulations were issued)
  - For matching contribution plans, to plan years beginning after December 31, 2014.
- Since the sponsors of non-elective type safe harbor plans could not have known that new wording would be needed in the annual notice, the ability to exit without an economic loss will be available for the first year that the "maybe not" language is included in the annual notice.
  - The new wording should generally be included in the annual notice for all non-maybe notice plans.

#### **Exiting Versus "Maybe" Notice**

- The "maybe" notice design (which remains unchanged and in effect) for non-elective safe harbor plans still provides more flexibility since sponsors can wait up to 30 days before the end of the plan year to adopt a plan amendment that activates the safe harbor plan provisions.
- The "maybe" notice approach however, **only applies to** safe harbor plans using **NON-ELECTIVE** contributions.
- Going forward, it will make sense to add the new language concerning the possibility of contributions being reduced or suspended to all safe harbor plan annual notices. This now becomes the "maybe not" notice.



# "Maybe" Notice Safe Harbor 401(k) Plans



#### **Maybe Notice Plans**

- An employer may not be certain before the plan year starts that it wants to (or can afford to) commit to the safe harbor for the entire plan year.
- Or, the employer would just like to wait and see.
- 401(k) regulations offer the employer this option but only for plans using the non-elective safe harbor contribution approach.
- Using this late election approach involves giving what we affectionately call the "MAYBE" NOTICE.



#### Maybe Notice: The Mechanics

- Plan sponsor gives the "maybe" notice before the beginning of the plan year advising employees that the employer may elect into safe harbor status during the plan year.
- Applies ONLY to the 3% non-elective alternative.
  - Maybe notice does **NOT** apply to a safe harbor plan with matching safe harbor contributions.
  - This is due to the potential for abuse by those who may "know" a match will be made and make deferral elections accordingly while those not in the "know" may be reluctant to do so.



# The Mechanics (Continued)

- Employer elects into safe harbor by: •
  - Giving a supplemental notice no later than 30 days before the end of the plan year
  - Affirmatively amending the plan to add the safe harbor language before the end of the year and
  - Otherwise complying with the safe harbor requirements.
- Even though amended mid-year, the plan is deemed to • satisfy the safe harbor rules for the full plan year.



# The Mechanics (Continued)

- If employer does not elect safe harbor status by giving the supplemental notice, plan must run ADP and ACP tests using current year testing.
- Plan sponsor may elect to follow the "maybe" notice approach each and every year — unlimited use.
- May combine the supplemental notice electing safe harbor status • with the annual safe harbor "maybe" notice — subject to timing considerations.



# Questions?





