

Reductions in Force (RIFs) May Impact Qualified Retirement Plans

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During this period of economic instability, many employers are contracting their businesses by laying off a portion of the workforce or closing (or selling off) a plant, division or line of business. An often overlooked and possibly costly consequence of a significant reduction in force is whether the employer's qualified retirement plan (i.e., 401(k) plan) experienced a "partial plan termination."

The Internal Revenue Code provides that when a qualified retirement plan terminates or partially terminates, all "affected" participants must be made fully (100%) vested in the benefits accrued or amounts credited to their accounts under the plan through the date of the termination or partial termination. Failure to vest "affected" participants could cause the disqualification of the plan, resulting in the loss of deductions for the employer, the recognition of income for participants, and possible lawsuits against the plan sponsor and plan fiduciaries responsible for failing to maintain the tax-qualified status of the retirement plan.

Neither the Code nor regulations define the term "partial plan termination." The regulations provide that whether a partial plan termination occurs shall be determined with regard to all the facts and circumstances of the particular case, including the exclusion from the plan, by reason of a plan amendment or severance by the employer, of a group of employees who have previously been covered by the plan.

20% Presumption

Recent IRS guidance provides some clarity as to how to determine whether a partial plan termination has occurred. According to the IRS, a partial plan termination is presumed to occur if the "turnover rate" is at least 20%. The turnover rate is determined by dividing the number of actively participating employees who had an "employer-initiated" severance from employment during the applicable period by the sum of all participants at the start of the applicable period and any employees who become participants during the applicable period.

In calculating the turnover rate, an employer should consider the following:

- All active participants are taken into account in calculating the turnover rate, including participants who are already fully vested in their accounts or benefits.
- An "employer-initiated severance" is broadly defined to include any separation from employment, other than separation on account of death, disability or retirement on or after the participant's normal retirement age. A severance will be considered "employer-initiated" even if caused by events outside of the employer's control, such as a severance due to depressed economic conditions. If the employer is able to verify, through information in the participant's personnel file, employee statements or other corporate records, that a participant's separation was not "employer-initiated," but voluntary on the part of the participant, such participant will not be taken into account when determining the reduction in plan participants.
- The applicable period over which to calculate the turnover rate is generally the plan year. In the case of a plan year that is less than 12 months, the applicable period is the short plan year plus the immediately preceding plan year. Depending on the circumstances, the applicable period could be a longer period if there are a series of related severances from employment; however the IRS does not provide any information on how to determine whether the severances are related.
- Participants who have had a severance from employment as a result of being transferred to a different controlled group are not considered as having an "employer-initiated" severance for purposes of calculating the turnover rate provided they continue to be covered by a plan that is a continuation of the plan under which they were previously covered (i.e., a spin-off of the plan).

The IRS guidance makes clear that the determination of whether a partial plan termination has occurred depends upon all of the facts and circumstances. The 20% presumption is not a bright line test and, in appropriate cases, may be disregarded. Facts and circumstances indicating that the turnover rate for an applicable period is routine for the employer may favor a finding that there is no partial plan termination for that period. Information as to the turnover rate in other periods, the extent to which terminated employees were actually replaced, whether the new employees performed the same job functions, had the same job classification or title, and received comparable compensation are relevant to determining whether the turnover rate is routine for the employer.

Employers who have implemented a reduction in force or are contemplating downsizing their workforce should carefully evaluate whether such actions will cause any qualified retirement plan to incur a partial plan termination. Failure to identify a partial plan termination on a timely basis may prove costly to the employer, particularly if the plan forfeits "affected" participants' nonvested account balances. Although the recent IRS guidance offers more definitive guidelines, whether a partial plan termination has occurred is ultimately determined based on all the facts and circumstances in the particular case.