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Assessing the Impact of Furloughs and Layoffs on Defined Contribution Retirement Plans

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As a result of the economic impact of COVID-19 on business operations, many employers are considering workforce furloughs or layoffs. This difficult decision not only impacts your workforce strategy, but also has important implications for your defined contribution plans covered by ERISA. Additionally, the Coronavirus Aid, Relief, and Economic Security Act of 2020 ("CARES ACT") offers plan participants affected by COVID-19 some special relief related to loans and distributions. These are complicated issues and we recommend that you work closely with legal counsel to determine the impact on your workforce.

This article explores:

- The potential impact:
  - A furlough or layoff could have on participant vesting
  - A partial plan termination could have on participant vesting and distributions, as well as future costs
- The CARES ACT introduces optional provisions to enhance the availability and repayment flexibility of plan participant loans and distributions
- Additional considerations for small businesses, plan administration and IRS guidance

UNDERSTAND KEY VESTING PROVISIONS OF YOUR PLAN DOCUMENT(S)

Before deciding on the best actionable steps to take, plan sponsors should first review their plan documents for a clear understanding of the definition of the "severance of employment" and the calculation of "vesting service" provisions. You should work with legal counsel to determine if those employees incur a severance of employment. For instance, would a layoff or furlough constitute a severance or termination of employment under the plan?

Elapsed Time Most plans use the "elapsed time" approach to count service—under which, a break-in-service of less than 12 months would not be considered as severance of employment and vesting service would be credited throughout the layoff period.

Number of Hours Alternatively, if a plan measures vesting service based upon a minimum hours requirement in a 12-month period, a participant may not earn service credit for time on layoff or furlough. Also, if a participant does not work for a number of hours specified in the plan (i.e. no more than 500) over the 12-month period, a break-in-service may be triggered—which may impact the vesting percentage for post-break employer contributions.

PARTIAL PLAN TERMINATION

Further complicating matters for plan sponsors is the application of the partial plan termination rules. Changes in employment status for defined contribution plan participants may be temporary but can potentially result in the immediate vesting of the account balances of affected individuals in plans with graded or cliff vesting schedules. Generally, if 20% or more participants are impacted by an employer-initiated severance of employment or furloughs as a result of adverse economic conditions or other reasons that are not within the employer's control, the affected participants may be deemed to be 100% vested in their account balances.

The measurement period is a plan year, unless related severance events occur over a multi-year period—so, the calculation would be performed at the end of the plan year.

- For example, for calendar year 2020 plans it will be likely that COVID-19 layoffs and furloughs that are not intended to be permanent will not create a partial plan termination event during 2020. However, if layoffs extend into 2021 or if groups of participants are not brought back into employment, a partial plan termination may ultimately occur.

- Note that participants who may have previously been terminated by employer-initiated actions and have not incurred five breaks-in-service may need to be included in the calculation if their non-vested balances have not been forfeited. In this event, account balances for certain terminated participants may need to be reinstated and additional distributions may be required to be processed.

While immediate vesting will not have an initial impact on costs, the amount of forfeitures available in future years to pay plan expenses and offset the cost of employer contributions may be reduced.

PARTICIPANT LOANS AND DISTRIBUTIONS UNDER THE CARES ACT OF 2020

The Coronavirus Aid, Relief, and Economic Security Act of 2020 provides special relief for retirement plan participants and their spouses impacted by COVID-19. For those qualified participants, spouses, or dependents who are diagnosed with COVID-19, have adverse financial consequences and are financially impacted by COVID-19, as a result of such events as layoffs and business closings, or being unable to work due to childcare responsibilities, the rules regarding retirement plan distributions will change through December 30, 2020. Note that participants who do not meet the above criteria, but whose spouse or partner is laid off or furloughed, will not be eligible to receive the special relief.

The bill provides for the option for plan sponsors to modify their plans to allow for coronavirus distributions:

- The qualified individual to receive distribution from all eligible retirement plans and IRAs of up to $100,000 without the application of the 10% penalty (if occurring before age 59½)
- The ability to repay that distribution over a 3-year period (creating, in essence a three-year, interest-free loan) as a rollover contribution within 3 years to an eligible retirement plan or IRA.
- No application of the special tax notice rules
- The option to include the distribution in taxable income ratably over a 3-year period, beginning in 2020
- Self-certification

Alternatively, qualified participants affected by COVID-19 as described above, may be eligible to receive loans in accordance with the following more favorable terms:

- Increase of the maximum dollar amount for loans from $50,000 up to $100,000 between March 27,2020 and September 22, 2020.
- Increased maximum percentage from 50% up to 100% of vested account balance—so, qualified participants could take a loan of the lesser of $100,000 (reduced by the highest outstanding balance within the past 12 months) or 100% of their vested account balance
- An optional deferment of payments due on loans, if the due date of the loan payment falls between March 27, 2020 and December 31, 2020
- Interest will continue to apply on any loan payment deferment and the length of the deferment period will be added to the term of the loan.

ADDITIONAL CONSIDERATIONS

CARES ACT RELIEF FOR SMALLER EMPLOYERS

The Paycheck Protection Program established under the CARES Act, provides for loans of up to $10 million to smaller businesses (generally, less than 500 employees). Businesses using this program may also be eligible for loan forgiveness on specified costs (e.g., payroll costs for those earning up to $100,000 per year, benefit costs, rent) during the 8-week period following the origination of the loan. The amount of loan forgiveness will be dependent upon the number of employees retained and the level of reduction in employee compensation.

PAYROLL AND HRIS SYSTEMS

If you make changes to your plan, don't forget to confirm that the "status codes" are updated appropriately on your payroll/HRIS system to ensure the correct treatment of the participants' data for vesting, loan, and distribution purposes.

COMPLEX AND UNCERTAIN RULES—UNIQUE FACTS AND CIRCUMSTANCES

Unfortunately, IRS guidance related to partial plan termination leaves considerable room for interpretation. Facts and circumstances need to be considered when determining the possible application of the rules. Also, definitions of vesting service and severance of employment will need to be reviewed carefully in light of employment changes influenced by COVID-19.

ACTION STEPS

Do you have plans to implement a layoff, furlough, or other reduction in hours or workforce?

If so, you should take the following steps:

1. Review plan document and work with legal counsel—understand the impact of any workforce actions—proposed or already executed
2. Work with your Fidelity service team to ensure that "status codes" are updated appropriately on your payroll/HRIS system to ensure the correct treatment of the participant for vesting, loan, and distribution purposes
3. Be aware of the potential implication of a partial plan termination on vesting and future costs
4. Evaluate potential plan changes

HOW WE CAN HELP

Fidelity is committed to supporting plan sponsors through these difficult decisions, and available to help with any plan re-design strategies, implementation of required changes, and participant communications. Helping clients during these unprecedented times remain a top priority at Fidelity. Fidelity does not provide legal or tax advice so please consult your legal or tax advisor for assistance.

For more information on this topic, please contact your Fidelity Managing Director.