

1976

Credited Service After ERISA

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Repository Citation

Lee, John W., "Credited Service After ERISA" (1976). *Faculty Publications*. 618.
<https://scholarship.law.wm.edu/facpubs/618>

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JOHN W. LEE*

Introduction

Pre-ERISA Participation, Vesting and Accrual of Benefits

Participation

Under pre-Employee Retirement Income Security Act of 1974 ("ERISA")¹ practice, retirement plans frequently required continuous employment or service for participation.² Plans could provide (but were not required to do so) that leaves of absence would constitute constructive continuous employment for such service requirement.³ Typically, in the context of participation, any service requirement (usually based on the date of hire) had to be completely satisfied on the annual entry date of the plan or the employee had to wait until the next entry date,⁴ although this could add as much as 11 additional months of service to his waiting period. For purposes of vesting, credit was commonly based on either full years of participation in the plan or, probably less frequently, full years of service since date of hire. A plan could provide

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¹ PUB. L. No. 93-406 (Sept. 2, 1974) (herein cited as ERISA).

² However, if this requirement, by excluding employees who regularly worked five or more months a year, prevented the plan from meeting the "breadth of coverage" test (under which 70 percent or more of all employees, exclusive of seasonal and part-time employees, or at least 70 percent of such employees had to be eligible under the plan and at least 80 percent of those eligible must participate) or all employees in any classification that was found by the Service not to be discriminatory in favor of the "prohibited group" or officers, shareholders, highly compensated employees and under prior law supervisors, the plan could be disqualified under pre-ERISA administrative practice. See Rev. Rul. 73-265, 1973-1 C.B. 195.

³ Cf. IRS, U.S. TREASURY DEP'T, PUBLICATION NO. 778, GUIDES FOR QUALIFICATION: PENSION, PROFIT-SHARING, AND STOCK BONUS PLANS pt. 4(f) (1972) (herein cited as PUB. No. 778).

⁴ Rev. Rul. 73-382, 1973-2 C.B. 134. But see Rev. Rul. 70-492, 1970-2 C.B. 92 (H.R. 10 plan).

that after an employee covered in a plan left the company's employment, upon rehire he again had to meet eligibility requirements just as did any new employee.⁵ Often, however, plans did provide for immediate re-entry (or at least at the next entry date) upon reemployment of a former participant, but they less commonly provided for pretermination service credit. Where such pretermination years of service or participation vesting credit was granted, such service usually applied only as to future contributions or accruals.⁶ In addition, many defined contribution plans required no contributions to be made on behalf of a participant in the year in which he separated from service unless he was still an active participant on the last day of the plan year—typically retired and deceased participants were deemed to be active participants until the last day of the plan year in which they retired or died so that they would receive contributions based upon their compensation for the part that they were employed of the plan year in which they died or retired.

Part-time employees—less than 20 hours a week or five months a year—did not have to be included in coverage for the numerical test of section 401(a)(3)(A), but apparently did have to be included applying the nondiscriminatory classification of section 401(a)(3)(B)⁷ and plans usually covered only full-time employees.

Plans frequently provided for a mandatory distribution of a participant's vested interest upon termination of employment prior to normal retirement age if it were less than a stated amount, often \$1,000. The timing of distributions in excess of this amount generally rested with the plan administrative committee, but it had to exercise its discretion, e.g., whether to cash out a participant or defer payment until the earlier of normal retirement age, death or disability, in a nondiscriminatory manner.⁸

Service, whether in the form of continuous service, full years of participation, hours a week or months a year, under prior law was only a building block for the largely statutory eligibility requirements and the equally larger administrative vesting requirements.

⁵ See Pub. No. 778, pt. 4(p).

⁶ See Rev. Rul. 70-126, 1970-1 C.B. 95.

⁷ Rev. Rul. 73-283, 1973-2 C.B. 133; Rev. Rul. 73-265, 1973-1 C.B. 195. *But see* Pepsi-Cola Niagara Bottling Corp., 48 T.C. 75 (1967), *rev'd on other grounds*, 399 F.2d 390 (2d Cir. 1968). The Treasury Department apparently hopes to preempt the next round in this particular controversy by providing in the temporary minimum participation regulations that for purposes of the nondiscriminatory classification test "all active employees (including employees who do not satisfy the minimum age or service requirements of the plan) are taken into account." Temp. Reg. § 11.410(b)-1(b)(2), 40 Fed. Reg. 45812, 45816 (Oct. 3, 1975).

⁸ Cf. Pub. No. 778, part 5(1). See Rev. Rul. 71-540, 1971-2 C.B. 206.

Vesting

Full vesting under prior law in the context of qualified corporate retirement plans was statutorily required only upon termination of the plan or complete discontinuance of contributions.⁹ The Code and the regulations did not require vesting in any other circumstances in a corporate plan prior to the time that a participant reached normal retirement age in a pension plan or stated age or other specified event in a profit sharing plan, but the Service had ruled that vesting must occur at such age or event.¹⁰ More significantly, the various District Directors of the Service, before issuing advance determination letters that a plan was qualified under section 401(a), required some degree of graded vesting¹¹ prior to normal retirement age or other specified event on the basis of the requirement in section 401(a)(4) that a plan would not qualify if contributions or benefits discriminated in favor of the prohibited group.¹² The Service reasoned that if forfeitures resulting from a lack of vesting would inure principally to the benefit of such group, the plan could not qualify.¹³ For a long period of time prior to 1970, many District Directors had informally required for advance ruling purposes that profit sharing plans provide for graded vesting at the rate of 10 percent a year commencing after three to five years of participation in the plan, with full vesting in all events within 15 years of participation.¹⁴ Vesting in defined benefit pension plans, particularly of larger employers, was generally much slower or nonexistent. Commencing after 1970, undoubtedly spurred by the proliferation of professional corporations in which turnover in many instances was high among the low paid group, many districts began to demand a much more rapid vesting schedule, first for professional corporations and then for closely

⁹ I.R.C. § 401(a)(7), prior to amendment by ERISA. Immediate vesting was, and continues to be, required as to H.R. 10 plans. I.R.C. § 401(d)(2)(A).

¹⁰ Pub. No. 778, pt. 5(c)(2).

¹¹ Graded vesting means a vesting formula under which a specified percentage of a participant's accrued benefits vest upon fulfillment of specified minimum service requirements. See MCGILL, *FUNDAMENTALS OF PRIVATE PENSIONS* 132 (3d ed. 1975) (herein cited as MCGILL). Vesting itself, referred to in the statute as a nonforfeitable right to a percentage of the participant's accrued benefit, refers to the right of a participant to receive his accrued retirement benefit at some stated point (no later than normal retirement age) whether or not he is in the service of the employer at such time. See *id.* at 130.

¹² Norman, *Private Pensions: A Study of Vesting, Funding and Integration*, 21 FLA. L. REV. 141, 164 (1968).

¹³ IRS, U.S. TREASURY DEP'T, PUBLICATION No. 794, *FAVORABLE DETERMINATION LETTER* (1973).

¹⁴ Norman, *Private Pensions: A Study of Vesting, Funding and Integration*, 21 FLA. L. REV. 141 (1968).

held businesses in general. For instance, a requirement generally applied by late 1972 in many districts to all closely held corporations was 20 percent vesting for each year of participation beginning with the first year of participation and full vesting at the completion of five years of participation.¹⁵ By late 1973, perhaps in anticipation of legislation, some districts had relaxed this requirement for closely held nonprofessional corporations, in some instances, back to as little as 10 percent for each year of participation. Other districts at that time imposed requirements based on the number of nonstockholder participants, such as 100 percent vesting for new corporations with only one or two nonstockholder participants; 20 percent vesting a year if a corporation had three to nine nonstockholder participants; and 10 percent a year for corporations with ten or more nonstockholder participants.¹⁶ There was, however, no national uniformity.¹⁷

Accrual of Benefits

Many defined contribution plans prior to ERISA provided that no allocation of any employer contribution or forfeitures would be made to participants who separated from employment prior to the last day of the plan year. Hence, no benefit was accrued, *i.e.*, contribution allocated, to terminated employees. All participants who were still employed on the last day of the plan year usually received an allocation of the

¹⁵ *Tax Clinic*, 3 TAX ADVISOR 614 (1972).

¹⁶ *Tax Clinic*, 5 TAX ADVISOR 26-27 (1974); *Points to Remember*, 27 TAX LAWYER 521 (1974).

¹⁷ It was suggested to the Senate Committee on Finance that the anti-discrimination provisions of the Code prior to ERISA had not been interpreted uniformly throughout the country, and the committee warned "that appropriate guidelines should be provided to the district offices to achieve a uniform interpretation of the law." S. REP. NO. 93-383, 93d Cong., 1st Sess. 47 (1973). The conference committee took a different tack, as discussed below, while recognizing that the law in the area of vesting and discrimination had been administered on a case by case basis in the past, without uniform results in similar fact situations, directed the Service not to require a vesting schedule more stringent than 40 percent vesting after four years of employment with 5 percent additional vesting for each of the next two years, and 10 percent additional vesting for each of the following five years, and to apply this more rapid vesting requirement only where the rate of likely turnover for officers, shareholders, or highly compensated employees with substantially less (perhaps as much as 50 percent less) than the rate of likely turnover for rank and file employees. H.R. REP. NO. 93-1280, 93d Cong., 2d Sess. 276-77 (1974). In Revenue Procedure 75-49, 1975-48 I.R.B. 34, the Service adopted an advance ruling position that should satisfy both the Senate Committee on Finance and the conference committee. On a national basis the above-described vesting formula, dubbed the four-forty vesting test, will be applied only where the plan cannot meet a key employee test or a turnover test, or both in some circumstances.

employer contributions, if any (and forfeitures, if any, where the plans allocated forfeitures to participants' accounts), in proportion to their compensation, or taking into account social security contributions by the employer under an integration formula,¹⁸ or a weighted allocation with years of service and compensation both considered.¹⁹ Less than full-time service under all of these allocation formulas was reflected in a reduced allocation.

In a defined benefit plan, prior to ERISA, much flexibility and fluidity as to benefit accruals was permitted. The employer had complete discretion as to the pattern of benefit accruals built into the plan so long as it did not favor the prohibited group.²⁰ Flat amount formulas in defined benefit plans prior to ERISA generally did not reflect the employee's length of service directly. However, in effect, service was usually recognized since most such plans required that an employee must have been employed for some period of time by his normal retirement age, such as 25 years.²¹ The flat percentage of earnings formula—such as 20 to 40 percent of earnings on either a career average or final average basis—usually did not take an employee's service into account. However, if such plans required that the employee have completed a minimum period of service by his normal retirement date or provided for a proportionately reduced benefit if his service was less than the required number of years, they did take service into account.²²

A substantially different formula, which probably was the model for the hours of service approach under ERISA, was frequently found in negotiated plans: a flat dollar amount for each year of service accumulated by the employee.²³ The dollar amount varied, of course, from plan to plan, but in the early 1970's a benefit of \$2, \$4, or even as much

¹⁸ See Rev. Rul. 71-446, 1971-2 C.B. 187.

¹⁹ Rev. Rul. 68-653, 1968-2 C.B. 177; see Reg. § 1.401-4(a)(2)(iii).

²⁰ MCGILL at 104.

²¹ ALLEN, MELONE & ROSENBLOOM, *PENSION PLANNING* 36 (3d ed. 1976). The flat benefit plan provides a flat dollar amount, generally to all employees who satisfied the minimum period of credited service. This type of formula was typical of early plans negotiated between management and labor, the pattern being a flat benefit of \$100 per month, offset for the social security primary old age insurance amount, for 25 years of service. As these plans were renegotiated, the flat benefit was increased and modifications introduced. MCGILL at 102.

²² This formula provides for a retirement benefit based upon a percentage of earnings, usually ranging from 20 to 40 percent, and usually apply a different percentage as compensation below and above the taxable wage base, thereby employing the step rate formula of integration. This type of plan has been used frequently, particularly in defined benefit plans that covered salaried or clerical employees. ALLEN, MELONE & ROSENBLOOM, *PENSION PLANNING* 37 (3d ed. 1976).

²³ *Id.* at 39.

as \$8 or \$9 a month for each year of service was not uncommon. Such a formula frequently required that an employee work for a minimum number of hours of service during a plan year in order to accrue a full benefit credit for such year. Minimums often used for this purpose were 1,600 and 1,800 hours and if an employee worked less than the required number of hours in a given year, he usually received some proportionate credit for the actual hours worked.²⁴

Under the unit credit or past and future service formula, an employee received a benefit credit equal to a percentage of his earnings for each year that he was a participant under the plan.²⁵ The percentage of earnings credited varied from plan to plan, a typical percentage would be 1 percent or 1.25 percent per year of credited service. Such plans, by pegging the benefit credit to a formula taking into consideration each year that the employee was a participant under the plan, in effect, frequently required a full year of coverage as a participant for credit.

Overview of ERISA Participation, Vesting and Accrual Rules

Participation

The purpose of minimum service and minimum age requirements for entry into a plan is to ease plans' administrative burdens by eliminating the need to keep records for employees who usually display a higher turnover rate, such as recently hired employees and younger employees.²⁶ In outline form ERISA prohibits covered plans from requiring age and service participation requirements any stricter than one year of service and attainment of age 25.²⁷ The one year of service requirement can, however, be lengthened to three years of service if the plan provides for immediate vesting upon entry into the plan.²⁸ This exception was designed to accommodate the type of plans prevalent in the college teacher's area²⁹ and to permit the prior H.R. 10 plan limitations to continue unchanged.³⁰ Similarly, as an alternative, the age 25 component may be extended to age 30 in plans maintained exclusively for employees of a governmental or tax-exempt educational organization if the plan provides for full and immediate vesting and entry after one

²⁴ *Ibid.*

²⁵ *Ibid.*

²⁶ 120 CONG. REC. H8703 (1974); *cf.* S. REP. NO. 93-127, 93d Cong., 1st Sess. 19 (1974). *See generally* MCGILL at 82.

²⁷ I.R.C. § 410(a)(1)(A).

²⁸ I.R.C. § 410(a)(1)(B)(i).

²⁹ S. REP. NO. 93-127, 93d Cong., 1st Sess. 19-20 (1974).

³⁰ MCGILL at 83.

year of service.³¹ This requirement is widespread among plans funded through the facilities of the Teachers Insurance and Annuity Association and its affiliate, the College Retirement Equities Fund.³²

Entry Dates. The minimum age and participation standards of ERISA³³ also require that a plan must provide that an otherwise qualified employee commences participation no later than (1) the first day of the first plan year commencing after the date on which such employee first satisfied the minimum age and service requirements, if any, or (2) six months after the date on which he satisfied them, unless he has separated from the service before the applicable entry date. Thus, an employee age 25 or older generally must be admitted to a plan within six months after his personal anniversary date of employment or by the beginning of the first plan year following such date, whichever occurs earlier. These rules do not, however, require participation if the employee "separated from the service" prior to the applicable entry date. Neither the Code nor the regulations³⁴ define this term, but the conference report indicates that it means that an employee is discharged or quits, but does not include a temporary absence due to sick leave, vacation, strike or seasonal layoff.³⁵

This six month rule in effect requires no more than semi-annual entry dates in a corporate retirement plan. It would appear that this rule is not available for H.R. 10 plans, which must bring in common-law employees no later than the third anniversary of the date of hire.³⁶ While the minimum participation standards relate solely to age and service conditions and do not preclude a plan from establishing other conditions, such as employment within a specified job classification (subject, of course, to the 70/80 or nondiscriminatory classification test of section 410(b)), plan provisions may be treated under section 11.410(a)-3(e) of the temporary regulations as imposing age and service requirements, even though they do not specifically refer to age

³¹ I.R.C. § 410(a)(1)(B)(ii).

³² MCGILL at 83.

³³ I.R.C. § 410(a)(4).

³⁴ See Temp. Reg. § 11.410(a)-4(b)(1), 40 Fed. Reg. 45812, 45815 (Oct. 3, 1975).

³⁵ H.R. REP. NO. 93-1280, 93d Cong., 2d Sess. 262-63 (1974).

³⁶ See I.R.C. § 401(d)(3)(A). See also Prop. Labor Reg. § 2530.202-2(c)(1)(ii), 40 Fed. Reg. 41654, 41665 (Sept. 8, 1975). This H.R. 10 rule is probably the reason that the proposed labor regulations do not permit a shiftover where the plan uses a three year waiting period from eligibility computation periods based upon date of hire to the vesting computation periods, generally the plan year, until after the employee has completed the three years of service requirement, uninterrupted by a one year break in service.

or service where they have the effect of requiring an age or service requirement with the employer.³⁷

Maximum Age. Many pre-ERISA plans imposed a maximum age limitation as well as a minimum age limitation. The purpose of such limitation in a defined benefit plan was to hold down the cost of the plan and to limit the employer's plan obligations to those employees who had rendered a substantial amount of service prior to retirement.³⁸ In defined contribution plans undoubtedly the rationale for exclusion was that such a plan would not prolong in any event the longevity of older employees. ERISA generally provides that no employee can be denied participation under a maximum age provision unless (1) he is within five years of normal retirement age at the time that he began work and (2) the plan is a defined benefit or target benefit plan.³⁹ The exception for defined benefit plans was grounded on a desire to avoid making it more difficult for older workers to find employment since it is more expensive under such plans for the plan sponsor to finance an equivalent retirement benefit for an older rather than a younger employee.⁴⁰ Target benefit plans in turn were included in the exception under the theory that in many respects the pattern of cost and benefits

³⁷ 40 Fed. Reg. 45812, 45814 (Oct. 3, 1975).

Example (1). Corporation A is divided into two divisions. In order to work in division 2 an employee must first have been employed in division 1 for 5 years. A plan provision which required division 2 employment for participation will be treated as a service requirement because such a provision has the effect of requiring 5 years of service.

Example (2). Plan B requires as a condition of participation that each employee have had a driver's license for 15 years or more. This provision will be treated as an age requirement because such a provision has the effect of requiring an employee to attain a specified age.

Example (3). A plan which requires 1 year of service as a condition of participation also excludes a part-time or seasonal employee if his customary employment is for not more than 20 hours per week or 5 months in any plan year. The plan does not qualify because the provision could result in the exclusion by reason of a minimum service requirement of an employee who has completed a year of service. The plan would not qualify even though after excluding all such employees, the plan satisfied the coverage requirements of section 410(b).

Example (4). Employer A establishes a plan which covers employees who have retired and which does not cover current employees. The plan fails to satisfy the requirements of section 410(a) because the plan imposes a minimum age and service requirement in excess of that allowed by this section.

³⁸ MCGILL at 84.

³⁹ I.R.C. § 410(a)(2).

⁴⁰ H.R. REP. NO. 93-807, 93d Cong., 2d Sess. 17 (1974). See also *Hearings on S. 4, S. 1179, and S. 1631 Before the Subcommittee on Private Pension Plans of the Senate Committee on Finance*, 93d Cong., 1st Sess. 341 (1973) (testimony of Secretary of the Treasury Shultz).

in such plans closely resembles the pattern of defined benefit plans.⁴¹ Where a plan defines normal retirement age as the later of age 65 or the tenth anniversary of the employee's participation in the plan (a design feature intended to minimize the cost of benefits for employees near retirement when the plan is established or in some professional corporations that desire to take advantage of certain integration formulas to enable older participants to still obtain maximum benefits under the plan⁴²) no maximum age limitation can be imposed under ERISA since no one would ever be within five years of normal retirement age when first employed.

The minimum age and service requirements for participation pertain only to the time when the employee will first enter into the plan. Entry into the plan is closely correlated with accrual of benefits, at least in defined benefit plans. These rules have nothing to say about what service must be recognized for purposes of determining a participant's place on the vesting schedule. And ERISA apparently does not require retroactive recognition of preparticipation service for purposes of benefit accrual, while in most instances it does for determination of the participant's vesting status.

