Employee Benefits & Executive Compensation
Client Service Group

To: Our Clients and Friends January 26, 2009

Planning During a Recession: 2009 Employer Checklist

Introduction

The recession is now official. Employers are well aware how this has impacted their bottom lines and are looking to cut costs. The purpose of this checklist is to alert you to some of the potential effects – direct and indirect – of the downturn upon employee benefit and executive compensation planning and administration. Careful planning now can help employers determine whether and how to restructure benefits and compensation packages in order to minimize exposure to liability and reduce operational costs.

Layoffs/Severance Pay

A layoff is an obvious way to contain future costs. Some of the legal and practical issues to consider in implementing job terminations include the following:

- Termination or reduction of benefits under a severance pay plan subject to ERISA is permitted only if consistent with plan provisions on amendment and termination. The formal amendment authorizing the cutback must be duly authorized and executed, and ideally, affected employees would be notified before the cutback occurs.
- If an individual severance agreement or severance plan provides for cash or in-kind benefits for a period that lasts beyond the year of termination, it should be reviewed for compliance with the requirements of Internal Revenue Code Section 409A, which carries hefty penalties for non-compliance.
- A layoff can trigger partial termination of a company's tax-qualified retirement plan, requiring 100% vesting for the terminated employees. There is not a bright line test to determine when a partial termination occurs, but generally this issue must be considered if roughly 20% of participants cease accruing benefits under the plan. Involuntary terminations in prior or

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subsequent years may be required to be taken into account in determining whether there is a partial termination, depending on the facts and circumstances.

- Layoffs require attention to the COBRA rules for health plans, conversion rights under life insurance and disability plans, and rollovers under tax-qualified retirement plans. It is appropriate to review and update related administrative forms in advance, and to refresh the training of benefits staff.
- It may be appropriate to use an early retirement window under pension and medical plans to accomplish a reduction in force. The utility of these plans in structuring a window benefit will depend on the plans' funded status and the effect of the window on the employer's accounting cost.
- Be aware of your obligations under the Worker Adjustment and Retraining Notification ("WARN") Act.
- If you are obtaining releases relating to age claims under the ADEA, have your forms reviewed to make sure they are compliant with the current court decisions and rulings of the EEOC. You should also consult with employment counsel to make sure that any notice requirements of the Older Workers' Benefit Protection Act are met and to review potential discrimination claims that may arise from the layoff.

Health Plan Costs

Health plan costs are often scrutinized as a potential opportunity for cost cutting.

- Reduction of employer contributions and reductions in coverage under health plans must be carried out in accordance with ERISA requirements regarding plan amendments and participant disclosures. Advance notice of certain reductions in health benefits is required before such reductions can be effective.
- A reduction in health care coverage may allow your employees to make changes to Flexible Spending Arrangement ("FSA") medical spending account elections, if allowed under the terms of your cafeteria plan.
- Less generous health care coverage for new employees under a self-funded health plan could create discrimination issues under Internal Revenue Code Section 105(h).
- Consumer-driven health care options, such as a health savings account, health reimbursement account, or FSA may provide relatively low-cost coverage options.
- Institution of wellness programs designed to encourage healthy behavior by participants may reduce health plan costs; however, wellness programs may not discriminate on the basis of a mental or physical condition.

401(k), Profit-sharing and Money Purchase Plans

- If employer contributions are suspended in 2009 under a 401(k) plan that uses prior year non-discrimination testing, then matching contributions for highly compensated employees will not be possible in 2010 unless the plan switches permanently to current year testing. Current year testing lacks the certainty of prior year testing.
- Changes to a safe harbor design 401(k) plan will take the plan outside the safe harbor and testing will be required.
- There is a limited moratorium on age 70½ required minimum distributions for minimum distributions attributable to 2009, otherwise payable by April 1, 2010. There is no moratorium for minimum distributions attributable to 2008 which must be paid by April 1, 2009, or minimum distributions attributable to 2010. A plan amendment may be required to implement the 2009 moratorium.
- Employers may facilitate efficient administration of hardship distributions by switching to the safe harbor method for determining hardships.

Employee Stock Ownership Plans ("ESOPs")

- Plan sponsors may wish to review their distribution policy and take advantage of the maximum distribution period allowed for ESOPs if they are currently making distributions more rapidly than required.
- Plan sponsors may consider whether they should cause a special valuation date to be declared, if permitted by the plan, in order to protect the plan from large losses due to payments being made based on a stale valuation.

Single-Employer Defined Benefit Pension Plans

Legislation passed in 2008 relaxes certain funding requirements enacted in 2006.

