Legislative and regulatory bulletin

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COVID-19: The impact of the economic disruption on retirement plans

The coronavirus pandemic, known as COVID-19, has had an unprecedented effect on the lives of nearly everyone. To help relieve the financial stress many individuals and employers are facing, Congress passed the Coronavirus Aid, Relief, and Economic Security (CARES) Act—a sweeping, $2 trillion relief package—on March 27. Included in the nearly 900-page bill are provisions that affect IRAs, employer-sponsored retirement plans and plan participants. They include penalty-free withdrawals and increased retirement plan loan limits for individuals affected by the virus, and a waiver of required minimum distributions for 2020. (See our March 27 Special Bulletin for a description of the CARES Act changes affecting retirement plans.) It's possible we may see additional relief from Congress if the pandemic persists.

But many employers that sponsor defined contribution plans have been forced to consider difficult decisions because of the loss of revenue due to social distancing and other factors. For example, some have found it necessary to lay off employees. Others suspect that they may not be able to make the employer contributions to their plans that they had intended. Below we address some of the defined contribution plan issues that are arising in the wake of the economic disruption caused by COVID-19.

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Reduction-in-force issues

- **Severance from employment.** Generally, when a plan participant incurs a "severance from employment" he or she can take a distribution from the plan.[1] Whether a severance from employment occurs depends on the facts and circumstances. Typically, if an employee is laid off with no likelihood of performing further services for the employer and the individual is no longer considered an employee for other benefits purposes, a severance has occurred. Other situations might not be as clear. For example, if an employer lays off employees with the expectation that they will be rehired in the near future, has a severance from employment occurred for retirement plan purposes? Employers should consult with their legal counsel for guidance.

[1] See, for example, Internal Revenue Code Section 401(k)(2)(B)(i)(I).

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- **Severance from employment with an outstanding plan loan.** Under most plans, if a terminated participant has an outstanding plan loan, the loan balance becomes due and will be offset against the participant's plan account. The participant will be taxed on the amount of the loan balance that was offset and, unless an exception applies, will be subject to a 10% penalty if he or she is under age 59½. To avoid taxation and the possible 10% penalty, the participant can roll over an amount equal to the amount of the offset to an IRA by the due date of his or her tax return for the year, including extensions.
- **Partial plan termination: 100% vesting of terminated employees.** Under the Internal Revenue Code and Internal Revenue Service (IRS) regulations, a partial termination of a plan can occur if there is a significant reduction in a plan sponsor's workforce. Whether a plan is partially terminated depends on the facts and circumstances. However, the IRS presumes that a partial termination has occurred if 20% or more of a plan's participants are terminated by the employer.[2] As a consequence of the partial termination, terminated employees become fully vested in their plan accounts.

Reducing or suspending employer contributions

- **Safe harbor 401(k) contributions.** Many 401(k) plans comply with one of the design-based safe harbors, thus avoiding the need to perform tests for nondiscrimination (i.e., the actual deferral percentage [ADP] and actual contribution percentage [ACP] tests). Among other things, the safe harbors obligate the plan sponsor to make either matching or nonelective contributions. Under IRS regulations, plan sponsors can reduce or suspend safe harbor contributions in the middle of a year if the plan sponsor is operating at an economic loss or if the safe harbor notice that was given to participants prior to the start of the year informed participants that the plan could be amended during the year to reduce or suspend employer contributions. Participants must be given a supplemental notice informing them of the reduction or suspension, generally at least 30 days prior to the effective date of the amendment reducing or suspending contributions. The supplemental notice must explain the consequences of the amendment, its effective date and the procedures participants should use if they wish to change their contribution elections. The plan sponsor must make safe harbor contributions through the effective date of the reduction or suspension. The plan will need to satisfy the ADP and ACP tests for the year and will be subject to the top-heavy rules.[3]
- **Fixed matching contributions.** Plans can generally be amended prospectively to reduce or eliminate fixed matching contributions. Eligible participants should be notified of the change and must still receive the full match through the effective date of the amendment.
- **Discretionary matching or profit-sharing contributions.** Discretionary contributions can generally be reduced or eliminated without a plan amendment because there is no provision in the plan document that obligates the plan sponsor to make them. Although there is typically not a requirement to notify participants, many plan sponsors may nonetheless choose to do so, especially those that have regularly made matching contributions that participants have come to expect.

It is likely that the IRS and Department of Labor (DOL) will be issuing guidance on the retirement provisions of the CARES Act. In fact, the Act provided the DOL with expanded authority to postpone certain deadlines under ERISA. Perhaps the agencies will provide additional clarity and flexibility to plan sponsors that are doing their best to manage their plans during these difficult times.

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[2] IRS Revenue Ruling 2007-43.
[3] Treas. Reg. Sections 1.401(k)-3(g) and 1.401(m)-3(h); IRS Notice 2016-16.

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