Vesting

Under ERISA a plan is required to meet one of three minimum vesting schedules.⁴³ Vesting refers to the right of a participant to receive his accrued pension benefit—or account balance in the case of a defined contribution plan—at normal or early retirement whether or not he is in the service of the employer at that time.⁴⁴ The term that the statute uses is a nonforfeitable right. However, such nonforfeitable or vested right may nevertheless be terminated upon the occurrence of certain events.⁴⁵ Thus, a vested or nonforfeitable accrued benefit may in some circumstances be terminated by the participant's death prior to normal or early retirement if the plan so provides.⁴⁶ Historically, defined contribution plans have not so provided, but defined benefit plans have.⁴⁷ Vesting is either immediate or deferred; in the latter case full vesting is

⁴¹ H.R. REP. NO. 93-1280, 93d Cong., 2d Sess. 262 (1974).

⁴² MCGILL at 84.

⁴³ I.R.C. § 411(a)(2).

⁴⁴ MCGILL at 130.

⁴⁵ I.R.C. § 411(a)(3). *See generally* MCGILL at 139.

⁴⁶ I.R.C. § 411(a)(3)(A); Temp. Reg. § 11.411(a)-4(b)(1), 40 Fed. Reg. 51421, 51423 (Nov. 5, 1975).

⁴⁷ *See generally* MELONE & ALLEN, PENSION PLANNING, 298-308 (2d ed. 1972); MCGILL at 131.

generally deferred until stipulated service requirements are met.⁴⁸ Deferred vesting in turn may be broken down into full vesting and graded vesting. Full vesting exists where, upon the satisfaction of certain service requirements, all accrued benefits at that time vest in their entirety and, as benefits accrue thereafter, they also are completely vested.⁴⁹ Graded vesting consists of a vesting formula under which only a specified percentage of a participant's accrued benefits vests upon fulfillment of specified minimum requirements.⁵⁰ The fact that a participant has a nonforfeitable accrued benefit does not necessarily mean that upon separation from service he will at that time receive such benefit; it may be deferred, for example, until the plan year in which he would have reached normal retirement age had he remained in the employ of the company.⁵¹ But, frequently, where lesser amounts are involved, the plan can provide for, and in some instances may mandate, that a terminating employee take the full actuarial value, in the case of a defined benefit plan, and the account balance, in the case of a defined contribution plan, that is nonforfeitable at the time of his separation from service, in cash in the plan year, or shortly thereafter, in which he separates from service.⁵²

Minimum Vesting Schedule. Under ERISA a plan is required to meet one of three minimum vesting schedules.

(1) Under the five to 15 year graded vesting alternative, an employee must be at least 25 percent vested in his accrued benefit after five years of covered service, with 5 percent additional vesting for each of the next five years, and 10 percent additional vesting for each year thereafter.⁵³

(2) Under the 10 year notch or cliff alternative, which is a full vesting schedule, a plan can provide that each employee must be 100 percent vested after ten years of service.⁵⁴

⁴⁸ MCGILL at 131.

⁴⁹ *Ibid.*

⁵⁰ *Ibid.*

⁵¹ *Id.* at 132-34. See I.R.C. § 401(a)(14)(A).

⁵² MCGILL at 134. Cf. I.R.C. § 411(a)(7)(B).

⁵³ I.R.C. § 411(a)(2)(B). This graded vested option was designed to permit a gradual vesting (avoiding the "notch" effect of the ten year cliff vesting) on an age neutral basis (unlike the "rule of 45" vesting option). H.R. REP. NO. 93-807, 93d Cong., 2d Sess. 55 (1974). This approach has the advantage of some vesting at a relatively early option and of minimizing the cost of vesting by being gradual. *Ibid.*

⁵⁴ I.R.C. § 411(a)(2)(A). This notch or cliff vesting—no vesting for nine years and then 100 percent at the end of the tenth year—was provided because it affords participants full or complete vesting protection at the completion of a

(3) A plan under the rule of 45 can provide that each employee with five or more years of service will be 50 percent vested when the sum of his age and years of service equals or exceeds 45 (provided that he has completed five years of service at that time), with 10 percent additional vesting for each year thereafter, provided, that in any event each employee with ten years of covered service, regardless of his age, must be at least 50 percent vested at such time and vest at an additional 10 percent a year thereafter.⁵⁵

Although the pattern of vesting under these three minimum vesting standards is quite different,⁵⁶ their cost in a defined benefit plan is similar.⁵⁷ Yet when vesting is viewed not from the viewpoint of cost to the plan, but instead from the viewpoint that (1) retirement benefits are provided in lieu of current compensation⁵⁸ and (2) deferred rather

relatively short period of service, and the employee who stays ten years has greater vesting protection than under the graded vesting alternative. H.R. REP. NO. 93-807, 93d Cong., 2d Sess. 20, 55 (1974). This notch vesting, however, has been criticized as giving an employer too much of an incentive to dismiss employees rather than absorb the sharp increase in plan costs. Speech by John Hall, Association for Advanced Life Underwriting 12, May 10, 1974; S. REP. NO. 93-383, 93d Cong., 1st Sess. 46 (1973). Such dismissal would, however, constitute a violation of section 510 of ERISA, which renders it unlawful for any person to interfere with rights protected under ERISA.

⁵⁵ I.R.C. § 411(a)(2)(C). This alternative minimum vesting option was designed for firms that wish to provide faster vesting for their more mature employees than for their younger employees. See H.R. REP. NO. 93-807, 93d Cong., 2d Sess. 19, 55 (1974).

⁵⁶ WINKLEVOSS, ANALYSIS OF THE COST OF VESTING IN PENSION PLANS 88-89 (U.S. Dep't of Labor 1972); see *Hearings on H.R. 2 and H.R. 462 Before the General Subcommittee on Labor of the House Committee on Education and Labor*, 93d Cong., 1st Sess. 81 (1973). From this, one commentator has concluded that the three alternate vesting standards provide about the same amount of vesting, in the aggregate, but the distribution of vested benefits varies. For example, employees who are young upon their entry into a pension plan would achieve a fully vested status more quickly under the ten year notch standard. On the other hand, in most plans a higher percentage of employees would have some degree of vesting under the five to 15 graded vesting and rule of 45 vesting formula. Obviously, under the rule of 45 the older an employee is upon entry into the plan, the more quickly that he will achieve a vested status. The normal cost for a plan with a representative age and service distribution and a moderate rate of employee terminations would be about 15 to 20 percent higher in a defined benefit plan under any of these three vesting standards than it would be in the absence of any disability, early retirement or preretirement vesting. MCGILL at 138. Of course, most plans had some provision for preretirement benefit, so that the costs in defined benefit plans of adopting one of the three minimum vesting schedules is usually quite minimal.

⁵⁷ MCGILL at 138.

⁵⁸ S. REP. NO. 93-383, 93d Cong., 1st Sess. 45 (1973); H.R. REP. NO. 93-807, 93d Cong., 2d Sess. 53 (1974).

than immediate vesting is permitted only because otherwise the increased costs (primarily to defined benefit plans) of immediate vesting might cause plan terminations and serve as an impediment to the installation of new plans,⁵⁹ any vesting formula that does not result in proportionate distribution of vested benefits among all employees according to their service is inequitable.⁶⁰

Four-Forty Antidiscrimination Vesting Formula. ERISA provides that a plan that satisfies any one of the alternative minimum vesting requirements set forth above is deemed to satisfy any vesting requirement resulting from the application of section 401(a)(4) unless "(A) there has been a pattern of abuse under the plan (such as dismissal of employees before their accrued benefits become nonforfeitable) tending to discriminate in favor of employees who are officers, shareholders, or highly compensated, or (B) there have been, or there is reason to believe there will be, an accrual of benefits or forfeitures tending to discriminate in favor of employees who are officers, shareholders, or highly compensated."⁶¹ The latter exception in essence constituted the basis under prior law for requiring vesting, particularly in smaller corporations, which was much more rapid than any of the three minimum vesting schedules. However, the conference report, concerned with uniformity and, apparently, parity among small and large corporations, made statements that will undoubtedly change the development of the previously informal requirement of more rapid vesting where forfeitures would tend to inure to the benefit of the prohibited group. Since the conference

⁵⁹ S. REP. NO. 93-383, 93d Cong., 1st Sess. 18-19 (1973); H.R. REP. NO. 93-807, 93d Cong., 2d Sess. 19 (1974); *Hearings on H.R. 2 and H.R. 462 Before the General Subcommittee on Labor of the House Committee on Education and Labor*, 93d Cong., 1st Sess. 235, 330, 411, 509 (1973); *Hearings on S. 4, S. 1179, and S. 1631 Before the Subcommittee on Private Pension Plans of the Senate Committee on Finance*, 93d Cong., 1st Sess. 341-46 (1973).

⁶⁰ This reasoning probably is the unarticulated reason that H.R. 4200, as passed by the Senate, 93d Cong. 1st Sess. § 221(2) (1973), permitted only the graded five to 15 year vesting for new plans. However, the House committees and the conference committee adopted the approach of three alternative minimum vesting standards, on the grounds that only with such alternatives was adequate flexibility provided so as to mold all plans into one mold. See H.R. REP. NO. 93-807, 93d Cong., 2d Sess. 19 (1974); 120 Cong. Rec. H1136, H1142, H1146 (1974). Since, however, such flexibility results in employees other than those who earned their benefit accruals benefitting from actual funding in defined benefit plans through vesting that may favor other employees, the final provisions approved by Congress may be viewed as a withdrawal from the stance that retirement benefits are provided in lieu of current compensation to participants and a concession to interest groups that wished to pick and choose among which employees they would reward with vested benefits—long-term employees, older employees, et cetera.

⁶¹ I.R.C. § 411(d)(1).

committee recognized that the law had been administered on a case by case basis, the conference report directed the Service, except where actual misuse of the plan occurred in operation, not to require a vesting schedule more stringent than the 40 percent after four years of *employment* (not years of service) with 5 percent additional vesting for each of the next two years, and 10 percent additional vesting for each of the following years, with full vesting in 11 years.⁶²

The Service referred to the vesting schedule as the "four-forty" test in Revenue Procedure 75-49,⁶³ announced in early November 1975. Under this procedure the Service provided that an advance determination letter would not be issued as to the initial qualification or any amendment of a plan (that provides contributions or benefits for members of the prohibited group) as to whether such plan's vesting schedule might discriminate in favor of such group, unless the plan provided for vesting as rapid as the four-forty schedule or meets a "key employee" test (relating to the percentage that key employees constitute of the prohibited group)⁶⁴ or a "turnover" test (relating to the rates of turnover or terminations among the prohibited group and the rank and file⁶⁵) or both.⁶⁶ Revenue Procedure 75-49 did not speak to existing

⁶² H.R. REP. NO. 93-1280, 93d Cong., 2d Sess. 276 (1974).

⁶³ 1975-48 I.R.B. 34 (Dec. 1).

⁶⁴ Section 3.03(1) of Revenue Procedure 75-49, sets forth the key employee test as the percentage of the plan participants who are key employees of the class of employees who constitute the prohibited group, *i.e.*, officers, shareholders or those highly compensated. Section 5.01 of Revenue Procedure 75-49 defines a key employee as an employee who is (1) a shareholder, (2) an officer of the employer and among the five most highly compensated employees of the employer or (3) a partner who owns more than 5 percent of either the capital interest or the profits interest in such partnership. The term shareholder in turn is limited to a 5 percent shareholder (voting power or total value), using the attribution rules of section 1563(e) of the Code. The applicable percentage of the prohibited group, which if the key employees exceed means that the key employee test is not satisfied, turns on the number of months in the relevant employment period consecutive full calendar months during which an employer has one or more employees ending with the last month of the pre-application year: 36 or fewer months, 30 percent; 72 or fewer months but more than 36 months, 40 percent; more than 72 months, 50 percent. This test is not applicable if the pre-application year begins after the employer's employment experience exceeds 40 employment years or periods of 12 months during which a rank and file employee is continuously employed by the employer. *Id.* at § 5.02.

⁶⁵ The turnover test is not satisfied if the rank and file turnover rate for the 80 month period ending on the last day of the pre-application year exceeds the greater of (1) 6 percent or (2) the applicable percentage of the prohibited group turnover rate. Again, the applicable percentage turns on the number of months in the relevant employment: 48 or fewer, 300 percent; 60 or fewer but more than 48, 250 percent; and more than 60, 200 percent. *Id.* at § 3.03(2). Apparently the basis for the more lenient requirement for younger companies was a belief that turnover would be highest in the first years of an enterprise.

plans with faster than four-forty vesting standards relaxing their standards to the four-forty schedule.⁶⁷

The Service's turnover test is supported by the more recent case law, as well as the above legislative history. Prior to ERISA, the test used by the Service seems to have been whether a lack of vesting resulted in the plan benefits inuring principally to the benefit of the prohibited group,⁶⁸ and the thrust of its application of the vesting provisions seems to have been to determine whether the plan was for the exclusive benefit of employees in general.⁶⁹ Thus, the Service apparently would not give approval to plans under which only the prohibited group would ultimately receive benefits under the plan even though low paid employees were initially covered.

Prior to 1942, the revenue acts provided that a pension plan would qualify if it benefited "some or all of [the] employees."⁷⁰ The plan had only to be continuing.⁷¹ This approach, however, allowed employers to establish qualified plans that in effect amounted to compensation for the sole benefit of highly paid personnel.⁷² The legislative history of the Revenue Act of 1942 focused primarily on discrimination in coverage

Where there is a material reduction in force (or the average number of employees of the employer for any 90 day period beginning within the 12 month period is at least 20 percent less than the average number of employees for the corresponding 90 day period in the preceding 12 month period by reason of the separation from service of employees whose jobs are eliminated for reasons other than cyclical business conditions), section 4.04(2) will not be taken into account if throughout the 12 month base period the plan satisfies the key employee test. *Id.* at § 4.04(1).

⁶⁶ If the relevant employment period does not exceed 24 months, then the plan must either meet the key employee test or provide for four-forty vesting; if the relevant employment period is more than 24 months but not more than 84 months, then the plan must meet the key employee test and the turnover test or provide for four-forty vesting; and if the relevant employment period is more than 84 months, then the plan may meet either the key employee or the turnover test. *Id.* at § 3.02.

⁶⁷ H.R. REP. NO. 93-1280, 93d Cong., 2d Sess. 277 (1974), provides that "it generally is not intended that any plan (or successor plan of a now existing plan) which is presently under a more rapid vesting schedule should be permitted to cut back its vesting schedule as a result of this statement [the Service is directed not to require a vesting schedule more stringent than the four-forty test]." Revenue Procedure 75-49 does not appear to address this question at all.

⁶⁸ Rev. Rul. 68-302, 1968-1 C.B. 163; PUB. NO. 794.

⁶⁹ Rev. Rul. 71-263, 1971-1 C.B. 125; *see also* Rev. Rul. 69-24, 1969-1 C.B. 110.

⁷⁰ *See, e.g.*, Revenue Act of 1921, § 219(f), 42 Stat. 227 (1921).

⁷¹ *See* Harold G. Perkins, 8 T.C. 1051 (1947).

⁷² *See Hearings Before the Joint Committee on Tax Evasion and Avoidance*, 75th Cong., 1st Sess. 290 (1937). *See also* Phillips H. Lord, Inc., 1 T.C. 286 (1942), *acq.*; Princess Garment Co., 1 T.C.M. 186 (1942); Albert W. Harris, 1939 B.T.A.M. ¶ 30,472.

and not in benefits, but some passages may be read as precluding a higher rate of ultimate benefits to the prohibited group: The legislation according to Congress was prompted by the establishment of plans covering only "a small percentage of employees" or favoring "higher paid or stockholding employees."⁷³ Certainly where turnover is twice as high among the low pay as among the prohibited group, the plans favor the higher paid employees.

Early Tax Court cases appear to have sidestepped the discriminatory aspects of graded vesting by holding that benefiting permanent as distinguished from transient employees was not the type of discrimination forbidden by the statute.⁷⁴ The Eighth Circuit in *United States v. Hall*,⁷⁵ however, took a quantum step in applying the anti-discrimination requirement to vesting, but it did so in a way that can be viewed as focusing primarily on coverage and not on discrimination in benefits. It stated, "inequalities in vesting are discriminatory . . . if they operate, alone or with eligibility requirements, to effectively exclude so many employees from the practical benefits of the plan that its value to the employee group as a whole is illusory." A more recent district court decision, *Gold Seal Products Co. v. United States*,⁷⁶ had the occasion to apply the anti-discrimination requirement to a plan which allegedly discriminated in benefits. This decision indicates some judicial approval of the legislative rationale for applying the four-forty vesting requirement.⁷⁷

The salaried only profit sharing plan in *Gold Seal Products* contained

⁷³ H.R. REP. NO. 2333, 77th Cong., 1st Sess. 51 (1942).

⁷⁴ See, e.g., *Ryan School Retirement Trust*, 24 T.C. 127, 134 (1955); *Sherwood Swan & Co.*, 42 T.C. 299, 307 (1964), *aff'd*, 352 F.2d 306 (9th Cir. 1965).

⁷⁵ 398 F.2d 383, 390 (8th Cir. 1968).

⁷⁶ 363 F. Supp. 313 (N.D. Ala. 1973).

⁷⁷ The case is also analogous to the more recent "weighted allocation" line of cases. Contributions under a money purchase pension plan or a profit sharing plan may vary from a level percentage of compensation applied to all employees by reason of an allocation formula that takes into consideration years of service, such a formula usually is called a weighted allocation. However, such allocation may result in the prohibited discrimination. Compare Rev. Rul. 68-653, 1968-2 C.B. 177 (addition of units of compensation and units of service did not result in prohibited discrimination), with Rev. Rul. 68-654, 1968-2 C.B. 179 (multiplication of units of compensation by units of service resulted in prohibited discrimination). The courts in *Auner v. United States*, 440 F.2d 516, 519 (7th Cir. 1971), and *Bernard McMenamy*, 54 T.C. 1057, 1062 (1970), *aff'd*, 442 F.2d 359 (8th Cir. 1971), held that where the allocation formula resulted in a benefit in comparison to compensation of prohibited group that was substantially disproportionate to benefit in comparison to compensation of the rank and file employees, the plan discriminated in operation. In *Auner* the allocation to the low pay group as to percentage of compensation was 36 percent of the allocation as to the prohibited group as percentage of compensation.

no minimum age or waiting period requirement and vesting was at the rate of only 5 percent a year. Relatively high turnover existed as to all employees, including the prohibited group. The district court rested its conclusion that the low vesting and high turnover did *not* result in discrimination in favor of the prohibited group on the following factors:

(1) The lengthy vesting period adversely affected 60 percent of the original prohibited group (three out of five) and 50 percent of the original low pay group (four out of eight).

(2) Fifty percent of the forfeited amounts came from the accounts of the prohibited group.

(3) The average vesting of the prohibited and the low pay groups was 31 percent and 34 percent, respectively.

(4) The 20 year vesting schedule with no waiting period was a common formula.

(5) The plan was not integrated.

(6) All early terminations resulted from death or resignations by the employees and not from discharges by the employer.

It would appear that the *Gold Seal Products* court would have found the prohibited discrimination had the turnover rate of the rank and file been twice that of the prohibited group.

