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UPDATE Coronavirus furloughs vs. layoffs: What's the difference? And what does that difference mean for employer-sponsored retirement plans?

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ALERT UPDATE: The Coronavirus Aid, Relief, and Economic Security Act (the "CARES Act") was signed into law on March 27, 2020. The CARES Act contains a number of special rules aimed squarely at addressing several of the retirement plan issues covered in this alert. New updates are provided in this alert, in red, to reflect any changed guidance in the wake of the CARES Act.

Employers are scrambling to change their day-to-day operations in response to the unprecedented conditions created by the nationwide—and worldwide—response to the Novel Coronavirus (COVID-19) pandemic and the resulting impact on their businesses and organizations. Unfortunately, many employers are already facing the tough choices involved with reducing their workforces and dealing with the ramifications of those reductions on top of everything else.

In connection with those choices, the most commonly asked question we've heard from employers as the COVID-19 pandemic-related issues multiplied over the past few weeks is "What's the difference between a furlough and a layoff?"—followed closely by questions regarding what that difference means for the employer's retirement plan, and whether and how affected employees can withdraw funds from their accounts in their employer's retirement plan (e.g., a 401(k) plan, 403(b) plan, etc.).

The frequently asked questions (FAQs) below address these questions and discuss the employer-sponsored retirement plan issues employers should be thinking about as they communicate with both their employees and their retirement plan service providers in the days and weeks ahead:

Q1: What is a furlough?

A1: A furlough is the placing of an employee in a temporary nonduty, nonpay status because of lack of work or funds, or other nondisciplinary reasons.

Q2: What's the difference between a furlough and a layoff?

A2: Generally, a layoff is recorded by an employer as a termination of employment, not for any performance-related cause. An employer will use a furlough to retain staff it can't afford to pay but doesn't wish to lay off. In contrast, when an employer lays off employees, it terminates their employment with the employer.

Furloughed employees have an expectation that they will return to work with the same employer. Usually (but not always), an employer will specify a date or a condition for furloughed employees to resume their duties. Laid-off employees have no expectation that they will return to work with the same employer.

Q3: What can furloughed employees expect during the furlough period?

A3: Furloughed employees often retain some or all of their benefits, usually retaining access to health and life insurance during the furlough period, and remaining active—rather than terminated—participants in their employer-sponsored retirement plans.

Q4: What if a furloughed employee performs work for the employer during the furlough?

A4: Any time spent working for the employer by a furloughed employee triggers the requirement for the employer to pay for the time worked. An exempt employee generally is entitled to pay for a full week in any week in which they perform any work, and a non-exempt employee generally is entitled to pay for any work performed even if that work is performed outside the office.

For a more in-depth discussion of employers' responsibilities and applicable labor law requirements for furloughs and layoffs in response to COVID-19, please see the recent alert, "Workforce management in response to COVID-19 business interruptions and closures: Voluntary leaves, hours reductions, furloughs and layoffs," March 17, 2020.

Q5: Can a furloughed employee take a distribution from the retirement plan?

A5: Only if the plan permits in-service distributions. A furloughed employee still is an active participant for retirement plan purposes. Because a furloughed employee has not terminated employment, he or she may not take a termination distribution from the plan. However, a furloughed employee may be able to withdraw part of his or her account under the plan if the furloughed employee meets the plan's requirements to make a hardship withdrawal, take a participant loan, or otherwise take an in-service distribution.

It's very important for employers, and their plans' record keepers, to understand that a furloughed employee is not a terminated employee, and employers should take care to code or flag the furloughed employee's status appropriately for the plan's record keeper so that a furloughed employee is not mistakenly permitted to take a termination distribution from the plan. Doing so is an operational failure that the Internal Revenue Service (IRS) requires an employer to correct by restoring the distributed amount to the plan—and if the employer can't recover that amount from the employee, the employer may be on the hook for restoring the improperly distributed amount to the plan.

