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Covid-19 and Your Benefit Plans: What You Need To Know Now

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In a matter of a few weeks, the COVID-19 pandemic has caused drastic changes to our businesses and personal lives. The effects are already substantial, from those personally affected by illness and shelter-in-place orders to companies seeing sharp declines in business activity. Although your to-do list may be long, we encourage you to find time to evaluate the impact of the crisis on your benefit plans. Below, we summarize key considerations to be aware of in the areas of retirement, welfare and nonqualified deferred compensation plans.

401(K), 403(B) and Profit Sharing Plans

If you sponsor a defined contribution retirement plan, such as 401(k), 403(b), and profit sharing plans, the following opportunities and challenges may come up in the near future.

Employer Contributions. As state and local governments mandate the closure of businesses on account of COVID-19, employers who are seeking ways to reduce expenses may be considering whether they can reduce or eliminate contributions to their 401(k), 403(b) or profit sharing plans.

- **Discretionary and Mandatory Employer Contributions (Non-Safe Harbor):** If the employer contributions (either non-elective or matching) are discretionary, rather than mandatory, the employer can suspend or reduce such contributions without a plan amendment. If the employer contributions are mandatory, meaning that the plan document specifically provides that the employer is required to make a matching or non-elective contribution, the plan document must be amended to suspend or reduce these contributions and the employer will be required to make the employer contributions for the portion of the plan year prior to the effective date of the amendment. In both instances, employees must be notified of any suspension or reduction in employer contributions.
- **Safe Harbor 401(k) Contributions (Non-Elective and Matching):** If the 401(k) plan is a safe harbor plan, which allows a plan to avoid nondiscrimination testing, an employer is restricted from suspending or reducing the safe harbor contribution midyear. Safe harbor plans can reduce or suspend employer contributions only if the employer is operating at an "economic loss" or the annual safe harbor notice provided to employees before the plan year began included a statement that such contributions may be suspended or reduced. Any reduction or suspension of employer contributions will require a 30 day notice period. The employer must continue to make the safe harbor contributions through the effective date of the amendment and the plan will be required to meet applicable nondiscrimination tests (ADP/ACP) for the plan year.

  For safe harbor non-elective contributions, the SECURE Act eliminated the annual safe harbor notice for plan years after December 31, 2019. Unless such plans can rely on the "economic loss" exception to reduce or suspend contributions, it is unclear how this change impacts an employer from reducing or suspending safe harbor non-elective contributions. Hopefully, the IRS will issue guidance soon.

Partial Plan Termination. Employers who are considering layoffs and employee terminations may trigger a partial plan termination of their retirement plans. If a partial plan termination occurs (generally, when 20 percent or more of the eligible employees are terminated or laid off), IRS regulations require the plan to fully vest all participants who are affected by the partial plan termination.

In-Service Withdrawals. As employers furlough employees or reduce their hours as a result of COVID-19, affected employees may wish to have access to the funds in their retirement plan accounts. In-service distributions are generally limited to hardship withdrawals and age 59-½ withdrawals and must be permitted under the terms of the Plan document. Most plans that allow hardship withdrawals have adopted the IRS "safe harbor" hardship events, which include the following: deductible expenses for medical care for the employee, spouse, dependent and primary beneficiary; payments necessary to prevent the eviction from an employee's principal residence or mortgage foreclosure; expenses for certain tuition payments; funeral expenses for family members; or expenses and losses incurred by the employee on account of a FEMA-declared disaster. Although the recently declared national emergency does not constitute a FEMA disaster declaration, as of the date of this alert, FEMA has declared the COVID-19 pandemic as a major disaster in New York, Washington and California. This should enable employees in those states to take a hardship withdrawal for expenses and losses

incurred on account of such disaster. In future days and weeks, the list of states for which FEMA has declared COVID-19 as a major disaster may expand.

