

# Insight

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## *One Year Later – Reinstating Your 401(k) Match*

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What a difference a year makes. It was just about this time last year that we wrote about some of the problems inherent in suspending the matching contributions to a 401(k) plan. Shortly after our initial article, the Internal Revenue Service (IRS) provided some relief for sponsors of safe harbor 401(k) plans so that they too could suspend their matching contributions without facing qualification issues.

In 2010, the design challenge reversed itself. As we appear to emerge from the worst of the economic doldrums, many companies are reinstating their matching contributions, either to their prior levels or to some other level. While this seems like a simple, well-intentioned change, it could bring with it some challenges. Fortunately, all are surmountable with a bit of knowledge and planning.

### **Reinstating a Safe Harbor Design**

Companies that once sponsored a safe harbor plan design might want to return to that design, and they can; but, not in the middle of a plan year. First, you cannot have a plan that is a safe harbor for part of a plan year and not for the other part. Second, sponsors of safe harbor plans must provide notice of the design and safe harbor status of a plan at least 30 days before the beginning of the plan year for which the plan will be a safe harbor. One might say that ship has already left the harbor.

So, a company can reinstate the safe harbor design during 2010, but they will not be exempt from actual deferral percentage (ADP) and annual contribution percentage (ACP) testing until 2011, assuming amendment and notification by December 1, 2010. For 2010, they will need to prove nondiscrimination in the amount of deferrals and matching contributions using the ADP and ACP tests. And, while failing those tests may simply require that the plan refund certain amounts to highly compensated employees (HCEs), it is worth noting that the results of those tests may be unexpected.

### **Testing Challenges**

Even plans that perform ADP and ACP testing may face a challenge when reinstating a matching contribution.

A 401(k) plan must specify in the plan document which testing method it uses – the current year method or the prior year method. Oversimplifying somewhat, if you use the current year method, you calculate your testing percentages for non-highly compensated employees

# Insight

## *One Year Later – Reinstating Your 401(k) Match*

(NHCEs) **based on their deferrals and Roth contributions, and the after-tax and matching contributions** for the plan year in question. If you use the prior year method, then the ADP and ACP for the NHCEs is calculated based on their contributions for the prior year. The advantage of the prior year method is that before the plan year starts, you know exactly what the ADP and ACP results for your HCEs can be to still pass the tests.

Now, suppose a plan sponsor using the prior year method matched 50 cents on the dollar for the first 6% of pay deferred during the first 3 months of 2009 and then suspended their match. This same sponsor reinstated the same match effective April 1, 2010. Finally, the plan uses the prior year method. From a testing standpoint, the NHCE percentages will be based on 2009 (the year with 3 months of matching contributions) behaviors, and the HCE percentages will be based on 2010 (9 months of matching contributions) behaviors. A quick analysis indicates that this plan is likely to fail the ACP test.

In fact, if we consider the behavioral aspects, the ADP test could be in jeopardy. Although surveys have generally shown some resilience during the economic downturn, one would expect that among those who reduced their deferral elections, the greatest proportion would consist of NHCEs, either because the match was eliminated or because they could least afford to continue making contributions.

For our plan using the prior year method, this would cut the extent to which HCEs can defer in 2010. Even for plans using the current year method, the tougher economy will create some additional degree of difficulty passing the ADP test. However, in our scenario, the challenges for the plan using the current year method appear far less than for the plan using the prior year method.

### **Amending the Plan by December 31**

If you like the testing method that is written in your plan, stick with it. If you don't – for example, if you are using the prior year method and you would like to use the current year method – you can change it. All you need do is amend your plan to change its testing method by the end of the plan year. (Note, you may find this amendment useful even if you plan to revert to a safe harbor design for 2011.) For that matter, the plan could even be written to use the prior year method for one test (ADP or ACP) and the current year method for the other test, although certain limitations may apply. In general, the regulations permit plans to be amended to change from the current year testing method to the prior year testing method only after expiration of a five-year period.

### **Making Your Decision**

Since a change in testing method from prior year to current year will affect your plan for five years, such a change should not be made lightly. Plan sponsors need to know exactly what

# Insight

## *One Year Later – Reinstating Your 401(k) Match*

their circumstances are. We recommend that you start by looking at your ADP and ACP percentages for your NHCEs for 2009. Were they markedly lower than what would be needed to support successful ADP and ACP tests for 2010? If not, is it worth making the change in 2010 knowing that you can't revert back until 2015 (most plan sponsors consider the prior year method easier from both a communications and a compliance standpoint)? In addition, employers who sponsor multiple plans need to be aware that plans aggregated for testing must use the same method.

Decisions like this require careful analysis. Your Aon consultant can help.

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