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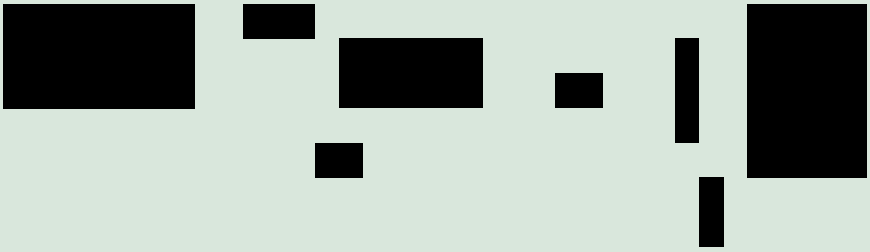

Insider

COVID-19 relief for reducing contributions to 401(k) and 403(b) safe harbor plans midyear

By Gary Chase and Bill Kalten

In **Notice 2020-52**, the IRS clarifies how existing rules apply to a midyear amendment to a safe harbor 401(k) or 403(b) plan that reduces or suspends only contributions made on behalf of highly compensated employees (HCEs) and provides temporary relief for changing safe harbor contributions to all eligible employees. The clarifications are intended to help employers that may need to reduce or suspend contributions under their safe harbor plans in order to satisfy payroll and other operating costs as a result of the unexpected financial challenges caused by the COVID-19 pandemic.

Background

To ensure that 401(k) plans do not unfairly benefit HCEs, companies must conduct an annual Actual Deferral Percentage (ADP) nondiscrimination test on pre-tax and Roth elective deferrals made to a 401(k) plan. As an alternative, a plan may satisfy the ADP safe harbor provisions of section 401(k)(12) – the traditional safe harbor – or section 401(k)(13) – the qualified automatic contribution arrangement (QACA) safe harbor.

In addition, matching and after-tax contributions made under either a 401(k) plan or a 403(b) plan must generally satisfy an annual Actual Contribution Percentage (ACP) test. As an alternative to satisfying the annual ACP test with respect to matching contributions (but not for after-tax contributions), a plan may satisfy the ACP safe harbor provisions of section 401(m)(11) – the traditional safe harbor – or section 401(m)(12) – the QACA safe harbor.

Safe harbor and non-safe harbor contributions

All safe harbor plans are required to provide non-highly compensated employees (NHCEs) either a safe harbor matching or a safe harbor non-elective contribution, the amount of which depends on the type of safe harbor.

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The safe harbor contribution must generally be made for the entire plan year. Safe harbor plans may also provide additional contributions (subject to certain requirements).

Current rules for midyear changes to safe harbor plans

In general, safe harbor plan provisions must be adopted before the first day of the plan year and remain in effect for an entire 12-month plan year.

IRS regulations allow reductions in future safe harbor matching or nonelective contributions during the plan year if the plan is also amended to provide that the ADP and/or ACP test (as applicable) will be satisfied for the entire plan year (using the current year testing method) and if certain other requirements are satisfied. An employer must generally meet one of the following requirements:

- Be operating at an economic loss
- Have included in the plan's safe harbor notice for the plan year a statement that the plan may be amended during the plan year to reduce or suspend safe harbor contributions and that the reduction or suspension will apply at least 30 days after all eligible employees are provided notice of the reduction or suspension

In addition, the reduction or suspension of safe harbor contributions may not be effective earlier than the later of the date the amendment is adopted or 30 days after eligible employees are provided a supplemental notice that describes the impact of the amendments and the procedures to change a deferral election. Finally, the regulations require providing eligible employees with a reasonable opportunity to change their cash or deferred elections and, if applicable, their employee contribution elections before the safe harbor contributions are reduced or suspended.

IRS Notice 2016-16 provides additional guidance on midyear changes to safe harbor plans to the extent that conditions for those midyear changes are not addressed in the code or regulations. A plan may make a midyear change to a safe harbor plan if 1) the change affects the plan's terms that are described in the plan's safe harbor notice and the plan satisfies the notice and election opportunity conditions in Notice 2016-16, and 2) the change is not described in a list of prohibited midyear changes in Notice 2016-16.

