



# Compliance Advisory

September 2009

## Workforce reductions may result in partial plan termination

In challenging economic times, employers may be forced to reduce their workforces. In those instances, employers must be aware that a reduction in workforce could lead to a partial plan termination, requiring affected participants to become fully-vested in their retirement benefit.

The terminology employers use to describe workforce reductions may vary. Employers may use terms such as “layoff,” “downsizing,” or “restructuring” to describe a reduction in force. Regardless of the name, a reduction in the number of active plan participants could result in a partial plan termination.

### Partial plan termination determination

In general, the determination as to whether or not a partial plan termination has occurred is based on facts and circumstances, including the extent to which participants have terminated employment. However, any of the following events could result in a partial plan termination:

- A significant reduction in plan participation;
- A plant or facility shutdown or sale that results in the exclusion from the plan of a group of participants;
- A plan amendment that results in a group of participants being excluded from further participation;
- A plan amendment that adversely affects the rights of participants to vest in their account balances or accrued benefits; and
- Any other event the IRS may deem to be a partial plan termination.

If a partial plan termination occurs, affected participants must be fully vested in their account balances or accrued benefits (to the extent funded). Participants who are not affected by the partial plan termination continue to be subject to the plan’s vesting schedule. A partial plan termination, in itself, is not a distributable event. However, participants who have severed employment as a result of the workforce reduction may be eligible for a distribution of their account balances or accrued benefits.

When determining whether a partial plan termination has occurred due to a reduction in workforce, plan sponsors may look to guidance provided by the IRS in [Revenue Procedure 2007-43](#), which states that a turnover rate of at least 20% creates a rebuttable presumption that a partial plan termination has occurred. This 20% threshold is provided as “rule-of-thumb” guidance, and is not intended to be a brightline test. Therefore, facts and circumstances may result in a partial plan termination even if the turnover rate is less than 20%. Likewise, a turnover rate exceeding 20% may not be a partial plan termination. In reviewing the facts and circumstances, the plan sponsor should compare the plan’s turnover rate to the plan’s “routine” turnover rate.

### Turnover rate calculation

The turnover rate is a fraction:

$$\frac{\text{Terminated Participants}}{\text{Starting Participants} + \text{New Participants}}$$

The numerator of the fraction is equal to the number of terminated participants who had an employer-initiated severance during the year. Generally, any severance other than an employee’s voluntary termination, death, disability, or retirement

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on or after normal retirement age is considered an employer-initiated severance. A severance is employer-initiated even if it is caused by events outside of the employer's control, such as depressed economic conditions. In addition, a severance is employer-initiated even if it was due to good cause, e.g., firing an employee for work-related reasons. The IRS presumes that all terminations are involuntary, unless the employer is able to demonstrate otherwise. As a result, employers should document the circumstances of each employee's termination.

The denominator of the fraction is a sum equal to the number of active participants at the start of the plan year and the number of employees who become participants during the plan year.

When determining the turnover rate, all participants, vested and nonvested, must be included. Additionally, an employee in a 401(k) plan is considered to be a participant if he is eligible to make elective deferrals, regardless of whether he actually contributes to the plan.

The applicable period used for this calculation is generally the current plan year, but if the plan year is less than 12 months, the current plan year and the immediately preceding plan year must be used. The period of time may be longer than the plan year if there are series of related severances. For example, if the plan sponsor terminates employees over multiple plan years, the turnover rate must be determined for the entire related period.

### **IRS examples of partial plan terminations**

The IRS has provided the following examples of a partial plan termination:

**Example 1:** A qualified plan that covered all of the employer's 15 employees opened a new business location, closing the original one, but only three employees moved to the new location and remained in the plan. The IRS determined a partial plan termination occurred due to the termination of the other 12 employees in connection with the change in business location.

**Example 2:** A qualified defined benefit plan covered 165 employees in the two divisions of a business. The business closed down one division and terminated 95 participants. The IRS determined a partial plan termination occurred.

