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## Partial Plan Terminations of Qualified Plans

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The economic downturn that grew in late 2008 and continued during 2009 and into 2010 required many companies to reduce costs, which frequently involved suspending new hiring, not filling vacated positions, implementing reductions in force and freezing benefit accruals. By taking these actions, an employer may have unwittingly triggered a “partial plan termination” with respect to its qualified retirement plan.

A partial plan termination can occur for many reasons, including a plan amendment that adversely affects the rights of employees to vest in benefits under the plan or that excludes a group of employees who previously were covered by the plan, the reduction or cessation of future benefit accruals that results in a potential reversion to the employer or, the most common cause, employer-initiated severances from employment, which is the focus of this article.

Whether a partial plan termination occurs is based on a facts and circumstances test. The general rule of thumb in the context of employer-initiated severances from employment is that a partial plan termination occurs if such employer-initiated severances from employment result in a 20% or more decrease in the number of plan participants. If a partial plan termination occurs, affected participants must be made fully vested to the extent their benefits are funded as of the date of the partial plan termination.

In addition, employer-initiated severances from employment may cause a “reportable event” to occur if the number of active plan participants in a defined benefit pension plan insured by the Pension Benefit Guaranty Corporation (PBGC) falls to less than 80% of the number of active plan participants at the beginning of the plan year or



less than 75% of the number of active plan participants at the beginning of the prior plan year. If a reportable event occurs, a notice generally must be filed with the PBGC within 30 days of the event.

### Background of Partial Plan Terminations

Neither the Internal Revenue Code nor the regulations issued thereunder define what is meant by a partial plan termination. Regulations provide that “whether or not a partial termination of a qualified plan occurs shall be determined by the Commissioner with regard to all the facts and

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circumstances in a particular case.”<sup>1</sup> For a partial plan termination to have occurred, the number of severed employees must be substantial when compared to the number of total plan participants.<sup>2</sup>

In 2007, the Internal Revenue Service (IRS) issued Revenue Ruling 2007-43 to explain its position regarding certain circumstances under which a partial plan termination occurs with respect to a defined contribution plan.<sup>3</sup> The IRS takes the position that when employer-initiated severances from employment reduces the number of plan participants by 20% or more, a partial plan termination is presumed to have occurred, regardless of the vested status of the participants.<sup>4</sup> Several courts also have held there is a presumption that a 20% or greater reduction in the number of plan participants constitutes a partial plan termination.<sup>5</sup>

### Calculation Methodology

Performing these calculations is not always straightforward because various determinations must be made and there is only limited guidance.

As a preliminary matter, the vested status of a participant is irrelevant when determining whether a partial plan termination has occurred.<sup>6</sup> One famous case from the early 1990s held the proper methodology was to calculate the ratio of the number of non-fully vested employer-initiated terminations to the total number of non-fully vested plan participants.<sup>7</sup> Thus, fully vested participants were removed from the numerator and the denominator on the theory that fully vested employer-initiated terminations were not affected by a partial termination. Although two other cases originally held fully vested participants should be excluded from the numerator but not the denominator, in both cases this methodology was ultimately overruled in favor of the IRS methodology.<sup>8</sup> Thus, the recommended approach for determining whether a partial termination has occurred is to follow the IRS methodology, which does not take into account the vested status of the participants.

Whether a partial plan termination has occurred requires three significant determinations:

#### Which employees are taken into account?

All employer-initiated severances from employment are taken into account when determining whether a partial plan termination has

occurred. An employer-initiated severance may be the result of internal events, such as a restructuring, or external events, such as poor economic conditions.

Certain severances from employment do not have to be taken into account. For example, severances from employment on account of death, disability or retirement on or after normal retirement age do not have to be included. An employer may be able to show that an employee’s severance was purely voluntary (and exclude the employee) through such items as information from personnel files, employee statements and other similar documentation.

In addition, facts and circumstances could show there is routine turnover for an applicable period, which would favor excluding those employees, especially if the employees were replaced by new employees who performed the same functions, had the same title or job classification and received comparable compensation.

Finally, employees who have a severance from employment can be excluded if they continue to be covered by a plan that is a continuation of the plan under which they were previously covered (*i.e.*, the portion of the plan covering those employees is spun-off and maintained by a new employer).

An unresolved question is whether employees who are terminated “for cause” must be included. The argument against including such employees is that they were fired for doing something wrong and they should not unfairly benefit by being made fully vested. However, the IRS’s presumption is that *all* employer-initiated severances should be included in the calculations, and the IRS has not stated that a severance for cause is a basis for excluding employees when determining whether a partial plan termination has occurred and who, as a result, must be made 100% vested.

