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Small Employers Face Pandemic-Induced 401(k) Plan Challenges

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The Covid-19 pandemic and its shock to the country's economy have been felt particularly hard by small employers, who are also likely to face a number of looming problems with their 401(k) plans. This article discusses three of those problems.

FAILURE TO SATISFY REGULATORY AND OPERATIONAL REQUIREMENTS

Businesses grappling with the speed at which the pandemic overwhelmed their operations may have missed or had difficulty fulfilling regulatory requirements.

Take, for example, Form 5500, which 401(k) plans are required to file annually. For calendar year 401(k) plans, the due date for the 2019 Form 5500 filing was July 31, 2020, although that deadline could have been extended until October 15, 2020, by filing a Form 5558 with the IRS on or before July 31, 2020. Employers whose tax year and 401(k) plan year are both the calendar year are also able to extend the due date for filing their 2019 Form 5500 until Oct. 15, 2020, if they have been granted an extension to file their 2019 federal income tax return.

It will come as no surprise that harried businesses struggling for financial survival may not have gotten around to filing their 401(k) plan's 2019 Form 5500 by July 31, 2020. Even if a company obtained an extension for the Form, with the waves of layoffs and other problems that continue to bedevil the economy, it can be expected that many employers will miss the extended deadline.

Not filing a 2019 Form 5500 on time exposes an employer to potentially severe penalties: an IRS penalty (recently increased by The Setting Every Community Up for Retirement Enhancement Act of 2019 (SECURE Act))[1] of $250 per day, up to a maximum of $150,000, and a Department of Labor (DOL) penalty of $2,233 per day, with no maximum.

The DOL has in place a Delinquent Filer Voluntary Compliance Program (DFVCP), which provides a significantly reduced late filing penalty for plans that voluntarily file delinquent Forms 5500.[2] Employers that satisfy the requirements of DFVCP may also be able to obtain relief from the IRS penalty.[3] The existence, however, of mechanisms to ameliorate the DOL and IRS late filing penalties, which themselves entail a fair measure of complexity, will provide little consolation to companies struggling with the effects of Covid-19.

Cash-strapped small employers may also find themselves in the unenviable position of owing required contributions to their 401(k) plans for 2019 that they are no longer in a position to make. One likely candidate is the top-heavy minimum contribution. An employer that has a 401(k) plan in which 60% or more of the account balances as of the last day of the prior plan year (adjusted for certain distributions) are for ''key employees,'' as defined by the I.R.C., generally must make a three percent contribution for all of the employer's employees who are not key employees and who were eligible to make a contribution for the plan year and who are employed on the last day of the plan year.[4]

The IRS has not specified the date by which the top-heavy minimum contribution for a plan year must

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[1] Pub. L. No. 116-94.

[2] *See* https://www.dol.gov/sites/dolgov/files/ebsa/about-ebsa/our-activities/resource-center/faqs/dfvcp.pdf.

[3] Notice 2014-35.

[4] §416(c)(2)(A). All section references herein are to the Internal Revenue Code of 1986, as amended (the "Code"), or the Treasury

be made. Many practitioners, however, have looked to a regulation applicable to another I.R.C. provision, which sets the deadline by which an employer contribution must be made, in order to be credited for a year,[5] as a basis for taking the position that the deadline for a plan year's top-heavy minimum contribution is 30 days after the due date of the employer's federal income tax return for the tax year that coincides with or includes the last day of the plan year.

An employer that does not make the 2019 top-heavy minimum contribution on time faces the risk of its 401(k) plan losing its tax qualification. Although disqualification can be avoided by making the contribution (increased by missed earnings) at a later point in time, any number of small employers will go out of business without having done so.

SAFE HARBOR PLAN PROBLEMS

An employer is permitted to bypass the statutorily-imposed nondiscrimination testing applicable to 401(k) plan elective contributions and matching contributions by making ''safe harbor contributions'' to its 401(k) plan. These contributions may be in the form of either matching or nonelective contributions.

IRS regulations limit the ability of an employer to reduce or suspend safe harbor contributions after a plan year has begun. Under the regulations, an employer must either be operating at an economic loss for the plan year or have included a statement in the required annual notice to employees that the plan may be amended during the plan year to reduce or suspend safe harbor contributions.[6] If those requirements are met, the reduction or suspension of safe harbor contributions cannot take effect until the later of the date the plan is amended to make the change or 30 days after eligible employees are given notice of the change. Employees must be given a reasonable period of time after receiving the notice to modify their 401(k) elections.[7]

In Notice 2020-52, the IRS clarified that an employer may reduce or suspend safe harbor contributions for highly compensated employees by providing a notice to them of the change and an opportunity to modify their 401(k) election. This clarification reflects the fact that contributions on behalf of highly compensated employees are technically not safe harbor contributions.

Notice 2020-52 also temporarily eases the restrictions on plan amendments reducing or suspending safe harbor contributions. For plan amendments adopted by an employer between March 13, 2020, and August 31, 2020, an employer need not be operating at an economic loss for the plan year or have included a statement in the annual notice to employees that the plan may be amended during the plan year to reduce or suspend safe harbor contributions. The only requirement for amendments adopted during this period is that employees be notified of the change at least 30 days before the change takes effect. Nonelective (but not matching) safe harbor contributions may be reduced or suspended on less than 30 days notice to employees, as long as the employees receive the notice by August 31, 2020.

What does this mean for employers?

1. Although any sort of relief is always welcome, complying with even the relaxed requirements for a safe harbor contribution change will in many instances be impractical during the pandemic. Reducing or eliminating safe harbor contributions to a 401(k) plan without satisfying the IRS requirements can cause the plan to forfeit its tax qualification. Although the IRS has correction procedures to address a flawed safe harbor contribution change, taking advantage of these procedures will not be realistic for many businesses.

