Are Discretionary Matching Contributions Becoming a Little Less...Discretionary?

Facts

My company has sponsored a 401(k) plan for many years, and it provides for a discretionary matching contribution. I've always sought to build in as much flexibility as possible, so having discretion not only in how much we match each year and when we make those contributions (each pay period, monthly, etc.) has worked well for us. I recently heard something about the IRS removing some of that flexibility with regard to matching contributions.

Question

Is it true that discretionary matching contributions are going to become a little less discretionary? What changes is the IRS requiring (and why)?

Answer

What you heard is correct. As part of the mandatory "Cycle 3" plan document restatements, the IRS is placing some additional limitations on just how much discretion is allowed when determining company matching contributions. And, spoiler alert, these changes bring with them new terms and acronyms to learn too (woo-hoo!).

First, just to set the foundation, in many current plan documents, the "discretionary" in discretionary match truly is just that. Subject to certain annual nondiscrimination tests, plan sponsors generally have the flexibility to determine the match each year, including the following:

- Whether or not to make a match;
- The matching formula (including the ability to use different formulas for different employees or groups of employees); and
- The calculation timing, e.g. each pay period, quarterly, at year end, etc.

In other words, these provisions allow for ultimate flexibility without requiring any additional participant notices, amendments, or other formal documentation around your yearly match decision.

Sounds great, right? Well, the IRS doesn't think so. The catch is that there is an underlying rule that says the benefits/contributions in company-sponsored retirement plans must be "definitely determinable." Even though the IRS approved past language that offers so much latitude in determining the match, their current position is that giving sponsors that much discretion makes the match not definitely determinable.

The good news is that your matching contribution can still be completely discretionary with respect to the match formula that you use each year. However, there are two areas where the new Cycle 3 plan documents limit some of your previous flexibility – uniformity and timing.

Uniformity

This simply means that the discretionary match formula used must be uniform for all eligible participants. Have no fear…you can still use different formulas for different groups of employees, e.g. by department, location, job classification, etc.; however, in order to do so going forward the plan document must identify those groups and indicate that different formulas can be used for each.

Timing

Here, we are referring to the timeframe used to calculate the match, e.g. pay period, month, year, etc., rather than when the match is actually deposited. Calculating the match each pay period can be easier for budgeting and smooths out the cash flow, while using the entire plan year allows for true-up contributions for participants who weight deferrals to one part of the year over another.

Want more information on how the computation period affects matching contributions? We've got you covered here.

It is currently acceptable for this factor to remain discretionary, leaving it to plan sponsors to make the decision each year (or more frequently). Going forward, however, that flexibility comes at a price…in the form of a new participant notice.

With the new Cycle 3 plan documents, there are now two types of discretionary matching contributions. Our plan document refers to them as the Rigid Discretionary Match (RDM) and Flexible Discretionary Match (FDM). Other documents have these same contribution types but may call them something different.

Rigid Discretionary Match

The Rigid Discretionary Match (a bit of an oxymoron) allows plan sponsors to retain discretion over the amount and formula for the company match each year but must specify the computation period. For example, you could set the match formula as 50% of the first 5% deferred in one year and then switch to 20% of the first 8% deferred the next.

Where things will look and feel different with the RDM, compared to PPA discretionary match, is in the uniformity requirement and the computation period.

With the RDM provision, plan sponsors have flexibility over the matching formula so long as it is *uniform* to all eligible participants. In addition, a plan sponsor must select in the plan document whether they will calculate the match on a payroll, monthly, quarterly, annual, or some other basis.

Flexible Discretionary Match

The Flexible Discretionary Match (from oxymoronic to redundant) preserves more of the year-to-year flexibility to which companies have grown accustomed – flexibility to determine not only the formula (and the ability to use different formulas for different employee groups) but also the computation period.

The piece that makes the FDM less desirable is the new notice to plan participants. Use of an FDM requires the plan sponsor to provide a summary of the matching formula and related details to participants receiving an allocation no later than 60 days after the match is fully deposited for the plan year. And since this is an IRS notice (rather than DOL), it does not fall under the recently expanded electronic disclosure rules.

A second, though likely less daunting, requirement for the FDM is that the company must provide the Plan Administrator or trustee written instructions regarding the FDM by the date the sponsor deposits the match. Since the company is usually the Plan Administrator, and the Trustee(s) is/are usually the owners or officers of the company, this may be just a simple matter of documenting the details in writing before making the deposit for the year. In cases where these roles are filled by different parties, the formality of this step becomes more important.

Ready for some good news? This instruction and notice requirement comes with a delayed implementation date. These requirements don't come into play until the plan year after the plan year you sign your Cycle 3 document into place.

Now that we've added RDM and FDM to your vernacular, let's add just one more for good measure, Operational Match. To keep it simple, this allows you to utilize the flexibility of the FDM (but without the participant notice and internal instructions) if needed to improve or correct testing.

Okay, so where does all this leave us? If you're comfortable making a few decisions at the time of restatement with regards to matching contributions, you can keep much of the same formula flexibility and avoid the need for additional notices. But retaining the full flexibility you're used to will come with the price of the new documentation and participant notices. The big takeaway here is the importance of reviewing your plan document as well as your "in-practice" plan operations to ensure they are consistent.

WWW.DWC401K.COM / P.O. BOX 241267, ST. PAUL, MN 55124 / T 651.204.2600 F 651.204.2700