IRS Gives SECURE Act Guidance on Traditional and QACA Safe Harbor Plans

The SECURE Act makes it easier for employers to adopt ADP/ACP safe harbor plan provisions. These plans, which include both "traditional" safe harbor plans and qualified automatic contribution arrangements (QACAs), have proven popular with many employers. This is because such plans are usually deemed to pass several nondiscrimination tests. IRS Notice 2020-86 provides guidance on some of the details of these SECURE Act provisions, including direction on amendments and notices. But while this notice gives important direction, we await more comprehensive regulatory guidance.

Background

Retirement plans, such as 401(k) plans, are subject to various nondiscrimination tests. The ADP test[1] applies to employee deferrals and the ACP test[2] applies to matching and after-tax contributions. The top-heavy test helps ensure that key employees' accounts do not contain a disproportionate share of overall plan assets. Failing these tests can result in certain employees having to remove deferrals or in employers having to make additional—and at times substantial—contributions. But Internal Revenue Code Sections (IRC Secs.) 401(k)(12) and 401(k)(13) contain provisions that allow employers to avoid the ADP test. And if certain other conditions are satisfied, they can also avoid the ACP and top-heavy tests. Plans known as traditional safe harbor plans and QACA safe harbor plans must meet the requirements of IRC Secs. 401(k)(12) and (13), respectively. Employers that have these plans must make the proper matching or nonelective contributions to non-highly compensated employees.

Employers with traditional safe harbor 401(k) plans must make either a matching contribution to those who defer income into the plan, or a nonelective contribution of 3 percent, which goes to all employees that are eligible to participate in the plan. Employers with QACA safe harbor plans must make similar contributions and must enroll eligible employees in the plan automatically. These employees must have at least 3 percent of their compensation deferred into the plan in the first year—unless they opt out or choose a different deferral amount. Each year, the deferral percentage is increased by at least 1 percent. When an employee's deferral percentage reaches 6 percent, it can remain there, or it can continue to increase until the percentage cap is reached. Before the SECURE Act, the cap was set at 10 percent.

For all the benefits of adopting a traditional or a QACA safe harbor plan, there have been some concerns about the requirements that apply to these plans.

- Employers must generally maintain the plan under the traditional or QACA safe harbor rules for the entire plan year.
- Detailed notice requirements—in addition to other 401(k) notices—accompany these plans.
- The QACA 10 percent automatic deferral cap may not provide employers with enough plan design flexibility or may not encourage a high enough savings rate.

[1]The ADP test—or the actual deferral percentage test—compares the highly compensated employees' (HCEs') deferral percentage with the nonHCEs' average deferral percentage. This test helps ensure that HCEs do not contribute a disproportionate percentage of deferrals in relation to nonHCEs.

[2]The ACP test—or the actual contribution percentage test—is like the ADP test. But the ACP test compares the HCEs' percentage of matching and after-tax contributions with the nonHCEs' percentages of such contributions.

SECURE Act Provisions
The SECURE Act, generally effective for plan years beginning on or after January 1, 2020, provides relief from some of the restrictions of the previous rules.

***QACA plans now have a higher cap on deferral percentages* –** Instead of the previous 10 percent cap on automatic deferrals, QACAs now have a maximum 15 percent default deferral rate. During the initial plan year, employers may automatically enroll eligible employees at a default rate ranging from 3 percent to 10 percent of their compensation. Employers may then automatically increase the deferral rate to 15 percent in the second year. Most employers, however, will likely increase the deferral rates more gradually. (The QACA rules still require the automatic deferral amount to be at least 4 percent in the second year, 5 percent in the third year, and 6 percent in the fourth year.)

***Employers that make nonelective contributions may have reduced notice requirements and more opportunities to adopt a safe harbor feature* –** Under the old rules, an employer could amend an existing 401(k) plan to add a safe harbor nonelective contribution up to 30 days before the end of the plan year. But this was only allowed if the employer provided a contingent notice before the start of the plan year *and* a follow-up notice 30 days before the end of the plan year. Now, an employer may more easily adopt a safe harbor nonelective contribution design mid-year—without first providing notices—but only if the contribution is made on employees' full-year compensation. This change allows employers to amend their plans, for example, if they discover that they are failing the ADP test for the current year. By adopting a safe harbor nonelective contribution feature, an employer may avoid the ADP test—and usually the ACP and top-heavy tests, as well. But specific contribution and timing rules apply.

- As before, an employer may amend the plan up to 30 days before the end of the current plan year. Eligible participants must still receive a 3 percent nonelective contribution based on their full-year compensation. But in some cases, the SECURE Act removed the need to provide a contingent and follow-up notice.
- The SECURE Act now allows an employer to amend the plan up to the end of the *following* plan year, but only if eligible participants receive a 4 percent nonelective contribution based on full-year compensation. For example, an employer could add a safe harbor feature to a calendar-year plan for 2020 up until December 31, 2021.

Notice 2020-86 Provides Details
Notice 2020-86 offers guidance on both the QACA default deferral cap and on electing safe harbor 401(k) status. The notice also acknowledges that more complete guidance is needed, stating that the notice "is intended to assist taxpayers by providing guidance on particular issues while the Treasury Department and the IRS develop regulations to fully implement these sections of the SECURE Act."

While more than half of the notice deals with a variety of specific notice issues, the following items are the most relevant.

