2 Ways Furloughs and Layoffs Could Impact 401k Plans

In the wake of the COVID-19 pandemic and the resulting economic uncertainty, many small employers are faced with decisions that could have significant impacts on their employer-sponsored retirement plans.

While some have had to resort to outright layoffs, many employers are turning to unpaid leaves of absences and furloughs as a way to scale back on costs temporarily while maintaining a connection to employees they will rely on once they are able to restart normal business operations.

Layoffs, indefinite unpaid leaves of absence and furloughs can present complex administrative issues for many common employee-sponsored retirement plans.

A recent benefits law alert from Nixon Peabody LLP said the most commonly asked question they've heard from employers recently is, "What's the difference between a furlough and a layoff?" That inquiry is followed closely by questions regarding what that difference means for the employer's retirement plan, and whether and how affected employees can withdraw funds from their plan accounts.

Generally, the brief says, a layoff is recorded by an employer as a termination of employment, not for any performance-related cause. An employer will use a furlough, on the other hand, to retain staff it can't afford to pay but doesn't wish to lay off.

Furloughed employees often retain some or all of their benefits, usually remaining active—rather than terminated—participants in their employer-sponsored retirement plans.

"It's very important for employers, and their plans' recordkeepers, to understand that a furloughed employee is not a terminated employee," the brief continues, "and employers should take care to code or flag the furloughed employee's status appropriately for the plan's recordkeeper so that a furloughed employee is not mistakenly permitted to take a termination distribution from the plan."

Two of the main retirement plan issues that can arise from reductions in workforce are possible triggers of 100% vesting and a bump in 401k loan defaults. Here's a closer look at those two issues, courtesy of a pair of recent briefs from Nixon Peabody and from K&L Gates LLP.

Triggering 100% vesting in a 401k plan

Per the Internal Revenue Code of 1986, as amended, when a 401k plan is deemed to be "partially terminated," all participants who have been affected by the partial termination and who are not yet fully vested in their plan benefits must become fully vested.

The K&L Gates alert notes a plan is deemed to be partially terminated based on the specific facts and circumstances of a particular case, including whether a group of employees who have previously been covered by the plan are now excluded from the plan due to severance.

The Internal Revenue Service has ruled that, generally speaking, a reduction in force that results in the termination of 20% or more of the total number of plan participants will be presumed to be a partial termination of the plan. Based on the specific facts and circumstances, a broad-based furlough could likewise result in a partial termination, depending on the length of the furlough and the method used by the plan to measure vesting service.

The K&L Gates brief says employers that are considering or have chosen to layoff or furlough a number of employees in light of COVID-19 should consider whether the layoff or furlough could cause employer contributions to employees' 401k accounts to immediately vest.

Employers contemplating layoffs of 20% or more of their workforce should consult their employee benefits attorney regarding whether their plan has a partial termination, the Nixon Peabody brief adds, and will need to coordinate with their service providers to ensure vesting is properly credited and the correct amounts distributed from the plan when the affected employees take distributions.

For those employers utilizing vesting schedules under their plans, this means that the laid-off employees who were either not vested or only partially vested when they were laid off must be treated as 100% vested and will receive the entire amount of the employer contributions in their plan accounts when they take their distributions from the plan.

Default of 401k plan loans

Many qualified employer plans, including 401k plans, permit plan participants to obtain loans from their plan accounts, providing them with access to cash on a tax-free basis to be repaid over time, typically through payroll deductions.

Depending on the plan's provisions, outstanding plan loans may be designed to accelerate the entire remaining principal and interest upon a participant's termination of employment, meaning that participants with outstanding loans who are terminated may be required to repay their entire outstanding loan balance or risk defaulting on the loan.

Furloughed employees with existing participant loans may end up defaulting on the outstanding balance of those loans if they're unable to make their regularly scheduled loan repayments. This is especially likely where their repayments must be made via payroll deduction, the Nixon Peabody brief notes. Laid-off employees are even more likely to default on their outstanding loan balances, especially in situations where the plan does not permit manual repayments following termination of employment, or where a plan provides the immediate acceleration of outstanding loan balances upon termination of employment.

A defaulted plan loan results in an immediate deemed distribution of the unpaid portion of the loan. A deemed distribution is subject to ordinary income tax in the same manner as any other distribution (including a possible 10% penalty for early distributions) from the plan and may not be rolled over to another eligible retirement plan or IRA.

The CARES Act provides some relief by delaying certain loan payments for furloughed and laid-off employees (and other qualified individuals) with outstanding participant loan balances, the briefs note.

Employers will need to monitor outstanding participant loans to ensure that any delinquencies are addressed promptly. In addition, the expanded availability of participant loans and hardship distributions under the CARES Act likely will create additional administrative work for employers where furloughed employees are involved.

K&L Gates says employers need to be aware that employees with outstanding plan loans may default on the loans if terminated in a reduction in force or furlough, which could cause the employee to incur federal income and state income tax.

Employers should also consider whether changes to the plan's loan procedures are appropriate to prevent employees from automatically defaulting on their loans, such as by allowing loans to continue to be repaid while on layoff or furlough (to the extent that an employee has sufficient funds to make repayments on the loan).

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Source: Anderson, Brian. "2 Ways Furloughs and Layoffs Could Impact 401k Plans." 401k Specialists, 13 Apr. 2020, 401kspecialistmag.com/2-ways-furloughs-and-layoffs-could-impact-401k-plans/?utm_source=401k&utm_medium=email&utm_campaign=401k_enl_04142020.