



Todd M. Cleary

414.287.9433

tcleary@gklaw.com

Layoffs can trigger vesting requirements for retirement plan

If a qualified defined contribution retirement plan (e.g., 401(k), ESOP) experiences a “partial termination,” then “affected employees” generally must be fully vested in their plan accounts. The Internal Revenue Code does not provide extensive detail regarding what constitutes a partial termination, and whether a partial termination occurs depends upon the facts and circumstances. However, a general rule is that a plan is presumed to have partially terminated if at least 20 percent of participating employees experience an employer-initiated severance from employment during the applicable period. This presumption can be rebutted in some situations, though. Also, in the federal Seventh Circuit Court of Appeals (which includes Wisconsin), a partial termination can occur when the turnover rate is as low as 10 percent.

According to Internal Revenue Service (IRS) guidance, an “employer-initiated severance from employment” for this purpose generally includes any severance from employment other than a severance that is on account of death, disability or retirement on or after normal retirement age. This appears to include employees who are fired, even for cause or if due to adverse business conditions. However, the IRS guidance indicates that an employee who voluntarily terminates is not an “affected employee.” The “applicable period” over which the calculations must be made varies depending upon the given fact pattern, and can span across multiple plan years if there are a series of related severances from employment.

Many employers are not aware of the partial termination requirements. This lack of knowledge is dangerous because failure to fully vest affected employees when required can disqualify the plan. In that case, the plan’s tax advantages are jeopardized.

Regardless, employers that are considering layoffs due to the 2019 novel coronavirus (COVID-19) pandemic should consider whether a partial termination may occur. Partial termination analysis can be nuanced and complicated, so employers should consult with experienced employee benefits counsel to help.

For more information on coronavirus and its legal implications for your retirement plan, contact our Employee Benefits Practice Group.

The information in this article is based on a summary of legal principles. It is not to be construed as legal advice. Individuals should consult with legal counsel before taking any action based on these principles to ensure their applicability in a given situation.