

Employee Benefits Alert

401(K) PLANS IN A DISTRESSED ECONOMY

As a result of the downturn in the economy, a number of issues impacting the operation of 401(k) plans have arisen. This Benefits Alert describes some of the more frequent problems and planning considerations faced by employers maintaining 401(k) plans.

1. Matching Contributions

As the recession has progressed, employers looking for cost savings have sought to reduce or eliminate matching contributions to their 401(k) plans. In the case of discretionary matching contributions, the central issue is adequately communicating the changes to plan participants. In order to craft a plan of action, employers will need to determine whether the plan document mandates a particular process or procedure for reducing or eliminating discretionary matching contributions.

If the matching contributions are not discretionary, such as under a safe harbor arrangement designed to avoid 401(k) nondiscrimination testing, additional requirements apply. Employers with safe harbor arrangements must not only provide notice of the changes to plan participants, but must also address nondiscrimination testing and match calculation issues. The employer must first amend the plan to reduce or eliminate the safe harbor match and to require nondiscrimination testing. Next, the employer must provide plan participants with at least 30 days advance notice of the changes as well as a reasonable opportunity to modify elective contributions. Even if the safe harbor match is terminated near the end of the plan year, the employer is required to conduct nondiscrimination testing for the entire plan year. The employer is also required to tender matching contributions for the portion of the plan year prior to the effective date of the reduction or elimination of the matching contribution. The amount of match required to be paid depends on whether the plan provides that the match is calculated on a payroll by payroll basis, or is based on aggregate elective contributions for the plan year.

Apart from the foregoing, if an employer fails to make a promised matching contribution to its 401(k) plan, the plan's tax qualification may be jeopardized and the employer may be found to have engaged in a prohibited transaction or a fiduciary breach.

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2. Participant Loans

Most 401(k) plans allow plan participants to borrow against their plan benefits. Under IRS and Department of Labor regulations, participant loans must be repaid pursuant to payroll withholding over a 5-year period (which may be for a longer period, if the loan is used to acquire a principal residence), with level amortization. If an employee fails to timely make a loan payment, the remaining balance of the loan is treated as a taxable distribution and generally will also be subject to an additional 10% tax if the employee has not attained age 59½ at the time that the loan default occurs. A plan administrator may provide for a cure period that ends on the last day of the calendar quarter following the calendar quarter in which a loan payment is missed. What this typically means is that if an employee with a plan loan terminates employment and does not repay the loan within the cure period, the remaining balance of the loan will be taxable.

In order to conform to IRS and Department of Labor requirements, the maximum amount that a participant may borrow may not exceed the lesser of \$50,000 or 50% of the participant's vested plan benefits. Importantly, in view of the significant investment losses experienced by many 401(k) plan participants, the 50% requirement need only be satisfied at the time the loan is made and need not be periodically re-evaluated.

Participant loans have presented a number of challenges in this economy. These are some of the more prevalent ones.

➤ Impact of Furloughs

During the course of the recession, many employers have furloughed employees rather than terminating them. Under the IRS' regulations, employees with plan loans who are placed on unpaid leave of absence may forego making loan payments during the leave of absence without triggering taxation of the loan as long as the following requirements are met:

- The furlough period must not exceed one year.
- The loan must be repaid by the end of the original term of the loan. The loan payments missed during the furlough period may be repaid by either continuing the original rate of repayment, with a balloon payment of the missed installments at the end of the term, or by ratably increasing the installments during the remainder of the repayment period. This requirement poses potential practical problems in the case of an employee who is furloughed near the end of the original term of the loan.

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➤ Loan Repayments from Severance Pay

In an effort to assist employees who have been laid off from having to fully repay a plan loan by the end of the cure period in order to avoid being taxed on the balance of the loan, some employers permit terminated employees who are receiving severance payments to continue paying their loans by withholding loan payments from their severance pay. Such an arrangement is permissible – by way of contrast, it is not permissible to make 401(k) contributions from severance pay. Please keep in mind the following:

- The plan's borrowing guidelines need to provide that loan payments may be made from severance pay.
- Withholding loan payments from severance pay may create administrative difficulties, since employers often handle severance pay operationally in a different manner than payroll payments.
- Care needs to be taken not to inadvertently create an IRS nondiscrimination problem, which might occur if severance pay is disproportionately provided to highly compensated employees.