Plan Loans and Loan Repayment Suspension. Participants may take loans from their retirement accounts, subject to IRS limits, if permitted by the plan. Employers whose plans do not permit loans may consider amending the plan to allow for loans. For those plans that allow loans, if the loan policy limits the number of loans outstanding, employers may consider increasing that limit. It is possible that the IRS and DOL may issue guidance relaxing the rules for making plan loans, similar to relief issued in response to past natural disasters.

With work schedules changing in response to COVID-19, employers should review their plan loan policies, to determine whether loan repayments are suspended during a leave of absence and to understand the "cure" period for nonpayment of loans. Under current rules, a plan may suspend a participant's loan repayment obligation for up to one year during an unpaid leave of absence (or paid leave if the amount of the installment payment is more than the rate of pay). The "cure period" that would allow a participant to make up for a missed payment (and not cause the loan to become a taxable distribution) cannot go beyond the end of the quarter following the quarter in which the missed payment was due. An employer should consider amending the loan policy to allow for repayment suspensions upon leaves of absence if the policy does not so allow and to extend the cure period to the maximum period permitted.

Paid Leaves of Absence and Plan Contributions. If employers provide employees with paid leave (for example, emergency paid sick leave under the Families First Coronavirus Response Act), such pay may be treated as eligible compensation for purposes of elective deferrals and employer contributions. If paid leave is considered eligible compensation for retirement plan purposes, employers will need to continue to take deferrals from employees' paychecks in accordance with their elections, unless the employees change their elections. Employers should consider reminding employees that they can stop their elective deferrals in accordance with the plan's regular processes.

Defined Benefit Pension Plans

Not since the 2008 financial crisis have employer-sponsored pension plans faced circumstances as have arisen with the COVID-19 outbreak. Since the beginning of the outbreak, financial markets have lost over 25% of their value and interest rates are at or below the levels reached in 2008. Employers should consult, on a coordinated basis, their legal, investment and actuarial advisors to determine the proper course of action during this financial and economic crisis. Plan investments, plan funding and consideration of other actions to protect the plan, its participants and beneficiaries should be considered in these consultations.

Pension Plan Investments. In addition to a significant reduction in a pension plan's asset base, financial markets are likely to remain volatile, at least near-term. This will pose significant challenges to pension plan investment fiduciaries. The duty to act prudently is one of a plan fiduciary's central responsibilities under ERISA. Plan fiduciaries are required by ERISA to act prudently and in the best interests of plan participants. The requirements of care, skill, prudence and diligence have developed into a requirement that fiduciaries follow a course of procedural prudence in decision-making. Plan fiduciaries should diligently engage in an investigation and discussion of information leading up to the investment decision. Plan fiduciaries should be prepared, through documentation of the processed followed, to demonstrate that the decision to make a particular investment was made after a careful and diligent evaluation of other investment choices and competing investments of the same type.

Plan fiduciaries must also understand that a change in the investment policy for a defined benefit pension plan involving "de-risking" (such as the purchase of annuity contracts for frozen benefits) will likely impact required funding for the plan. Coordination with the plan actuary and investment advisor in making such decisions will be critical.

Plan Funding. Pension plans funding will be impacted in a variety of ways by the current financial crisis. In addition to a lower asset base, the potential for a lower anticipated lower rate of return would increase funding requirements. Furthermore, a drop in interest rates will increase the present value of pension benefit obligations, thereby potentially increasing funding requirements. Fully understanding the impact on a particular plan will require the expertise of the Plan's actuary, with close coordination with the investment advisor.

Changes in Plan Formula. In light of the uncertainty created by the COVID-19 outbreak, and the resulting current financial crisis, employers who sponsor active pension plans may determine it is prudent to amend those plans to either freeze or reduce future pension accruals. This can be done on a prospective basis provided the employer (i) provides advanced notice of the change to participants, which typically requires at least 45 days prior notice, and (ii) adopts a formal plan amendment to document the change prior to the effective date.

