PUBLICATION

Advice for Employers in This Difficult Economy, Part 1

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In today's difficult economic climate, many employers are considering ways to cut costs. Downsizing a work force or reducing contributions to 401(k) or similar retirement plans are common approaches. The employer should be aware of the implications of, and restrictions on, these actions. This focus addresses some common implications of these employer actions under the tax laws and the Employee Retirement Income Security Act of 1974 (ERISA) for "defined contribution" retirement plans. These are retirement plans in which participants have account balances, such as 401(k), profit sharing, money purchase pension and employee stock ownership plans.

With respect to retirement benefits, downsizing may seem to some like a purely business decision - if an employee is laid off, he or she earns no more benefits and no further employer contributions are required. However, the results can be far more complex, depending primarily on the type of retirement plan involved and the way the plan is written.

Ability to Stop Contributions

As a general rule, an employer is free to amend a plan to reduce or cease contributions, at least where the participants have not already satisfied the requirements to earn the contribution at issue.

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In many plans, some contributions are discretionary, at the election of the employer. These typically include profit sharing and non-safe harbor matching contributions. In those cases, the employer can simply not exercise any discretion to make a contribution, and thereby avoid the cost of these contributions. In other cases, a plan will require a contribution by its terms. Here, the type of contribution and the type of plan can greatly limit the employer's ability to make changes relatively quickly, or at all. Some contributions, such as non-safe harbor matching contributions which are expressly required by the plan document but which are not required by law can be reduced or eliminated prospectively by adopting a plan amendment. In those cases, no advance notice to participants is legally required, but of course HR considerations may result in a need to provide notice and an explanation. Contributions which are required by the terms of the plan and certain statutory funding rules (e.g., contributions to a money purchase pension plan), can be reduced or eliminated prospectively, but if the change is a "significant reduction" in future benefits an advance "204(h) notice" may have to be given, at least 45 days before the change is put into effect. Similarly, if a plan provides for safe harbor matching contributions, at least 30 days advance notice must be given to participants before those contributions stop, and other requirements must be met. Unlike an employer's limited ability to stop making safe harbor matching contributions after appropriate notice, there is no mechanism to eliminate an employer's 3% of pay safe harbor nonelective contribution for the current plan year.

Regardless of the type of plan and the type of contribution, no change in the contribution provisions of a plan may take away rights which the participants already have. For example, if a plan provides for an employer contribution of some sort for all participants who are both employed at year-end and credited with at least

1,000 hours of service for that year, there is generally no prohibition against amending the plan before year-end to reduce or eliminate those contributions (allowing adequate time for notice where required). This would be the normal result for many plans, because no individual had already met all requirements for the contribution (e.g., year-end employment). However, if the same plan is written to waive the year-end employment requirement and/or the 1,000 hour requirement for the year in which an individual leaves by retirement, disability or death, then at least those individuals who have already left employment for one of those reasons before the date the plan is amended would still have to be provided the contributions for which the requirements had already been met for the year. Depending upon the makeup of that group and the application of the coverage rules, it may be necessary to make current year contributions to at least some other employees as well.

Vesting

Work force downsizing generally reduces the number of participants in a retirement plan. Most employers are aware that if they terminate a tax-qualified retirement plan the accounts of all affected employees must be treated as fully vested. One often overlooked result of a significant reduction in plan participation is a requirement for 100% vesting of certain persons. Such a "partial termination" of a plan, and the resulting requirement for full vesting of affected employees, occurs when the percentage of plan participants is significantly reduced as a result of some employer-initiated event or series of events, such as layoffs. While there is no precise standard, and the IRS will look at all of the facts and circumstances. The generally accepted rule set by the IRS is that a 20% involuntary reduction in participation is enough to vest the affected employees. The "partial termination" analysis can be fairly simple where there is one, employer-initiated reduction event, such as a single layoff event. However, where there is a series of reductions within a single plan year, or a series of sufficiently related employer-initiated events, like multiple layoffs, spanning two or more plan years, the IRS and the courts may aggregate all of those events for these purposes. If the aggregate percentage reduction is high enough, all affected employees from the earliest reductions forward must be treated as fully vested in their accounts. All participants are taken into account in determining whether the reduction is significant, whether or not vested. Participants who leave for unrelated or employee-initiated events (e.g., quit) generally are not counted. Note that the vesting in these circumstances would be retroactive to the earliest work force reductions, which may have been far short of a 20% reduction at the time. Consequently, the early layoffs may have resulted in forfeitures which appeared appropriate at that time. Later, related layoffs may raise the reduction to an overall significant level. Those later reductions could then cause considerable administrative burdens and expenses in re-establishing the accounts of persons who had forfeited amounts years earlier, including finding those persons, sending out new notices, processing distributions, etc. The application of these rules may be complicated by the cashout or "deemed" cashout rules, where a partially vested or non-vested person is cashed out before the event which raises the overall reduction to a significant level.

Vesting is also required where, under the facts and circumstances, there is a "complete discontinuation of contributions" to most types of account balance retirement plans. Thus, for example, if an employer stopped making any contributions to a profit sharing plan, without any formal decision or declaration that no further contributions would ever be made, and if that discontinuation lasted for several years (three to five years is generally enough to cause IRS questions), and if there was no demonstrable evidence that the discontinuation was essentially an involuntary suspension of contributions because of a drop in profits or other special business circumstances for the period at issue, then the accounts of all affected participants may have to be 100% vested.

Summary

Because there are a variety of factors which may come into play, it is important to understand the options and the effects and requirements of each before getting too far into the process. Once any plan amendments are adopted, the employer's options from that point forward could be limited, and unexpected contributions or vesting of accounts may be required. Other considerations may come into play as well, involving not only other ERISA rights such as COBRA, but also labor and other laws. For example, there may be collective bargaining agreements restricting the employer's latitude to act, there must not be any impermissible discrimination in any work force reduction or other action, and no action may be taken for the purpose of depriving employees to benefits to which they are entitled.