The underlying concern is that an employee’s severance from employment “for cause” should not be a subterfuge for a reduction in force. For example, severing an employee for sub-par performance could be “for cause” and unrelated to any other events, but such severance could be a workforce reduction if a department is required to sever one person and the decision is made based on the poorest performer in the department

1 Treas. Reg. §1.411(d)-2(b).

2 IRM §7.12.1.2.7.1(5).

3 Although the Revenue Ruling involves a defined contribution plan, most of the analysis is equally applicable to a defined benefit plan. 4 Rev. Rul. 2007-43; IRM §7.12.1.2.7.2(2).

5 See *Matz v. Household International Tax Reduction Investment Plan*, 388 F.3d 570 (7th Cir. 2004); *Halliburton Co. v. C.I.R.*, 100 T.C. 216 (1993).

6 Rev. Rul. 2007-43.

7 *In re Gulf Pension Litigation*, 764 F.Supp. 1149 (S.D.Tex. 1991).

8 See *Matz*, 388 F.3d. 570; see also *Weil v. Retirement Plan Administration Committee of the Terson Co., Inc.*, 933 F.2d 106 (2d. Cir. 1991).

(thus, “performance” is not an independent basis for the termination). In this case, a former employee’s exclusion from full vesting in a partial plan termination could be defended by showing he or she was replaced.

Ultimately a severance “for cause,” such as illegal behavior, is the kind of “fact and circumstance” that could justify excluding the employee and not providing 100% vesting because, conceptually, the employee caused his or her own severance from employment. The risk is that the plan is at some point audited, an affected employee sues or initiates a complaint with a government agency or a conclusion is later reached that an employee should not have been excluded and should have been made 100% vested. At that time the employee might have to be made fully vested if the decision to exclude the employee cannot be defended.

### What is the total number of participants?

The total number of participants is the number of active participants at the beginning of the applicable period plus the number of participants added during the period.<sup>9</sup> For a 401(k) plan, the term “active participants” includes those employees who are eligible to, but do not, make salary deferral contributions to the plan.

### What is the applicable period?

The applicable period generally is the plan year. For a plan year that is less than 12 months, the applicable period is the short plan year plus the immediately preceding plan year.<sup>10</sup> The applicable period may be a longer period if there is a series of related events that occur over multiple years.

When there is a series of related events, it is not clear whether the “longer period” begins on the date of the first severance from employment in a series or on the first day of the plan year in which the first severance from employment in a series occurs. To be consistent with the method of determining the applicable period for a plan year that is less than 12 months, it is reasonable to take the position that the determination is made beginning on the first day of the plan year in which the first event occurs.<sup>11</sup>

The question whether there is a series of “related severances from employment” has been addressed in several court cases. For example, in *In Re Gulf Pension Litigation*, the court found that a series of layoffs resulting from the merger of Gulf and Chevron were related even though they occurred over multiple years,<sup>12</sup> and in *Matz*, the court determined that terminations that

occurred over three plan years were the result of sales of subsidiaries and assets that were closely related in time and “had the same motives” (*i.e.*, the company underwent a multi-year reorganization after it was acquired).<sup>13</sup>

However, in *Admin. Comm. of the Sea Ray Employees’ Stock Ownership and Profit Sharing Plan*, the court did not overturn the district court’s and plan administrator’s distinction between the decrease in plan participants due to the general economic downturn in the small boat industry and the decrease in plan participants due to a new luxury tax on large boats resulting in a downturn in luxury boat sales.<sup>14</sup> The court concluded the determination that the two events were not related, did *not* have to be aggregated and were *not* arbitrary and capricious.

Thus, a series of related events that occur over more than one year generally must be aggregated and considered as a single event for purposes of determining whether a partial termination has occurred.<sup>15</sup> Therefore, the applicable period may be longer than one year if a series of related severances occur.

If, after making these three determinations, the ratio of the number of employer-initiated participant severances to the number of total plan participants is 20% or more, a partial plan termination probably has occurred. If the ratio is less than 20%, a partial plan termination probably has not occurred.

Subsequent events must be reviewed to determine whether they must be treated as part of the same series of events. If a partial plan termination occurs due to later related events, participants who were affected by an earlier event that was determined not to be a partial plan termination will be retroactively affected.

### Vesting Requirement

Participants affected by a partial plan termination have to be made fully vested in their benefits to the extent funded as of the date of the partial plan termination.<sup>16</sup> For a defined contribution plan with individual accounts, the balance in the affected participants’ accounts should be made 100% vested. If any of the affected participants were not fully vested upon termination and previously received a distribution of his or her vested balance, each such participant should receive a distribution of the additional portion of the account that was not vested when the distribution was paid. For those participants, the administrator generally may follow the participants’ original distribution elections to process the additional payments.