Thus, the requirement that the turnover rate for rank and file employees not exceed twice the turnover rate for the prohibited group (the 200 percent turnover test) had ample support in the legislative history and some support in recent case law. However, the release of Revenue Procedure 75-49 unleashed a firestorm of criticism. This vesting schedule seems to have been the first aspect of ERISA that would have substantially increased the pension costs for large corporate defined benefit pension plans, *i.e.*, it would have resulted in meaningful, not just cosmetic, reform, because many (probably most) employers large and small could not meet the turnover test. In the face of approximately 1,500 comments (only two of which were to any degree favorable⁷⁸) and congressional oversight hearings, the Service first announced in early December 1975,⁷⁹ that Revenue Procedure 75-49 was under reconsideration and that pending such reconsideration an applicant could request that its application for an advance determination letter as to the qualified status of its plan be processed without regard

⁷⁸ This statement is based upon a telephone call to the author by a Service employee who was reviewing and responding to all of the comments submitted on Revenue Procedure 75-49 and upon a conversation with a senior Service staff member in the office of the Assistant Commissioner on Employee Plans.

⁷⁹ Rev. Proc. 76-1, 1976-6 I.R.B. 26 (Feb. 9).

to Revenue Procedure 75-49. In the event of such request a caveated determination letter (containing a caveat that such letter was not a determination as to whether the vesting provisions of the plan satisfy the nondiscrimination requirements of section 401(a)(4)) would be issued. Thus, at this time plans had two alternatives: meet Revenue Procedure 75-49 or request a caveated determination letter.

Revenue Procedure 76-11,⁸⁰ announced February 2, 1976, added two further alternatives "[p]ending completion of reconsideration of Revenue Procedure 75-49":

(1) The prior letter test under which a plan which previously had received a favorable determination letter need not meet Revenue Procedure 75-49 so long as each participant has at least the same percentage of vesting at every point under the amended plans as provided under the most recently approved pre-ERISA version of the plan.

(2) The facts and circumstances test under which the applicant may demonstrate to the Service's satisfaction that there has not been, and that there is no reason to believe there will be, an accrual of benefits or forfeitures tending to discriminate in favor of the prohibited group.

The stated rationale for the prior letter test was that "in issuing the prior determination letter, the Service had already determined that discrimination was not likely to occur as a result of the plan's vesting schedule."⁸¹ In practice, however, the Service had applied different standards to large and small corporations, in effect imposing faster vesting schedules to prevent discrimination only upon small corporations. Precisely this difference in treatment between large and small corporations was the genesis of the four-forty vesting schedule. Representative Collier (who, in his own words, was the conferee who proposed the four-forty vesting alternative) stated in the floor debate on the conference bill:

Generally speaking, *the Internal Revenue Service has forced on small employers faster rules of vesting than it has on the larger plans* since there may be more likelihood of turnover and greater benefits to highly paid workers in those plans than in the larger companywide plans. Unfortunately, *the law has not been administered on a uniform basis*, and the conferees were made aware of a number of situations where *small employers*, who were attempting to provide their employees with a *meaningful pension*

⁸⁰ 1976-9 I.R.B. 22 (March 1).

⁸¹ T.I.R. No. 1441, Feb. 2, 1976, 1976-9 I.R.B. 22 (March 1).

plan, have had to vest and fund their plans at levels significantly in excess of those required of major corporations.

The conferees attacked this problem by providing in general that a plan which meets the vesting requirements provided in the bill is not to be considered discriminatory unless there is a pattern of abuse under the plan or there has been or is reason to believe that there will be an accrual of benefits or forfeitures tending to discriminate in favor of employees who are officers, shareholders or highly compensated. It seems to me that once a plan meets the standards established in this bill there should be no greater requirement for it and the Internal Revenue Service should not be allowed on a general basis to require faster vesting of the small employer than it would a large corporate employer.

The provisions in this bill provide, except in cases where actual abuse occurs, the Internal Revenue Service in administering the vesting provisions will not require a vesting schedule more stringent than 40 percent vesting after 4 years of employment with 5 percent additional vesting for each of the next 2 years and 10 percent additional vesting for each of the following 5 years.

Additionally, this more rapid vesting would generally not be required except in a case where the rate of likely turnover for executives was substantially less than the rate of likely turnover for rank and file employees.⁸²

The prior letter test in practical effect maintains faster rules of vesting for most small employers. Given that both small and larger employers generally fail the turnover test of Revenue Procedure 75-49 and that many plans recently established by small employers were previously forced to adopt a vesting schedule at least as fast as the four-forty schedule in order to obtain an advance determination letter, while most large employer plans did not, the prior letter test of Revenue Procedure 76-11 serves to continue the Service's prior benign neglect of discriminatory vesting schedules in large employer plans.

Furthermore, under these procedures new plans, of both large and small employers, must meet Revenue Procedure 75-49 or, less practically, request a caveated letter or meet the facts and circumstances test. Since most large employers had established retirement plans prior to ERISA, this aspect of Revenue Procedure 76-11 also continues the different treatment accorded large and small employer vesting. In short, the Service's retreat from Revenue Procedure 75-49 leaves the situation generally as it was prior to ERISA: the Service forcing on small employers faster rules of vesting than it has on the larger plans. It is submitted, however, that where a 200 percent turnover test cannot be

⁸² 120 CONG. REC. H8713-14 (daily ed. Aug. 20, 1974) (remarks of Representative Collier) (emphasis added).

met, a retirement plan with slow vesting discriminates in favor of the prohibited group, be it a plan of either a large or a small employer. The last chapter in this story is yet to be written. In addition to the fact that the Service intends Revenue Procedure 76-11 to be interim only, pending reconsideration of Revenue Procedure 75-49, the avenue to rank and file employees of seeking a declaratory judgment⁸³ in the Tax Court that the Commissioner's determination that a particular plan continues to qualify as to its vesting schedule under the prior letter test, despite failing a 200 percent turnover test, remains available. In all fairness, however, Congress undoubtedly did not contemplate that all plans would have to adopt a four-forty vesting schedule. It simply was not aware of the wide pattern of higher turnover in rank and file employees. Nevertheless, such a turnover pattern if coupled with vesting slower than the four-forty schedule should (and does) constitute the prohibited discrimination. If the courts or the Service impose the four-forty test on large employers, however, Congress in all likelihood will come to their rescue and change the rules.

Look Back Rule. ERISA does not authorize limitations upon service for purposes of participation other than the breaks in service rules. In contrast, the vesting rules contain a number of additional permitted limitations. The general rule is that once an employee becomes a participant in a plan under the look back rule of section 411(a)(4) all preparticipation years of service must be taken into account for purposes of vesting, *i.e.*, retroactive vesting credit is required. This rule is subject to the following exceptions for periods of service which may be ignored under the minimum vesting standard (if the plan so provides):

Years of service before age 22 if the plan's vesting schedule would satisfy either the ten year notch or five to fifteen year "graded" vesting schedules.⁸⁴ Under this exception, service during the vesting computation period within which the employee attained age 22 cannot be disregarded.⁸⁵ Congress fashioned this exception in order not to discourage plans from providing immediate participation and accrual of benefits for all employees.⁸⁶ Under the rule of 45, by contrast, there is no age limitation on the look back. The ERISA look back rule is a modified version of the Senate bill look back rule (which would have given a participant up to five years of back credit for service prior to admission to the plan) while also serving as a substitute for the House bill partici-

⁸³ I.R.C. § 7476(a)(1).

⁸⁴ I.R.C. § 411(a)(4)(A).

⁸⁵ Temp. Reg. § 11.411(a)-5(b)(1)(iii), 40 Fed. Reg. 51421, 51424 (Nov. 5, 1975).

⁸⁶ H.R. REP. NO. 93-807, 93d Cong., 2d Sess. 56 (1974).

pation rule which would have required that an employee be admitted to a plan when he had three years of service prior to age 25.⁸⁷

Years of service during a period for which an employee did not participate in mandatory contribution plan for such year solely because of his failure to make mandatory contributions to the plan,⁸⁸ and similarly for periods for which the employer did not maintain the plan or a predecessor plan,⁸⁹ *e.g.*, before the plan was established or after the employer terminated the plan (but perhaps kept the trust in existence in order to pay already earned benefits when due).⁹⁰ The effect of the solely for failure to contribute rule is to preclude use of this exception where the employee is not allowed to participate and, hence, contribute for a plan year, for instance, as a penalty for withdrawal of employer contributions (a frequent pre-ERISA provision primarily designed to avoid constructive receipt).

Service not required to be taken into account under the participation breaks in service rules discussed below.⁹¹

Years of service prior to January 1, 1971, unless the employee has had at least three years of service after December 31, 1970.⁹² Read literally, this rule cuts off pre-1972 service unless the employee had already completed the requisite three years of post-1970 service prior to reemployment. While House Report Number 93-807 appears to contemplate only a waiting period by stating that the House Committee on Ways and Means bill provided that a plan would not have to credit pre-1970 service until the employee served at least five years of post-1968 service,⁹³ both section 1012(a) of House bill 12855 and the House passed bill provided that the following service could be disregarded: "(F) service before January, 1969, *unless* the employee has had at least five years of service after December 31, 1968."⁹⁴ Thus, the House Committee on Ways and Means report appears to have interpreted the provision phrased identically to section 411(a)(4)(E) as requiring only a waiting period and not an automatic cutoff. The tem-

⁸⁷ 120 CONG. REC. S14745 (daily ed. Aug. 22, 1974). The purpose of the House provision was to cover more equitably blue collar (and women) workers who began working at an earlier age. 120 CONG. REC. H1283 (daily ed. Feb. 28, 1974).

⁸⁸ I.R.C. § 411(a)(4)(B).

⁸⁹ I.R.C. § 411(a)(4)(C).

⁹⁰ H.R. REP. NO. 93-807, 93d Cong., 2d Sess. 56 (1974).

⁹¹ I.R.C. § 411(a)(4)(D).

⁹² I.R.C. § 411(a)(4)(E).

⁹³ H.R. REP. NO. 93-807, 93d Cong., 2d Sess. 57 (1974).

⁹⁴ Temp. Reg. § 11.411(a)-5(b)(5), 40 Fed. Reg. 51421, 51424 (Nov. 5, 1975).

porary regulations clearly adopt a waiting period interpretation, requiring only that the three years of service be completed at any time after December 31, 1970. In any event, this exception was prompted by the congressional view that it was undesirable to provide for retroactive vesting for employees who had already terminated their employment. It was thought that such vesting would create a substantial unexpected cost for the plan thereby possibly jeopardizing the size of benefits for employees still covered under the plan and might involve serious record keeping problems.⁹⁵

Years of service prior to the first plan year to which section 411 applies, if such service would have been disregarded under the rules of the plan with respect to breaks in service as in effect on such date.⁹⁶ This exception too appears directed at the problem of employees who have already terminated their employment, and in addition, probably represents an acknowledgement of the problem of pre-ERISA service records not reflecting hours of service as such. Not unexpectedly the temporary regulations on minimum vesting standards do not require that the plan's pre-ERISA rules relating to breaks in service bore that designation.⁹⁷ In a quite liberal interpretation these regulations sweep within such breaks rules any pre-ERISA plan rules that related "to required minimum hours or other length of service."⁹⁸ Thus, employees who had been excluded from participation under a plan's pre-ERISA requirement that they work, for example, 30 hours a week (usually incorporated in the plan's definition of full-time employee) would not have to be given vesting credit for those pre-ERISA years of service in which they completed 1,000 hours of service (for example, 50 weeks at 20 hours a week), but not 30 hours a week. This reasonable approach probably reflects the practicality that the plan administrator now most likely has no access to any records that would show whether the employees who failed to work 30 hours a week in pre-ERISA periods completed 1,000 hours of service per plan year during such periods.

The four-forty vesting schedule is not permitted to use all of the six exceptions to the look back rule for purposes of vesting. The conference report refers to "4 years of employment," whereas section 411(a)(4) refers to "years of service" for purposes of determining the participant's nonforfeitable percentage; therefore, Congress apparently did not intend

⁹⁵ 120 CONG. REC. H8703 (daily ed. Aug. 20, 1974); H.R. REP. NO. 93-807, 93d Cong., 2d Sess. 57 (1974).

⁹⁶ I.R.C. § 411(a)(4)(F).

⁹⁷ Temp. Reg. § 11.411(a)-5(b)(6), 40 Fed. Reg. 51421, 51425 (Nov. 5, 1975).

⁹⁸ *Ibid.*

to incorporate all of the exceptions to years of service since it used a different term.

If the conferees considered at all the exceptions to retroactive vesting in the context of the four-forty vesting schedule, it is likely that they did not expect the age 22, installation of the plan or three year waiting period for pre-January 1, 1971 service cutoffs to apply—a clear implication of the use of years of employment language.⁹⁹

While all six exclusions ease record keeping and other administrative problems use of the breaks in service exception (and in some circumstances use of the plan's pre-ERISA breaks rules) appears essential to plan administration, at least in defined contribution plans.¹⁰⁰ If non-vested accounted balances were forfeited upon a one year break in service, restoration of such forfeited amount in defined contribution plans can come only from employer contributions or possibly current forfeitures, regardless of whether the earlier forfeitures had been added to the account balances of other participants or were applied to employer contributions.¹⁰¹ Employer restored forfeitures upon their face would appear to come within the definition in section 404(a)(3)(A) of "deductible contributions," in which case their payment in some instances might not be deductible currently.¹⁰² Even if this is not the case, the timing of their restoration, since unpredictable, could cause financial planning problems.

Fortunately, in apparent recognition of these problems Revenue Procedure 75-49 in defining "year of employment"—the term used in the four-forty vesting schedule—provides that it means "a year of service, required by Section 411(a)(4) of the Code to be taken into account in computing an employee's nonforfeitable percentage (without regard to subparagraphs (A), (B), and (C) of section 411(a)(4))."¹⁰³ Accordingly, the breaks (section 411(a)(4)(D)), three year post-1970 waiting period (section 411(a)(4)(E)), and plan's pre-ERISA minimum service rules (section 411(a)(4)(F)) exceptions are available under the four-forty vesting schedule.

Types of Benefits Vested. To this point, the time and rate at which accrued benefits vest have been examined. There remains the question of the kinds of benefits that are vested. ERISA uses here the term

⁹⁹ BNA, TAX MANAGEMENT MEMO 75-16, *ERISA (Employee Retirement Income Security Act of 1974)—Service for Participation and Vesting* (Aug. 4, 1975).

¹⁰⁰ *Ibid.*

¹⁰¹ Compare Ns. 279-282 *infra* and the accompanying text.

¹⁰² *Ibid.*

¹⁰³ Rev. Proc. 75-49, § 5.04.

"accrued benefit," which in the case of a defined benefit plan is defined by section 411(a)(7)(A)(i) as the employee's accrued benefit determined under the plan and expressed in the form of a single life annuity (without ancillary benefits), or the actuarial equivalent of such annuity, commencing at normal retirement age.¹⁰⁴ A subsidized early retirement benefit and the subsidized value of a joint and survivor annuity are not included in such definition,¹⁰⁵ and, hence, do not have to vest under a retirement plan.

Accrual of Benefits Tests: Defined Benefit Plans

The more significant ERISA defined benefit rules in this context are those concerning the scale of benefits for years of participation in the plan and those concerning the number of hours of service that must be completed in an accrual period to accrue a minimum benefit. The first rules are designed to prevent "back loading" under which a higher scale of benefits is provided for later years of service than for the earlier years. Thus, section 411(b)(1) requires that each defined benefit plan (other than certain insurance contract plans) satisfy one of three accrued benefit tests intended by Congress to limit back loading.¹⁰⁶

3 Percent Test. Under this, each participant must accrue for each year of participation at least 3 percent of the benefit that is payable under the plan to a participant beginning participation at the earliest possible entry age and serving continuously to the earlier of age 65 or normal retirement age under the plan.¹⁰⁷

133 1/3 Percent Test. Under this, the accrual rate for any participant for any later year is not more than 133 1/3 percent of his accrual rate for the current year.¹⁰⁸

Pro Rata or Fractional Rule. Under this, the accrued benefit is computed as though the participant continued to earn the same rate of compensation annually that he had earned during the years which would have been taken into account under the plan (but not in excess of ten), had the participant retired on the date in question. This amount is then multiplied by a fraction, the numerator of which is the participant's

¹⁰⁴ I.R.C. § 411(c)(3).

¹⁰⁵ Temp. Reg. § 11.411(a)-7(a)(1)(ii), 7(c)(3), 40 Fed. Reg. 51421, 51426-27 (Nov. 5, 1975).

¹⁰⁶ H.R. REP. NO. 93-1280, 93d Cong., 2d Sess. 271 (1974). For an example of backloading, see H.R. REP. NO. 93-807, 93d Cong., 2d Sess. 61 (1974).

¹⁰⁷ I.R.C. § 411(b)(1)(A). The aim of this alternative was not to discourage plans (particularly "flat benefit" plans) from providing for a flat or stated benefit as an early retirement benefit after completion of a stated number of years.

¹⁰⁸ I.R.C. § 411(b)(1)(B).

number of years of participation in the plan as of the date of separation from service, and the denominator of which is the total number of years of participation that he would have had at normal retirement age.¹⁰⁹

The fractional rule and the 3 percent rule each have advantages and disadvantages in terms of costs. A common accrual formula meeting the former test is 4 percent per year taking into account only 25 years of participation. Under this formula an employee hired at age 55 who retired at age 65, normal retirement age under the plan, would have accrued only 40 percent of his pension benefit. Thus, if the benefit formula were a flat 50 percent of compensation, he would have accrued a pension benefit equal to 20 percent of his compensation. Conversely, if the plan accrual formula were the fractional rule, such employee would have accrued the maximum possible pension benefit of 50 percent of pay since both the numerator and the denominator of the fraction applied to the fractional rule benefit would be ten. Consequently, in this instance the fractional rule would be a far more expensive rule. Conversely, if an employee were hired at age 25 and separated from service at age 50 under the above plan formulas, he would have accrued a benefit of 50 percent of compensation at age 50 under a 4 percent accrual formula, while under a fractional accrual method he would have accrued a benefit of only 32 percent of his compensation

$$\left(\frac{25}{40} \times 50\%\right).$$

From a cost point of view plan designers probably would prefer to use the fractional rule as to any employee with more than 25 years of participation at his termination and a percentage accrual rule, 4 percent in this case, as to any employee who terminated or retired with less than 25 years of participation.

Frequently, pre-ERISA flat percentage of earnings benefit plans, *e.g.*, a defined benefit plan providing a retirement benefit equal to 50 percent of compensation, reduced the benefit proportionately for years of participation less than 25. Arguably, such a plan contains in effect an accrual rule of 4 percent for each year of participation. Some plan designers have suggested that such a plan may retain its benefit formula as 50 percent of compensation reduced proportionately for service less than 25 years of participation and at the same time adopt the fractional method for determining accrued benefits. The argument is that the fractional rule benefit to which the fraction is applied, described in section 11.411(b)-1(b)(3)(ii)(A) of the temporary regulations as

¹⁰⁹ I.R.C. § 411(b)(1)(C).

the "annual benefit commencing at the normal retirement age under the plan," would be the flat benefit proportionately reduced for years of participation less than 25. In effect, under such provisions even where the participant has been covered under the plan for more than 25 years when he terminates, he would not be entitled to the plan's maximum flat benefit since his accrued benefit would be reduced under the fractional method, for example, to 32 percent if he were employed at age 25 and terminated at age 50. In short, if such approach were permitted where the years of participation are equal to or greater than the maximum number of years of participation necessary for no reductions in the flat benefit, then the fractional method would apply. Conversely, where the participant had less than 25 years of participation at his retirement or termination in effect only the percentage rule would apply. For example, if an employee enters the plan at age 55 and retires at age 65, then his retirement benefit under the above example would be 20 percent of his compensation

$$\left(\frac{10 \text{ actual years of participation}}{10 \text{ years of participation at 65}} \right. \\ \times 50 \text{ percent of compensation} \\ - 15 \text{ years} \times (4 \text{ percent} \\ \times 50 \text{ percent of compensation}) \\ \left. = 20 \text{ percent of compensation} \right).$$

If the same employee entered the plan at age 55 and completed five years of participation and then terminated, his accrued benefit would be 10 percent of compensation

$$\left(\frac{5 \text{ actual years of participation}}{10 \text{ years of participation at 65}} \right. \\ \times 50 \text{ percent of compensation} - 15 \text{ years} \\ \times (4 \text{ percent} \times 50 \text{ percent of compensation}) \\ \left. = 10 \text{ percent of compensation} \right).$$

Of course, exactly the same result in the above two illustrations would be obtained under a simple 4 percent of maximum benefit at normal retirement age times years of participation.