- The 2006 legislation requires employers to fully fund the present value of all accrued benefits under a defined benefit plan over a period of seven years. Lower funding targets apply for 2008, 2009 and 2010, but missing the funding target for one of these three years accelerates the full funding obligation to the next year. The 2008 legislation provides that a plan that fails to meet the target for one of these three years is not required to satisfy the full funding obligation for the next year. However, the plan does have to meet the specified lower target that applies to the next year.
- The 2006 legislation requires a plan funded at less than 60% of its target in the current year to freeze future benefit accruals. The 2008 legislation substitutes the preceding year for the current year in making this determination for plan years beginning between October 1, 2008 and September 30, 2009. This allows plans that fell below the 60% target level in 2008 to provide benefit accruals in 2009.

Other restrictions related to a plan's funded status were not affected by the 2008 legislation.

- If a plan is not at least 60% funded, the plan may not make any lump sum distributions.
- If a plan is between 60% and 80% funded, lump sum distributions must be restricted but they need not be entirely eliminated.
- If a plan is not at least 110% funded, it cannot make lump sum distributions to the top 25 employees by compensation unless it provides that the affected employee must repay the restricted amount if plan funding requirements are not satisfied.
- If you are considering reduction in future benefit accruals, remember that advance notice of the reduction must be given to affected participants under ERISA and the Code. This notice may be required to include examples of how the reduction affects participants.

Multiemployer Defined Benefit Pension Plans

- Diminution of plan asset value increases the withdrawal liability of an employer that completely or partially withdraws from a multiemployer defined benefit pension plan.
- Plans are required by law to provide participating employers with estimates of withdrawal liability on payment of the cost of preparing the estimate, generally in the range of $500 or less. It is a good practice to request these statements on an annual basis to assist in planning.
- New rules issued by the Pension Benefit Guaranty Corporation on December 29, 2008 affect computation of an employer's withdrawal liability. If a plan is less than 65% funded, special rules apply.
- If you are contemplating a withdrawal or partial withdrawal from a multiemployer plan, you should check the plan's funding status. Since the withdrawal liability is based on the funding status as of the last valuation date prior to the withdrawal, careful planning of the timing of the withdrawal may avoid increased liability for current market losses.

Nonqualified Deferred Compensation Plans

Section 409A of the Internal Revenue Code imposes hefty penalties on employees and independent contractors who participate in nonqualified deferred compensation arrangements that do not satisfy applicable requirements. Even if a plan document satisfies the requirements of Section 409A, an operational deficiency may trigger imposition of these penalties.

- Recent guidance from the Internal Revenue Service prescribes methods for self-correcting certain operational errors and for computing the tax due in the event correction is either unavailable or untimely. It is important to administer plans correctly and to address any errors as soon as they are detected to make best use of the limited available relief. However, correction of an erroneous early payments of deferred compensation is not permitted if the erroneous payment occurred in a year in which the company experiences a substantial financial downturn.

- If a public company or any member of its controlled group has a defined benefit plan that is less than 80% funded, it may have to suspend funding of any rabbi trust relating to its nonqualified deferred compensation obligations or expose important executives to the penalties imposed by Section 409A.
- Normally, companies retain some discretion to terminate and liquidate nonqualified deferred compensation plans under Section 409A. This is prohibited when the company is experiencing a downturn in financial health.
- If making a scheduled payment would jeopardize a company's ability to continue as a going concern, the payment otherwise due may be temporarily suspended under Section 409A.

Fiduciary Responsibility under Tax-qualified Retirement Plans

- Given the volatility in the market and questions about the financial health of some insurance companies, brokerage houses and banks, companies should pay close attention to and monitor more frequently the investments they are offering under the plan and the investment professionals with whom they deal.
- Review the plan's investment policy statement on a regular basis; revise as circumstances require based on expert advice.
- Periodically review the performance of plan fiduciaries; make changes if necessary.
- For a plan with participant-directed accounts, consider implementing a qualified default investment arrangement for participants who do not provide direction.
- For a plan with participant-directed accounts, evaluate the plan's diversification as well as its documentary and operational compliance with ERISA Section 404(c), which limits the responsibility of plan fiduciaries with respect to participant-directed investments.
- Disclose risks and communicate strategy to plan participants without providing investment advice.
- Review fiduciary insurance policies to ensure officers and plan fiduciaries are appropriately covered.

Conclusion

Planning for benefits and compensation issues, while never simple, takes on new complexity because of the state of the economy. Thoughtful decision-making and careful consideration now can prevent unexpected consequences in the future. If you would like assistance in addressing these issues, please contact a member of the Employee Benefit and Executive Compensation Client Service Group.

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