

Retirement Plan Considerations in the Current Economy



By Peter Shuler and Lori Stuart

Although the market has recovered somewhat, negative investment returns for qualified retirement plans were front-page news for months, but poor returns are not the only consequence retirement plans might face as a result of the troubled economy. Authors Lori Stuart and Pete Shuler explore the significant impact the economic slowdown could have on 401(k) plans, profit-sharing plans, employee stock ownership plans (ESOPs), and similar defined contribution plans.

Since last year, much of the media's economic coverage has focused on the volatile behavior of investments. Many employees have seen the value of their retirement savings drop precipitously as their retirement plans attempted to weather the volatility. But the recession has implications for retirement plans that go beyond negative investment returns.

The Ripple Effect of Layoffs

The implications of company layoffs reach into many facets of the company,

including its retirement plan. Laying off 20 percent or more of active plan participants could trigger a partial plan termination, leading to the immediate 100 percent vesting of the account balances of the laid-off participants, regardless of their years of service and the plan's vesting schedule.

Many companies use the forfeiture of nonvested balances to fund employer contributions or to pay plan expenses. The immediate vesting triggered by a partial plan termination could drastically reduce the forfeitures available for these

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purposes, forcing the company to reduce the contribution or to fund more of the contribution from company cash. Similarly, plan expenses would then have to be borne either by participants or by the company directly.

Because nonpublicly traded companies sponsoring ESOPs must fund the distributions from those ESOPs, immediate vesting will increase cash outflow related to this funding. The increased funding needs will occur no more than five years after the layoff and could be significant, especially when the company is confronting other demands on its cash flow.

Layoffs can affect retirement plans in additional ways. The amount a company can contribute to a retirement plan is generally capped at 25 percent of the payroll of plan participants. A layoff will reduce the payroll and, in turn, reduce the maximum contribution a company can make. Most companies do not contribute at this level, but those that do, like those sponsoring leveraged ESOPs, could be affected adversely by the lower maximum contribution.

Retirement plans also are legally required to provide benefits to a certain percentage of employees. Many retirement plans require that participants be employed on the last day of the plan year to receive employer contributions. A layoff could cause the plan to provide benefits to too few participants.

Further, the “annual additions” that participants can receive in qualified retirement plans is capped at the lesser of 100 percent of their salary or (for 2009) \$49,000. Annual additions include employee deferrals, all employer contributions, and reallocated forfeitures. If layoffs reduce the number of participants

receiving employer contributions and reallocated forfeitures, those remaining will receive larger amounts and could exceed the statutory limit. And a layoff not large enough to trigger a partial plan termination could increase reallocated forfeitures, exacerbating this situation.

Reducing or Eliminating Contributions: Proceed With Caution

To conserve cash, many companies are reducing or eliminating contributions to their retirement plans. Most plans permit this exercise of discretion, but the suspension of contributions for more than a couple of years could trigger 100 percent vesting. Also, some plans require an amendment to reduce or eliminate contributions, and such amendments must be enacted before any participant has earned the right to receive the contribution.

The Potential Rush of Distribution Requests

Job losses in their household might cause employees to turn to distributions from their retirement plan, so plan sponsors could experience increased requests for in-service and hardship distributions and loans. The terms of a plan dictate the reasons for which a participant may receive a hardship distribution (such as paying medical bills or preventing eviction), and plan sponsors must adhere to these provisions. The reduced value of a participant’s account balance due to the down market will affect the amount available for a loan, especially if the participant has another loan outstanding.

If a company is forced to lay off employees, it will probably see a significant increase in distribution requests

because many terminated employees will need cash to replace lost wages. Most non-ESOP retirement plans offer immediate distributions, and the tidal wave of requests will likely occur quickly. ESOPs often impose a five-year wait for distributions due to termination other than death, disability, or retirement – which will postpone the rush for distributions. Because privately held ESOP companies must fund these distributions, the delay gives them time to arrange funding. Companies with ESOP provisions that don’t contain a five-year wait may be tempted to add one, but they must approach such an amendment carefully and with counsel, as a right earned by participants cannot generally be taken away.

One unanticipated consequence of significant distributions is that, if plan expenses are paid from plan assets, the remaining assets will absorb a larger percentage of those expenses. This will further depress already abysmal investment returns.

Covering and Controlling Plan Expenses

Expenses related to retirement plans are coming under scrutiny as companies seek to minimize cash outflow. Many plan-related expenses can be paid with plan assets, and companies that had been paying these expenses directly might consider this alternative. The rules covering the use of plan assets to pay expenses are not straightforward, and legal counsel should be consulted before undertaking such a change. It is also important to consider, as discussed above, the negative impact that paying expenses with assets will have on participant returns.

Companies seeking lower-cost alternatives should carefully analyze the services they will receive for the reduced cost. Proposals that appear to be less expensive initially might not include all necessary or desired services; a company might find little or no savings when fees for those services are included. In addition, some providers may have lower direct costs but higher asset-based charges. To achieve true savings, the total costs proposed for all needed or desired services should be compared to those currently being paid.

Calming Employee Fears

How are plan participants receiving information? In many cases, the scary scenarios repeated daily on the news are the only information employees receive about the economy and the markets where their funds are invested. Now is a great time to have the retirement plan's financial adviser hold educational meetings for plan participants. In addition to answering employees' questions about current market conditions, a good adviser can realign their focus to long-term results and the investment opportunities offered by the market.

For companies that sponsor an ESOP, frequent and open communication is vital in stressful times. Communication

vacuums are often quickly filled by rumors, and those stories may be far worse than reality. Honest discussions about the company's current financial health and future prospects could ease employees' minds and enlist their help in getting through tough times. Discussions can address ESOP fundamentals, such as how employees' everyday actions can influence the value of the company and, ultimately, their retirement balances.

In a tough economy, even the price of a healthy company can be dragged down. If this has happened to ESOP stock, it is important to emphasize the company's viability and explain the impact of external factors on the stock. It also may be advisable to compare the performance of private ESOP stock to that of stock in public markets.

Protect Your Company and Employees

If the issues discussed here hit home or even raise concerns, you should contact your plan's financial adviser, the firm that provides administrative services for your plan, or your ERISA counsel as soon as possible. With proper planning, as well as sensitivity to employee concerns, you can minimize some of the negative effects of economic conditions on your company.

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