The argument against use of the fractional method for accrual while

defining the benefit as being proportionately reduced for service less than some stated period, such as 25 or 33 $\frac{1}{3}$ years of participation, is that arguably the plan is using two methods for computing accrued benefits. The fractional method is applicable where a participant has completed more years of participation than the amount under which reduction occurs, such as more than 25 years of participation. Where a participant completes less than 25 years, in effect, a percentage method applies. Yet section 11.411(b)-1(a)(1) of the temporary regulations provides that a "defined benefit plan . . . must provide only one method for the computation of accrued benefits." While the Service may well approve such a plan (the writer has been informed by some district offices that in qualifying plans under ERISA the Service is not even looking at the plan's accrual rules), the final answer to whether such an approach is permitted will likely arise from litigation where a fully vested participant under such a plan terminates employment with more than, for example, 25 years of participation and then sues the plan for his accrued benefit determined under the percentage rule rather than the fractional method.

The term "year of participation" for purposes of determining a participant's accrued benefit under these tests is defined as a period of service beginning at the earliest date on which the employee participated in the plan and which is included in a period of service required to be taken into account under the participation (not vesting) breaks in service rules.¹¹⁰ This incorporation of the participation years of service rules reflects the concept that in the context of defined benefit plans the participation and accrual section "work in harmony to determine when an employee must become a participant in the plan and when he or she must accrue benefits while a participant."¹¹¹ A defined benefit plan may provide that if an employee has less than 1,000 hours during the relevant 12 consecutive month period (or accrual computation period) such service is not to be taken into account,¹¹² but if such service is less than full-time (while 1,000 hours or more) at least a ratable portion of the full-time (say, 2,000 hours) benefit must be accrued.

Pre-ERISA Benefit Accruals. The other element of retroactive vesting is whether the vesting formulae apply to benefits accrued in a defined benefit plan prior to the effective date of the vesting provisions. Generally they do, subject, however, to the break in service rules discussed below. Since many existing plans had no accrued benefit formula for

¹¹⁰ I.R.C. § 411(b)(3)(A).

¹¹¹ Preamble to Labor Regulations on Minimum Standards, 40 Fed. Reg. 41654 (Sept. 8, 1975) (herein cited as Preamble, Prop. Labor Reg.).

¹¹² H.R. REP. NO. 93-1280, 93d Cong., 2d Sess. 275 (1974).

the past,¹¹³ e.g., a plan providing for vesting only upon retirement, new section 411(b)(1)(D) provides that the accrued benefit of any participant as to years of participation prior to the first plan year to which the minimum vesting provisions apply cannot be less than the greater of (1) his accrued benefit determined under the plan as in effect prior to September 2, 1974 (without regard to any amendment adopted after that date) or (2) 50 percent of his accrued benefit determined under the tests of sections 411(b)(1)(A) through (C).¹¹⁴ Note that the section 411(b)(1)(D) formula refers to "accrued benefit determined under the plan" prior to September 2, 1974 and not to the vested accrued benefit. Therefore, the absence or degree of pre-ERISA vesting under the plan has no effect upon whether a participant in a defined benefit plan who separated from service prior to ERISA and is reemployed thereafter has an accrued benefit under the plan.

Accrued Benefit: Defined Contribution Plans

Section 411(a)(7)(A)(ii) defines the term "accrued benefit" in the context of a defined contribution plan as the balance of the participant's account. The partial accrual rules contained in sections 411(b)(3)(B) and (C) do not apply literally to defined contribution plans since only section 411(b)(1), which sets forth accrued benefit requirements for defined benefit plans, uses the term "year of participation" in determining a participant's accrued benefit. Nevertheless, as seems to be all too frequently the case, the conference report fails to distinguish between defined contribution and defined benefit plans.¹¹⁵ ERISA itself appears silent at least in the vesting and accrual rules as to the method of determining the accrued benefit, i.e., account balance, of a participant in a defined contribution plan.

Hours of Service, Years of Service and Breaks in Service

Years of service and breaks in service, both of which turn upon hours of service, constitute more than mere building blocks for the eligibility and vesting requirements under ERISA. They themselves are intended to effectuate certain congressional policies and contain rules far more

¹¹³ *Ibid.*

¹¹⁴ See Ns. 106-107 *supra* and the accompanying text.

¹¹⁵ See H.R. REP. No. 93-1280, 93d Cong., 2d Sess. 269 (1974) ("For purposes of benefit accrual, in general the plan may use any definition of the term 'year of service' which the plan applies on a reasonable and consistent basis However, the plan must accrue benefits for less than full-time service on at least a pro rata basis Generally, a plan would not be required to accrue any benefit for years in which the participant had less than 1,000 hours of service.").

complex than the vesting and participation rules themselves. Breaks in service rules for participation and vesting basically are intended to place an employee, who separates from and returns to service, at the same point upon such return that he was on the vesting schedule of the plan before a break in service "insofar as this is practicable without creating serious administrative problems."¹¹⁶ Congress intended year of service rules in turn to determine whether an employee may be excluded from the plan as a seasonal or part-time employee.¹¹⁷ On the surface these rules are substantially similar for purposes of participation and vesting, but in substance they differ materially in details. Moreover, the breaks in service rules, while modified in the statute in their application to defined contribution plans,¹¹⁸ appear at this time to pose at least quite serious drafting problems and in all probability more serious administrative problems as to such plans.

Hours of Service

Generally for all purposes an hour of service consists of each hour for which an employee is directly or indirectly paid, or is entitled to payment, by the employer for the performance of duties during the applicable computation period.¹¹⁹ The immediate source of funds for such payment is not determinative, *e.g.*, hours also must be credited when the payment is from sources other than the employer, such as tips by customers or a share of the proceeds of, say, a sports event.¹²⁰

Also, for purposes of all computational periods, an hour of service consists of each hour for which back pay, irrespective of mitigation of damages (*e.g.*, for reasons such as the employee's bad faith or receipt of compensation for other services during the period that he was wrongfully not employed), has been awarded or agreed to by the employer.¹²¹ Such hours are credited to the computation period to which the award or agreement pertains rather than to the period in which it is made.¹²²

¹¹⁶ H.R. REP. NO. 93-807, 93d Cong., 2d Sess. 45 (1974).

¹¹⁷ H.R. REP. NO. 93-1280, 93d Cong., 2d Sess. 263 (1974).

¹¹⁸ *See, e.g.*, I.R.C. § 411(a)(6)(C).

¹¹⁹ Prop. Labor Reg. § 2530.200b-2(a)(1), 40 Fed. Reg. 41654, 41662 (Sept. 8, 1975). ERISA Technical Release No. 2001 (July 1, 1976), issued after this article was completed, states that the final regulations will define an hour of service as each hour for which an employee is directly or indirectly paid by the employer for the performance of duties and for *reasons other than the performance of duties* (such as vacations, holidays and sick leave if the employee is paid for such time). *See* N. 212 *infra*.

¹²⁰ Preamble, Prop. Labor Reg. 41656.

¹²¹ Prop. Labor Reg. § 2530.200-2(a)(2), 40 Fed. Reg. 41654, 41662 (Sept. 8, 1975).

¹²² *Ibid.*

The rationale for this back pay hours of service rule is that back pay is generally dependent upon a showing that a person was legally entitled to have been compensated as an employee but in fact either was not employed or was not fully compensated.¹²³

Determination of Hours of Service

Generally hours of service must be ascertained from the records of hours worked by, or hours from which payment is made or owing to, an employee, but the plan need not describe in its documents which records, such as payroll records, are to be used for such determination.¹²⁴ Under an elective alternative method of determination for nonhourly employees the plan may instead credit each such employee with 40 hours of service per week (or eight hours of service per day), provided that (1) this alternate is limited to employees whose compensation is not determined on an hourly basis, *e.g.*, salary, commission or piece work basis compensated employees; (2) each such employee is credited with at least 1,000 hours of service per computation period; and (3) this rule is not applied to the employees whose hours are required to be counted and recorded on an hourly basis by any other federal law, such as the Federal Labor Standards Act.¹²⁵ The rationale for this alternate method is that employers commonly do not maintain hourly records as to employees who are not compensated on an hourly basis and who are exempt from wage hour laws.¹²⁶ To avoid unduly burdensome record keeping requirements in such circumstances, the proposed Labor regulations proposed this alternative.¹²⁷ Congress expected the Labor regulations would consider the particular problems of different plans and industries in providing the ways in which hours of service could be computed, including the use of earning data. For example, in some industries where

¹²³ Preamble, Prop. Labor Reg. 41656.

¹²⁴ Prop. Labor Reg. § 2530.200b-3(a), 40 Fed. Reg. 41654, 41662 (Sept. 8, 1975).

¹²⁵ *Id.* at § 2530.200b-3(b)(2). ERISA Technical Release No. 2002 (July 1, 1976) revealed that (1) the nonhourly paid alternative method of determining hours of service would be deleted from the final regulations, (2) a number of other alternative methods (*e.g.*, a plan could credit hours of service for both hourly and nonhourly employees on the basis of days, weeks or months by treating an employee who completed at least one hour of service during the day, week or month with 10, 45 or 190 hours of service, respectively), and (3) use of certain equivalency methods or combination of such methods could result in discrimination prohibited by section 401(a)(4). One practitioner and frequent lecturer on ERISA, prior to ERISA Technical Release No. 2002, had suggested that the proposed nonhourly 1,000 equivalency was tailor made for covering semiretired executives while excluding part-time rank and file employees.

¹²⁶ Preamble, Prop. Labor Reg. 41656.

¹²⁷ *Ibid.*

correct hours worked might be difficult to obtain, Congress anticipated the regulations could permit hours of service to be computed upon the basis of data concerning the earnings of workers.¹²⁸ With the alternate method the proposed labor regulations happily meet this expectation.

The requirement that each employee be credited with at least 1,000 hours of service per computation period may mean that the alternative method can only be applied to nonhourly employees who complete a sufficient number of weeks or days of service under the alternative method to be credited with 1,000 hours of service, for example, 25 weeks of service. Under this reading any salaried employee (exempt from wage hour laws) who completed less than 25 weeks or 125 days of service must be credited by the plan administrator on the basis of its actual records of hours worked by such employee, but these records may be payroll records. Apparently the thought of the draftsmen was that so many consequences attach to completion of 1,000 hours of service (year of service for vesting, at least partial year of participation for accrual purposes in a defined benefit plan, et cetera) that the alternate method should not be permitted whenever an employee would not reach that threshold, because the alternate method could result in less than 1,000 hours of service being credited, while the records of hours worked could show completion of 1,000 hours or more during the applicable computation period. If this be the premise, it raises difficult administrative problems, for example, as to summer law clerks who may well complete 1,000 hours of service during a summer. The other, perhaps more common, reading of this proposed regulation is that if a plan elects this alternative, every nonhourly employee must be credited with 1,000 hours of service.

Preeffective Date Record Keeping Problems

While some of the preeffective date record keeping problems—arising from the fact that most plans computed eligibility, vesting and benefit accrual (special rules handle the particular problems that arise in the last context) on a basis other than 1,000 hours—can be solved by the optional vesting provision to disregard preeffective date service if it would have been disregarded under the plan rules concerning breaks in service existing prior to ERISA, others would not. The proposed Labor regulations offer a handy solution here.

A plan may use for determining preeffective date service whatever records are reasonably accessible to it and may make whatever calcu-

¹²⁸ 120 CONG. REC. H8697 (daily ed. Aug. 20, 1974); 120 CONG. REC. S15738 (daily ed. Aug. 22, 1974).

lations are necessary to determine the approximate number of hours of service completed during such period.¹²⁹ For example, where records of compensation only exist, hours of service may be derived by dividing an employee's compensation by the customary hourly rate during such period.¹³⁰ Furthermore, if rather complete records are available as to some employees, then the hours of service of other employees in the same job classification may be estimated from such records.¹³¹ The preamble to the proposed labor regulations states that this approach, where necessary, can be carried even further to a group of employees, or even to a single employee.¹³² The preamble points out that a safeguard arises from the procedure under section 105(a) of ERISA whereby an employee could obtain a statement of his past service credits and then could challenge the employer's determination through court action or under the benefits claim procedure of section 503 of Title I of ERISA.¹³³

Year of Service

Section 2530.200b-1(a) of the proposed labor regulations provides that a plan must designate (1) eligibility computation periods; (2) vesting computation periods; and (3) accrual computation periods.¹³⁴ It does not distinguish on its face between defined contribution and defined benefit plans. An employee who completes 1,000 hours of service during an eligibility computation period has completed a year of service for purposes of the minimum participation standards.¹³⁵ Similarly, if he completes 1,000 hours of service during a vesting computation period, he has completed a year of service for purposes of minimum vesting standards. As to the accrual computation period, however, completion of 1,000 hours requires in some plans only that the employee be given credit for at least a partial year of participation, but full accrual for such year is required only where the employee completes the number of hours of service prescribed under the plan for completion of a full year of participation.¹³⁶

Section 2530.200b-1(b)(2) of the proposed labor regulations¹³⁷

¹²⁹ Prop. Labor Reg. § 2530.200b-3(c), 40 Fed. Reg. 41654, 41663 (Sept. 8, 1975).

¹³⁰ *Ibid.*

¹³¹ *Ibid.*

¹³² Preamble, Prop. Labor Reg. 41657.

¹³³ *Ibid.*

¹³⁴ 40 Fed. Reg. 41654, 41661 (Sept. 8, 1975).

¹³⁵ *Ibid.*

¹³⁶ Prop. Labor Reg. § 2530.200b-1(a), 40 Fed. Reg. 41654, 41661 (Sept. 8, 1975).

¹³⁷ 40 Fed. Reg. 41654, 41661 (Sept. 8, 1975).

provides that employment or absence from employment at either the beginning or the end of an applicable computation period does not determine whether an employee has completed a year of service or a year of participation, or has incurred a break in service. (Again no explicit distinction is drawn between defined benefit and contribution plans.) Instead, such determinations must be made solely with reference to the number of hours of service that he completed during the applicable computation period. Thus, at the end of each computation period the plan administrator must look back over the period and determine which employees had the requisite number of hours and cannot rely upon whether an employee is still employed at the end of the computation period, whether it be for accrual of benefits or vesting.

Eligibility Computation Period

The eligibility computation period serves two functions: (1) It measures eligibility to participate initially. (2) Once an employee becomes a participant in the plan, this period measures retention of eligibility to participate (and consequent nonforfeiture of accrued benefits in defined benefit plans).¹³⁸ Thus, its use does not stop with entry into the plan. However, after completion of any minimum service requirement—which may precede actual entry by some duration—the plan may shift over to the vesting computation period in order to measure maintaining eligibility.

Initially, the eligibility computation period must be the 12 consecutive months period beginning with the “employment commencement date,” which in turn is defined as the date on which the employee first performs an hour of service for the employer.¹³⁹ Similarly, where a plan provides for a three years of service waiting period (permitted only where it provides immediate vesting upon entry into the plan), the initial eligibility computation periods are the 12 consecutive months period beginning with the employment commencement date and the succeeding 12 consecutive month periods beginning on the anniversaries of the employment commencement date, until the three years of service are completed (without an intervening one year break in service, if the plan so provides).¹⁴⁰

Switchover to Plan Year. If an employee fails to complete 1,000

¹³⁸ Preamble, Prop. Labor Reg. 41655, 41657; see Ns. 149 and 150 *infra* and the accompanying text.

¹³⁹ Prop. Labor Reg. § 2530.202-2(a)(1), 40 Fed. Reg. 41654, 41664-65 (Sept. 8, 1975).

¹⁴⁰ Prop. Labor Reg. § 2530.202-2(a)(2), 40 Fed. Reg. 41654, 41665 (Sept. 8, 1975).

hours of service in the twelve consecutive months period beginning with his employment commencement date, a plan may elect to switch his eligibility computation period over to the plan year that includes the first anniversary of his employment commencement date and, where additional eligibility computation periods are required, to succeeding plan years; or it may continue to measure such employee's eligibility computation period by reference to the anniversaries of his employment commencement date.¹⁴¹ Under a literal reading of the rule contained in the proposed labor regulations that the selected alternate from alternate computation periods permitted under ERISA, and these regulations, must be set forth under plan documents,¹⁴² a plan which does not so switch over would have to provide explicitly that a year of service for purposes of eligibility is measured with reference to the employment commencement date, even if the employee does not complete 1,000 hours of service during the first 12 month period commencing with such date. As a drafting technique where the switchover is not utilized, it would be preferable to be able to provide simply that a year of service for purposes of eligibility was determined initially with reference to the employment commencement date.

Shiftover to Eligibility Computation Period. The drafters of the proposed labor regulations on minimum standards were fully aware that most plan administrators would prefer to base all computation periods on the same 12 consecutive month period.¹⁴³ Accordingly, they came up with the brilliant concept of permitting a plan to ignore the eligibility computation period (based on date of hire) as soon as a participant met the service requirement, if any, of the plan, even though he still had to meet an age or other requirement, and at that time shift over to the vesting computation period for purposes of maintaining eligibility.¹⁴⁴

Once an employee has met the one year or three years of service requirement of his plan, his date of hire is no longer significant if he still must satisfy an age or other requirement. For in such circumstances the applicable entry date would be the earlier of the first day of the first plan year beginning after the date on which the employee satisfied the minimum age requirement or the six month anniversary of such date. In any event such entry date, of course, only coincidentally would have any relationship to the commencement of employment date. Therefore,

¹⁴¹ Prop. Labor Reg. § 2530.202-2(b), 40 Fed. Reg. 41654, 41665 (Sept. 8, 1975).

¹⁴² Prop. Labor Reg. § 2530.200b-1(b)(1), 40 Fed. Reg. 41654, 41661 (Sept. 8, 1975).

¹⁴³ Preamble, Prop. Labor Reg. 41656, 41658.

¹⁴⁴ *Ibid.*

once an employee satisfies the minimum service requirement, the only continued effect of such date for purposes of initial participation would be if the employee subsequently incurred a break in service prior to satisfying an age or other eligibility requirement. Accordingly, the drafters of the proposed labor regulations provided that a plan may elect to use in computing the years of service before a one year break in service either (1) the eligibility computation periods beginning with the employee's employment commencement date or (2) the eligibility computation period (or periods in the case of a three year waiting period plan) prior to the time that the employee met his plan's years of service requirement *plus* all vesting computation periods beginning with the vesting computation period that includes the date on which the employee completed the service requirement of the plan.¹⁴⁵ In other words, in this context the plan may shift over to the vesting computation for the measuring period to use in determining whether an employee has incurred a one year break in service for purposes of eligibility prior to entry (and whether the number of consecutive one year breaks in service equals or exceeds the number of years of service completed prior to the last such break).