Employers with 401(k) or 403(b) plans that do not currently permit participant loans and/or hardship withdrawals may want to consider amending their plans—at least temporarily—to permit furloughed employees to take out participant loans, or to take hardship withdrawals if they meet the regulatory requirements for doing so. (See Q&A-5a and Q&A-5b below for a discussion of the coronavirus-related distributions and temporarily increased maximum participant loan amounts provided under the CARES Act for qualified individuals.) In addition, employers whose plans already permit loans, but limit the number of outstanding loans and/or prohibit the refinancing of existing loans, should consider amending their plans to allow additional outstanding loans and permit refinancing. Note, however, that many record keepers prohibit loan refinancing, so employers considering this option must check with their record keepers first before amending their plans.

Q5a: What distributions are available to furloughed employees under the CARES Act?

A5a: The CARES Act includes special rules applicable to certain in-service distributions and participant loans:

- Coronavirus-related distributions under the CARES Act

  The CARES Act allows certain qualified individuals—including furloughed employees—to take penalty-free in-service "coronavirus-related distributions" of up to $100,000 from their retirement plan accounts between January 1, 2020, and December 31, 2020. To be qualified, the individual must be a participant who is diagnosed with coronavirus or COVID-19, whose spouse or dependent is diagnosed with coronavirus or COVID-19, or who experiences adverse financial consequences due to quarantine, job loss, or work hour reductions; being unable to work due to the lack of child care because of the coronavirus or COVID-19; closure or reduced operating hours of an owned or operated business due to the coronavirus or COVID-19; or any other factors determined by the Department of Treasury. Employees who were furloughed by their employers in connection with the coronavirus or COVID-19 are qualified individuals.

- New participant loans under the CARES Act

  Qualified individuals (as described above) who take out new participant loans from their retirement plans during the 180-day period following the CARES Act (i.e., between March 27, 2020, and September 23, 2020) are permitted to borrow a maximum of $100,000 (or 100% of their vested account balance, if less). This doubles the usual maximum limitation of $50,000 (or 50% of their vested account balance, if less).

For an additional discussion of CARES Act provisions applicable to employer-sponsored retirement plans, please see the recent alert, "CARES Act includes several Employee-Benefits-related provisions," March 27, 2020.

Q5b: When will the coronavirus-related distributions and increased participant loan amounts permitted under the CARES Act be available to furloughed employees?

A5b: Employers who wish to make coronavirus-related distributions and/or increased participant loan amounts available to furloughed employees and other qualified individuals may do so immediately simply by operating their plans in compliance with the CARES Act. It's not necessary for employers to amend their plans before making these distributions and loans available, as employers aren't required to actually amend their plan documents until the last day of the plan year beginning on or after January 1, 2022 (i.e., December 31, 2022, for calendar year plans).

However, while the relief provided by the CARES Act's special rules for the use of retirement funds is optional (i.e., employers are not required to implement the special rules for coronavirus-related distributions and increased participant loan amounts), many record keepers are preemptively making these changes available on their record keeping platforms unless employers affirmatively opt out of the changes.

Q6: How will furloughed and laid-off employees with existing participant loans be affected?

A6: Furloughed employees with existing participant loans may end up defaulting on the outstanding balance of those loans if they're unable to make their regularly scheduled loan repayments (this is especially likely where their repayments must be made via payroll deduction). Laid-off employees are even more likely to default on their outstanding loan balances following their layoff, especially in situations where the plan does not permit manual repayments following termination of employment, or where a plan provides the immediate acceleration of outstanding loan balances upon termination of employment. Defaulted loan balances must be reported on Form 1099-R as taxable distributions to both furloughed and laid-off employees for the year the loan defaulted.

Although many plans provide a "cure period" to allow time for a participant to make up a missed payment before the defaulted loan balance is treated as taxable, the maximum amount of time for a cure period currently expires on the last day of the calendar quarter following the calendar quarter in which the payment was missed. For example, furloughed and laid-off employees who miss a loan payment on March 31st will be in default, and must make up that missed payment no later than June 30th (and potentially sooner than that if the plan uses a shorter cure period). (But see Q&A-6a below for a discussion of the special relief provided under the CARES Act for qualified individuals with existing participant loan balances.)

Employers whose plans don't provide for a cure period, or whose plans provide for a shorter cure period than the maximum permitted, should consider amending their plans to add a cure period or extend their existing cure period to the maximum permitted timeframe, and to eliminate acceleration upon termination of employment. In addition, wherever possible employers should coordinate with their service providers to implement procedures to facilitate manual check and ACH loan payments. (Again, however, see Q&A-6a below for a discussion of the special relief provided under the CARES Act for qualified individuals with existing outstanding participant loan balances.)

