Partial Plan Terminations

As a result of the current economic downturn, scores of law firms have been forced to lay off large numbers of both legal and administrative employees. Management teams should be aware that reductions in workforce ("RIFs"), while seemingly cost-cutting in nature, can actually yield the opposite result, and can cause unintended and costly consequences with respect to a firm's tax-qualified employee benefit plan.

Many employers, in the legal field and otherwise, are blissfully unaware that a tax-qualified plan that incurs a so-called "partial plan termination," or a significant reduction in plan participation, must immediately vest all affected participants. This rule is intended to prevent greedy employers from terminating large numbers of non-highly compensated employees in order to gain control of their resulting forfeitures. This article summarizes the applicable law regarding partial plan terminations, so that employers contemplating a RIF may avoid any unintended consequences.

1. Potential Consequences of Failing to Treat a Plan as Having Incurred a Partial Termination

If a partial termination occurs with respect to a tax-qualified plan and the plan sponsor does not vest affected employees in their accrued benefits, the plan will cease to be tax-qualified. The consequences of disqualification of a retirement plan are as follows:

(a) for open tax years, the employer loses its deduction for nonvested contributions made to the plan for such years;
(b) for open tax years, participants recognize income with respect to their vested accrued benefits;
(c) for open tax years, the plan's trust recognizes income on its earnings;
(d) distributions from the disqualified plan are not eligible for rollover into another tax-qualified vehicle, such as an IRA; and
(e) the plan sponsor and/or the plan fiduciaries responsible for failing to maintain the plan's tax-qualified status face the risk of lawsuits by participants who are forced to prematurely recognize income and for breach of fiduciary duty.

2. Discussion of the Partial Plan Termination Rule

The Internal Revenue Code of 1986, as amended (the "Code") provides that, in the event of a termination or "partial termination" of a tax-qualified retirement plan, the rights of affected participants to accrued benefits become nonforfeitable. The regulations provide that the question of whether a partial termination has occurred is resolved on the basis of "all the facts and circumstances" of the particular case.

Neither the Code nor the regulations explicitly define the term "partial termination." Therefore, the determination of whether a particular reduction in a plan sponsor's workforce results in a partial termination of the sponsor's tax-qualified plan is often problematic.

In Revenue Ruling 2007-43, the IRS adopted a 20 percent presumption standard (the "significant percentage test") . Thus, if the turnover rate is at least 20 percent, there is a "presumption" that a partial termination has occurred. However, the IRS noted that whether a partial termination occurs on account of normal participant turnover is ultimately dependent on all of the facts and circumstances in a particular case. Facts and circumstances indicating that the turnover rate for an applicable period is "routine" for the employer favor a finding that there is no partial termination for that period. For this purpose, 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.

3. <u>Class of Affected Employees</u>

In applying the significant percentage test, certain classes of separated plan participants are excluded from the terminated class. Revenue Ruling 2007-43 uses the term "employer-initiated severance" to describe the class of affected participants to be used in the applicable test. For these purposes, an employer-initiated severance from employment generally includes any severance from employment (even if caused by an event outside of the employer's control) other than a severance that is on account of death, disability, or retirement on or after normal retirement age. In addition, the IRS indicated that the employer may be able to verify than an employee's severance was not employer-initiated through supporting information as to its voluntary nature from personnel files, employee statements and other corporate records.

Another complicating issue has historically been whether the significant percentage test applies with respect to "all" participants or only to participants who are "actively employed" as of the dates being analyzed under the test. Revenue Ruling 2007-43 clarifies the IRS's position on this issue by providing that the test is to be applied with respect to active participants, <u>i.e.</u>, participants who are employees.

4. <u>The Relevant Time Period</u>

Neither the Code, nor its legislative history, nor the applicable regulations specify whether aggregation of multiple plan years is required or permitted in determining whether a partial plan termination has occurred. Most IRS rulings and court decisions analyzing the partial termination rules have applied the significant percentage test on a plan year basis, without discussion of the merits of such decision. On this point, Revenue Ruling 2007-43 provides that the applicable period depends on the circumstances, and indicates that the applicable period is generally the plan year, but could be a longer period if there are a series of related severances from employment.

The court cases that have used a facts and circumstances analysis to hold that employee terminations during consecutive plan years should be taken into account have stated that the applicable time period runs from the start of the event causing the employer-initiated terminations through its completion.

5. IRS Determination Letter Process

The IRS will, upon request for a determination through the filing of an IRS determination letter application, rule on the issue of whether a partial termination has occurred with respect to a particular plan. In this regard, the IRS has taken the position that a plan sponsor who requests a partial termination determination before fully vesting affected participants may rely on the qualified status of its plan if the IRS determines that a partial termination has occurred and the sponsor thereupon retroactively vests all affected participants as of the date of the partial termination. Thus, the plan will retain its qualified status if the employer vests affected participants after the occurrence of the partial termination so long as the vesting occurs within a fairly short period of time after the IRS's determination of the occurrence of a partial termination.

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Because of the uncertainty in the application of the partial termination rule and the severe adverse consequences that could result from making an erroneous determination in this regard, an employer which has seen its workforce shrink in recent times should engage in careful analysis as to whether any of its tax-qualified plans have incurred a "partial termination." An employer might consider utilizing the IRS's determination letter program to seek a ruling from the IRS as to whether the applicable plan has incurred a partial termination.

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