COVID-19 pandemic

Reduction in contributions made to HCEs

Notice 2020-52 clarifies that contributions made on behalf of HCEs are not considered safe harbor contributions, so a midyear change that only reduces contributions made on behalf of HCEs can be made regardless of whether the employer is operating at an economic loss at year-end or a statement about reducing safe harbor contributions is included in the plan's safe harbor notice. However, since contributions received by an HCE are described in the safe harbor notice, the employer would need to satisfy the requirements in Notice 2016-16 by providing an updated safe harbor notice and a timely election opportunity to HCEs to whom the midyear change applies.

The regulations require providing eligible employees with a reasonable opportunity to change their cash or deferred elections... before the safe harbor contributions are reduced or suspended.

Temporary relief for reductions or suspensions of safe harbor contributions

Notice 2020-52 provides two types of temporary relief that apply if an amendment to reduce or suspend safe harbor contributions is adopted between March 13, 2020, and August 31, 2020. While the relief simplifies the process for a plan to reduce or suspend safe harbor contributions as described below, the relief does not exempt the plan from becoming subject to ADP/ACP testing for the entire plan year.

First, the employer does not need to be operating at an economic loss or have included a statement about reducing safe harbor contributions in the plan's safe harbor notice.

Second, in the case of safe harbor nonelective contributions, the plan does not need to provide a supplemental notice to eligible employees at least 30 days before the reduction or suspension of safe harbor nonelective contributions is effective, provided that (1) the supplemental notice is provided to eligible employees no later than August 31, 2020, and (2) the plan amendment that reduces or suspends safe harbor nonelective contributions is adopted no later than the effective date of the reduction or suspension of safe harbor nonelective contributions. However, the relief regarding the timing of supplemental notices does not apply to a midyear reduction or suspension of safe harbor matching contributions. The IRS was concerned that matching contribution levels communicated to employees directly affects employee decisions regarding elective contributions (and, if applicable, employee contributions); therefore, the IRS retained the existing timing requirement for supplemental notices where the change affects safe harbor matching contributions.

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DOL proposes rule on ESG factors in selecting retirement plan investments

By Gary Chase and Bill Kalten

The Department of Labor (DOL) has issued **proposed changes** amending its "investment duties" regulation under ERISA, along with a related **fact sheet**. The proposal addresses the DOL's concerns related to the growing emphasis on investments based on environmental, social and governance (ESG) or other nonfinancial factors as well as the potential for ERISA plan fiduciaries to inappropriately consider ESG factors when selecting investments for an ERISA plan. The proposal comes shortly after DOL auditors began sending information requests to sponsors of plans that include investments that consider ESG factors.

The proposed rule emphasizes compliance with existing fiduciary obligations when selecting and monitoring investments and warns against selecting investments to further social or environmental goals. Under the proposal, an ESG factor may be considered when it is a material economic consideration or as a tiebreaker when investment options are equal based solely on financial factors; however, fiduciaries would be required to document the reasoning for selecting an investment that considers ESG factors. The proposal also prohibits an investment that considers ESG factors from being part of the plan's qualified default investment alternative (QDIA).

The proposed rules would apply sixty days after the final rule is published.

Background

Under ERISA, plan fiduciaries must act solely in the interest of the plan's participants and beneficiaries, for the exclusive purpose of providing benefits and defraying reasonable expenses of plan administration. Fiduciaries must also diversify plan investments to minimize the risk of large losses.

Subregulatory guidance issued in 1994 addressed selecting investments that generate collateral benefits in addition to investment returns. The "all things being equal" or "tiebreaker" standard generally provides that a fiduciary may select an ESG investment if its expected rate of return is at least commensurate to that of an alternative investment with similar risk characteristics that did not consider ESG factors, and that it is otherwise appropriate based on factors including diversification and the plan's investment policy; however, the characterization of when the tiebreaker standard is appropriate has varied depending on the administration in power at the time.

The DOL's main concern is that fiduciaries may select ESG-focused investments to advance social or environmental objectives.