The notification requirements for this type of amendment will require the employer to provide a fairly detailed overview of the plan changes. We typically recommend that the Plan's actuary be involved in this drafting process to make certain the change in plan terms is accurately described. In addition, it is essential that the notices be delivered to all impacted Plan participants. To the extent an employer has relied upon electronic notification for plan communications (i.e., email), it is critical that the employer confirm that all impacted Plan participants are able to receive notification in that manner. To the extent this cannot be determined, an employers may wish to issue this notice through a standard mailing to each participant's home address.

Cash Balance Plan Issues. The significant drop in both market performance and interest rates may create significant issues for pension plans that use a cash balance plan design. Cash balance plans typically provides participants with a benefit equal to a hypothetical account balance that grows each year with "Pay Credits" and "Interest Credits." The Treasury Regulations provide a number of which may be used to determine the interest crediting rate, several of which are determined based on either market returns on invested assets or by reference to a designated interest rate (typically the 30-year treasury bill). For plans that calculate the interest credit based on market returns, substantial and ongoing losses in the market could effectively eliminate all earnings on a participant's pay credits, which could result in additional funding obligations based on the minimum, lifetime capital preservation rule. Employers will need to visit with the plan's actuary to confirm that lower interest crediting rates do not result in backloading or forfeiture issues.

Potential Plan Amendments. Due to the significant financial issues faced by employees and former employees, employers may wish to amend defined benefit plans to provide for additional liquidity for participants. Although it is not required, a defined benefit plan may permit actively employed participants to elect to commence benefit payments at age 59-½ without terminating their employment. This rule would permit an employer to amend a defined benefit plan to allow active employees to commence their benefits after attaining a minimum age. In addition, an employer that sponsors a plan that does not allow a terminated employees to receive a distribution until normal retirement age could amend its plan to permit distributions at an earlier age. In each case, however, these changes would create additional administrative issues and will likely have a negative impact on the plan's funding levels at a time when asset values are significantly reduced.

Welfare Benefit Plans

Since most Americans rely on employer-sponsored health and welfare benefit plans for medical coverage, the public health emergency created by COVID-19 will also have a large impact on the administration of these plans. Some of these effects will be caused by actions that are being taken by the federal, state, and local governments in response to the virus, while others may be consequences of business responses to the effect of the virus on business and daily life.

Coverage for COVID-19 Expenses

- As we reported HERE last week, the Internal Revenue Service issued Notice 2020-15 to confirm that, pending further guidance, a high deductible health plan will comply with HSA contribution guidelines if it provides health benefits associated with testing for and treatment of COVID-19 without a participant first satisfying the deductible. Such coverage will be treated as "preventive care."
- Although many states already took action to mandate no-cost coverage of COVID-19 expenses under fully-insured plans and many claims administrators under self-insured plans were following suit, the Families First Coronavirus Response Act, which was signed by the President on March 18, 2020, requires group health plans and health insurance issuers offering group or individual health insurance coverage (including plans that are grandfathered under the terms of the Affordable Care Act) provide coverage without regard to any deductibles, copayments, or coinsurance for approved in vitro diagnostic products for the detection of COVID–19 as well as health care provider office visits, urgent care center visits, and emergency room visits. In addition, subject to some limitations, the Act allows for tax credits relating to an employer's group health plan expenses that are "properly allocated" to qualified emergency leave and sick leave wages paid to employees.
- It is important to note that stop-loss policies, which protect self-insured plans from the risk of large claims, usually require advance notice of changes to plan terms. Please consider whether any coverage changes relating to COVID-19 require notifying your stop loss carrier.

Effect of Other Employment-Related Actions on Plans and Plan Coverage. To avoid drastic options like mass layoffs or plant closings, many employers are considering other cost-saving measures. Some of these measures, such as reduced work hours and furloughs, may have inadvertent consequences for employer-sponsored health and welfare benefits. Communication with employees is critical to keeping your employee population up to date regarding available coverage.