Q6a: What relief is available under the CARES Act to furloughed and laid-off employees with outstanding participant loan balances?

A6a: The CARES Act provides welcome relief by delaying certain loan payments for furloughed and laid-off employees (and other qualified individuals) with outstanding participant loan balances. This relief applies to loans with outstanding balances on or after March 27, 2020. (This means the relief is also available for the loans discussed in Q&A-5a above – even if the loans did not exist on March 27, 2020.)

If the due date for any loan payment for a qualified individual with an outstanding participant loan balance on or after March 27, 2020, occurs between March 27, 2020, and December 31, 2020, the due date for the loan payment is delayed for one year, and any subsequent loan payments will be adjusted to reflect the delayed due date and corresponding accrued interest. This one-year suspension doesn't count against the maximum loan term (five years for general loans and potentially longer for residential loans).

This relief extends by one year the time period by which a defaulted loan must be reported to the IRS as a deemed taxable distribution to the participant. As a result, it may not be necessary for employers whose plans have short cure periods or don't have cure periods at all to amend their plans to add a cure period or extend their existing cure period to the maximum permitted timeframe. Nevertheless, employers still will need to coordinate with their service providers to implement procedures to facilitate manual check and ACH loan payments. In addition, employers will need to ensure their service providers and record keepers are properly administering the loans, correctly accounting for the one-year loan payment suspensions, and accurately reporting any loans that ultimately default as deemed taxable distributions on Form 1099-R.

Q6b: When is the one-year suspension of loan payments for existing outstanding loan balances available to furloughed and laid-off employees?

A6b: Just like the coronavirus-related distribution and maximum participant loan amount discussed in Q&A-5b above, the one-year loan payment suspension is optional. Employers who wish to make the one-year loan payment suspension available to furloughed and laid-off employees and other qualified individuals may immediately operate their plans in compliance with the CARES Act. Employers will not be required to amend their plan documents to reflect these one-year loan payment suspensions until the last day of the plan year beginning on or after January 1, 2022 (i.e., December 31, 2022, for calendar year plans).

Because many record keepers are preemptively implementing the one-year loan payment suspensions available on their record keeping platforms, employers who have not already heard from their record keepers should contact their record keepers as soon as possible to coordinate the necessary administrative and accounting procedures.

Q7: How will furloughs and layoffs affect employer matching and nonelective contributions made to the plan this year?

A7: For those plans with allocation requirements for the matching and/or nonelective contributions made under their plans (e.g., a 1,000 hours/year requirement, or a requirement to be employed on the last day of the plan year, to receive an allocation of the contribution), furloughs may prevent employees from completing 1,000 hours during the year, and layoffs will preclude employees from receiving contributions under plans that require employment on the last day of the plan year. This may affect a plan's ability to satisfy the annual coverage and nondiscrimination testing requirements applicable to the plan, which in turn would require corrective action, and potentially corrective contributions, by the employer.

Note that employers still will be required to make certain types of contributions to the plan, such as safe harbor contributions, and matching or nonelective contributions that don't have any allocation requirements. While the associated costs of making these contributions for furloughed employees will be mitigated to the extent that employees have stopped deferring into the plan (i.e., they won't receive any match) and/or are not receiving compensation or are receiving reduced compensation (i.e., the matching or nonelective contribution will be lower), employers will need to take these costs into account as part of their decision-making and planning process in connection with any furloughs and layoffs.

Employers will need to coordinate with their service providers regarding any applicable coverage and nondiscrimination testing for the current plan year, and, if necessary, perform projections through the end of the plan year to determine whether their plan is likely to pass or fail the required testing. If the plan is projected to fail testing, the employer should consult with its counsel and service providers regarding plan design changes—both temporary and permanent—it can make now to address the projected testing failure.

Q8: What other potential retirement plan compliance issues should employers watch out for in connection with both furloughs and layoffs?