***The 15 percent cap on QACA default deferrals* –** Employers may choose to amend their QACA plans to reflect the increase in the maximum automatic deferral percentage to 15 percent. For example, an employer with a plan that expressly limits the default deferral percentage to 10 percent may retain this provision.

But the notice also addresses other plans that may incorporate the maximum default percentage by reference to the statute. Because the SECURE Act raised the statutory cap to 15 percent, those employers that apply the statutory limit in the plan will raise the plan's cap to 15 percent by default. On the other hand, for a plan that incorporates the statutory limit, the employer could keep the cap at 10 percent. But the employer would have to document this decision, continue to consistently apply this cap, and amend the plan by the deadline (discussed below).

***Notice requirements* –** Traditional and QACA safe harbor regulations have allowed a safe harbor provision to be added to a 401(k) plan mid-year if the employer 1) gives the nonelective safe harbor contribution (versus a matching contribution) and 2) provides the proper notices. The regulations required two distinct notices: a contingent notice and a follow-up notice. The contingent notice was required to be given a reasonable time before the beginning of each plan year, specifying that the plan *may* be amended mid-year to provide a nonelective contribution to satisfy the safe harbor rules. A follow-up notice would be required—at least 30 days before the end of the plan year—if the employer amended the plan mid-year to adopt the safe harbor provision.

- The SECURE Act eliminated the notice requirements in IRC Secs. 401(k)(12) and 401(k)(13) for employers that adopt a nonelective safe harbor feature. For example, consider a 401(k) plan that has only a deferral feature and no employer contributions. If an employer determines during the year that the plan will fail the ADP test, providing a 3 percent nonelective contribution will allow the plan to be treated as passing the test. (If no other contributions are made, the plan is also deemed to pass the ACP test and the top-heavy test.)
- The SECURE Act did not, however, eliminate the notice requirements of IRC Sec. 401(m)(11), which address the ACP test requirements for plans that provide for matching (or after-tax) contributions. Consequently, plans that allow for matching contributions that fall within the ACP test safe harbor limitations (e.g., no match on deferrals that exceed 6 percent of a participant's compensation) are still subject to the notice requirements that normally apply to traditional safe harbor plans. The result is different for QACA arrangements where employers are making safe harbor nonelective contributions. This is because the SECURE Act *did* eliminate the safe harbor notice requirement under IRC Sec. 401(m)(12) for those plans. QACA arrangements are, however, still subject to annual notice requirements that allow plan participants to opt out of automatic contributions.
- Notice 2020-86 uses several examples to illustrate when various notices are required. Some of these examples also show the complexities of the notice requirements. In Q&A 4, the notice uses an example of a 401(k) plan that meets the ADP safe harbor nonelective contribution requirement and also provides matching contributions that are *not* intended to satisfy ACP safe harbor rules. The plan does not need to satisfy the ADP or ACP safe harbor notice requirements, but it must satisfy the ACP test.
- Notice 2020-86 points out that the requirements for permissible reduction or suspension of safe harbor contributions have not changed. For example, if an employer wishes to amend a plan to remove the safe harbor contribution requirements during a plan year, it either 1) must be operating at an economic loss, or 2) must have included in the notice a statement that the plan may be amended during the year to reduce or suspend contributions. While certain notice requirements have been eliminated, employers wishing to retain the option to reduce or suspend contributions should continue providing this language to participants.
- Notice 2020-86 addresses numerous combinations of nonelective and matching contributions for both traditional and QACA safe harbor plans. But because the IRS is expected to release additional guidance, employers may choose to continue providing the same safe harbor notices that they have been providing—even if they may not be required to in every case.
- To assist with providing notices in general, Q&A 7 contains further relief. For the first plan year beginning after December 31, 2020, safe harbor notices will be considered timely if given to each eligible employee 30 days before the beginning of the plan year or January 31, 2021, whichever is later. For calendar-year plans, this gives employers approximately 60 days more than normally allowed.

Amendment requirements – Throughout Notice 2020-86, the IRS points out that employers must generally amend their plans for SECURE Act provisions by the end of the plan year that starts on or after January 1, 2022. (Governmental plans have two additional years to amend.) Of course, plans must operationally comply with whatever plan provision is in effect before the formal amendment. In addition, a plan may be amended after the applicable SECURE Act plan amendment deadline, in accordance with the plan amendment provisions that apply to adopting the nonelective safe harbor provisions in the SECURE Act. So if adopting a 3 percent nonelective contribution in the current year, the employer must amend the plan before the 30th day before the end of the plan year. If adopting a 4 percent nonelective safe harbor contribution for the previous plan year, the employer must amend the plan by the end of year following the year to which the amendment applies.

***Contribution deductibility* –** The notice also addresses contribution deductibility when a plan adopts the 4 percent nonelective safe harbor feature. It clarifies that, to claim a deduction for the year for which the contribution is made, the contribution must be made by the tax return due date, plus extensions, for the business. If the employer makes the safe harbor contribution after that date, the deduction may be taken for the taxable year in which the contribution is made, to the extent otherwise deductible under IRC. Sec. 404.

Looking Ahead

While Notice 2020-86 provides needed guidance on a few particular issues, the IRS has indicated that more comprehensive regulatory guidance is coming. Ascensus will continue to follow any new guidance as it is released. Visit ascensus.com for further developments on this and other guidance.