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Jettisoning Benefits to Keep Your Company Ship Afloat During the COVID-19 Storm

COVID-19 Resource

The economic crisis caused by the COVID-19 virus is forcing many businesses to look for cost-savings measures to improve their financial situation or, in some cases, to survive. Some businesses have laid off or placed employees on standby unemployment benefits. Others are looking for creative ways to reduce costs to keep employees on the payroll. Some businesses are considering whether they can save costs by reducing or suspending company contributions to their 401(k) plan. Given the complex federal laws that control benefit plans, many clients facing unforeseen financial issues have asked, “Is it even possible to change our plan in the middle of a plan year?” The answer depends on whether your business has a “safe harbor” plan and your plan’s specific terms.

Safe harbor plans are designed to avoid annual testing under nondiscrimination rules that are designed to prevent favored treatment of highly compensated employees. Safe harbor plans avoid the prospect of failing the nondiscrimination testing and the need to return elective deferrals to highly compensated employees. Because these “safe harbor” plans must comply with numerous regulatory requirements, it is more difficult to reduce or suspend contributions to safe harbor plans during a plan year. On the other hand, plans that are not safe harbor plans are generally free to make mid-year changes unless the specific terms of the plan restrict such changes.

Non-Safe Harbor Plans

Sponsors of non-safe harbor plans can generally reduce or suspend company contributions — matching or “nonelective” contributions — during the plan year simply by adopting an amendment. If the company contributions are discretionary, it may not even be necessary to amend the plan; a board resolution may be sufficient. However, some non-safe harbor plans provide for a fixed employer contribution. In that case, if employees have already met the eligibility conditions to receive those contributions for the year, the company may not be able to reduce or suspend contributions, at least with respect to the first part of the year. For example, if the plan uses a fixed formula (e.g., four percent of compensation) and employees are not required to work certain hours to receive a share of the contribution, the contribution might be suspended only prospectively.

Of course, suspending or reducing the company’s contributions to the plan mid-year could impact nondiscrimination testing. For example, highly compensated employees may “front load” their elective deferrals in a 401(k) plan, perhaps by deferring a percentage of their bonuses. In this case, the plan could fail the nondiscrimination tests at year-end, forcing the plan to return some or all of those deferrals to highly compensated employees.

Importantly, the Internal Revenue Code does not require your business to decide whether to make a discretionary contribution to a plan until after the end of the year (assuming the plan permits it), and the contribution can be made by the (extended) due date of the company’s tax return for the year. For this reason, if your business currently faces a dire financial situation, but you expect to recover quickly once COVID-19 restrictions are lifted, you may want to keep your options open and decide early next year whether to make a contribution and how much.

Safe Harbor Plans

Generally, safe harbor matching or nonelective contributions cannot be reduced or suspended mid-year; however, this is subject to two important exceptions if your business:

- Reserves the right to reduce or suspend safe harbor contributions mid-year in its annual safe harbor notice (the “wait-and-see” approach); or
- Is “operating at an economic loss” for the plan year.

If one of the two exceptions applies, your business must:

- Provide plan participants with a supplemental notice explaining the change at least 30 days prior to the effective date;
- Provide a reasonable period after receipt of the notice for eligible employees to change their deferral elections before the change is effective;
- Adopt an amendment that is effective no earlier than 30 days after all eligible employees are given the notice (or, if later, the date the amendment is effective); and
- Make company contributions for periods prior to the effective date of the amendment.

Important changes made by the SECURE Act may modify or eliminate some of these requirements beginning in 2020, but we are awaiting IRS guidance on the new law. Until guidance is issued, we recommend that businesses follow the pre-2020 rules regarding reduction or suspension of contributions.

Remember that when a company reduces or suspends its safe harbor contributions, the plan becomes subject to the nondiscrimination testing requirements for the entire plan year. If the plan fails these tests, highly compensated employees may have some of their contributions returned.

Key Takeaways for Businesses Considering Changes to 401(k) Plans

If your business wants to consider a mid-year reduction or suspension:

- Determine whether your plan is a safe harbor plan
 - If so, work with your benefits consultants or attorney to determine whether you are permitted to do so and what steps you need to take
 - If not, review the plan carefully to determine whether there are any restrictions on mid-year changes
 - If so, make the amendment prospective
 - Amend the plan or adopt a resolution
- Consider whether to take a wait and see approach if you have discretionary contributions

For more information, consult Lane Powell's [COVID-19 Resource Center](#) or contact [Katheryn Bradley](#) or [Craig Day](#).