9 Rev. Rul. 2007-43; IRM §7.12.1.2.7.2(1).

10 Rev. Rul. 2007-43.

11 This interpretation should result in a larger denominator because the number of active participants at the beginning of the plan year plus the number of participants added during the period will include those participants who may have terminated employment prior to the event that are not employer-initiated severances from employment.

12 *In re Gulf Pension Litigation*, 764 F.Supp. at 1167-68.

13 *Matz v. Household International Tax Reduction Investment Plan*, 227 F.3d 971, 977 (7<sup>th</sup> Cir. 2000).

14 *Admin. Comm. of the Sea Ray Employees’ Stock Ownership and Profit Sharing Plan v. Robinson*, 164 F.3d 981, 987-988 (6<sup>th</sup> Cir. 1999).

15 Rev. Rul. 2007-43; *Matz v. Household International Tax Reduction Investment Plan*, 388 F.3d 570 (7<sup>th</sup> Cir. 2004). We should note that a decision made in one circuit court is not binding on a different circuit court.

16 Code §411(d)(3)(A).



For a defined benefit pension plan, calculating the amount to which affected participants may be entitled is more complicated. The accrued benefits of the plan's participants and the market value of the plan's assets are determined as of the date of the partial termination. The plan's assets are then allocated among participants in the order in which the assets of a terminated pension plan are to be allocated under Section 4044 of the Employee Retirement Income Security Act of 1974, as amended (ERISA).<sup>17</sup> The benefits of nonvested participants vest only after the plan's assets have been allocated in this manner and to the extent there are any assets remaining to fund those benefits. Thus, nonvested participants who are affected by a partial plan termination may not become fully vested in their accrued benefits. An employer might wish to provide full vesting of the accrued benefits of such participants, depending on the cost of such vesting, employee relations and administrative complexity.

### PBGC Reporting

When the number of active plan participants in a defined benefit pension plan insured by the PBGC reduces to less than 80% of the number of active plan participants at the beginning of the plan year or 75% of the number of active plan participants at the beginning of the previous plan year, a reportable event has occurred.<sup>18</sup> Thus, employer-initiated severances from employment can result in a reportable event.

The PBGC must be provided with notice within 30 days of a reportable event unless a waiver or extension applies.<sup>19</sup> Failure to provide this notice may result in the PBGC assessing penalties of up to \$1,100 per day for each day the required notice is late.

PBGC Form 10 is used to provide the PBGC with notice of a reportable event, and it includes a statement explaining the reason for the reduction. The PBGC notice requirement may be waived in certain situations; for example, notice is waived if:


- There is no variable rate premium (this premium is paid by PBGC-insured single-employer plans with unfunded vested benefits);
- There is less than \$1 million in unfunded benefits; or
- The fair market value of the plan's assets is at least 80% of the vested benefits amount *and* the active participant reduction is not reportable as a result of the cessation of operations at one or more facilities.

If a PBGC Form 10 is filed to report an active participant reduction for a plan year and the number of active participants on the first day of the subsequent plan year is less than 75% of the number of active plan

participants at the beginning of the prior plan year (the trigger for the initial notice), another reportable event will have occurred and another PBGC Form 10 will have to be filed because each plan year begins a new reporting cycle.

Finally, if an employer implements a reduction in force at a particular facility or with respect to a specific operation affecting 20% or more of the plan's participants, a cessation of operations may have occurred.<sup>20</sup> In addition to potentially causing a partial plan termination and a reportable event, such an event can lead to additional funding liability; an explanation of this liability is beyond the scope of this article.

### Conclusion

Determining whether a partial plan termination has occurred with respect to a plan can be complicated. When a partial plan termination occurs, affected participants have to be made fully vested to the extent their benefits are funded. If subsequent events occur, such events must be reviewed to determine whether the subsequent event should be aggregated with earlier events and treated as part of the same series of events, or whether the events causing such terminations are unrelated and do not have to be aggregated. Thus, it is important that employers keep their legal counsel and other advisors apprised of such events as they occur. 



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17 This methodology is acceptable under Treas. Reg. section 1.411(d)-2(a)(2)(ii) and was used by at least two federal courts (see Freeman v. The Central States, Southeast and Southwest Areas Pension Fund, 32 F.3d 90 (4<sup>th</sup> Cir. 1994); see also Burstein, M.D., v. Retirement Account Plan for Employees of Allegheny Health Education and Research Foundation, 2002 WL 31319407 (E.D.Pa. 2002)).

18 ERISA §4043.

19 The PBGC notice may be extended to the latest of: (i) 30 days after the PBGC Form 1 due date for the event year, (ii) 30 days after the plan's Form 5500 due date if the reportable event was the cessation of operations at a facility, and (iii) the due date for PBGC Form 1-ES for the plan year following the event year if the reportable event was the cessation of operations at a facility.

20 ERISA §4062(e).