2. If an employer does successfully reduce or suspend safe harbor contributions to a 401(k) plan for a plan year, the IRS's regulations require that the elective contributions and matching contributions made to the plan must satisfy nondiscrimination testing for the entire plan year. Doing so for 2020 may bring unwelcome news in the form of a failed test, with the consequence that the plan is obligated to repay to highly compensated employees the portion of their elective contributions needed to pass the test. In addition, a failed test may result in the highly compensated employees having to forfeit some of their matching contributions.

An employer that stops making safe harbor contributions could consider performing the nondiscrimination test on an interim basis, and if necessary, reduce highly compensated employee 401(k) contributions during the balance of 2020 to avoid failing the test. Under the current circumstances, it is probable that many such employers will not run the test until after the end of the plan year. In that event, it is quite possible that a highly compensated employee who is impacted by the test's failure for 2020 may have terminated employment and taken a distribution of their plan account during 2020. If that happens, the employer would need to request a refund of any matching contributions that failure of the test required be forfeited. If the distribution had been rolled over to an IRA, the employer would have to inform the highly compensated employee that some of the elective con-

regulations promulgated thereunder, unless otherwise indicated.

[5] Reg. §1.415(c)-1(b)(6)(i)(B).

[6] Reg. §1.401(k)-3(g).

[7] Reg. §1.401(k)-3(g).

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tributions and/or matching contributions that were contributed to the IRA are not eligible for rollover treatment and are subject to adverse tax consequences if not removed from the IRA.

3. Apart from avoiding nondiscrimination testing, another benefit of making safe harbor contributions is that the employer does not have to make top-heavy minimum contributions, which are discussed above. This benefit is lost if safe harbor contributions are reduced or suspended mid-year.

As a result, an employer that suspends 2020 safe harbor contributions might find itself giving back the anticipated savings from the suspension by having to make a three percent top heavy minimum contribution in 2021. In most cases, this impact is reduced, at least somewhat, because safe harbor contributions made prior to the suspension can be counted toward the top heavy minimum and because the top heavy minimum does not have to be contributed for any employee who is not employed on the last day of the year. Still, there will be a variety of circumstances in which small employers will come to learn next year that suspending safe harbor contributions did not save them money, but rather had the opposite effect.

PARTIAL TERMINATIONS

A condition of tax qualification is that the document pursuant to which a 401(k) plan is maintained must specify that, upon a partial termination, all affected employees will be fully vested in the employer contributions made for them, without regard to the plan's vesting schedule.

The tax law does not define ''partial termination.'' Instead, the IRS's regulations state: ''Whether or not a partial termination of a qualified plan occurs (and the time of such event) shall be determined by the Commissioner with regard to all the facts and circumstances in a particular case. Such facts and circumstances include: the exclusion, by reason of a plan amendment or severance by the employer, of a group of employees who have previously been covered by the plan; and plan amendments which adversely affect the rights of employees to vest in benefits under the plan.''[8]

Among other things, this rather amorphous description leaves open the question of how many employees must be terminated to trigger a partial termination. To this end, in Rev. Rul. 2007-43, the IRS established a presumption that a reduction of 20% or more of the number of plan participants will be presumed to have resulted in a partial termination.

But, of course, there are uncertainties. To name a few:

- In applying the 20% standard, does one consider only plan participants with employer contributions that are not fully vested or do all plan participants get counted? The IRS says all plan participants. What about plan participants that are eligible to participate in a 401(k) plan, but have not elected to make 401(k) contributions? Are they, as the regulation states, ''covered by the plan''? Presumably, but not definitively, yes.
- The IRS has stated that, although the occurrence of a partial termination is typically evaluated for a single plan year, a series of related severances from employment that occurs in more than one year can be combined to produce a partial termination. Determining whether successive downsizings are related to each other can be difficult and may leave some unfortunate employers who have layoffs in both 2020 and 2021, not knowing at the end of 2020 if their 401(k) plan has had a partial termination.
- Another question is how a rehired employee is to be viewed in the context of a potential partial termination. In a Q&A added to its website on July 30, 2020, the IRS stated that a plan participant terminated in 2020 and rehired by the end of 2020 does not count for purposes of measuring whether there has been a partial termination.[9] Apparently, rehiring a group of employees in 2021, who had been laid off in 2020, will not save a 401(k) plan from having a partial termination. A similar point of potential confusion is how employees furloughed during 2020 and not brought back to work by the end of the year are to be treated. Will the outcome depend on whether the employer realistically believed on December 31, 2020, that it might bring the furloughed employees back, or will some other standard be used?
- Legislative changes that have shortened the permissible length of vesting schedules applicable to employer contributions have significantly reduced the practical effect of a partial termination. Nevertheless, if an employer who has terminated part of its workforce does not recognize that its 401(k) plan has had a partial termination and does not fully vest the plan participants whose employment was terminated, the plan can be disqualified. In addition (as if that isn't bad enough), the employer is exposed to potential employee claims for the failure to have their employer contributions fully vested.

CONCLUSION

As the examples discussed above illustrate, the combination of the complexity of the 401(k) plan

[8] Reg. §1.411(d)-2(b)(1).

[9] *See* https://www.irs.gov/newsroom/coronavirus-related-relief-for-retirement-plans-and-iras-questions-and-answers.

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rules and the unprecedented challenges created by the pandemic virtually assure that the 401(k) plans of a large number of small businesses will in one way or another fall out of compliance. Unfortunately, because of the manner in which the tax law is written, there is little that the IRS can do to address this problem. Any broad-based solution must come from Congress.

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