

Benefits in Focus

PLAN SPONSOR NEWSLETTER

COVID-19 AND PARTIAL RETIREMENT PLAN TERMINATION

Retirement plans are an important component of a comprehensive employee benefits program that allows employers to attract and retain talented employees and help such employees financially prepare for retirement. When employers decide to sponsor tax-qualified retirement plans, whether in the form of defined contribution plans or defined benefit plans, they do so with the best of intentions.

However, due to the economic challenges incident to the COVID-19 pandemic, many employers currently need to make critical decisions to protect the profitability of their companies, reduce expenses or prevent complete business closures. In order to reduce operating costs, such employers often must resort to plant, division or location closings; mergers, acquisitions and spinoffs of companies and their respective retirement plans, and layoffs or reductions in work force. If a retirement plan has a vesting schedule and is subject to ERISA, these types of actions can significantly affect the plan and plan participants, resulting in something known as a partial plan termination. This summary addresses some frequently asked questions regarding partial plan terminations in the context of COVID-19.

FREQUENTLY ASKED QUESTIONS

What is a partial plan termination?

A partial plan termination can occur when a significant percentage of plan participants are affected by certain employer-initiated events, such as: a layoff or a series of layoffs; a reduction in the workforce; one or more plant or division closings; or organizational merger, acquisition or spinoff activity.

It can be difficult to determine when a partial plan termination has occurred. However, the IRS has provided some useful guidance regarding this issue. Treasury Regulation Section 1.411(d)-2(b) provides that the determination as to whether a partial plan termination has occurred is based on the facts and circumstances of each situation. The regulation indicates that “facts and circumstances” can include the significant reduction of a group of participants from the retirement plan due to involuntary and employer-initiated severance of employment.

IRS Revenue Ruling 2007-43 provides additional guidance and certain benchmarks to assist an employer in determining whether an event or series of events has resulted in a partial plan termination. While there is not a specific number of employees who must be affected during the applicable period which will unequivocally indicate that a partial plan termination has occurred, a rebuttable presumption of a partial plan termination is created where there is a reduction or a turnover rate of at least 20% in the number of participants covered under a plan due to an employer-initiated event or series of related events. In other words, if the turnover rate is 20% or more the presumption is that a partial plan termination has occurred. However, the presumption may be rebutted if there is evidence of extenuating facts and circumstances, such as showing the 20% turnover rate is routine for the employer on a year-to-year basis.

What is the “applicable period?”

The “applicable period” depends on the facts and circumstances of an employer’s situation. Generally, the applicable period is the plan year (or, in the case of a short plan year, the short plan year plus the immediately preceding plan year, if applicable). However, if there is a series of employer-initiated events leading to instances of severance of employment, the applicable period could be extended over one or more plan years.

By way of example, an employer with 500 participants might have implemented three different

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layoff events during the 2020 plan year: in March, 20 participants are laid-off; in September, a location closing results in the layoff of 35 participants; and in December 2020, 10 participants are laid-off. During the 2021 plan year, the employer lays off 10 participants in June and 35 participants in August. There would be no presumption of a partial plan termination during the 2020 plan year, but when the 2020 plan year and the 2021 plan year are considered together, the total number of participants laid-off equals 110 participants which is 22% of the 500 participants and thus a (rebuttable) presumption that a partial plan termination has occurred over the applicable period from January 1, 2020 through December 31, 2021 has been created.

Who are “affected participants?”

All plan participants, whether fully vested, partially vested or not vested, who have experienced a severance from employment during the applicable period are generally considered to be “affected participants.” Severance from employment must be involuntary and employer-initiated, such as a layoff. Participants who voluntarily sever employment or who have separated service not due to an employer-initiated event (such as firing for cause) or who are severed from employment as a result of death, disability or retirement are generally not considered “affected participants.” Such participants are not counted in the determination of the 20% of participants who have experienced severance from employment due to an employer-initiated event, such as a layoff; location, division or plant closing; or the exclusion, by plan amendment, of certain groups or classifications of participants who were previously covered under the plan. However, the IRS has taken the position that once a partial plan termination determination is made, participants who voluntarily terminated during the applicable period are “affected” and are also entitled to full (100%) vesting.

How is the “turnover rate” calculated?

The turnover rate is generally determined by dividing the total number of affected participants during the applicable period by the sum of all participating employees during the applicable period. If the percentage is at least 20%, this results in a rebuttable presumption that a partial plan termination has occurred during the applicable period. However, the presumption is not necessarily conclusive. For example, it is possible that an employer’s turnover rate can be demonstrated (usually by employment records and data) to equal or exceed 20% or more on a routine basis, every year. If that were the case, it is more likely than not that a partial plan termination has not occurred in that employer’s retirement plan.

When must the determination of a partial plan termination occur: mid-year or at the end of a plan year?

A facts and circumstances analysis can take place at any time during a plan year; however, during times of volatility in which one or more layoffs can occur during a plan year followed by rehiring of some or all employees, it is probably advisable to postpone the determination until the end of the plan year for the most accurate determination. Please note, however, if any affected participants received distributions and incurred forfeitures of unvested balances before the actual partial plan termination determination is made, the forfeitures must be restored, and such participants will need to receive their full (100%) vested balance.

What happens if a plan experiences a partial plan termination?

A qualified retirement plan that is determined to have experienced a partial termination must fully vest, that is, apply 100% vesting, to the account balance or accrued benefit of each affected participant. After a partial plan termination determination is made, full vesting must be applied even if affected participants have taken distributions of their account balance or accrued benefit, which will require additional distributions to such affected participants. Further, the IRS believes that once a determination is made that a partial plan termination has occurred, even employees who voluntarily terminated employment during the applicable period are “affected” and should also receive the full (100%) vesting.