In the preamble to the proposed rule, the DOL expresses concerns regarding the increasing popularity of ESG-focused investments, including that there is no consensus about what an ESG investment is, ESG rating systems are vague and inconsistent, and these funds may have higher fees due to the costs of investigating and monitoring these investments. The DOL's main concern is that fiduciaries may select ESG-focused investments to advance social or environmental objectives, rather than making investment decisions in accordance with their fiduciary obligations.

Proposed regulations

The key changes in the proposal both emphasize and build on the core principles of the current fiduciary rule for making investment decisions:

- **Exclusive purpose requirement incorporated.** The proposal emphasizes that plan fiduciaries must act solely in the interests of participants and beneficiaries for the exclusive purpose of providing benefits to participants and their beneficiaries, and defraying reasonable expenses of plan administration.
- **New factor required for "appropriate consideration" of investments.** The current rule requires fiduciaries to give "appropriate consideration" to three specific factors that are relevant to the particular investment or investment course of action involved. The proposal would add a fourth factor: The investment being considered must be compared with alternatives on the basis of diversification, liquidity and current return of the portfolio relative to the plan's cash flow needs and funding objectives.

- **Additional investment duties related to ESG factors.** The proposal states that the analysis of an investment option or approach must solely focus on "pecuniary factors" (i.e., economic considerations that materially affect risk and return of an investment based on appropriate investment horizons, consistent with the plan's funding policy and investment policy objectives). It specifically prohibits accepting any trade-off of investment return, increase in investment risk or higher fees to promote goals unrelated to the financial interests of the plan's participants and beneficiaries or the purposes of the plan (i.e., ESG or similar "non-pecuniary" goals).

The proposal would permit ESG factors to be considered when selecting investments in two cases:

1. In the first case, the ESG factor is considered an economic risk or opportunity that a qualified investment professional would treat as a material economic consideration under generally accepted investment theories.[1] An example included in the preamble is of a company that improperly disposes of hazardous waste, as it would implicate business risks and opportunities, litigation exposure and regulatory obligations. The preamble also notes that dysfunctional corporate governance could also represent a material risk and warns that a material ESG factor must still be considered among other relevant economic factors.
2. The second case involves the "all things being equal" standard, where investments are determined to be economically indistinguishable, a situation that is highly unlikely. Under the proposal, to select an otherwise equal investment based on ESG considerations, the fiduciary must document (i) specifically why the selected investment was indistinguishable from an investment that did not consider nonfinancial factors; and (ii) why it was chosen based on the plan's purpose, diversification of investments, and the interests of participants and beneficiaries in receiving plan benefits.

The proposal would apply different rules to the selection of investment alternatives for defined contribution plans that allow participants and beneficiaries to make investment elections based on a broad range of investment alternatives. Essentially, these plans could not include investments that consider ESG factors unless a materiality standard is satisfied. This standard would require that (i) the investment alternative is selected and monitored based solely on risk-return criteria, including benchmarks, expense ratios, fund size, long-term investment returns, investment manager's philosophy and experience, and mix of asset types; and (ii) the plan fiduciary must document its selection and monitoring of the investment in accordance with the factors described above.

Finally, the proposal prohibits investments that consider ESG factors from being included as, or being a component of, the plan's QDIA. This restriction would apply even if the selection of the investment was not based on ESG factors.

ESG-related information requests

The proposed rule comes weeks after reports of the DOL sending information requests to sponsors of plans that include ESG investments. The information requests seek a wide range of information, including policies and procedures related to how ESG factors are used to select and monitor investments, contact information for fiduciaries and advisors involved in decisions related to the ESG investments, details regarding specific investments that consider ESG factors and the investment returns for these investments, prohibited transaction exemptions relied on in selecting proprietary funds, and meeting notes or minutes related to the consideration of ESG funds by fiduciaries.

Going forward

If the proposal is finalized as currently drafted, plan fiduciaries will need to ensure that they meet the documentation and analysis requirements for any investments that consider ESG factors. Plan fiduciaries may wish to begin the process ahead of the regulations being finalized to gain a sense of the scope of any actions that may be required.

