



# Update

April 2009



## Suspending the 401(k) match: Look before you leap

The US has entered into what may be a prolonged recession, and as a result, many organizations are looking for ways to preserve cash, including suspending or reducing contributions to 401(k) and other defined contribution (DC) plans. While suspending matching or nonelective contributions provides a relatively easy and immediate source of expense reduction, it's important to understand both the implications and the potential pitfalls of taking this action.

### Who's suspending contributions?

In a November 2008 Mercer survey, just 17 percent of respondents said that they were "likely" or "very likely" to suspend DC plan contributions. More recent surveys – and news headlines – reveal a growing trend in contribution suspension. In the first three months of 2009, more than 80 employers publicly announced plans to reduce or suspend contributions to their DC plans. Contribution suspensions are especially common in industries most affected by the economic downturn – media, automotive, airlines, retail, hospitality and gambling.

### What are the strategic human capital implications?

The scarcity of financial capital during the current economic recession sets this downturn apart from others. The most successful companies will be those that remain strategic while adapting to this new environment. In the midst of huge layoffs, many organizations struggle to attract and retain talent in certain key areas. While broad-based actions such as match suspension may make sense for some organizations, others may want to take a more farsighted and precise approach when identifying cost savings, targeting cuts that will minimally affect those employee segments that are critical to the employer's success. These organizations are looking to the future by considering all options before choosing an approach that best positions them to move forward once the economy rebounds.

### **What are the implications for employees?**

Over an employee's working lifetime, the loss of one year's employer contribution will not have a major impact on the employee's ultimate retirement benefit. However, such action may represent yet another incremental loss to a plan that is already weakened by a history of low participation rates and inconsistent investment behavior – and has most recently been pummeled by unprecedented market losses.

Additionally, suspending contributions may result in a lost opportunity to purchase equities at historically low prices. These implications must be weighed against the severity of the organization's need to preserve capital.

### **What are the potential regulatory pitfalls?**

Regulatory implications vary greatly from plan to plan. Employers maintaining an IRS "safe harbor" design are subject to specific rules, or even restrictions, on suspending or reducing contributions during a plan year. Other plan designs may offer more flexibility in terms of changing employer contributions, but even these plans must satisfy various regulatory requirements. In particular, employers should consider whether a formal plan amendment is required and whether that amendment raises any potential "anti-cutback" issues. Plan sponsors may also want to review past employee communications to determine whether any language could be interpreted as a promise to provide ongoing contributions. Organizations with collectively bargained or other employment agreements in place may be prevented from making companywide changes to DC contributions. Ordinarily, employer contributions can't be reduced retroactively, but exceptions may apply in cases where contributions are discretionary or conditioned on future service.

When employer contributions are suspended mid year – so that a plan is using less than a full year's compensation – the IRS may require that the plan prorate the statutory limit on plan compensation. For example, if matching contributions are suspended on July 1, 2009, the prorated compensation limit for purposes of the match calculation would be \$122,500 (half of \$245,000). In some cases, this could result in the forfeiture of employer contributions already credited to participant accounts.

Reducing or suspending employer contributions could have important implications for the plan's nondiscrimination requirements, which may be compounded by changes in compensation practices or by participant behavior related to the economic downturn. To avoid surprises and potentially costly remediation, employers should consider projecting the effect of contribution changes on nondiscrimination tests. Even if a plan passes ADP/ACP testing, employers should consider whether the timing or nature of the change in plan formula favors higher-paid employees over rank-and-file employees.



## **For further information, please contact:**

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Generally, participants should receive notice with sufficient opportunity to change their deferral elections before any changes in the match structure take effect – and indeed, safe harbor designs carry specific advance participant notification requirements. Of course, contribution changes may also need to be incorporated into the plan's summary plan description or summary of material modifications, and all regularly distributed communications materials should be reviewed and updated. Employers also will want to update online tools and coordinate with vendor customer service representatives to avoid pre-suspension data being provided via websites or phone inquiries.

## **Are there other implications to consider?**

Plan sponsors offering auto-enrollment should review this feature in light of any suspended or reduced matching contributions and should update auto-enrollment materials. Plans providing a true-up matching contribution at year end also require careful consideration, with special attention given to the pay and contributions that will be taken into account when calculating the true-up. Organizations with nonqualified deferred compensation programs, especially “mirror” plans, should consider other potential effects, including whether any matching contributions should be suspended in the nonqualified program.

Decision makers at distressed organizations may feel that they do not have the time or resources to carefully consider the effects of contribution reductions or to evaluate whether alternative approaches may better suit their long-term objectives. However, the time invested up front to thoroughly consider all options could save considerable time and expense later when dealing with unexpected consequences of the decisions made today.