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BUSINESS DISRUPTION: LAYOFFS AND PARTIAL TERMINATIONS OF RETIREMENT PLANS

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With the economic downturn related to COVID-19, employers who are struggling financially may need to lay off significant numbers of employees. This type of layoff can result in what is referred to as a “partial termination” of an employer’s retirement plan.

The partial termination rules also apply to multiple employer plans (“MEPs”), but differently than what some might expect. We discuss MEPs below.

According to the IRS website:

*“Your plan may have a partial termination if more than 20% of your total plan participants were laid off in a particular year. Partial terminations can occur in connection with a significant corporate event such as a closing of a plant or a division, **or as a result of general employee turnover due to adverse economic conditions or other reasons that are not within the employer’s control.**” (Emphasis supplied)*

If a partial termination occurs, the employer is required to fully vest all participants affected by the partial termination. The accelerated vesting occurs regardless of the plan’s otherwise applicable vesting requirements. The full and immediate vesting does not apply to any participants who are not affected by the partial termination event, i.e., participants who remain eligible for the plan as active employees.

A partial termination is generally determined on a plan year basis; however, the period for determining whether a partial termination has occurred, referred to as the “applicable period,” may exceed a single plan year, depending upon the facts and circumstances. For example, a partial termination could occur as a result of a single group layoff or a series of layoffs spanning multiple years.

As noted above, the general position of the IRS is that a turnover rate exceeding 20% of plan participants creates a rebuttable presumption that a partial termination has occurred. This assumption can be overcome or rebutted based upon facts and circumstances. The “turnover rate” is determined by (1) dividing the number of participating employees who had an employer-initiated severance (e.g., due to an economic downturn) during the applicable period



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(generally, the plan year) by (2) the sum of all of the participating employees at of the start of the applicable period and the employees who became participants during the applicable period.

Generally, voluntary terminations do not count in determining whether a partial termination has occurred (i.e., in determining whether the turnover rate exceeds 20%). However, the IRS takes the position that even employees who voluntarily sever from employment during the applicable period get the benefit of the accelerated vesting triggered by the partial termination.

There are many factors to consider in determining whether a plan has had a partial termination and legal counsel may need to be consulted. In some instances, employers may choose to seek a determination letter from the IRS as to whether a partial termination has occurred. The failure to recognize a partial termination and take appropriate action (i.e., fully vest affected participants) can result in a plan's disqualification.

Common fact pattern: When employees are laid off, many take a distribution of their retirement plan account balance. If their vested balance is less than \$5,000, the plan's terms may require a force-out distribution. For those participants who are not 100% vested, the distribution automatically triggers the forfeiture of their non-vested account balance. If it is later determined that a partial termination occurred and the participants who incurred a forfeiture should have been fully vested, the participants will be owed more benefits. To the extent forfeited amounts have been used for other purposes, such as to reduce future employer contributions or pay for plan-related expenses, then the employer will be responsible for making the affected participants whole.

If an employer considers it possible that a partial termination has occurred (or will occur), the employer might consider delaying the use of forfeitures arising during the applicable period, pending a final determination of whether a partial termination has occurred. Delaying the use of forfeitures can be a compliance concern, because allowing forfeitures to accumulate for too long can result in adverse tax consequences for a plan. However, if the delay is reasonable, then the improperly forfeited amounts would be available to make the affected participants whole if it is determined that a partial termination occurred. When faced with the likelihood of a partial termination, other possible courses of action include deeming a partial termination to have occurred and fully vesting the affected participants.



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IMPACT ON MULTIPLE EMPLOYER PLANS (“MEPS”), INCLUDING PEO-SPONSORED MEPS

In our view (and some commentators may differ), the partial termination rules apply to MEPs (including PEO-sponsored MEPs) differently than might be expected. Under the statutory scheme, the vesting rules of Internal Revenue Code (“Code”) §411 generally apply if all employers adopting the plan constitute a single employer (see Code §413(c)(3)). As a consequence, the determination of whether the turnover rate exceeds 20% would be made by looking at the participants of all adopting employers (i.e., the MEP as a whole), instead of considering each MEP adopter separately. Even if some MEP adopters lay off substantial percentages of their employees, this would not necessarily cause a partial termination if those terminated employees do not constitute more than 20% of all employees participating in the MEP.

APPLICATION OF RULES TO MEP MAY HELP SMALLER EMPLOYERS

An employer with a smaller participant population is at a disadvantage when applying the partial termination rules, as a significant percentage reduction can result with only a small number of participants being eliminated from the plan. For example, suppose an employer with 8 employees lays off 2 of them during the plan year as a result of adverse business conditions. The involuntary reduction is 25%, triggering a rebuttable presumption that a partial termination has occurred. Defined contribution MEPs often have significant numbers of smaller adopters and the application of the partial termination rules to a MEP might be advantageous, depending upon the turnover rate of the MEP as a whole.

Determining whether a MEP has incurred a partial termination and taking appropriate action can be particularly challenging. As noted above, the failure to recognize and act on a partial termination could result in disqualification and reinstating forfeited amounts to participants’ accounts could be costly.

PARTIAL TERMINATION RELIEF SOUGHT

Partial terminations are an area in which the American Retirement Association is calling on the Treasury Department for COVID-19 related relief from the impact of the partial termination rules. Some commentators are skeptical that the IRS will provide relief and/or relax the rules with respect to partial terminations.

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