A8: The two compliance issues discussed below are likely to occur for many plans given the currently prevailing circumstances in the wake of COVID-19. This is not a complete list of compliance issues; employers should consult with their employee benefits attorney regarding their plans and any potential compliance issues specific to their plans.

- **Partial plan terminations**: If a group of participants is eliminated from a plan due to an involuntary termination of employment (i.e., layoffs), and the reduction in the number of participants is "significant" (i.e., approximately 20%), the IRS presumes that the plan had a "partial termination." Under a partial termination, the affected employees must be 100% vested. For those employers utilizing vesting schedules under their plans, this means that the laid-off employees who were either not vested or only partially vested when they were laid-off must be treated as 100% vested and will receive the entire amount of the employer contributions in their plan accounts when they take their distributions from the plan.

  Employers contemplating layoffs of 20% or more of their workforce should consult their employee benefits attorney regarding whether their plan has a partial termination, and will need to coordinate with their service providers to ensure vesting is properly credited and the correct amounts distributed from the plan when the affected employees take distributions. If any portion of affected employees' accounts under the plan are forfeited upon distribution, the IRS will treat that forfeiture as an operational failure, and will require the employer to correct the failure by making a corrective distribution of the forfeited amounts, plus earnings, to the affected employees. In addition, employers will need to coordinate with their service providers to ensure proper reporting on their required annual returns.

- **Untimely remittance of participant contributions**: Both furloughs and layoffs may impact payroll processing time, including the withholding of participant contributions —such as elective 401(k) or 403(b) deferrals and participant loan payments—and the associated reconciliation and remittance of those amounts to the plan. This is especially likely to occur where the furloughed or laid-off employees were the individuals who were responsible for the payroll processing and plan contribution reconciliation and remittance tasks.

  Because participant contributions are classified as plan assets before they're actually contributed to the plan, employers are subject to strict timing requirements for depositing participant contributions to their plans after they're withheld from employees' pay. Failure to timely deposit these contributions is both a fiduciary breach and a prohibited transaction, and employers will be liable for excise taxes that must be reported and paid to the IRS. In addition, employers must report late-deposited participant contributions on the annual Form 5500 return filed with the Department of Labor (DOL), which may trigger an inquiry or investigation by the DOL, and may necessitate correction via the DOL's Voluntary Fiduciary Correction program.

  Although a 7-business-day safe harbor rule is available for small plans (i.e., plans with fewer than 100 participants at the beginning of the plan year) so that contributions made within that time period are deemed to be timely deposited, contributions made outside that time period are not subject to the safe harbor, and no similar safe harbor rule is available to employers with large plans.

Employers should take steps now to establish or revise their internal procedures, and should coordinate with their service providers to ensure the timely remittance of participant contributions to their plans.

Q9: What else can employers do now to anticipate and/or mitigate these retirement plan compliance issues?

A9: Employers should contact their plan's service providers (third-party administrators, record keepers, vendors, consultants, etc.) now to notify them about the furloughs and/or layoffs, identify and properly label the affected participants' status on the service providers' computer systems, and communicate with the service providers regarding the appropriate messaging and notification to be provided to affected plan participants.

Due to the impact of the furloughs and layoffs on business operations, some employers whose plans provide for safe harbor contributions, or whose plans do not otherwise impose allocation requirements on non-safe harbor contributions, may soon encounter difficulties with meeting their obligations to make the contributions required under the terms of their plans. As discussed in Q&A-7 above, some of the cost of these contributions with respect to furloughed and laid-off employees will be mitigated to the extent that employees either stopped making deferral contributions to the plan (i.e., they won't receive a matching contribution) and/or are no longer receiving compensation or are receiving reduced compensation (i.e., any matching or nonelective contribution based on a percentage of pay will be lower).

To further mitigate this issue, however, employers may wish to consider amending their plans now, if possible, to prospectively eliminate required employer contributions and replace them with discretionary employer contributions. In certain cases, the anti-cutback rules applicable to accrued benefits under a plan, including the right to receive a particular contribution, may require advance notification regarding the discontinuation of contributions. Also, 401(k) plans structured with "safe harbor" contributions are subject to special limitations on reducing employer contributions mid-year. Accordingly, employers considering this change should consult with their employee benefits attorney before amending their plans.

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