Why is it important to determine whether a partial plan termination has occurred and to fully vest all affected plan participants?

It is important to determine whether a partial plan termination has occurred and to ensure that if an event or series of employer-initiated events has resulted in a partial plan termination, because affected participants may make claims and initiate litigation, or the IRS may find that a partial plan termination has occurred after the fact. If a partial plan termination is made after the fact, the employer must reconstruct which participants should have been fully vested and provide them with additional benefits. Ultimately, the failure to fully vest affected participants can lead to plan disqualification.

Employers should work with their retirement plan consultants to make the determination as to whether a partial termination has occurred, especially when the determination is complex due to a series of events, such as layoffs, furloughs; rehires, terminations, location or division closings all occurring during an applicable period. In addition, the IRS permits an employer to request a determination as to whether a partial plan termination occurred by filing a determination letter application on the IRS Form 5300, which can be relied upon by the employer.

Is there a legal definition for furlough, and how are furloughed employees treated when determining a partial plan termination?

Whether or not employees have been furloughed, as opposed to laid-off or subject to a reduction in force, is determined by the employer's intent and the facts and circumstances surrounding the event. Generally, a furlough is the placing of an employee in a temporary non-duty, non-pay status because of lack of work or funds, or other non-disciplinary reasons. However, there is no federal legal definition of furlough. Employers who are considering furloughing employees should first determine what state laws may apply when employees are placed on furlough and determine if there are any other employee benefit issues that may be relevant to furloughed employees. Furloughed employees are generally not considered to be affected participants when determining the turnover rate for partial plan termination, but they may have to be factored into the analysis if the furlough later becomes a layoff. With respect to retirement plans, whether a participant is furloughed vs. terminated can affect the participant's distribution options, repayment of any loans, eligibility for new loans or hardship distributions, and vesting requirements (e.g., vesting based on 1,000 hours a year), etc. Further, depending on the provisions of their plans, employers may want to consider adopting plan amendments in order to count a certain amount of furloughed time as service credit for vesting purposes under the plan.

Is there a point at which someone goes from being considered furloughed to being laid-off, regardless of the employer's future intentions?

Generally, furloughs do not last longer than one year and should end as soon as the lack of work or funds is restored. The determination of when a furlough becomes a termination is based on the facts and circumstances which make it clear that the furloughed employees will no longer be rehired if, for example, the employer's intent is to no longer rehire the employees, or the company is downsizing or going out of business.

If a partial plan termination is determined, are there are any other implications besides acceleration of vesting to consider?

There are no direct compliance issues raised by a partial termination other than the requirement that participants "affected" by the partial termination must be fully (100%) vested.

However, the issues noted below should be reviewed to the extent that reduction in force is likely to be permanent rather than transitory:

- **Plan Design** – Since the reduction-in-force will change the overall employee and participant demographics, certain plan design challenges (or opportunities) may present themselves. For example, if a disproportionate number of younger, lower paid employees are terminated then (i) a new comparability profit sharing allocation benefitting older participants may be less likely to pass testing while (ii) it may be easier for an employer matching contribution to pass testing, since younger lower paid employees often do not participate (i.e. make match eligible elective deferrals). Controlled group coverage testing may also arise where a plan sponsor and related entities maintain multiple plans.
- **Plan Cost Issues** – Terminated participants with account balances under \$5,000 should be distributed to minimize plan costs and administrative burdens. In addition, for audited plans if the number of eligible participant post-termination is under 100, the plan sponsor should consider spinning off and terminating the portion of the plan that contains terminated vested participants in order to avoid the additional cost of an annual plan audit.

What happens if the company rehires laid-off employees before the end of the plan year?

It is possible, especially during a volatile economic plan year that layoffs and rehired employees can occur multiple times during a plan year. During such a year or longer period of time, if applicable, it is advisable to perform the analysis and determination of whether a partial plan termination has occurred at the end of the plan year (and if the circumstances dictate, perhaps waiting until the following plan year), to take into account all of the events that potentially lead to the partial plan termination determination.

Is a plan amendment required if a partial plan termination has occurred?

The adoption of a plan amendment is generally not required to document a partial plan termination. However, it is recommended that an employer document, in writing, (i) the event(s) that lead to the determination of a partial plan termination; (ii) a list of the affected plan participants, together with their respective vesting status prior to the 100% vesting; and (iii) identify the applicable period.

BEST PRACTICES

To avoid partial plan termination issues that arise or to prepare for employer-initiated termination events that may lead to a presumed partial plan termination, employers may want to consider some of the following best practices.

Employers should inform their retirement plan providers and consultants before the transactions and events listed below occur in order to discuss various options regarding how such activity affect the retirement plan and plan participants. Additionally, employers should consider any employment law issues that may be applicable before proceeding with any of the following transactions.

- Initiating plant, division or location closings;
- Planning layoffs, reductions in force, furloughs, or large-scale severance of employment;
- Adopting plan amendments that reduce participants' vesting rights or that reduce benefits in a manner that could result in a reversion to the employer;
- Adopting plan amendments that exclude one or more groups of participants who were formerly covered by the retirement plan; or
- Contemplating merger, acquisition or spinoff transactions.

Employers should work with their retirement plan providers and consultants to document the facts and circumstances:

- identify and describe the employer-initiated event(s);
- identify the dates of the applicable period(s);
- identify the affected participants; and
- attach the documentation as an addendum to the plan document and include in the plan's files for future reference by plan auditors.

USI Consulting Group is available to provide guidance and support to clients during these challenging times. Our consultants are on hand to answer your questions and provide guidance to proactively address potential partial plan termination issues, consider what options are available and whether it makes sense to fully vest participants who would potentially be affected by certain employer-initiated events in anticipation of such events.