In addition to the requirement that the employee must have completed the service requirement for initial entry into the plan, the shiftover must be accomplished in the same manner as a plan amendment changing the vesting computation, *i.e.*, the vesting computation period shifted to must be the one that includes the last day of the eligibility computation period in which the employee first completed the service requirement, so that by virtue of such overlap an employee would not lose creditable service as a result of any gap between computation periods.¹⁴⁶ Where the employee's employment commencement date already coincides with the first day of the vesting computation period (or plan year), for example, because he first commenced employment on the first day of the plan year or because the plan administrator already switched his eligibility computation period over to plan year when he failed to complete 1,000 hours of service during his first eligibility computation period, there should be no need to provide double credit as to the shift over year provided that the plan is properly designed. The plan should provide that the eligibility computation period shifts over only as to employees whose eligibility computation period does not already coincide with the plan year. Such a provision would not appear to conflict

¹⁴⁵ Prop. Labor Reg. § 2530.202-2(c)(1), 40 Fed. Reg. 41654, 41665 (Sept. 8, 1975).

¹⁴⁶ Prop. Labor Reg. §§ 2530.202-2(c)(2), 203-2(c), 40 Fed. Reg. 41654, 41665 (Sept. 8, 1975); Preamble, Prop. Labor Reg. 41658-59.

with the principle announced in the vesting computation period provision, but surely applicable to all computation periods, that the period chosen must apply equally to all participants.¹⁴⁷ Here, not all employees would be switched over (with the above overlap rule applying) but all employees after completion of the minimum service requirement would have their eligibility and maintaining eligibility years of service measured on the vesting computation period.

It should be emphasized that this ability to shift over does not require eligibility to participate in the plan, only satisfaction of any service requirement for eligibility.¹⁴⁸ Thus, a 19 year old employee who had completed one year of service but had not yet attained the 25 year minimum age requirement of his plan could have his eligibility computation period shift to the vesting computation period.

Although the rule of permitted shift overs appears directed in large part to the problem of an employee maintaining his satisfaction of the plan's service requirement until he can satisfy other preconditions for eligibility—such as attainment of a minimum age—the drafters of the regulations clearly also contemplate this same approach is needed after an employee becomes a participant, at least in a defined benefit plan. For example, while a break in service for purposes of further vesting would turn upon the vesting computational period, conceptually, the participant also has a requirement of continued eligibility to participate. Generally in a defined benefit plan in which a participant has not yet achieved any degree of vesting, it is only when a participant fails to complete the minimum number of hours required to maintain eligibility (500) during his eligibility computation period that a plan may safely forfeit his then forfeitable accrued benefit. The basis for this result is that in defined benefit plans a participant's accrued benefit is determined by his years of participation, which incorporate the participation breaks in service rules. Prior to attaining any vested interest, such participant's accrued benefit could be forfeited pursuant to the rule of parity under the participation, not vesting, breaks rules.¹⁴⁹ Again, the proposed labor regulations on minimum standards fail to distinguish between defined benefit and defined contribution plans.¹⁵⁰ In a defined contribution plan

¹⁴⁷ Prop. Labor Reg. § 2530.203-2(a), 40 Fed. Reg. 41654, 41665 (Sept. 8, 1975).

¹⁴⁸ See Preamble, Prop. Labor Reg. 41657, 41658.

¹⁴⁹ See Ns. 235 and 236 *infra* and the accompanying text.

¹⁵⁰ "The break in service rules of section 202(b), therefore, apply both to eligibility to participate and for measuring the period of participation on which benefits must be accrued. Therefore, these rules (§ 2530.200b-4) govern both eligibility to participate initially and retention of eligibility to participate. As long as an employee retains participant status, he or she is eligible to accrue benefits

the forfeiture in such circumstance would arise under the rule of parity under the vesting breaks rule.¹⁵¹

A defined benefit plan could elect to maintain the requirement of eligibility for participation based upon the original eligibility computation period, while basing vesting on a different vesting computation period.¹⁵² The following example illustrates both the manner in which such a plan would compute breaks in service and the concept of maintaining eligibility after entry into a defined benefit plan. Assume that (1) employee *A*'s eligibility computation period is July 1 through June 30 (his date of hire was July 1, 1975), (2) his defined benefit plan, which he entered on July 1, 1976, does not provide for a shift of eligibility computation period to the vesting computation period, which is a calendar year and (3) the accrual computation period is the same as the participant's eligibility period. Assume further that employee *A* completes the following hours of service:

<i>Period</i>	<i>Hours of Service</i>
7/1/75-12/31/75	500
1/1/76-6/30/76	500
7/1/76-12/31/76	800
1/1/77-6/30/77	200
7/1/77-12/31/77	200
1/1/78-6/30/78	800

Employee *A* remains a participant during the periods July 1, 1976 through June 30, 1977 and July 1, 1977 through June 30, 1978 with benefit accruals for each such period being made on his behalf. How-

although benefits under most plans need not be accrued for years in which the employee fails to complete 1,000 hours of service." Preamble, Prop. Labor Reg. 41655. "The single exception to the rule that the vesting computation period must be used to measure breaks in service relates to determining eligibility to participate. If the eligibility computation period is used to compute prior service, the plan may elect to measure breaks on the eligibility computation period. An employee may have more years for eligibility than for vesting (e.g. years completed prior to age 22). This employee would not forfeit accrued benefits until the number of consecutive breaks equals the prior years for eligibility although vesting credit may be forfeited when the number of consecutive breaks equals the employee's years of service for vesting purposes.

"For the purpose of maintaining eligibility to participate (and consequent non-forfeiture of accrued benefits), the employee's prior service for eligibility may be measured by continuing the eligibility computation periods throughout or by switching to the vesting computation period when the employee first obtained eligibility to participate (§ 2530.202-2(c)(1)). The plan must use the same computation periods both for measuring prior service and measuring breaks in service." *Id.* at 41657.

¹⁵¹ See Ns. 235 and 236 *infra* and the accompanying text.

¹⁵² Preamble, Prop. Labor Reg. 41657.

ever, for purposes of vesting alone he incurred a one year break in service during the period January 1, 1977 through December 31, 1977. Since *A* had only one year of service for purposes of vesting prior to July 1, 1977, if he had no vested interest at that time, his years of service for purposes of vesting could be wiped out under the rule of parity on December 31, 1977 and, on January 1, 1978, he would start anew toward his first year of service for vesting purposes. In summary, in a defined benefit plan, where a one year break in service for purposes of vesting cannot preclude further vesting in prebreak accruals (as a defined contribution plan¹⁵³), but can only call into play a one year waiting period after reemployment before further vesting credit must be provided and the rule of parity,¹⁵⁴ forfeitures of accrued benefits prior to a participant's attaining any vested interest under the vesting formula of the plan (which might not occur until the participant had completed as much as 14 years of service¹⁵⁵) arise only from the participation break in service rule of parity—in essence where the number of consecutive one year breaks in service in the eligibility computation periods exceed the number of prior years of service or better years of participation prebreak years of service credit is forfeited. In contrast, in a defined contribution plan forfeitures arise prior to a participant's attaining any vested interest from the vesting breaks in service rules applied to the vesting computation periods. The surprising and frustrating failure of the proposed regulations of the Department of Labor on minimum standards (and in particular their preamble) to distinguish here between defined benefit and defined contribution plans generated widespread confusion among practitioners.

The plan may, however, if it explicitly so provides, shift to the vesting computation period for purposes of maintaining eligibility to participate after entry into the plan. The plan must use, however, the same computation period, both for measuring prior service for purposes of maintaining eligibility to participate (and consequent nonforfeiture of accrued benefits in a defined benefit plan) and for measuring breaks in service as to retained eligibility.¹⁵⁶

¹⁵³ I.R.C. § 411(a)(6)(C); see Ns. 221–44 *infra* and the accompanying text.

¹⁵⁴ I.R.C. §§ 411(a)(6)(B), (C).

¹⁵⁵ If a plan adopted the ten year notch vesting under section 411(a)(2)(A) and the employee was hired at age 18, and the plan elected to disregard for purposes of vesting years of service before age 22 under section 411(a)(4)(A), the employee would have no vesting until age 32 at which time he would have full vesting. However, for the 14 year period between ages 18 and 32 the employee would have no vesting.

¹⁵⁶ Prop. Labor Reg. § 2530.202–2(c)(3), 40 Fed. Reg. 41654, 41665 (Sept. 8, 1975); Preamble, Prop. Labor Reg. 41657.

Plan designers are permitted to simplify computation period complexities in two other ways, but both present inherent disadvantages that probably will preclude their widespread use. The first is that a plan may designate that the eligibility, vesting, and accrual computation period always will be the same 12 month period.¹⁵⁷ But the only 12 month period which can fit that bill is the 12 month period that commences on each employee's employment commencement date and its subsequent anniversaries due to the statutory requirement that (at least) the initial eligibility computation period be computed with reference to such date. Due no doubt to the fact that this approach may result in as many different computation periods as there are employees, the drafters of the proposed labor regulations observed that "[t]his approach, however, probably will not serve the record keeping needs of most plans."¹⁵⁸

The second approach which may ease record keeping problems, at least where covered employees have low initial turnover, is to eliminate any minimum service requirement. In that case a plan would not be required to maintain an eligibility computation period, and hence all computations could be made on the plan year (or vesting computation period).¹⁵⁹ The preamble to the proposed labor regulations states that "[a]dmitting every employee to participation on the beginning of the first plan year after commencement of employment would allow all computations to be made on the plan year."¹⁶⁰ The obvious disadvantage to this approach is its application to an employer who experiences considerable turnover with employees in their first year of service. However, the drafters of the proposed regulations anticipated that plans would provide much more favorable plan participation and entry standards in order to achieve a single computation period for all purposes.¹⁶¹

The proffered solution of the Department of Labor of a single entry date is contained only in the preamble to the proposed labor regulations on minimum standards and not in the body of those regulations. Undoubtedly this was due to the fact that the regulations were to cover the minimum participation requirements as well as the rule that an employee must be admitted into a plan no later than the earlier of the first day of the first plan year beginning after the date on which the employee satisfied such requirements, or the date six months after the date on which he satisfied such requirements.

Unfortunately, the minimum participation regulations do not address

¹⁵⁷ Preamble, Prop. Labor Reg. 41656.

¹⁵⁸ *Ibid.*

¹⁵⁹ *Ibid.*

¹⁶⁰ *Ibid.*

¹⁶¹ *Id.* at 41658.

the question of a single entry date. Instead there exists only Treasury Information Release Number 1334,¹⁶² which preceded the proposed Labor minimum standards regulations by nine months and in which the Service offered one solution to the single entry date issue: entry upon the later of (1) the first day of the first plan year beginning on or after an employee attains age 24½ or (2) the first day of the first plan year beginning at least six months after his date of hire. The Service stated that such a plan could not require an employee to complete any specified number of hours of service within the six month waiting period.¹⁶³ The author is aware of early single entry date post-ERISA plans that required six months of service in which an employee completes 500 hours of service. The plans ignored the situation of an employee, whose date of hire is in, for example, the fifth month of a plan year, and who completes less than 500 hours of service in his first six or even seven months of service (so that he would not enter on the first entry date after his hire) but who completes thereafter 12 months after date of hire sufficient hours of service to total 1,000 hours of service—the next entry date would be seven months after he completed a year of service. It should be noted that the labor and Service approaches to a single entry date are not necessarily inconsistent or exclusive. The labor approach deals solely with computational periods and the Service approach is permitting an employment, but not service, rule, which is concerned only with time of participation or entry date.

Vesting Computation Period

A plan may designate any consecutive 12 month period as the vesting computation period so long as the plan applies that period uniformly to all employees (although the periods need not be identical for each employee, *e.g.*, if the vesting computation period is based upon date of hire) and as long as it does not result in artificial postponement of vesting credit, such as would occur where the period was measured by anniversaries of the date four months following the employment commencement date.¹⁶⁴

Where the vesting computation period is not the same as the eligibility computation period, a participant who completes 1,000 hours of service during an eligibility computation period can fail to complete 1,000 hours of service in either of the two vesting computation periods that

¹⁶² T.I.R. No. 1334, Jan. 8, 1975, 759 CCH ¶ 6873.

¹⁶³ *Id.* at P-3.

¹⁶⁴ Prop. Labor Reg. § 2530.203-2(a), 40 Fed. Reg. 41654, 41665 (Sept. 8, 1975).

the eligibility computation period overlaps. Accordingly, the proposed labor regulations on minimum standards provide that where (1) an employee's eligibility computation period overlaps two vesting computation periods, (2) he completes 1,000 hours of service in the eligibility computation period, but not in either of the overlapped vesting computation periods and (3) he is admitted to participation in the plan, the year of service completed in the eligibility computation period that so overlapped the vesting computation period also must be considered a year of service for purposes of vesting at the time the employee becomes a participant.¹⁶⁵ The clear implication of this rule is that if such an employee incurred a break in service prior to entry and was rehired, such eligibility vesting overlap year of service would not be counted for the vesting rule of parity.

This overlap rule does not apply to plans requiring three years of service, but there is no need in such circumstances because such plans must have immediate vesting in any event upon entry into the plan.¹⁶⁶ This rule could be considered as a slight exception to the principle that the eligibility computation period may be ignored after the year of service requirement of a plan is satisfied. Until entry into the plan where there are overlapped vesting computational years without 1,000 hours of service in either of the overlapped years, the records for the overlapping eligibility participation year, or at least the fact that the employee worked 1,000 hours during such period, must be retained.

While ERISA speaks specifically to changes in vesting schedules,¹⁶⁷ there is no specific reference to changing the vesting computation period.¹⁶⁸ The proposed labor regulations, however, provide that a plan may be amended to change the vesting computation period to a different consecutive 12 month period, but the first amended vesting computation period must begin before the last day of the preceding vesting computation period. This rule is intended to avoid a gap in credited service. As discussed above, careful plan drafting should be able to avoid double crediting of a year of service where the employee's prior vesting computation period happened to correspond with the new vesting computation period.

Prior to ERISA, plans frequently provided for vesting for only a full, complete or continuous year of service or participation. In an early

¹⁶⁵ Prop. Labor Reg. § 2530.203-2(b), 40 Fed. Reg. 41654, 41665 (Sept. 8, 1975).

¹⁶⁶ I.R.C. § 410(a)(1)(B)(i); see Ns. 28-30 *supra* and the accompanying text.

¹⁶⁷ I.R.C. § 211(a)(10).

¹⁶⁸ Prop. Labor Reg. § 2530.203-2(c)(1), 40 Fed. Reg. 41654, 41665 (Sept. 8, 1975).

ERISA announcement the Service stated that "fractional years of service" did not have to be taken into account for the minimum vesting standards, only "complete years."¹⁶⁹ The proposed labor regulations on minimum standards clearly state, however, that the number of hours of service completed during a computational period (and not employment at the beginning or end of the period) is determinative.¹⁷⁰ Due to this rule an employee who has been employed for only 12 months prior to entry into a plan can easily have at that point two years of service for purposes of vesting. For instance, in a plan with a calendar year vesting computation period and dual entry dates of January 1 and July 1, an employee who satisfies any minimum age requirements may be hired on July 1, 1976, complete 1,000 hours of service from July 1, 1976 through December 31, 1976 and 1,000 hours of service from January 1, 1977 through June 30, 1977. At entry on July 1, 1977 such employee would already have completed two years of service for vesting purposes.

Accrual Computation Period

Every defined pension benefit plan must satisfy certain benefit accrual requirements, some of which are based upon years of participation.¹⁷¹ The less easily resolved question is whether any of these rules, including designation of an accrual computation period, applies to a defined contribution plan. The period for determining a year of participation is the accrual computation period, which (unless the plan uses the alternative career method) is any consecutive 12 month period chosen by the plan, provided that it applies uniformly to all participants.¹⁷² Such accrual computation period may be the vesting computation period, the plan year or the consecutive 12 month period beginning on either of the two semi-annual dates in a dual entry date plan.¹⁷³ Plans choosing to have one fixed annual computation period may be required to admit participants retroactively upon completion of the service requirements for eligibility or to credit a partial year of participation.¹⁷⁴

Year of Participation and Partial Year of Participation. The function of a year of participation is to determine whether the plan must provide a benefit accrual for a particular accrual computation period. A year

¹⁶⁹ T.I.R. No. 1334, Jan. 8, 1975, 759 CCH ¶ 6873 at V-2.

¹⁷⁰ Prop. Labor Reg. § 2530.200b-1(b)(2), 40 Fed. Reg. 41654, 41661 (Sept. 8, 1975).

¹⁷¹ Prop. Labor Reg. § 2530.204-1, 40 Fed. Reg. 41654, 41665 (Sept. 8, 1975).

¹⁷² Prop. Labor Reg. § 2530.204-2(a), 40 Fed. Reg. 41654, 41665 (Sept. 8, 1975).

¹⁷³ *Ibid.*

¹⁷⁴ *Ibid.*

of participation for purposes of accrual differs slightly in concept from a year of service for eligibility or vesting purposes. Under the eligibility and vesting provisions an employee is credited for a full year of service upon the completion of 1,000 hours of service during either an eligibility or vesting computation period, as the case may be. During an accrual computation period, however, completion of 1,000 hours of service may not give rise to a credit for a full year of participation in a defined benefit plan that is permitted to make a full year of participation dependent upon the completion of a number of hours of service specified by the plan (such as 1,600 or 2,000 hours of service) during the accrual computation period.¹⁷⁵ In such a defined benefit plan completion of 1,000 hours would give rise to only a partial year of participation for benefit accrual. The proposed labor regulations on minimum standards provide that participants in such plans who complete at least 1,000 hours of service but less than the number of hours required for a full year of participation must be credited with at least a ratable portion of the benefit accrual, which generally will be expressed as a partial year of participation.¹⁷⁶ For example, a plan that required 1,800 hours of service per accrual computation period for full benefit accrual would have to give at least 75 percent of a year of participation credit to a participant who completed 1,350 hours of service during the accrual computation period.¹⁷⁷

The simplest case for accrual of partial years of participation arises where the employee does not complete the requisite number of hours under the plan for a full year of participation, but is employed on and off throughout the entire accrual computation period. As indicated above, accrual of a partial year of participation may be appropriate. However, where a defined benefit plan is involved and it provides benefits on the basis of hours or compensation and does not adjust less than full-time service to reflect the equivalent of full-time hours or full-time compensation, as the case may be (such a plan formula could specify that the monthly retirement benefit is a certain amount for each hour of service completed while the individual was a plan participant, such as \$.10 per hour of service), it has built-in proration, consequently, section 2530.204-2(d)(1) of the proposed labor regulations¹⁷⁸ prohibits such a plan from further prorating or reducing benefit accrual by crediting only partial years of participation. Such plans must credit,

¹⁷⁵ Preamble, Prop. Labor Reg. 41655.

¹⁷⁶ *Id.* at 41659.

¹⁷⁷ *Ibid.*

¹⁷⁸ Prop. Labor Reg. § 2530.204-2(d)(1), 40 Fed. Reg. 41654, 41666 (Sept. 8, 1975).

except where service is less than 1,000 hours and can be disregarded accordingly under section 204(b)(3)(C) of ERISA and section 411(b)(3)(C) of the Code, less than full-time employees with a full year of participation for the purposes of accrual benefits. This is because proration of the benefit accrual for a computation period in which the employee failed to complete a requisite number of hours of service for full benefit accrual would result in double proration of the benefit accrual.¹⁷⁹

The significance of the permitted proration exception in the proposed labor regulations on minimum standards for plans where compensation for less than full-time service is adjusted to reflect the equivalent of full-time compensation lies in a special limitation in the temporary regulations on minimum vesting standards on the determination of a plan's normal retirement benefit. Such regulations provide that a defined benefit plan basing its normal retirement benefit on employee compensation must adjust such compensation to the equivalent of full-time compensation where an employee completes less than a full year of participation unless the computation base cannot decrease, *e.g.*, a plan which bases the normal retirement benefit on the highest five consecutive years.¹⁸⁰ The vesting rule in effect forces any reduction in the normal retirement benefit for less than full-time participation where the retirement benefit is based on compensation into the year of participation element of the retirement formula and not the computation base. This may be illustrated by the following hypothetical: Assume that employee *B*, with 19 years of credited service in a plan that bases the retirement benefit on a participant's final five year average compensation, completed only 1,000 hours of service during his twentieth year under the plan and in which he retired earning \$10,000 in that year. Assume further that he had earned \$20,000 in each of the preceding four years and that the plan's benefit formula is 2 percent times years of participation times final five years' average pay. *B*'s benefit could be computed through increasing his compensation in his final year to full-time compensation and crediting him for only one half of a year of participation in that year resulting in the following retirement benefit: $2\% \times 19.5 \text{ years} \times \$20,000 = \$7,800$ per year straight life annuity. But the plan could not by virtue of the temporary regulations compute the benefit by using the \$10,000 earned during a partial year of participation in the final five year average. If this were permitted, the benefit would be substantially less per year

¹⁷⁹ Preamble, Prop. Labor Reg. 41659.

