Potential Benefits Issues of Employee Terminations: Who Just Became Fully Vested?

By Arthur J. Glassman

Arthur J. Glassman works with businesses, business owners, and individuals in the areas of employee benefit plans, wills and trusts, and business and corporate operations. He may be reached at GlassmanA@moss-barnett.com or 612.877.5272.

Current difficult economic times have resulted in layoffs and other employee terminations. Employers need to be aware that terminating a significant number of employees may result in a "partial termination" of a 401(k) plan or other retirement plan.

If a partial termination occurs, the plan is treated as terminated with respect to the terminated participants and their employer funded benefit must become 100% vested. A partial termination also requires an allocation of any unallocated forfeitures that the plan may be holding.

The IRS has created a rigid rule for determining whether there is partial termination. Some courts, however, have been more reluctant to find that a partial termination has occurred. IRS guidance presumes a partial termination if there is a 20% or more turnover rate in the plan due to employer action. The 20% computation includes both vested and non-vested participants. The presumption can be rebutted by showing that the turnover rate is routine.

If employer termination of participants occurs over multiple plan years, the turnover rate must be determined for the entire related period. For example, if an employer begins laying off employees during the 2009 plan year and continues to do so in 2010, the IRS says that both plan years must be looked at together. This may result in a partial termination for the entire 2009-2010 period, even if the turnover rate in 2009 is less than 20%.

As partial terminations can be effective retroactively, an employer may not realize that a partial termination has occurred until after some participants have received the distribution of their benefits. Once participants receive distributions, it can be difficult to locate them because they do not keep the plan administrator up-to-date on their current addresses. Questions can arise about possible misallocation of amounts that should not have been forfeited. On the other hand, an improper partial termination may give rise to a claim by remaining participants that they should have received forfeitures wrongly eliminated, subjecting the plan to penalties and disqualification. These issues illustrate the importance of making a timely and proper determination of whether a partial termination has occurred.

Please contact your attorney at Moss & Barnett with any questions about partial terminations or any other issues relating to executive compensation and employee benefits.