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[1] The proposal does not define "generally accepted investment theories"; however, in the preamble to the **final rule** amending the prohibited transaction exemption for providing investment advice to participants and beneficiaries, the DOL explained this standard by noting that "[i]n response to the Department's solicitation, commenters indicated that generally accepted investment theories is a term defined by wide usage and acceptance by investment experts and academics, and is subject to change over time."

Impact of COVID-19 on performance-based incentives accounting, disclosures

By Tom Kelly and Steve Seelig

A recent Willis Towers Watson pulse survey of nearly 300 companies found that most respondents are currently maintaining their previously approved incentive compensation plan goals. However, in light of COVID-19's impact on executives' annual and long-term incentives, many companies are considering adjusting plan targets and using discretion to determine any earned awards after the performance period. Before taking action, employers should be aware of the potential accounting and disclosure implications of these changes by consulting with audit firms and legal counsel.

Mid-course changes could bring added scrutiny from investors, proxy advisors and the press. And alternatives such as modifying performance goals have limited appeal with so much uncertainty about how long the pandemic will affect business operations.

Companies waiting to exercise discretion until the end of the performance period should consider the related complications for performance-contingent equity grants and cash-based annual bonus plans, as outlined below.

Annual bonus plans

Until the repeal of the performance-based exception for Internal Revenue Code section 162(m),[1] many annual bonus programs used negative discretion[2] to fund bonus plans at maximum for attaining threshold performance levels. This meant that disclosure of most company annual bonus plans was included in the "Non-Equity Incentive Plan Compensation" column of the Summary Compensation Table (SCT).[3]

With many companies no longer utilizing negative discretion plans, a discretionary payment relating to a cash incentive program may simply require reporting the paid amount in the SCT's "Bonus" column. This would be the case if such bonus is earned for services provided (and performance results attained) during the previous fiscal year (even if the decision to make such a bonus is not made until early the following year). It would also be the case even if a cash bonus payment is deferred until some later year.

Before taking action, employers should be aware of the potential accounting and disclosure implications of these changes by consulting with audit firms and legal counsel.

Although accounting rules do not impact the proxy disclosure treatment of cash bonuses (unlike for equity grants, as discussed below), how a company accounts for bonus accruals must be considered if discretion may be used to increase the bonus at period end. The rules of the Financial Accounting Standards Board ASC 450-20 require companies to estimate the amount of a bonus whose payment is *probable.* For annual bonuses, determining the accruals for each quarter would then be apportioned to each period to reflect the reasonable portion of the expense recognized for each period.

Companies that intend to exercise positive discretion at year-end should consult with their auditors to understand what actions they must take to make the likelihood of payment as *probable* for accrual purposes during interim quarters when the objective plan goals established at the start of the year will not be met. Any difference between the actual earned bonus for the year and the amount previously accrued is a change in accounting estimate, something the company may wish to avoid. Auditors will look to board minutes, internal and external communications, and other documentation to discern whether they agree with the bonus accrual to be recorded.

Performance-based equity awards

Performance-based equity grants are usually made under a legally enforceable award agreement between the company and employee, governed by terms of a shareholder-approved plan document:

[1] See "**Changes to 162(m) prompt revisiting pay plans and proxy disclosures**," *Insider*, July 2019.

[2] The ability to exercise negative discretion was permissible under the prior 162(m) rules for companies seeking to meet the performance-based exception to permit a compensation committee to reduce or eliminate the amount of an award at the end of the performance cycle.

[3] Pursuant to Question 119.02 of the Compliance & Disclosure Interpretations issued by the Securities and Exchange Commission Corporate Finance Division's interpretations of Regulation S-K

- Some award agreements and equity plans may not even consider the potential application of discretion in determining the number of shares earned at the end of a measurement period.
- Other award agreements reference that discretion can be used to adjust performance goals at the end of the cycle in recognition of unusual or nonrecurring events or transactions affecting the company or its financial statements pursuant to old section 162(m) and current accounting rules.
- Others still provide even more flexibility for compensation committees, including explicit use of discretion to determine the number of shares earned.