¹⁸⁰ Temp. Reg. § 11.411(a)-7(c)(5), 40 Fed. Reg. 51421, 51427 (Nov. 5, 1975).

computed as follows: $2\% \times 20 \text{ years} \times \$18,000 = \$7,200$ per year straight life annuity. It is surely to prevent the multiplier effect of using reduced compensation in an average that prompted the drafters of the Treasury regulations to channel reductions, if any, into the year of participation rather than the computation base.

Where a plan covers employees who work at least a 1,000 hours per plan year but work considerably less than say 2,000 hours per plan year, the special limitation can cause distortion in the amount of benefit that such an employee would accrue. If an employee were working 20 hours per week or 1,000 hours per year, then at his retirement under a five year final average pay formula, his compensation under the special limitation would have to be adjusted as if he were working full time. If he had 20 years of participation in which he worked only 1,000 hours per year and only the special limitation were being used, the result would be to multiply full-time pay by 17.5 years of participation, *i.e.*, 15 years of participation (1,000 hours per plan year of participation) where not prorated for less than full-time service and then the final five years prorated or reduced by half as his compensation during the five year base period is bumped to full-time. The apparent answer where part-time employees, who work at least 1,000 hours per year, are involved and the plan uses a terminal average benefit formula, is to adjust the pay of all such part-time employees to full-time and credit them with only partial years of participation throughout their covered service.

Partial Accrual Computation Period: Entry or Reentry on Other Than First Day of Plan Year. In addition to requiring accrual for a partial year of participation as to the lesser number of hours during a complete accrual computation period proration situation, the proposed labor regulations on minimum standards require accruals for partial years of participation in a defined benefit plan in two other situations: (1) when an employee becomes a participant or resumes active participation following a break in service on a date other than the first day of the designated accrual computation period and (2) when the plan is amended to change accrual computation periods.¹⁸¹ In both of these situations a defined benefit plan must compute a partial year based upon the hours completed in the gap before the beginning of the next accrual computation period; thus, such a plan must credit an employee with a partial year of participation for the period beginning with his first day of such participation and ending at the beginning of the succeeding accrual computation period.¹⁸² Where plans are permitted to utilize a

¹⁸¹ Prop. Labor Reg. § 2530.204-2(c)(1), 40 Fed. Reg. 41654, 41666 (Sept. 8, 1975).

¹⁸² *Ibid.*

minimum service requirement for benefit accrual expressed in terms of hours of service required for a year of participation, the proposed labor regulations mandate that the method of computing partial years of participation in these circumstances must be (1) to ascertain the percentage of a calendar year involved and (2) then to multiply this percentage against, for instance, a 1,000 hour floor for a partial year of participation to determine the minimum number of hours that must be completed during this short period for a partial accrual and (3) to credit employees who complete at least that number with a partial year of participation.¹⁸³ The proposed labor regulations provide the following illustration:

For example, an employee becomes a participant on July 1, 1976 in a plan which uses a calendar year accrual computation period. The employee completes 750 hours of service between July 1, 1976 and December 31, 1976. The plan may not disregard the hours of service because they fall short of 1,000; the applicable figure, 500, is determined by multiplying 1,000 by the percentage of a year of participation to be credited (50 percent multiplied by 1,000). If the plan is allowed under §2530.204-2(d) to prorate benefit accrual further and if the plan had set 2,000 hours of service as the amount necessary for full accrual, the employee would be credited with 37.5 percent (750 divided by 2,000) of a year of participation.¹⁸⁴

Accrual Computation Period and Defined Contribution Plans. Prior to ERISA, defined contribution plans frequently limited allocation of the employer contribution to the plan and forfeitures, if any, to participants who had not terminated employment as of the end of the plan year. For defined contribution plan administration such a provision is probably much more desirable than an inactive status classification (by analogy the Code provision that a defined benefit plan need provide no accrual for less than 1,000 hours of service and the participant year of service floor of 1,000 hours legitimize an inactive participant status in such plans) because it allows the plan administrator in allocating contributions and forfeitures, if any, to simply disregard any employee who has separated from service at plan yearend without investigating his hours of service, et cetera. Continued use in a defined contribution plan of such a provision has much indirect support.

(1) Under the view that ERISA is silent as to benefit accruals in defined contribution plans and prior law continues to govern plans,

¹⁸³ Prop. Labor Reg. § 2530.204-2(c)(2), 40 Fed. Reg. 41654, 41666 (Sept. 8, 1975).

¹⁸⁴ *Ibid.*

it can be pointed out that prior administrative practice accepted such allocation provisions routinely, even without question.

(2) The participation rules, which are built upon similar years of service and break in service concepts, are concerned basically with the problem of part-time or seasonal service and not with employees who have separated from service (until they return, when the breaks rules apply).¹⁸⁵

(3) Section 301(d)(3) of the Tax Reduction Act of 1975¹⁸⁶ requires that an employee stock ownership plan established to take advantage of the 11 percent investment tax credit election must "provide for allocation of employer securities transferred to it or purchased by it . . . to the account of each participant (who was a participant at any time during the plan year, whether or not he is a participant at the close of the plan year) as of the close of each plan year." It may be argued that Congress believed that absent this provision employer contributions would not have to be allocated to employees who had separated from service by the close of the plan year.

A contrary argument could be raised that such a provision is precluded by the minimum participation standards of section 410(a)(1). The argument would be that participation without allocation of any contribution or forfeiture is meaningless, and, therefore, an employee who satisfies the minimum age and service requirements must participate in any employer contributions (except for the less than full-time service rules applicable only to defined benefit plans). A possible answer is that just as a plan is not required to admit an employee who met such age and service requirement if he had separated from the service prior to the otherwise applicable admission date,¹⁸⁷ it should not be required to make a contribution if a participant separated from the service before the employer contribution was made or accrued.

Prior to the promulgation of the proposed Department of Labor regulations on minimum standards, most practitioners, who had considered the issue, probably concluded that a permitted yearend employment requirement for allocations in a defined contribution plan was not changed by ERISA. After those regulations (but prior to the temporary regulations on participation and vesting, which were distressingly silent

¹⁸⁵ Compare H.R. REP. NO. 93-1280, 93d Cong., 1st Sess. 263 (1973) ("breaks in service"), with *id.* at 262-63 ("years of service defined").

¹⁸⁶ Tax Reduction Act of 1975, § 301(d)(3), 89 Stat. 26.

¹⁸⁷ I.R.C. § 410(a)(4) (flush language).

on this question), in the experience of the writer, the conclusions of many practitioners were altered. For the tenor, apparent premises and, in places, literal language of these proposed labor regulations on minimum standards, and particularly their preamble, on the surface indicated that all pension benefit plans, whether defined contribution or defined benefit, have to designate an accrual computation period, and that employment for a full computation period is not required for obtaining credit for that period; credit for a particular purpose is determined solely on the basis of numbers of hours of service completed during the computation period in question.¹⁸⁸ Section 2530.200b-1(a) of the proposed labor regulations¹⁸⁹ flatly states that "a plan must designate" eligibility computation periods, vesting computation periods and "accrual computation periods pursuant to Section 2530.204." It is true, of course, that section 2530.200b-1(a) later refers to a "partial year of participation for purposes of Section 204 of the Act and Section 411(b) of the Code."¹⁹⁰ Both of these provisions relate to defined benefit plans, in that a year of participation is a defined term only as to that type of plan.

While section 2530.204-1 of the proposed labor regulations¹⁹¹ (the introduction to year of participation for benefit accrual) is speaking only to accrual under section 411(b), which, of course, is limited to defined benefit plans, section 2530.204-2¹⁹² (which amplifies the requirement of designating an accrual computation period) does not limit the requirement of designating an accrual computation period to a defined contribution plan. Indeed, generally, the proposed labor regulations on minimum standards speak of an "employee pension benefit plan," which is a generic term encompassing both defined contribution and defined benefit plans.¹⁹³ And, on occasion in the context of accrual rules that could be applied literally only to defined benefit plans, these proposed regulations use defined benefit plan terminology, while in adjacent provisions a not necessarily so limited generic terminology is employed.

A reading of these proposed regulations from the stance that in a defined contribution plan the requirement of a contribution arises from eligibility and not from section 411(b) also finds ample support in the preamble which constantly links together eligibility and accrual of

¹⁸⁸ Preamble, Prop. Labor Reg. 41655, 41658.

¹⁸⁹ *Id.* at 41661.

¹⁹⁰ *Ibid.*

¹⁹¹ Prop. Labor Reg. § 2530.204-2, 40 Fed. Reg. 41654, 41665 (Sept. 8, 1975).

¹⁹² *Ibid.*

¹⁹³ ERISA § 3(2).

benefits. As discussed above, however, this linkage probably ultimately rests on the incorporation by section 411(b)(3)(A) of the participation breaks in service rules. While the same conceptual linkage could arise in a defined contribution plan by basing the requirement of an allocation or accrual in a defined contribution plan on completion of a participation year of service, such a step is not inevitable and, in all likelihood, the draftsmen of the proposed labor regulations on minimum standards did not take it.

From a policy standpoint, hours of service completed during the accrual computation period, and not employment on the last day of the plan year, should govern allocation of employer contributions in a defined contribution plan just as they do in a defined benefit plan. From the face of the statute and legislative history it is not possible to determine whether the absence of a specific provision in ERISA governing such allocation analogous to the benefit accrual rules of section 411(b) was deliberate (if so, probably in response to interest group demands to retain the last day rule or better practice) or another oversight. The author understands, however, that the absence was in fact deliberate, in response to pressure from Sears, Roebuck & Company for a last day rule, and that ERISA does not expressly state the distinction due to a reluctance of the draftsmen to acknowledge that eligibility to participate in a defined contribution plan carried with it no privileges.

In Revenue Ruling 76-250,¹⁹⁴ the Service belatedly acknowledged that section 411(b)(1) related only to defined benefit plans so that a defined contribution plan would not violate sections 410 and 411

¹⁹⁴ 1976-27 I.R.B. 11 (July 1976), announced in Internal Revenue News Release IR-1623 (June 11, 1976). The timing of the ruling (after this article was substantially completed) was exquisite—just after the end of the original special reliance procedure. Almost a year earlier the precise reasoning ultimately adopted in Revenue Ruling 76-250 had been discussed. See BNA, TAX MANAGEMENT MEMO 75-16, *ERISA (Employee Retirement Security Act of 1974)—Service for Participation and Vesting* (Aug. 4, 1975). By late 1975 and early 1976 several Treasury officials had given speeches in which they stated that the current Service position was that ERISA did not itself prohibit defined contribution plans from basing allocation on not having separated from service on the last day of the plan year, but that the anti-discrimination concept of section 401(a)(4) would apply. The suspicion is unavoidable that the Service delayed as long as possible the issuance of Revenue Ruling 76-250 in order to impede adoption of a last day rule by small employers. The discrimination in operation aspect is also directed to that end. As indicated in text the author now believes that Congress did not intend or expect that a last day rule would be considered discriminatory in operation—it never had in the past. One should not expect here, however, a “prior letter” exception as in the four-forty rule. For the large plans, unlike small plans, are more likely to pass a zero allocation to terminated employees test and, hence, have less incentive to unleash another firestorm.

merely because it uses an employment on last day requirement for allocations. However, the ruling continued, by virtue of section 410 a plan participant who completes 1,000 hours prior to separation from service is still a plan participant—and section 401(a)(4) precludes discrimination as to participants. It therefore concluded that a participant in a defined contribution plan who completes 1,000 hours but who receives no allocation because of his separation from service before the last day of the plan year is considered to have received a zero dollar allocation, which may result in the discrimination in favor of the prohibited group in violation of section 401(a)(4). Thus, under Revenue Ruling 76-250 it might be that such an allocation formula would be considered discriminatory if a comparison of (1) the percentage of compensation that the yearend allocation to the prohibited group was of the aggregate compensation for the plan year to such group including the compensation of members of the prohibited group who terminated service prior to year end to (2) the percentage of compensation that the yearend allocation to the rank and file group was of the aggregate compensation for the plan year to such group including the compensation of members of the rank and file group who terminated service prior to year end, evidences a substantially higher percentage of compensation allocation for the prohibited group.

Congress does not seem to have anticipated that the Service would seek to apply section 401(a)(4) in this manner, as shown indirectly by two items. By virtue of section 410(a)(5)(C), a former participant who completes 1,000 hours of service in the 12 month period beginning on his reemployment commencement date retroactively must become a participant as of such reemployment commencement date. Because a retroactive allocation in a defined contribution plan for the plan year of reemployment is impossible, Congress apparently intended no requirement under section 410 or 411(b) for a retroactive allocation. Yet following the reasoning of Revenue Ruling 76-250, where a plan participant is denied a retroactive or current allocation in such circumstances, discrimination in operation could result. Any attempt to limit Revenue Ruling 76-250 to where 1,000 hours is completed and not to import the partial accrual computation period rules as well seems artificial. Certainly these reemployed participants retroactively are reinstated as "participants" in their year of return. Congress is unlikely to have intended for section 401(a)(4) to apply to an employment at yearend allocation provision in a defined contribution plan, but not to a provision in such a plan that does not give retroactive allocations to reemployed participants after a one year break in service. Additionally, the House certainly was aware that allocation formulas had to meet the

nondiscrimination requirements of the Code,^{194a} yet it noted that the proposed five year plan full vesting rule for class year plans would assure "an employee who terminates his employment under a class year plan he will not forfeit his rights to more than 4 years of employer contributions."^{194b} Congress thus clearly assumed that there was no requirement of an allocation in the fifth plan year in such a defined contribution plan regardless of at what point the employee separated from service during the plan year. In summary, to apply an analogous discrimination in operation rule through zero allocations would thwart Congress' understanding of how reentry has to operate in defined contribution plans and allocations on year of separation in class year plans.

Alternate Accrual Computation Method. A defined benefit plan that (1) provides for accrual of benefits on the basis of all service completed by the employee during his participation in the plan and (2) demonstrates that the plan satisfies at least one of the anti-backloading benefit accrual rules of ERISA, may use either the employee's career participation in the plan *or* a periodic computation period, which is based on a consecutive 12 month period, as a computation method for accrual of benefits.¹⁹⁵ Plans that provide for any backloading, *i.e.*, rate of accrual benefits increasing with length of service, must use a 12 month accrual computation period since the benefit accrual standards pertaining to maximum backloading limits are based upon accrual in yearly increments.¹⁹⁶ On the other hand, where plans use the employee's career participation to determine benefits rather than using yearly increments, and have no minimum service requirement for benefit accrual (so that backloading could not occur), the draftsmen of the proposed labor regulations on minimum standards reasoned that there would be no additional protections gained for the plan participants by requiring such plans to shift to a 12 month accrual computation period which would require reworking their entire defined benefit formula.¹⁹⁷ Accordingly, an alternate accrual computation method was provided. It should be noted that an amendment to the plan that increases benefit accrual is not considered backloading, provided that the new accrual rate is applied equally to all participants and it is in no way predicated on an advanced degree of service.¹⁹⁸

^{194a} See H.R. Rep. No. 93-807, 93d Cong., 2d Sess. 45 (1974).

^{194b} *Id.* at 66.

¹⁹⁵ Prop. Labor Reg. § 2530.204-3(a), 40 Fed. Reg. 41654, 41666 (Sept. 8, 1975).

¹⁹⁶ Preamble, Prop. Labor Reg. 41660.

¹⁹⁷ *Ibid.*

¹⁹⁸ *Ibid.*

One example of the alternate computation method is a career compensation benefit formula based upon a percentage of compensation earned in a participant's career or during participation with no variance in relation to hours completed in given periods.¹⁹⁹ Another illustration is a defined benefit formula crediting an employee with a specified amount of accrual for each hour of service completed by the employee during his or her entire career, *i.e.*, a credited hours approach.²⁰⁰

Deferral of Accrual in Certain Defined Benefit Plans. ERISA and the Code permit the benefit accrual formula of defined benefit plans, other than insurance contract plans, to defer accrual of benefits until an employee has completed two years of service determined as if for purposes of eligibility.²⁰¹ Accordingly, section 2530.204-4 of the proposed labor regulations²⁰² provides that in such circumstances an employee will be credited for a year of service for each eligibility computation period and successive computation periods in which he completes 1,000 hours of service.

Pre-ERISA Accruals in Defined Benefit Plans. Defined benefit plans, other than insurance contract plans, must choose one of three benefit accrual formulas under section 204(b) of ERISA and section 411(b)(1) of the Code. For pre-effective date years of participation such a plan must also choose such a formula, even though it is a different formula than the one it uses for post-effective date years of participation.²⁰³ The proposed labor regulations on minimum standards establish a method for determining date of commencement of participation for such pre-effective date accrual. All service from the date of participation in the plan as determined in accordance with the applicable provision is considered in determining an employee's year of participation. But when the plan documents do not provide a definite means for determining the day of commencement of participation, the day of commencement of employment covered under the plan during the period that the employer maintained the plan is presumed to be the date of commencement of participation in the plan. The plan, however, may rebut this presumption by demonstrating from circumstances surrounding the opera-

¹⁹⁹ Prop. Labor Reg. § 2530.204-3(b)(1), 40 Fed. Reg. 41654, 41666 (Sept. 8, 1975).

²⁰⁰ Prop. Labor Reg. § 2530.204-3(b)(2), 40 Fed. Reg. 41654, 41666 (Sept. 8, 1975).

²⁰¹ I.R.C. § 411(b)(1)(E). Under this section, the term "years of service" has the meaning provided by section 410(a)(3)(A).

²⁰² Prop. Labor Reg. § 2530.204-4, 40 Fed. Reg. 41654, 41666 (Sept. 8, 1975).

²⁰³ I.R.C. § 411(b)(1)(D).

tion of the plan, such as the commencement of mandatory contributions, that participation actually began on a later date.²⁰⁴ Prior to the promulgation of the temporary regulations on minimum vesting standards some practitioners had taken the position that under section 411(b)(1)(D), where a participant had no *vested* accrued benefit under the pre-ERISA plan's benefit formula, the plan could choose one of the ERISA accrued benefit rules and, under the provisions of that section, 50 percent of the selected ERISA accrued benefit rule would always be greater than his (vested) accrued benefit determined under the pre-ERISA plan's accrual rules, so that his accrued benefit for pre-ERISA service would be the former benefit. However, neither section 411(b)(1)(D) nor section 11.411(b)-1(c)(1) of the temporary regulations²⁰⁵ speaks of vested accrued benefits. Hence, if the participant's accrued benefit (albeit forfeitable or indeed forfeited) under the pre-ERISA plan provisions would exceed 50 percent of the benefit accrued under the ERISA accrued benefit rule chosen by the plan then the plan accrued benefit governs.

