Understanding the Impact of Workforce Reductions on 401(k) Plans

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Employee turnover often triggers a wave of issues for a company and its human resources department. Even 401(k) retirement plans — one of the most sought-after employee benefits — can be impacted when a substantial number of employees are involuntarily terminated. This can constitute a partial 401(k) plan termination where full vesting of the affected employees must occur to satisfy legal and regulatory requirements, yet partial terminations are often easy to overlook.

Identifying Partial 401(k) Terminations

An important part of 401(k) management is understanding how workforce reductions can affect the plan itself, as complete disqualification of the plan by the IRS is on the table when a partial termination goes unnoticed or is mishandled.

According to IRS regulations, a partial 401(k) termination may occur upon the involuntary termination of 20% or more of employees who are plan participants at the beginning of the year. It's likely that some of the employees will be fully vested, while others will not meet the plan's requirements for 100% vesting of employer contributions.

Employers, and HR departments specifically, should monitor fluctuations in employee headcounts and watch for events that can trigger a large workforce reduction that, in turn, could result in a partial 401(k) termination. However — and this is where confusion sometimes occurs — the 20% workforce reduction count is cumulative, can span more than one plan year, and can be triggered by events other than layoffs and plant closings, such as:

- Business restructuring that decreases the size of the workforce.
- Amendments to the 401(k) plan where the number of eligible employee participants decreases.
- Employee turnover for positions that are not expected to be replaced.

The IRS calculates the turnover rate using a specific formula: $TR = A / X + Y$. TR means the turnover rate equals the number of participants who were terminated (A) divided by the number of participants at the end of the prior year plus any added during the plan year (X+Y). For example, if 20 employees were terminated at a company that had 80 participants, the turnover rate would be 25%.
If it appears that a company's workforce has dropped or is expected to drop by 20% or more, employers, HR professionals, and plan administrators should closely scrutinize 401(k) plan documents and the laws and regulations governing such retirement plans.

Workforce Reductions and the 401(k) Plan

How does the termination of employee participants affect a company's 401(k) plan? Between the complexity of 401(k) plan regulations and vigorous IRS oversight, it's crucial to understand that significant employee turnover and other workforce-related events can have an impact on retirement plan operations and forfeiture accounts.

If it is determined that a partial 401(k) termination occurred, employers must fully vest the affected employees regardless of plan requirements. For example, plan documents might require an employee to work six years to become fully vested in the employer's contributions to the 401(k) plan. A layoff occurs which includes employees with less than six years of service. The employer must vest these employees at 100%, in part because they were not given the opportunity to meet that six-year benchmark. The same is true for other events, such as business restructuring and plan amendments that affect employee eligibility.

Immediate vesting of a large number of departing employees could potentially create financial hardship for the business. The plan's forfeiture accounts may be available to fund the vesting of employees without a significant immediate impact on cash flow. However, any required adjustments to vesting must occur whether the forfeiture accounts will cover the cost or not.

It's important to identify and plan for any event that could jeopardize the 401(k) plan. Failing to recognize a partial 401(k) plan termination is common, but companies can enhance their monitoring procedures and increase awareness.

Avoiding Partial Termination Missteps

The IRS can completely disqualify a 401(k) plan if vesting is not handled properly after a partial termination. Consider the following best practices to help mitigate the risk:

- **Learn the rules**. Rules and regulations surrounding partial terminations tend to be complex, consider consulting with an employee benefit plan professional or ERISA attorney to understand the rules.
- **Know your plan**. Become familiar with plan document provisions related to partial plan terminations, vesting provisions and the use of forfeiture accounts.
- **Establish oversight policies and procedures.** Monitoring employee voluntary and involuntary terminations by the plan sponsor and management should be ongoing. Consider turnover trends during the plan year as well as across multiple years.
- **Document all terminations.** It may be necessary to prove to the IRS whether a departure was voluntary or involuntary for the turnover calculation. The IRS may classify voluntary terminations as involuntary terminations if the employer cannot provide support for the nature of the employee's departure.
- **Manage forfeiture accounts.** The balance of the forfeiture account can include a variety of sources, including funds previously forfeited from participant accounts that are affected by a partial plan termination. The funds in the forfeiture account may be needed to reinstate the accounts of the affected participants.
- **Correct vesting failures.** The IRS offers the IRS Employee Plans Compliance Resolution Systems that can be used to correct this compliance failure.

If you have questions or want to discuss further, contact our Retirement Plan Services team.