### **Special rule for defined benefit plans**

Under a special rule that applies only to defined benefit plans, a partial termination is deemed to occur if a defined benefit plan ceases or decreases future benefit accruals under the plan, and as a result of the cessation or decrease, a potential reversion to the employer(s) maintaining the plan (determined as of the date the cessation or decrease is adopted) is created or increased. If no employer reversion results, a partial plan termination is deemed to have not occurred.

### **Corporate transactions**

The sale of a subsidiary or division may be a partial plan termination if the plan or a portion of the plan is not going to be transferred to the buyer and the employees of the sold subsidiary or division will cease to be participants in the plan. Whether or not a partial plan termination occurs because of the sale of a division or subsidiary will depend on the facts and circumstances of each case. Not all events will result in a partial plan termination. However, if a substantial number or percentage of employees is terminated, a partial plan termination may result. Since the sale of a division is a voluntary act by the employer, a reduction in plan participants of at least 20% is presumed to be a partial plan termination.

A key factor in a sale is whether the buyer is continuing the plan (or a portion of the plan) that covers the acquired participants. The buyer is treated as continuing the plan (or portion of the plan) if it merges the plan (or portion of the plan) into its own plan or separately maintains the plan that covers the acquired employees. Where a buyer continues the plan (or portion of the plan) that covers the acquired employees, the buyer is considered to be the "same" employer as the seller. As a result, the acquired employees' participation in the plan is uninterrupted and a partial plan termination has not occurred.

A plan merger generally does not result in a partial plan termination. The merged plan is a continuation of both plans involved in the merger.

### **IRS determination**

A plan sponsor may request a determination letter from the IRS on whether a partial termination has occurred with respect

to the plan. The request is submitted on a Form 5300. The IRS will review the relevant facts and circumstances and determine whether there is a partial plan termination.

However, to avoid the wait involved to receive a determination from the IRS, plan sponsors will often make the decision to proceed with 100% vesting of affected participant accounts or accrued benefits, particularly if the turnover rate exceeds 20%.

## Administrative considerations

Once it is determined that a partial plan termination exists, there are a number of administrative issues plan sponsors should consider:

- Affected participant's vesting must be updated to reflect 100% vesting;
- If any affected participants have incurred a termination of employment in conjunction with the partial plan termination, they may be eligible to receive distributions. When determining who is eligible for a distribution, sponsors of defined benefit plans should confirm that the plan is not subject to benefit restrictions, (e.g., [funding-based restrictions imposed by the Pension Protection Act](#)) and that affected participants are not [restricted participants](#).
- A plan amendment and/or revised summary plan description (SPD) or summary of material modifications (SMM) may be needed to reflect the partial plan termination;
- If there is a transfer or spin-off of assets and liabilities, a Form 5310-A filing may be necessary.
- For defined benefit plans and money purchase plans, a 204(h) notice may need to be distributed in certain situations (e.g., a sale of a division).

In addition, defined benefit plan sponsors must report certain events to the Pension Benefit Guaranty Corporation (PBGC). These events include:

- A reduction in active participants to below 80% of the number as of the beginning of the plan year or less than 75% of the number at the beginning of the preceding plan year;
- A transfer, during a 12-month period of 3% or more of total benefit liabilities from the plan or any other plan maintained by a member of the plan sponsor's controlled group to a person or plan that is maintained by a person that is not a member of the transferor's controlled group;
- A transaction resulting in one or more entities ceasing to be members of the plan sponsor's controlled group (e.g., controlled group break up, changes in the contributing plan sponsor, or a merger or consolidation within the controlled group); or
- A report of a facility shutdown causing separation from service of more than 20% of participants.

The plan sponsor should consult the plan's enrolled actuary regarding the need to report one of these events to the PBGC.

## Prudential's support

Plan sponsors that encounter a partial plan termination should provide a list of affected participants to Prudential Retirement so they will be fully vested. In addition, plan sponsors should notify Prudential of participants who are eligible for distributions due to a termination of employment in conjunction with the partial plan termination. If Prudential provides document services for your plan, contact your Prudential representative regarding the need to amend the plan document or revise the SPD to reflect the partial plan termination. Additionally, sponsors of defined benefit plans should contact their plan's enrolled actuary.



### Compliance Advisory by Prudential Retirement

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