Breaks in Service

The function of the ERISA breaks in service rules is to delineate what periods of service by an employee a plan must at least count for purposes of eligibility, vesting and by incorporation of the participation breaks rules accrual of benefits in a defined benefit plan. These rules generally are affected by whether the participant has any degree of vesting. In the case of a participant with some degree of vesting in his accrued benefit in a defined benefit plan, prior service credit is nonforfeitable and the only consequence of a break is possible suspension of participant status. But where such participant status is lost in a defined contribution plan, the account balance that is not nonforfeitable at that point may be forfeited. The credit that is retained in a defined contribution plan is simply that of years of service as building blocks for further vesting in any future allocations to the participant's account after reemployment.

The breaks in service rules apply to any separation from service, but the greater consequences attach to whether the participant incurs a one year break in service. The latter may be defined as a computation period during which the employee completes 500 hours or less of service.²⁰⁶ Generally, this computation period must be the same as the vesting com-

²⁰⁴ Prop. Labor Reg. § 2530.200b-3(c), 40 Fed. Reg. 41654, 41663 (Sept. 8, 1975).

²⁰⁵ Temp. Reg. § 11.411(b)-1(c), 40 Fed. Reg. 51421, 51432 (Nov. 5, 1975).

²⁰⁶ See I.R.C. §§ 411(a)(6)(A), 410(a)(5)(C); Prop. Labor Reg. § 2530.200b-4(a), 40 Fed. Reg. 41654, 41663 (Sept. 8, 1975).

putation period.²⁰⁷ The drafters of the proposed Labor regulations on minimum standards reasoned that this was warranted by the implications of a break in service, which turn, to a large degree, on whether a participant is vested or has prior years of service with no degree of vesting.²⁰⁸ Accordingly, in order to prevent possible confusion the regulations require that breaks must be measured on the vesting computation period.²⁰⁹ If the plan has not switched over the eligibility computation period to the vesting computation period, however, then breaks in service for the purposes of determining whether the participant retains eligibility status (and consequent nonforfeiture of accrued benefits in a defined benefit plan) are measured on the eligibility computation period.²¹⁰ In such circumstances an employee might have more years for eligibility than for vesting (*e.g.*, where for vesting purposes years of service completed prior to the vesting computation period in which the participant attained age 22 were not counted) such employee would not forfeit accrued benefits in a defined benefit plan until the number of consecutive breaks in service equaled the prior years of service for eligibility, although vesting credit could be forfeited when the number of consecutive breaks equal the employee's years of service for vesting purposes. In other words, a participant could still have years of participation for benefit accrual purposes in a defined benefit plan while he would have no vesting credit. The vesting schedule would start all over again but would be applied to an existing accrued benefit.²¹¹

Hours of Service for Break in Service Purposes

Solely for purposes of determining whether a break in service has occurred in a relevant computation period, the term "hour of service" under the proposed labor regulations on minimum standards must include, in addition to each hour for which an employee is directly or

²⁰⁷ Prop. Labor Reg. § 2530.200b-4(a), 40 Fed. Reg. 41654, 41663 (Sept. 8, 1975). ERISA Technical Release No. 2003 (July 1, 1976) announced that the date on which an employee's service was severed could mark the beginning of the 12 consecutive month period provided that a one year break would occur only if the employee were gone for the entire 12 months and reemployment during the 12 months would result in credited hours for the period of the less than one year break. Apparently the plan must meet a number of other conditions, possibly including adoption in toto of an elapsed time approach.

²⁰⁸ Preamble, Prop. Labor Reg. 41657.

²⁰⁹ *Ibid.*

²¹⁰ Prop. Labor Reg. § 2530.200b-4(a)(3), 40 Fed. Reg. 41654, 41663 (Sept. 8, 1975).

²¹¹ Preamble, Prop. Labor Reg. 41657; see Ns. 152-54 *supra* and the accompanying text.

indirectly paid (or entitled to payment) by the employer for the performance of duties during the applicable computation period, each hour for which the employee is directly or indirectly paid (or entitled to payment) for reasons other than performance of duties during the applicable computation period.²¹² Such reasons include paid vacation, paid sickness or disability leave, et cetera.²¹³ Basically such paid hours of service for reasons other than performance of duties during a computation period are determined by dividing the payments received during the computation period by the lesser of the employee's hourly rate or his average hourly rate during the most recent computation period in which he did not have a one year break in service.²¹⁴ This rule corresponds closely to the pre-ERISA practice of providing for constructive continuous employment where an employee was on disability leave, for instance. However, in comparison, it may be noted that such pre-ERISA provisions, particularly in defined contribution plans, seldom required that the leave of absence be paid, and in addition, plans frequently provided constructive continuous employment, not only for purposes of eligibility or maintenance of eligibility, but also for vesting. Usually they did not provide for constructive continuous employment for purposes of benefit accrual. The effect of including such hours solely in the computation of determining whether a break in service has occurred is that where such hours, together with hours actually worked, total 500 hours during a computation period, a break in service (giving rise to a forfeiture) will not arise. Such hours of service do not have to be included in hours of service for purposes of determining whether a participant vests further in his existing accrued benefit or he accrues further benefits.

The proposed labor regulations on minimum standards specifically state that the hours of service rules will not affect or supersede any federal law accompanying regulations; instead, the nature and extent of credit under any such law must be determined by its own terms.²¹⁵ The accompanying examples make clear that such federal laws are primarily those relating to military service and veterans' reemployment rights.²¹⁶ Case law in this area turns upon plan terms, with the general result

²¹² Prop. Labor Reg. § 2530.200b-2(b)(1), 40 Fed. Reg. 41654, 41662 (Sept. 8, 1975). According to ERISA Technical Release No. 2001 (July 1, 1976) such hours of service will have to be credited for all purposes.

²¹³ *Ibid.*

²¹⁴ Prop. Labor Reg. § 2530.200b-2(b)(2), 40 Fed. Reg. 41654, 41662 (Sept. 8, 1975).

²¹⁵ Prop. Labor Reg. § 2530.200b-2(c), 40 Fed. Reg. 41654, 41662 (Sept. 8, 1975).

²¹⁶ Prop. Labor Reg. § 2530.200b-2(d)(4); Preamble, Prop. Labor Reg. 41656.

being only that a participant will not incur a break in service while in the armed forces, but neither would he accrue further benefits or vest further for the periods while he was in the armed forces if further vesting or accrual turned upon actual performance of hours of service.²¹⁷ In short, in most plans it is only necessary that hours of service while in the armed forces, which would be governed by federal laws on veterans' reemployment rights, be counted for purposes of determining whether a participant has incurred a break in service.²¹⁸ Since preemption applies here,²¹⁹ any state laws that might affect credited service analogously to the federal laws on veterans' reemployment rights (such as for jury duty) are no longer applicable.²²⁰

One Year Waiting Period After a One Year Break in Service

The breaks in service rules, both for purposes of participation and vesting, provide that after a one year break in service, an employee's prebreak in service years of service are not required to be taken into account under the plan until after the employee has completed a year of service after his return.²²¹ Congress felt that this waiting period was necessary in order to alleviate the necessity of searching out the extent of prior service in the case of employees who returned but stayed for only a short period of time.²²²

Section 411(a)(6)(B) does not provide the reference point from which the one year of service after an employee's return is to be measured. On the other hand, section 410(a)(5)(C) provides that in computing an employee's period of service for purposes of the minimum eligibility standards in the case of any participant who has incurred a one year break in service, service before such break does not have to be taken into account under the plan until the employee has completed a year of service after his return, as defined in section 410(a)(3). Section 410(a)(3)(A) provides that computation of the 12 month period for a participation year of service must be made with reference to the date on which the employee's employment commenced in most circumstances. The conference committee report indicates that the 12 month waiting period for both vesting and eligibility after a one year break in service

²¹⁷ Compare *Litwicki v. Pittsburgh Plate Glass Ind. Inc.*, 505 F.2d 189 (3d Cir. 1974), with *Davis v. Alabama Power Co.*, 383 F. Supp. 880 (N.D. Ala. 1974).

²¹⁸ *Ibid.*

²¹⁹ ERISA § 514.

²²⁰ Preamble, Prop. Labor Reg. 41656.

²²¹ I.R.C. §§ 410(a)(5)(C), 411(a)(6)(C).

²²² H.R. REP. No. 93-807, 93d Cong., 2d Sess. 270 (1974).

commences with the date of reemployment, not original employment.²²³ This approach is adopted in the proposed labor regulations on minimum standards which provide that for the purposes of the permitted one year waiting period after a one year break in service, a year of service is determined in the same manner that a year of service would be determined for purposes of eligibility if the employee had no prior service with the employer,²²⁴ but instead of using the employee's employment commencement date, the measuring point is his reemployment commencement date, which is determined with reference to the first date on which the employee completes an hour of service following the last computation period in which a break in service occurred.²²⁵ The preamble to these regulations notes that a new eligibility computation period, consisting of the 12 consecutive months following the reemployment commencement date, would also have to be established and completion of at least 1,000 hours of service within such period would entitle the employee to resume active participation, retroactively according to the preamble, if the plan utilized the one year waiting period rule.²²⁶ The proposed labor regulations, however, do not address the problem of such retroactive accrual of benefits in a defined contribution plan (or defined benefit plan) but instead expressly left the problem to the Treasury regulations which at that time had not yet been promulgated.²²⁷

The temporary regulations relating to minimum vesting standards, in the context of benefit accruals, do not address the question of retroactive accruals after satisfaction of the one year waiting period. The temporary regulations on minimum participation obliquely address the question of retroactive entry, and perhaps in the context of defined benefit plans (through the incorporation of the participation break in service rules into the term "year of participation") retroactive benefit accrual as well. First, in example 3 of section 11.410(a)-4(b)(2) of the temporary regulations, the draftsmen, in illustrating the "time of participation" rules, explain that in a dual entry date plan (with the plan year being a calendar year) if a participant with a vested benefit, after

²²³ H.R. REP. No. 93-1280, 93d Cong., 2d Sess. 264, 270 (1974).

²²⁴ Prop. Labor Reg. § 2530.200b-4(b)(1)(i), 40 Fed. Reg. 41654, 41663 (Sept. 8, 1975).

²²⁵ *Ibid.*

²²⁶ Preamble, Prop. Labor Reg. 41657.

²²⁷ "Completion of at least 1000 hours within this [one-year waiting period after a one-year break-in-service] entitles the employee to resume active participation retroactively (see regulations prescribed by the Secretary of the Treasury under sections 410 and 411 of the Code). Retroactive accrual of benefits would be required if a partial year of participation is credited under the rules provided in § 2530.204-2(c) (based on the normal accrual computation period)." *Ibid.*

incurring a one year break in service, returns to employment during the plan year, for example, on February 1, 1990, and completes a year of service after his return, he must participate immediately on his return, February 1, 1990. "[An employee's] prior service cannot be disregarded, because he had a vested benefit when he separated from service. Therefore, the plan may not postpone his participation until July 1."²²⁸ Then, in explaining the one year waiting period after a one year break in service rules, the temporary Treasury regulations set forth an example of a calendar year plan in which a participant with a vested interest incurs a one year break in service and then returns to employment either on or after the first day of a plan year and completes by the end of the plan year, December 31, 1982, one year of service. These temporary regulations conclude that:

Prior to December 31, 1982, in computing the employee's period of service as of any date occurring in 1982, the employee's service before December 31, 1981, is not required to be taken into account for purposes of section 410(a)(1) and § 11.410(a)-3. Because the employee completed a year of service for the 12-month period ending December 31, 1982, however, his period of service is redetermined as of January 1, 1982. Upon completion of a year of service for 1982, the employee's period of service, determined as of any date occurring in 1982, includes service prior to December 31, 1981.²²⁹

It would appear that these temporary regulations contemplate that under a defined benefit plan the employee, after satisfaction of the one year waiting period, would retroactively accrue benefits for the one year waiting period. Even where the one year waiting period overlaps two plan years in a defined benefit plan, retroactive accrual of benefits would not constitute an insoluble problem. The harder question is whether Congress or the regulations require retroactive accrual for the plan year of reentry where the 1,000 hours requirement is completed only in the subsequent plan year but within the 12 month period commencing with the employee's reemployment commencement date. Revenue Ruling 76-250 implies not.

The conference committee report states that the general rule is that all service with the employer, prebreak and postbreak, must be taken into account for purposes of determining whether the employee has met the participation requirements, but when a plan uses the one year waiting

²²⁸ Temp. Reg. § 11.410(a)-4(b)(2) Ex. 3, 40 Fed. Reg. 45810, 45815 (Oct. 3, 1975).

²²⁹ Temp. Reg. § 11.410(a)-5(c)(3)(ii) Ex. 2, 40 Fed. Reg. 45810, 45815 (Oct. 3, 1975).

period after a one year break in service before reentry, at reentry the employee's prebreak and postbreak service must be aggregated.

[A]nd the employee is to receive full credit for the waiting period service. For example, if the plan is on a calendar year basis, and an employee who has a 1-year break in service reenters employment on November 1, 1976, works 200 hours in 1976, and 1700 hours by November 1, 1977, the employee under this provision would be considered as reentering the plan for 1977. As a result, his pre-break and post-break service would be aggregated, and he would advance one year on the vesting schedule for 1977. He would also accrue benefits for that year.²³⁰

The conference committee report, in discussing the use of the one year waiting period after a one year break rule in the context of vesting, continues this example and adds another hypothetical in which the employee reenters employment on March 1, 1976, works 1,700 hours before December 31, 1976, and concludes that the employee would be eligible to reenter the plan on March 1, 1977, advance one year on the vesting schedule for his 1976 service, and the plan would have to provide at least a partial benefit accrual for 1976.²³¹ Contrasting these two examples, based solely on the conference committee report, one would conclude that a partial accrual for the plan year of reentry is called for (presumably only in a defined benefit plan) only where at least 1,000 hours of service are completed in the plan year of reentry.

The proposed labor regulations on minimum standards suggest a different answer, at least in the context of defined benefit plans. They, as discussed above, introduce the concept of a "partial accrual computation period." Under this principle if an employee resumes active participation following a break in service on a date other than the first day of the designated accrual computation period, "the plan must credit the employee with a partial year of participation for the period beginning with his first day of such participation and ending at the beginning of the succeeding accrual computation period."²³² Where there is such a partial accrual computation period, plans with a minimum service requirement for benefit accrual under section 411(b)(3)(A) may use only a ratable portion of the minimum service requirement for this partial period.²³³ Applying these rules to the above hypothetical contained in the conference committee report in which an employee with

²³⁰ H.R. REP. NO. 93-1280, 93d Cong., 2d Sess. 263-64 (1974).

²³¹ *Id.* at 270.

²³² See Prop. Labor Reg. § 2530.204-2(c)(1), 40 Fed. Reg. 41654, 41666 (Sept. 8, 1975).

²³³ Prop. Labor Reg. § 2530.204-2(c)(2).

a one year break in service reenters employment on November 1, 1976, works 200 hours in 1976, and 1,700 hours by November 1, 1977, a defined benefit plan that required 1,000 hours of service for accrual of a benefit could only use a ratable portion of the minimum hours requirement or 166 hours ($2/12 \times 1,000 = 166$). Thus, following the proposed labor regulation partial accrual computation period rules the employee in the conference committee report example would be entitled to a partial accrual for the period November 1, 1976 through December 31, 1976. The proposed labor regulations do not directly address the question of whether this partial accrual could or must be retroactively provided in a defined contribution plan. Nor, unfortunately do the temporary Treasury regulations on minimum participation provide a completely explicit answer. However, reading these two provisions together, alongside the conference committee report, one is led to the conclusion that in a defined benefit plan a retroactive partial accrual must be provided where the employee works the ratable portion of the minimum hours requirement for the partial accrual computation period and completes within the 12 month period commencing with his reemployment commencement date 1,000 hours of service.

It appears, however, that the one year waiting period rule (with full credit for the waiting period) cannot be applied to a defined contribution plan. There is no benefit accrual as to employer contributions in a defined contribution plan when the participant is not in the plan for the plan year in which the contribution is made, since employer contributions are generally based upon and always allocated, at least in part, on the basis of the compensation of active participants. The conference committee report solution of a retroactive benefit accrual is inadequate for defined contribution plans and probably impossible. The problem is that if the one year waiting period extends beyond the end of the plan year in which an employee with a break in service is reemployed, retroactively bringing him into the plan as of some date within the plan year of his reemployment would entail either (1) retroactively reducing the other participants' yearend allocations of company contributions and forfeitures or (2) further contributions by the company, which might not be deductible in the plan year when made, if the other plan contributions for such year were equal to the maximum allowable deduction under sections 404(a)(3)(B) or 404(a)(7).

In connection with the first alternative, *i.e.*, retroactive reallocations, consider the practical effects of this approach where some other participants may have received at the end of such plan year lump-sum distributions of their vested account balances, either by termination or retirement. However, the technique of additional contributions by the

employer is no more palatable. For example, if there were two plans involved, consisting of a money purchase pension plan with a contribution of 10 percent of compensation of covered employees and a profit sharing plan with a contribution of 15 percent of compensation of the same covered employees, contributions in any taxable year in excess of 25 percent of the aggregate compensation paid or accrued during the taxable year to the beneficiaries of the overlapping qualified plan trusts would not be deductible in that tax year under section 404, but would have to be carried over to the following tax years. Accordingly, if the retroactive contributions on behalf of a participant rehired in the last quarter of a plan year who did complete the 1,000 hours of service in the 12 months commencing with his date of rehiring equaled 25 percent of his compensation for the last quarter of the plan year 1976, or \$1,000, and for the plan year 1977 a contribution of 25 percent of his compensation, say \$4,000, and of all other participants were made to the overlapping plans, the \$1,000 paid in 1977 at the same time as the \$4,000 contribution would not be deductible in 1977 and while carried over to the 1978 plan year would not be deductible in that plan year either, if the contributions on behalf of all participants in the overlapping plans constituted 25 percent of their aggregate compensation as to plan year 1978. Thus, the section 404(a)(7) limit on deduction in overlapping pension and profit sharing plans might serve to defer the deduction indefinitely.

The Service announced in Revenue Ruling 75-481²³⁴ that annual additions for purposes of section 415 do not include repayments of cash-outs under section 411(a)(7)(C) and presumably the plan's restoration of forfeitures as well.

It may be argued that there is no requirement of a retroactive contribution after a one year waiting period problem in defined contribution plans on the grounds that the retroactive accrual requirement arises from the fact that the defined benefit plan term year of participation for accrual purposes incorporates by reference the eligibility or participation breaks in service rules including the one year waiting period after a one year break in service, which is therefore ultimately the source of any retroactive benefit accrual. Year of participation as defined in section 411(d)(3), so this argument would continue, applies only to defined benefit plans, and, therefore, there is no retroactive contribution problems in defined contribution plans. While the reasoning of Revenue Ruling 76-250 supports this argument, the broader language in the

²³⁴ 1975-44 I.R.B. 9, § 4.03 (Nov. 3). See generally BNA, TAX MANAGEMENT MEMO 75-5 (Aug. 4, 1975).

conference committee report and the proposed labor regulations have led many practitioners and may yet lead judges to conclude the retroactive allocations would be required as well. (In all likelihood the absence of explicit ERISA rules governing accruals, *i.e.*, allocations in a defined contribution plan, constitute a cabalistic concession by the ERISA proponents in the compromises leading to the final statute to demands that the time honored tradition of allocations only to participants not terminated at year end not be disturbed.) Moreover, the newly sharpened tool of no prohibited discrimination, if valid, would apply. The conservative answer at this time for defined contribution plans is *not* to use the permitted one year waiting period rule for reentry and allocation of contribution in the plan year of reemployment.

Rule of Parity

Both the participation and vesting breaks in service rules permit the rule of parity.²³⁵ In the case of nonvested employees, prebreak years of service are not required to be taken into account if the number of consecutive one year breaks in service equals or exceeds the aggregate number of prebreak years of service.