After determining what is legally permissible, companies will then need to focus on whether or not discretion will be used in determining the earned awards and how it might be applied. Companies should understand how the timing of using discretion on performance share awards may affect accounting treatment and proxy disclosure.

The plan and grant agreements foreclose discretion

Where discretion to make changes is not permitted, the only way to apply discretion effectively is to make a new grant for the number of shares that otherwise might have been considered "earned." In this situation, the fair value of the new grant being made will be accounted for under ASC 718 over the vesting period. Fully vested grants will be expensed immediately.

Particularly for performance cycles ending in 2020, grant date timing will be an important consideration based on when the company can best tolerate the additional expense and, perhaps more importantly, when it wants the expense disclosed on the SCT. Thus, some companies may wish to make the new grant before the end of fiscal year 2020, while others will want to wait until early 2021 on the anniversary of the grant date.

The plan and grant agreements permit adjustments for unusual or nonrecurring events

Not all plans have these provisions, and how they are phrased may be very different for plans in different industries. Where these provisions exist, there will be interpretational questions about whether the onset of COVID-19 would meet the specific plan definitions. If yes, the next challenge will be to interpolate what corporate financial results might have been for the business had the pandemic never hit. This will be an incredibly time-consuming exercise for many companies, with the goal being to establish a level of bonus funding from which the compensation committee will then exercise negative discretion in settling the shares, much the same way that companies used umbrella plans and negative discretion to meet the performance-based exception of 162(m) for their annual plans.

Companies should understand how the timing of using discretion on performance share awards may affect accounting treatment and proxy disclosure.

The plan and grant agreements permit discretion

The following example illustrates applying the ASC 718 rules relating to using discretion on equity awards where financial performance conditions are in place (not those related to stock price or shareholder returns).

Suppose in early 2018, a company makes a performance-contingent equity award of 6,000 shares if a performance goal relating to cumulative operating income during the three-year period of 2018 to 2020 is achieved. The stock price on the grant date is $20 per share and the performance goal is considered likely to be achieved. The grant date fair value is $120,000 and the company begins recognizing the expense over the three-year period ($40,000 each year).

During the second quarter of 2020, the company determines that the performance goal is not likely to be achieved (attainment is "improbable" in accounting terms). In early 2021, the compensation committee determines that the operating performance goal has not been achieved but also decides that it will exercise its discretion and allow 3,000 of the shares to be earned and paid on a fully vested basis. The stock price on the date of that decision is $30, so the company must recognize expense of $90,000 immediately (3,000 shares multiplied by $30 stock price).

This example illustrates the principle that the fair value of any shares earned, which otherwise would have been forfeited because results were not achieved, is recognized as an expense over any remaining service period, although in this example grants are fully vested. Fair value of those shares earned based on discretion is the stock price on the date the terms of the award are modified in early 2021.

In the example, the disclosure of the modified grants would be made in the 2021 SCT, which may or may not be a desired result. Had the compensation committee taken that action in 2020, some or all of the disclosed value would have moved into the 2020 SCT.

It is uncertain how auditors will view, under the above example, whether the entire $100,000 expense must be reversed during the second quarter of 2020. Clearly, if the plan did not permit the use of discretion, that expense would have been reversed during that quarter. However, if the compensation committee makes clear it will exercise its discretion to allow some grants to vest at the end of the performance period, perhaps at least some portion of the expense would not be reversed. This question will become a case of first impression for many audit firms, and the answer will be very fact dependent. Of course, since disclosure will follow accounting, it is important to nail down this issue before any compensation committee decisions are made.

Note that where equity awards are earned based on performance conditions that are related to stock price or shareholder return (market conditions), the accounting would be similar to the above except that expenses for the original grants are not reversed in subsequent periods when the possibility of attaining performance goals becomes improbable.

Using discretion could trigger variable accounting for all performance share grants

Many companies structure their award agreements to restrict or otherwise limit the use of discretion in determining the number of earned shares. This allows the company to recognize expense on the awards based on the stock price on the original grant date, rather than reflecting any changes in stock price between the original grant date and the settlement date.