- Since group health plan coverage is often dependent on a threshold number of average working hours, a reduction in hours or a furlough could result in an employee's loss of medical benefits.
- Employers with fully-insured plans must review the terms of their underlying insurance policies in order to determine whether a reduction in hours or furlough will cause a loss of health insurance coverage.
- An employer with self-insured plan coverage may be able, or need, to amend its benefit plans to address eligibility issues, such as electing to change the manner in which the plan determines eligibility and provide coverage based on a lower number of hours. A plan amendment is likely required to reflect a change in coverage. Considering the urgency of the current situation, however, it is likely allowable to offer expanded coverage before adopting a plan amendment.
- Because most plans collect employee premiums and cost sharing amounts directly through payroll deduction, employers must also consider whether, even if employees will not lose eligibility for coverage on account of a reduction of hours or furlough, administrative adjustments must be made to accept premium payments from other sources, such as personal check or bank transfer. In this instance, employees should be aware of how to address, for purposes of their 2020 personal income taxes, the payment of these premium amounts with post-tax dollars.

- Absent changes to plan eligibility, cost-saving measures could trigger losses of benefit coverage requiring notice and benefit continuation rights under the Consolidated Omnibus Budget Reconciliation Act of 1985 ("COBRA"), under which employees must pay up to 102% of the full cost of coverage without any employer subsidy. Employers may, however, subsidize some or all of the cost of continuation coverage during a furlough period. Employers should be mindful that any such subsidy must be offered on a non-discriminatory basis in order to be provided on a tax-free basis to the employees.
- Since eligibility changes now may also impact compliance after business returns to normal, employers that choose to amend eligibility to avoid losses of coverage must also consider the impact of those changes for purposes of the method used for complying with Affordable Care Act coverage mandates, such as the lookback measurement method.

Privacy Concerns. Employers must also remember that, even during an emergency, HIPAA privacy rules still apply to "covered entities" such as employer-sponsored group health plans and continue to protect individually identifiable health information. Employers receiving health information outside of the context of their group health plan are not subject to HIPAA's restrictions regarding such information, health information should generally be treated as confidential since a range of employment laws, including the Americans with Disabilities Act, the Genetic Information Nondiscrimination Act, and other federal and state laws might apply.

Nonqualified Deferred Compensation Plans

Distributions. The COVID-19 pandemic may present opportunities and challenges related to distributions from nonqualified deferred compensation plans.

- **Unforeseeable Emergency.** Amounts deferred under nonqualified deferred compensation plans governed by Code Section 409A are subject to a limited set of distribution triggers. Typically, deferred amounts will become payable at a fixed date, separation from service, or change in control. However, another permitted trigger is the occurrence of an "unforeseeable emergency." That term is defined as a severe financial hardship to the participant resulting from illness or accident of the participant, the participant's spouse or a dependent, or loss of the participant's property due to casualty or other similar extraordinary unforeseeable circumstances arising as a result of events beyond the control of the participant, and the distribution amount may not exceed the amount necessary to satisfy the emergency and pay taxes, after taking into account the extent to which the hardship is or may be relieved through reimbursement or compensation by insurance or by liquidation of the participant's other assets. An employer may add an "unforeseeable emergency" to its plan with respect to previously deferred amounts. Note that the 409A regulations provide that where a plan allows for a distribution upon an unforeseeable emergency, the failure of a participant to take such distribution will not be treated as a re-deferral.
  - Employers should review their nonqualified plans' distribution events and consider adding "unforeseeable emergency" if it is not already a distribution event. In addition, employers could consider communicating with its participants regarding the potential availability of distributions under the nonqualified plans as a result of COVID-19. Of course, the employer will still be obligated to assess the facts and circumstances of any participant requests in light of COVID-19 to ensure the participant has experienced an unforeseeable emergency in accordance with the 409A regulations.
- **Separation from Service.** COVID-19 is already affecting the workforce. The past few days have seen an increased incidence of terminations of employment, reduction in hours, conversion to independent contractor status, and other potential business saving measures. As a result there may be increased pressure on determining whether a participant in a 409A plan has experienced a "separation from service" when such event is designated as a distributable event under the plan. Consideration will need to be given to, among other things, whether the parties actually anticipate a permanent cessation of services rather than a temporary hiatus.
  - For plans with a separation from service distributable event, employers should implement a system to track participant hours of service during this time.

