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A non-technical review of qualified retirement plan legislative and administrative issues

April 2009

Layoffs Can Result in a Partial Plan Termination Requiring 100% Vesting

With the current economic conditions, many companies have been forced to downsize either by laying off a portion of the workforce or closing a plant or line of business. These layoffs can have an impact on a qualified plan. If enough employees are terminated, a partial plan termination can occur which requires that the affected workers become fully vested in their benefits.

To avoid administrative problems, it is important to identify whether a partial termination has occurred at the time of the event and not several years later. The situation is particularly problematic in a defined contribution plan once the terminated employees' nonvested benefits have been forfeited. If, at that point, the IRS determines that a partial termination had occurred, the employer would be required to make additional contributions to restore the forfeited account balances of the nonvested participants.

Unfortunately, neither the tax code nor IRS regulations explain how plans sponsors should determine whether a partial plan termination has occurred. Fortunately, in a 2007 revenue ruling, the IRS provided guidance for making this determination.

This article will review the procedures for determining whether a partial plan termination has occurred along with providing examples of the application of these procedures.

Background

Over the years both the IRS and the courts have offered insight into how to determine whether a partial termination has occurred. Treasury regulations provide that whether a partial termination has occurred is determined with regard to all the facts and circumstances in a particular case.

The regulations point out that a partial termination can arise in a number of situations including:

- The termination of a group of employees formerly covered under the plan;
- A plan amendment excluding a group of employees who have previously been covered;
- A plan amendment that adversely affects the rights of employees to vest in benefits under the plan; or

- In a defined benefit plan, the reduction or cessation of future benefit accruals resulting in a potential reversion to the employer.

The regulations also clarify that the full vesting provisions only apply to the employees affected by the partial plan termination.

A number of courts have also ruled on this issue. In probably the most important case, *Matz v. Household International Tax Reduction Investment Plan*, the court held that there is a rebuttable presumption that a 20% or greater reduction in plan participants is considered a partial termination.

Clearer Guidance from the IRS

With this background, the IRS revisited the partial termination issue in a 2007 revenue ruling. This ruling was important because it established much clearer standards for determining whether a partial termination has occurred.

The case involved an employer that ceased operations at one of its four business locations. As a result, 23% of the plan's participants ceased active participation due to a severance from employment. Some of those terminated participants were already fully vested at the time of termination.

The IRS found that the facts and circumstances supported a finding of a partial termination because the severances from employment occurred as a result of the shutdown of one of the employer's business locations (and not as a result of routine turnover).

The 20% Presumption

In the ruling, the IRS adopted the *Matz* holding that, if the turnover rate is at least 20%, there is a presumption that a partial termination has occurred. It also adopted another court position that both vested and nonvested participants are counted in making this calculation.

Calculating the Turnover Rate

The IRS specified that the turnover rate is determined by dividing the number of participating employees who had an employer-initiated severance from employment during the "applicable period" by the sum of all of the participating employees at the start of the applicable period plus the employees who became participants during the applicable period (both vested and nonvested employees are included in this calculation).

The IRS defined the applicable period as a plan year or a longer period if there are a series of related severances from employment.

Example: Plan W has 300 participants at the beginning of the plan year. Due to a plant closing, 80 participants are terminated from employment during the year. An additional 20 employees become eligible to participate during the plan year. The turnover rate is 80÷320 or 25%.

Defining Employer-Initiated Severance

The IRS broadly defined "employer-initiated severance" to include any severance other than a severance that is on account of death, disability or retirement on or after normal retirement age. A severance is even considered employer-initiated if caused by an event outside of the employer's control, such as severance due to depressed economic conditions. However, the employer may be able to prove that an employee's severance was voluntary and not employer-initiated through documentation such as information from personnel files, employee statements and other corporate records.

Example: Plan X has 120 participants at the beginning of the plan year. Due to economic conditions, the company lays off 20 employees. In addition, 8 employees terminate on a voluntary basis (which can be documented). No new employees become eligible during the plan year. The turnover rate is 16.7% (20÷120).

Facts and Circumstances

Even though the focus is on the 20% presumption, the 2007 revenue ruling notes that whether or not a partial termination occurs is still ultimately dependent on all of the facts and circumstances in a particular case.

If the employer can demonstrate that the turnover rate for an applicable period is routine for the employer, this will favor a finding that there is no partial termination for that applicable period. In making the comparison, information as to the turnover rate in other periods and the extent to which terminated employees were actually replaced, whether the new employees performed the same functions, had the same job classification or title, and received comparable compensation are relevant to determining whether the turnover is routine for the employer.

Thus, there are a number of factors that are relevant to determining whether a partial termination has occurred as a result of turnover, both in the case where a partial termination is presumed to have occurred due to the turnover rate being at least 20% and in the case where the turnover rate is less than 20%.

Applying the IRS Rules

The IRS guidelines go a long way toward creating discernable standards. Especially helpful is the clearly defined method for determining the turnover rate. Even though the test is still a facts and circumstances test, the 20% presumption and the IRS's discussion of what facts are relevant should make it easier to decide whether a partial termination has occurred in a particular case.

Small Plans

The 20% presumption test may be most problematic for small employers. A small employer can face the partial termination issue if only one or two employees are laid off.

Example: Plan Y has 6 participants at the beginning of the plan year. Due to economic conditions, the company lays off 2 employees and no new employees become eligible to participate during the plan year. The turnover rate is 33.3% (2÷6) and the presumption is that a partial termination has occurred.

Note that even when the 20% threshold has been met, the employer can rebut the presumption with facts that show that this is a normal turnover rate—which may very well be the case with a small employer. Also, the potential for problems demonstrates the necessity to keep records documenting the circumstances of each employee's termination.

Series of Layoffs

If a partial termination occurs on account of turnover during an "applicable period," all participating employees who had a severance from employment during the period must be fully vested in their accrued benefits. According to the IRS's definition of the "applicable period," the IRS could look at the series as a single event. It's not entirely clear when or how this determination would be made, which could be problematic for the many employers facing this situation today.

Example: Plan Z has 100 participants at the beginning of the plan year. Due to economic conditions, the company lays off 10 employees in February. Fifteen months later in May of the following year 15 more employees are terminated. If the IRS considers this one "applicable period," it appears that the employees laid off in February must be fully vested, even though these layoffs did not result in a 20% or more turnover rate.

Other Concerns

In addition to these issues, here are several additional concerns under the current partial termination guidance:

- An employer should not rely entirely on the IRS guidance as courts have sometimes come to different conclusions. For example, some courts have focused on the number of terminated employees in contrast to the IRS's focus on the percentage involved. This could have an impact on larger employers.
- The 20% presumption does not preclude a finding of a partial termination if the percentage reduction is less than 20%. What changes is the IRS would have the burden to demonstrate that the partial termination occurred instead of the employer having to rebut the presumption.
- The rules not only apply to employee terminations but also can apply when exclusion from the plan is a result of a plan amendment. The IRS has not traditionally applied the partial termination rules in these cases, but the IRS revenue ruling reminds us of this possibility.

Conclusion

In these trying economic times, it is important for employers to be aware that layoffs or plan cutbacks can result in a partial termination of the company's qualified plan. The determination whether a partial termination has occurred should be made at or about the time of the employer-initiated reduction. Failure to 100% vest all affected participants can result in plan disqualification.

Since employees who terminate voluntarily are not affected by a partial plan termination, it is important for employers to document the circumstances of each employee's termination.

An employer facing a situation of reducing its workforce should review all the facts and circumstances in detail with the plan's advisors to determine the appropriate course of action.

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