Severance of Employment, Layoff, or Furlough?

BY **ROBERT RICHTER** | MARCH 30, 2020

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PRACTICE MANAGEMENT

In the wake of the Coronavirus outbreak, one of the countless issues facing plan sponsors and practitioners alike is determining a participant's employment status, more specifically whether there has been a severance of employment.

This determination must be made in order to apply a wide variety of rules that apply with qualified plans, IRC §403(b) arrangements and IRC §457(b) plans.**1**

What's in a Name?

While many other terms are used to describe an individual's change in employment status, such as separation from service, termination of employment, retirement, layoff, leave of absence or furlough, these terms are largely irrelevant with respect to the qualification of retirement plans. Rather, the rules are based on whether there has been a "severance of employment."

A severance of employment is (drum roll please)… based on "facts and circumstances." While we do not have a bright line test that provides clarity for that determination, the reality is that we're probably better off because employment relationships vary so greatly. There is some limited guidance, however, that is helpful, briefly summarized as this: There is a severance of employment if:

1. the severance was in good faith (bona fide);
2. the individual is not treated as an employee for other purposes (such as pa

programs; and
3. there is a reasonable expectation the person will no longer be performing any more duties with the employer.**2**

What's an Employer Suppposed to Do?

It's unlikely the IRS would challenge a reasonable determination of employment status by an employer that is made in good faith, particularly in view of the extraordinary circumstances we are facing with the COVID-19 pandemic. Moreover, the determination has consequences that could extend beyond the plan.

Why it Matters

If there is a severance of employment:

1. It can be a distributable event (depends on the terms of the plan).

2. It may accelerate the due date of a participant's outstanding loan (depends on the loan terms and the plan provisions; an employer could, pursuant to the CARES Act,**3** allow a participant to extend the due date and term of loan repayments for up to one year).

3. If more than 20% of the organization's employees are determined to have had a severance then it could be a partial plan termination—a condition that requires full vesting of the affected participants.

4. If the former employee is being paid, then the plan must credit the former employee with hours of service, up to a maximum of 501 hours.

If there is not a severance of employment:

1. There is no distributable event nor a partial plan termination.

2. The loan provisions may nonetheless be impacted (depending on the loan terms and the plan provisions):

a. If the participant is on a leave of absence (e.g., a furlough) with no pay, or at a rate of pay (after application of withheld taxes) that is less than the amount of the loan payments, then the loan can be suspended for up to one year, though not beyond the maximum five-year limit (unless it was for the purchase of the participant's principal residence). Many plans already include this provision in their loan program.
b. If the plan takes advantage of the CARES Act provisions, payments may be suspended for up to one year and/or the loan term can be extended for up to one year.

3. Just as is the case with a former employee, if a current employee performs no duties but is being paid, then the plan must credit the employee with hours of service, up to a maximum of 501 hours.

4. If an employee performs no duties and is not being paid, then the plan must generally credit the employee with enough hours of service to prevent a break-in-service.

Facts and Circumstances: What About the Following Situations?

Situation #1: Company ABC reduced the hours of most employees, mainly to ensure those employees could maintain benefits. The employees are not performing any job functions. Is there a severance of employment?

No. In this situation, the individuals are (still) employees.

Situation #2: Company RST furloughed employees, planning to bring their status to full employment once business picks up. Is there a severance of employment?

Not yet. This situation is open to interpretation. It seems the employer expects business to pick up and therefore it appears there is a reasonable expectation that the furloughed employees will perfor
the future. This would indicate there has not yet been a severance of employment.

Situation #3: Company XYZ was forced to close retail operations and lay off most employees. The employees are removed from payroll but will most likely be re-hired in several months. Is there a severance of employment?

Probably. This is also open to interpretation. In this situation, however, the likelihood of performing future duties seems more tenuous than in Situation #2 because the business operations ceased. Thus, one might reasonably conclude that in this situation there has been a severance of employment.

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Footnotes

1. This article focuses on retirement plan issues and does not address the rules applicable to other types of employer provided benefits nor labor laws.

2. For those interested in a deeper dive into this issue, **IRS Private Letter Ruling 201221033** is a starting point. This ruling is unusual in that it's difficult to see how anyone, including the IRS, could have reached a different conclusion. It relates to retirement (not the term severance), but it provides insight into whether an employment relationship has ended. In the situation covered by the PLR, a defined benefit plan had an early retirement benefit. The issue addressed by the IRS was whether an employee had retired where the employees had an understanding with the employer that early retirements were undertaken with the intention that the employees would return to work the next day or within a week. Neither the employees nor the employer expected that there would be any actual interruption of their performance of services for the employer. Yes, it's a "Captain Obvious" result. The IRS concluded that, in general, the retirements were not bona fide, and could not be recognized by the plan as an early retirement.

To support its conclusion in the PLR, the IRS cited Treas. Reg. §1.409A-1(h)(1)(i) and (ii) as determinative of when an employee legitimately retires. Although that regulation is issued in the context of the nonqualified plan rules under IRC §409A, the IRS ruled that the principles in that regulation are equally applicable to qualified plans. Thus, if both the employer and the employee know at the time of "retirement" that the employee will, with reasonable certainty, continue to perform services for the employer, a termination of employment has not occurred, and the employee has not legitimately retired. The IRS also pointed to Meredith v. Allsteel, Inc., 11 F.3d 1354 (7th Cir. 1993), where the court held that the word "retire" must be given its ordinary meaning, which means to leave employment after a period of service. That court cited the Webster's Ninth Collegiate Dictionary 1007 (1986), which defines retire as "to withdraw from one's position or occupation: to conclude one's working or professional career." Thus, an employee does not legitimately retire if he or she does not actually leave employment upon retirement. The Treasury also warned in the preamble to its proposed regulations on phased, published in the November 10, 2004, Federal Register, that the regulations "specifically do not endorse a prearranged termination and rehire as constituting a full retirement.

3. Note that, following passage of the CARES Act, while this may be done immediately, the plan document and/or loan program will eventually need to be amended to include this provision.