Deferral Changes. COVID-19 to the extent it rises to an unforeseeable emergency (as defined above) may also allow for a service provider's cancellation of a deferral election. The deferral election must be cancelled, not merely postponed or otherwise delayed. Accordingly, any later deferral election will be subject to the provisions governing initial deferral elections. To the extent the plan document does not address this issue, the employer would need to amend the plan to permit this action.

- Employers that receive requests to cancel deferrals should confirm the participant has experienced an unforeseeable emergency that requires such cancellation.

Liquidation on Plan Termination. Employees who do not qualify for distributions for "unforeseeable emergency" may try to pressure their employer to consider terminating the plan to permit a complete distribution of funds. This type of standard termination is possible, however, it comes with material disadvantages: (i) it would not help an employee in a timely fashion (as funds cannot be distributed for 12 months after the termination), (ii) it would require the termination of other similar plans (if the employer has multiple plans required to be aggregated), and (iii) prevents the employer from adopting a similar plan for 3 years after termination.

- Employers considering terminating a nonqualified plan should carefully review the 409A regulations and other plans sponsored by the employer before taking any action.

Supplemental Executive Retirement Plans (SERPs) and Excess Plans. Employers seeking opportunities to reduce compensation and benefits expenses during this time need to also consider the design of any SERPs and excess plans that they sponsor. While some of these plans are designed to calculate benefits by a formula tied to the qualified plan, others are designed with a formula that is not tied to the qualified plan and may require an amendment if a reduction in benefits is desired by the plan sponsor.

- Employers that sponsor SERPs and excess benefit plans need to review these plans to determine whether any suspension or reduction in contributions is needed. Consideration should be given in light of any potential changes they are making to their qualified plans that may be linked to these types of plans.

Equity Grants. Like the financial crisis of 2007-2008, COVID-19 has caused major market disruption in business operations and equity values, reintroducing volatility to the market that has not been seen in some time. Boards need to consider annual and multi-year grant practices including whether any action should or can be taken to smooth out the volatility in share values. For example, Boards may find it useful to reevaluate the mix of awards i.e. between full value shares and stock options and other appreciation awards. In addition, depressed equity values could cause award obligations that are measured in share value, either contractually (for example in an employment agreement) or by reason of policy including one published in prior proxies, to more quickly exhaust shareholder approved equity pools.

Additional attention should be given to any traditionally used performance vesting criteria that may produce unintended results by either being unreasonably difficult to attain or otherwise prone to artificial achievement, each as a result of the possible continued market volatility. Specifically, vesting conditions that key off metrics such as a sustained stock price over a pre-established period should be carefully reviewed. This process will be important to executives, as well as shareholders. In this regard, Boards should consider any amendments to plans that will provide needed flexibility in the months to come.

- Employers should review their non-equity and equity compensation mix in light of the current volatility in the market and the need to incentivize employees after a potentially steep drop in equity value.

Other Planning Opportunities. Code Sections 280G and 4999 impose deduction limitations on a corporation and excise taxes on certain executives in the event of significant payments made upon a change in control. In calculating the value of these payments under specially devised formula rules that generally measure the value of acceleration to determine whether the negative tax consequences are triggered, a company is required to use 120% of the applicable federal rate at the time the payment is made unless the company and executive elect on the date that the contract is entered into to use the rate in effect on that date. For corporations that are publicly traded (and therefore can't "cleanse" payments with a shareholder vote), reducing the value of these payments by taking advantage of today's lower interests rates is a material planning opportunity.

- Employers should consider exploring whether it is possible to hardwire into change in control agreements the current applicable federal rate while rates are low.

If you would like more information on the matters discussed herein, please contact the authors or your Locke Lord attorney.

Visit our COVID-19 Resource Center often for up-to-date information to help you stay informed of the legal issues related to COVID-19.

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