➤ Impact of Employee's Bankruptcy on Plan Loan

As a result of legislative changes made in 2005, if an individual with a loan from a 401(k) plan enters bankruptcy, the bankruptcy stay does not apply to loan payments during the bankruptcy and the loan is not discharged.

3. In-Service Distributions

In the current environment, many employers are interested in assisting employees who have had their hours reduced or who have been placed on furlough and would like to receive distributions of their 401(k) benefits, but who are not otherwise eligible for a distribution.

➤ Hardship Distributions of Employee 401(k) Contributions

Although as a general rule a participant's 401(k) elective contributions may only be paid to a participant upon a separation from service, an important exception is that a plan may provide that a participant can receive a hardship distribution of elective contributions. Most 401(k) plans make hardship distributions available pursuant to an IRS regulatory safe harbor. Compliance with this safe harbor alleviates the need for a plan administrator to make potentially difficult determinations as to whether a participant has, in fact, suffered a financial hardship.

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Under the IRS safe harbor, hardship distributions are only available for certain categories of enumerated expenses and, therefore, can not be made solely as a result of a reduction of hours or a furlough. In addition, before a participant may receive a hardship distribution, the participant must have taken all other available distributions from the plan (and certain other employer-sponsored plans specified in IRS regulations), including the maximum permissible plan loan. Also, under the safe harbor, a participant who receives a hardship distribution is precluded from making 401(k) elective contributions for 6 months.

➤ Matching and Other Employer Contributions

It is possible for a 401(k) plan to provide for in-service distributions of matching and other employer contributions. Such distributions are not subject to the more restrictive rules applicable to in-service distributions of 401(k) elective contributions. For example, if an employer wants to make 401(k) plan benefits available to participants whose hours have been reduced or who have been furloughed, the 401(k) plan could be amended to provide that a participant who is in such circumstances, and who has completed a minimum specified period of service (at least two years), may withdraw all (or up to a stated percentage or dollar amount) of the vested portion of the matching or other employer contributions held on the participant's behalf under the plan. If the amendment is structured to meet the IRS' "window benefit" rules, which primarily look to whether the right created by the amendment is temporary in nature, this in-service distribution right can be limited to hour reductions and furloughs occurring during a particular period of time.

4. Partial Terminations

A "partial termination" of a 401(k) plan exists if a significant reduction in plan participation occurs as a result of employer-initiated severances from employment. The effect of a partial termination is that all participants whose employment was terminated by the employer in connection with the partial termination must be treated as fully vested in the employer contributions held for their benefit under the plan, without regard to whether they would otherwise be fully vested under the plan's vesting schedule (by law, all employee elective contributions must be fully vested at the time that they are contributed). The IRS has stated that a partial termination will be presumed to have occurred if there is a 20% turnover rate. The IRS defines turnover rate as the amount determined by dividing the number of participants whose employment was severed by the employer during the measuring period by the total number of participants at the beginning of the measuring period increased by the number of employees who became participants during the measuring period.

Determining whether a partial termination has taken place poses vexing interpretative and administrative questions. To begin with, although the rule speaks in terms of "employer-

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initiated” severances from employment, the IRS considers it irrelevant that the severances may have arisen from depressed economic conditions outside the control of the employer. In addition, a literal reading of the most recent pronouncement from the IRS sweeps in employees who are terminated for cause, and the IRS has warned that resignations will be scrutinized to confirm whether they were “purely voluntary”. Most challenging, however, is the IRS view that the measuring period can be more than a single plan year “if there are a series of related severances from employment” that straddle two or more plan years. Employers are well advised to maintain appropriate records that address whether the 20% turnover rate is exceeded and whether separate layoff events are related.

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