Flashpoint: The Three-Month Rule and Retroactive Safe Harbor Elections: You Need to Adopt the Plan by October 1!

By S. Derrin Watson

Perhaps we should have expected it. It would have been nice if the IRS had provided guidance on the topic. But shoulda, woulda, coulda doesn't matter. Here we are, at the end of September, deluged with questions about the implications of the SECURE Act change that permits retroactive amendments to institute a safe harbor 401(k) plan.

The questions come in three forms:

1. Can an employer wait until November 30 to adopt a new calendar year 401(k) plan and add a 3% safe harbor nonelective contribution?
2. How about waiting until the due date of the 2020 return to adopt the plan, and adding a 4% safe harbor nonelective contribution?
3. Could we adopt a plan in November, make it retroactively effective to January 1 (or October 1), and allow people to start deferring upon adoption?

We won't keep you in suspense. The answer to all three questions is **NO**. We would be very surprised if the IRS interpreted the rules any other way.

SECURE Act Changes

The SECURE Act repealed the need for safe harbor nonelective ("SHNE") plans to provide a safe harbor notice. It also provided that "a plan may be amended after the beginning of a plan year" to add a SHNE contribution. [Code §401(k)(12)(F)] Safe harbor match plans are unaffected by these changes, and a safe harbor match feature must be put into place before the beginning of the plan year.

An amendment to initiate a SHNE plan with a safe harbor contribution of 3% of compensation must be adopted more than 30 days before the close of the plan year. (In a calendar year plan, the 30th day before the close of the plan year is December 1. That puts the amendment deadline at November 30.) The amendment to a SHNE plan can be adopted after November 30 up to 12

months after the end of the plan year, if the nonelective contribution for that year is at least 4% of compensation.

Three-Month Rule

The 401(k) regulations generally require that a safe harbor plan year be 12 months long. The preamble to the regulations explains why:

This requirement is consistent with the notion that the statute specifies a certain contribution level for NHCEs in order to be deemed to pass the nondiscrimination requirements. If the contribution level is not maintained for a full 12-month year, the employer contributions made on behalf of NHCEs should not support what could be a full year's contribution by the HCEs.

One of the rare exceptions to this rule relates to a newly established plan, other than a successor plan. The regulations permit the initial plan year for a new safe harbor 401(k) plan to be as short as three months. The only time it could be shorter is with a newly established employer. [Treas. Reg. §1.401(k)-1(e)(2)]

This requirement gives the NHCEs two things:

1. It guarantees that the safe harbor employer contributions will apply for at least a quarter of the year; and
2. It guarantees that the NHCEs will have at least three months during which they may save for their own retirement with the convenience of payroll deduction.

The SECURE Act did nothing to repeal or modify this requirement. With the new rules, an employer can adopt a calendar year ADP-tested 401(k) plan on October 1, find out how much the employees will defer, and wait until November 30 to decide to convert it to a safe harbor plan with a 3% nonelective contribution. Similarly, the employer could amend a plan that was in existence on or before October 1, 2020, anytime between December 1, 2020, and December 31, 2021, to add a 4% SHNE provision. But the employer cannot, consistent with the safe harbor, deprive the employees of the opportunity to defer for at least three months in 2020, or to receive the SHNE contribution in relation to compensation paid for those months.

Greedy, Greedy

The second question (which we have received more than once), about waiting until after the year is over to adopt the plan with a 4% nonelective contribution, illustrates well the need for the three-month rule. Presumably, this is a plan for a self-employed individual, who (the practitioner thinks) would still be able to contribute deferrals if the plan were adopted in the following year, as the SECURE Act permits. However, this arrangement would deny common law employees any ability to defer at all. The unfairness of that should not require explanation.

The three-month rule is not the only flaw with this approach. Self-employed individuals must make their deferral elections before the last day of the partnership or sole proprietor's tax year, even though the contribution can be deposited later. That's awfully hard to do if there isn't a plan in place before the end of the year!

Don't Hesitate: There's Less Than One Week Left!

So, don't wait. If an employer wants a calendar year 401(k) plan, and you think the employer might want the benefits of the ADP safe harbor, establish the plan by October 1. SECURE allows you to wait until later to add the safe harbor feature, but the plan needs to be in place first for at least three months.

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We are your ERISA solution™

Ilene Ferenczy • ilene@ferenczylaw.com | Alison Cohen • acohen@ferenczylaw.com
Adrienne Moore • amoore@ferenczylaw.com | Adriana Starr • astarr@ferenczylaw.com
Tia Thornton • tthornton@ferenczylaw.com | Leah Dean • ldean@ferenczylaw.com

2635 Century Parkway Suite 200, Atlanta, GA 30345
T 404.320.1100 | F 404.320.1105 | www.ferenczylaw.com