A key principle that permits the original grant date value to be used is that there must be a mutual understanding of the terms and conditions of the award when granted, with any performance conditions being objectively determinable and measurable.

Performance equity award agreements may provide compensation committees with some flexibility in how performance results will be calculated, including any adjustments that will be made or considered. But this type of "discretion" relating to performance results achieved is quite different from a situation where a committee uses discretion to increase the number of shares earned regardless of the performance results achieved. The plan and grant agreements may require that this exercise of discretion come with plan participant agreement.

The concern would be that the auditors would look to an exercise of discretion to indicate that the plan itself does not cause there to be a mutual understanding of the terms of any future grants made under the plan. The consequence could be that all outstanding and future equity awards with performance conditions will need to be expensed reflecting changes in share price between the original award date and settlement date.

Performance equity award agreements may provide compensation committees with some flexibility in how performance results will be calculated.

For some companies, the impact of COVID-19 may result in "no earned awards" for not only the measurement period ending this year but also those ending in subsequent years where goals have already been established and communicated. A determination to use discretion on equity awards with performance conditions for a single year may be viewed differently from a situation where discretion is used several years in a row. For this reason, it is critical for companies to consult with their auditors now to understand the potential accounting impact, although this may not become an issue given the current unprecedented circumstances.

Depending on the answer, companies may determine that a "new grant" is preferable to using discretion on a previous award. However, many stock plans now include a minimum vesting requirement of at least one year, so any new grants would not deliver any value to participants until the following year when they vest. Even a grant of unvested shares would be shown in the SCT when granted, although the additional service condition may be view somewhat more favorably by investors and proxy advisors.

Tax-deduction issues could be affected based on the decisions made above. Moving the exercise of discretion into 2020 would likely fix the deduction in that year for fully vested grants, rather than in 2021 under the typical grant cycle for performance share grants made early in the year. Because the tax deduction can influence cash on hand, assuming the company will be paying taxes during 2020, it must be factored into these decisions.

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News in Brief

IRS updates safe harbor rollover notices for SECURE Act and other legislative changes

By Gary Chase and Stephen Douglas

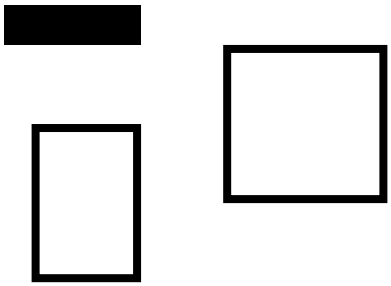
Under Internal Revenue Code section 402(f), administrators of qualified retirement plans and 403(b) plans must provide special tax notices — sometimes referred to as "section 402(f) notices" — to recipients of eligible rollover distributions. As a result of changes over the past few years in the law and other guidance, the IRS has released **Notice 2020-62**, which includes two updated safe harbor notices. Retirement plan administrators determine which of these notices to use depending on whether the distribution is from a designated Roth account or not.

The updated safe harbor section 402(f) notices primarily reflect changes under the Setting Every Community Up for Retirement Enhancement Act of 2019 (SECURE Act) that apply to defined contribution plans, specifically, 1) qualified birth or adoption distributions, and 2) the increase in the required minimum distribution age to 72 for participants who were born after June 30, 1949.

The updated notices also include minor changes intended to improve the notices' readability.

Notice 2020-62 explains that coronavirus-related distributions under the Coronavirus Aid, Relief, and Economic Security Act may be recontributed to an applicable eligible retirement plan but are not subject to the section 402(f) notice requirement or withholding rules; however, the updated safe harbor notices do reference the special tax and rollover rules that apply to disaster distributions.

While the updated safe harbor section 402(f) notices can be used immediately, they will not satisfy the 402(f) requirements with respect to any relevant tax law changes that occur after August 6, 2020. Plan sponsors should update their special tax notices as soon as administratively feasible, coordinating their efforts with plan service providers as appropriate.



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