It should be noted that where a plan utilizes various exceptions to the look-back rule for vesting computation purposes, an employee may have credited more years of service for eligibility than for vesting, such as years of service completed prior to age 22. In such circumstances the rule of parity would wipe out years of service for purposes of vesting before it would wipe out years of service for purposes of eligibility.²³⁶ In a defined benefit plan in which years of participation incorporate the eligibility breaks in service rules, including the rule of parity, it could be possible for an employee not to forfeit accrued benefits when the number of consecutive breaks in service did not equal or exceed the prior years of service for purposes of eligibility while such consecutive breaks in service during vesting computation periods could equal or exceed prior years of service so that vesting credit would be forfeited. Assume, for example, that an employee is hired at age 18 and completes 1,000 or more hours of service during the eligibility computation periods commencing with the one in which he attained age 18 through the eligibility and vesting computation period in which he attained age 23. Then he incurs two consecutive one year breaks in service, is reemployed at age 26 and in the plan year in which he is reemployed he completes

²³⁵ I.R.C. §§ 410(a)(5)(D) and 411(a)(6)(D).

²³⁶ See Preamble, Prop. Labor Reg. 41657. See generally *Ns. 152-55 supra* and the accompanying text.

1,000 hours of service. In such circumstances his years of service, for purposes of eligibility and participation in a defined benefit plan, completed prior to the two consecutive one year breaks in service total six years of service. In contrast, his years of service for purposes of vesting, at most, would total only two, based on the assumption that the plan used the age 22 limitation, and hence, at age 26 his two consecutive one year breaks in service would equal his two years of service for purposes of vesting. In short, in a defined benefit plan the participant at the end of the plan year in which he is reemployed at age 26 could have seven years of service for purposes of eligibility and participation or accrual but only one year of service for purposes of vesting. In contrast, in a defined contribution plan that, for example, used the five to 15 graded vesting formula with an age 22 limitation on the look-back rule, even if the employee is admitted into the plan at age 18 under the one year break in service rule discussed below, he would have at age 25 forfeited his entire account balance. At age 26 he would be entitled to immediate entry into the plan but would have no prior years of service credit for purposes of vesting in such a defined contribution plan; and his entire prebreak account balance could be forfeited both under the rule of parity and the one year break in service rule.

One Year Break in Service

The participation, but not the vesting, breaks in service rules provide that plans with a three year waiting period (hence, providing immediate vesting after entry) may exclude prebreak years of service after a one year break in service.²³⁷ In other words, after a one year break in service an employee must commence anew on satisfaction of the three years of service requirement for entry. The pitfall to avoid here is that while a year of service for purposes of this eligibility requirement arises only if the employee completes 1,000 hours of service during the relevant 12 month period, an employee will not incur a one year break in service during such period if he completes more than 500 hours of service. Accordingly, completion of more than 500 hours of service but less than 1,000 hours of service does not advance the employee any further towards completion of the three years of service requirement, but does not cut off the prior years of service already completed. Thus, for example, if in a calendar year plan an employee completed 1,000 hours of service in 1976; in 1977, 700 hours of service; in 1978, 1,000 hours of service; and in 1979, 1,000 hours of service; he would first satisfy the three years of service requirement in 1979. As the temporary Treasury

²³⁷ I.R.C. § 410(a)(5)(B).

regulations point out, such a plan cannot require as a condition of participation that an employee complete three consecutive years of service with the employer, but such a plan can require three years of service without a break in service, *i.e.*, three years with no intervening years in which the employee fails to complete more than 500 hours of service.²³⁸ It is also important to note that a plan with this eligibility requirement cannot shift the eligibility computation period over to the vesting computation period until after the employee completes three years of service.²³⁹

The vesting, but not the participation, breaks in service rules provide that after a one year break in service, defined contribution plans (and certain insured defined benefit plans) are not required to take into account postbreak service in determining vesting in prebreak accrued benefits, *i.e.*, account balance.²⁴⁰ In other words, after a one year break such a plan is not required to vest the employee (when he is later re-employed) in his accrued benefits that were not vested at the time that he separated from service.²⁴¹ Pre-one year break years of service must be counted, however (subject to the rule of parity as to nonvested participants),²⁴² in determining the nonforfeitable percentage of a participant's benefits that accrue after his reemployment commencement date.²⁴³ For example, if employee *A* in a defined contribution plan with a vesting computation period based upon the plan year (which is a calendar year) incurs a one year break in service in 1977, at which time he was 50 percent vested in an account balance of \$1,000, the plan can forfeit \$500 as of the end of 1977. On the assumptions that the plan distributed the vested portion of the account balance of \$500 to *A* by the end of 60 days after the close of the plan year ending on December 31, 1977, and on January 1, 1979, employee *A* returned to the service of the company, completed 1,000 hours of service during the plan year beginning January 1, 1979, and that a further year of service for

²³⁸ Temp. Reg. § 11.410(a)-5(c)(2)(ii), 40 Fed. Reg. 45810, 45815 (Oct. 3, 1975).

²³⁹ Prop. Labor Reg. § 2530.202-2(c)(1)(ii), 40 Fed. Reg. 41654, 41665 (Sept. 8, 1975). In a related point it may be noted that the switchover to the plan year where an employee fails to complete a year of service during the first eligibility computation period beginning on the employee's commencement date is available only if the employee fails to complete a year of service in the first eligibility computation period and not where he fails to complete a year of service in the second or third eligibility computation period. Preamble, Prop. Labor Reg. 41658.

²⁴⁰ Compare I.R.C. § 411(a)(6)(C), with I.R.C. § 410(a)(5).

²⁴¹ H.R. REP. NO. 93-1280, 93d Cong., 2d Sess. 270 (1974).

²⁴² See Ns. 235 and 236 *supra* and the accompanying text.

²⁴³ H.R. REP. NO. 93-1280, 93d Cong., 2d Sess. 270 (1974).

purposes of vesting would move the employee up an additional 10 percent on the vesting scale, and a \$100 contribution was made to his separate account for such plan year, then he would be 60 percent vested in his new account balance of \$100. Even had his prior vested account balance of \$500 not been distributed to him, but retained as a deferred vested account, it would be held in a separate nonforfeitable account and not included in his new account for purposes of vesting.²⁴⁴

On the surface the breaks in service rules mean that in the case of a defined benefit plan a participant with any degree of vesting will always step back into place on the vesting schedule, although after one year break in service he may be required to complete a year of service after his reemployment commencement date. A defined contribution plan, on the other hand, may provide that after a one year break in service, a participant will vest no further in his prebreak account balance but will be able to use his prebreak service (assuming that he was any degree vested or that the rule of parity did not wipe out such prebreak service) together with his postbreak service in determining his place on the vesting schedule as to allocations made after he returns to service. But in actuality where distributions are involved, this is only half of the story in both defined benefit and defined contribution plans, due to the cash out and buy back rules contained in sections 411(a)(7)(B) and (C).

Cash Out and Buy Back Rules

In a defined benefit plan where the actuarial value of the vested benefit of a terminating employee is not greater than \$1,750, the employer has the option, without the employee's consent, of discharging the obligation under the plan to pay him at normal retirement age his vested accrued benefit by making instead shortly after his separation from service a lump-sum distribution to him of the actuarial equivalent at that time of the present value of the employer-derived vested accrued benefit. Congress granted this cash out privilege to employers to enable them to avoid the expense of keeping track of a relatively insignificant claim against a defined benefit plan,²⁴⁵ but the conferees preferred that all amounts contributed for retirement purposes be retained and used for those purposes.²⁴⁶ Thus, the conference committee report points out a plan could provide for no cash out or the employee's collective bargaining unit might wish to bargain for such a provision.²⁴⁷

²⁴⁴ See T.I.R. No. 1334, Jan. 8, 1975, 759 CCH ¶ 6873 at V-8.

²⁴⁵ MCGILL at 134.

²⁴⁶ H.R. REP. No. 93-1280, 93d Cong., 2d Sess. 272 (1974).

²⁴⁷ *Ibid.*

Once the step of permitting cash outs is taken, a plan designer must address two problems arising upon an employee's return to employment:

(1) How to provide an offset against his total accrued benefit under the plan for the cash out that he may have already received; the statute does not explicitly address this problem, but the temporary regulations do.²⁴⁸

(2) The degree to which a plan may provide for a forfeiture of the nonvested accrued benefit (that would not be otherwise forfeited) when there has been a cash out and, if it does, the degree to which it must permit an employee to restore or buy back this forfeiture by paying back to the plan the cash out he has received.

This concept is addressed by the statute in the cash out and buy back rules. The key to any understanding of how these rules work in defined benefit and defined contribution plans is remembering that in a defined benefit plan once a participant has attained any degree of vesting, a forfeiture, aside from the cash out rules, cannot arise. In contrast, in a defined contribution plan a forfeiture can arise after a one year break, and, accordingly, the predominant application of the buy back cash out rules there is to situations in which a cash out is made prior to a one year break in service and the participant returns to employment without incurring such a break.

Disregard of Service After Cash Out

Section 411(a)(7)(B) permits for purposes of determining an employee's accrued benefit (to which the vesting formula applies) a plan, that so provides, to disregard service performed by an employee as to which he received (1) a cash out of his entire vested accrued benefit in an amount not in excess of \$1,750 or (2) a cash out on account of termination of participation of the present value of his nonforfeitable benefit (not limited to the entire value) that he elected to receive. The distribution must be made within one year after termination of an employee's participation in the plan,²⁴⁹ and the plan must have a repayment provision.

Such disregard of service means that where the breaks in service rules would otherwise require that an employee, who had separated from service and was later reemployed, continue to vest in his accrued benefit that was not vested at the time of separation as he completed additional

²⁴⁸ See Ns. 275 and 276 *infra* and the accompanying text.

²⁴⁹ Temp. Reg. §§ 11.411(a)-7(d)(1), (2), 40 Fed. Reg. 51421, 51428 (Nov. 5, 1975).

years of service, the plan would not be required to vest such previously unvested accrued benefits if it had cashed out such employee's *vested* accrued benefit for that period of service.²⁵⁰ In the case of a voluntary cash out that was less than the present value of the employee's total nonforfeitable benefit immediately prior to the distribution, the accrued benefit that is not required to be taken into account or further vested is calculated by multiplying the accrued benefit by a fraction, the numerator of which is the amount of the distribution and the denominator of which is the present value of the total nonforfeitable benefit immediately prior to the distribution.²⁵¹

Because section 411(a)(7)(B) permits disregard of service as to which a cash out has been received only for purposes of determining the accrued amount of a reemployed participant's benefit, pre-cash out service implicitly must be taken into account (subject to the break in service rules) for all purposes other than accrual, and in particular for vesting. The conference committee report clearly indicates²⁵² and the temporary vesting regulations expressly state,²⁵³ that service as to which a cash out has been received, cannot be disregarded by virtue of the cash out rules for purposes of determining an employee's years of service under the vesting look-back rules and the participation years of service rules. This principle may be illustrated by the following hypothetical: Assume that in 1975 a participant in a defined contribution plan with a 10 percent a year vesting schedule based upon the plan year (which is a calendar year) was 50 percent vested in an account with a balance of \$3,500, terminated employment and received a lump-sum distribution of \$1,750. If such a participant were to return to employment before incurring a one year break in service (but did not buy back the cash out) and \$180 was contributed to the plan on his behalf in 1975 and \$700 was contributed on his behalf in 1976 after he completed more than 1,000 hours of service in that plan year, at the end of 1976 he would be 60 percent vested, based upon pre- and post-termination service, in his postbreak accrued benefit or account balance of \$880, assuming no gains

²⁵⁰ H.R. REP. NO. 93-1280, 93d Cong., 2d Sess. 272 (1974).

²⁵¹ Temp. Reg. § 11.411(a)-7(d)(3), 40 Fed. Reg. 51421, 51428 (Nov. 5, 1975).

²⁵² H.R. REP. NO. 93-1280, 93d Cong., 2d Sess. 272 (1974): "If the plan does make such a cash-out, then the plan would not be required to vest the employee in his accrued benefits which are not vested at the time he separates from the service, if the employee is later reemployed. (However, the employee's pre-break service would have to be taken into account for all other purposes, subject to the break-in-service rules, *e.g.*, for purposes of his place on the vesting schedule.)"

²⁵³ Temp. Reg. § 11.411(a)-7(d)(3), 40 Fed. Reg. 51421, 51428 (Nov. 5, 1975) (last sentence).

or losses as to the account. Similarly, a defined benefit plan would apply the 60 percent vesting formula to the benefit accrued in 1976 and in 1975, if any, depending upon the partial service accrual rules of the plan. Had the participant in the hypothetical bought back the cash out, he would have been 60 percent vested in an account balance in a defined contribution plan of \$4,380 (\$3,500 plus \$880) at the end of 1976.

Some practitioners have suggested that a cash out of a participant's entire vested interest for purposes of the break in service rules (for example, in a defined contribution plan) would move a participant upon his reemployment (after completion of his one year waiting period) from vested status under which prebreak service must be tacked to postbreak service in determining his vested percentage and postbreak allocations to the status of a nonvested participant subject to the rule of parity, under which prebreak years of service could be lost, *i.e.*, not tacked to postbreak service, unless they exceeded the number of his subsequent one year breaks in service. The argument goes that section 411(a)(6)(D), in setting forth the rule of parity, states that "in the case of a participant who, under the plan, does not have any nonforfeitable right to an accrued benefit" years of service before a one year break may be disregarded under certain circumstances. Where a former participant previously has received a cash out of his vested accrued benefit at the time of his separation from service, it is argued that he is not a participant who has any nonforfeitable right to an accrued benefit since upon his reemployment he has no deferred vested benefits. However, it should be noted that this argument depends upon an ability to determine whether a participant has a nonforfeitable right to any benefit by determining whether he has such right at the time of his reemployment or at least immediately after the cash out. If one examines his accrued benefit prior to his separation from service, of course, he has a nonforfeitable right. Section 11.411(a)-6(c)(1)(iii) of the temporary regulations indicates that the time to determine whether an employee is a nonvested participant is "at the time he incurs a 1-year break in service." At that time if he has previously received a cash out, the one year break in service stops the need of a separate account and quite arguably the participant has no vested right to any employer derived benefits at that time. The conference committee report, however, would indicate that "nonvested" status is forever gone as soon as an employee has achieved any percentage of vesting: "[O]nce an employee has achieved any percentage of vesting, then all of his pre-break and post-break service must be aggregated for all purposes."²⁵⁴ A theory

²⁵⁴ H.R. REP. NO. 93-1280, 93d Cong., 2d Sess. 270 (1974).

supporting this approach would be that such a terminated employee continues to have a nonforfeitable interest to a benefit; it is merely offset by the distribution previously received. In short, the safer drafting approach now would be to apply the rule of parity only to participants who had no nonforfeitable interest at the time they separated from service.

Buy Back Provision

Additionally, in order to disregard such service under the cash out rules, the plan must provide for a plan repayment provision or a buy back,²⁵⁵ *i.e.*, any participant who resumes employment covered under the plan must be given the opportunity to repay the full amount of the cash out (and upon such repayment, the employee's accrued benefit must be recomputed taking into account the service so disregarded or, in other words, the accrued benefit which has been disregarded must be restored upon repayment to the plan by the employee of the full amount of the distribution²⁵⁶) if such cash out was less than the present value of his accrued benefit. The latter condition is met if any portion of the benefit was forfeitable at the time of the distribution.²⁵⁷

Section 411(a)(7)(C) of the Code provides that the application of the repayment provision under the plan is mandatory (on a participant by participant basis) only as to a participant who (1) received a distribution in any plan year to which section 411(a)(7) applied and such distribution was less than the present value of his accrued benefit; (2) resumes employment covered under the plan; (3) repays the full amount of the distributions with, in the case of a defined benefit plan, interest at a rate no greater than 5 percent if such plan so requires; and (4) in the case of a defined contribution plan, the plan repayment provision may provide that any such repayment must be made before the participant has incurred a one year break in service commencing after the withdrawal.

The requirement that the distribution or cash out have been made in any plan year to which ERISA appears directed to the obvious problem, primarily in defined benefit plans, of participants who might have received a cash out some years prior to ERISA who now return. The requirement that the distribution be less than the present value of the

²⁵⁵ Temp. Reg. §§ 11.411(a)-7(d)(1)(iv), (d)(2)(iv), 40 Fed. Reg. 51421, 51428 (Nov. 5, 1975).

²⁵⁶ Temp. Reg. § 11.411(a)-7(d)(4)(i), 40 Fed. Reg. 51421, 51428 (Nov. 5, 1975); H.R. REP. NO. 93-1280, 93d Cong., 2d Sess. 272 (1974).

²⁵⁷ Temp. Reg. § 11.411(a)-7(d)(4)(i), 40 Fed. Reg. 51421, 51428 (Nov. 5, 1975) (last sentence).

accrued benefit (including any forfeitable interest) obviously is in recognition of the fact that if the employee did not forfeit any part of his accrued benefit on the cash out, there is no real need to allow him to make what would in effect be voluntary contributions to the plan, entailing possibly greater administrative burdens upon the plan.

Resumption of employment covered under the plan acknowledges that the breaks in service rules really apply only to employees who do return.

A plan requirement of payment of interest is clearly limited by the statute and the temporary Treasury regulations on minimum vesting standards to defined benefit plans.²⁵⁸ As usual, the conference committee report apparently ignores the existence of defined contribution plans and states that the plan must provide for a restoration of all accrued benefits "if the employee repays the amount of the cash-out, with interest."²⁵⁹

The statute, as indicated above, clearly permits a defined contribution plan to provide that a repayment must be made before the participant has incurred a one year break in service commencing after his withdrawal. The temporary vesting regulations clarify that such a plan may provide that the employee must repay the full amount of his distribution before the close of the vesting computation period within which the participant has a one year break in service.²⁶⁰ Apparently the underlying

²⁵⁸ Temp. Reg. § 11.411(a)-7(d)(4)(ii), 40 Fed. Reg. 51421, 51428 (Nov. 5, 1975).

²⁵⁹ H.R. REP. NO. 93-1280, 93d Cong., 2d Sess. 272 (1974).

²⁶⁰ Temp. Reg. § 11.411(a)-7(d)(4)(iii), 40 Fed. Reg. 51421, 51428 (Nov. 5, 1975). Interestingly, this payment before a one year break in service does not apply to insurance contract plans, as defined in section 412(i), yet such an insurance contract plan (which is a defined benefit plan) is not required to take into account for purposes of determining the nonforfeitable percentage of a participant's accrued benefit derived from employer contributions years of service before a one year break in service as to such accrued benefits that accrued prior to such break in service. I.R.C. § 411(a)(6)(C). As discussed below in the text accompanying footnote 262, any plan including such a plan may provide that the buy back must be made within two years after the recipient is reemployed. Thus, such a plan, since it does not fall into the defined contribution plan provision permitting a requirement of a buy back prior to a one year break in service, must permit a participant to repay to the plan his distribution up to two years after he is reemployed. However, if prior to such two year period and repayment, the participant incurs a one year break in service, it would not appear that the repayment would restore the prior forfeiture. It is submitted that section 411(a)(6) is the overriding provision and that section 411(a)(7)(C) only restores a forfeiture that would not otherwise occur under the breaks in service rules in section 411(a)(6) and does not restore forfeiture in a defined contribution plan or an insurance contract plan that could be wiped out by a one year break in service.

rationale for this rule as to defined contribution plans is that since (1) after a one year break in service, postbreak service in a defined contribution plan does not increase the vested percentage of prebreak accrued benefits even if there were a buy back of any cash out, and (2) the vested percentage applied to postbreak accruals in such a plan will be based upon the prebreak service, subject to the break in service rules, even if no buy back is made, a buy back or repayment after a one year break in service in such a plan serves no purpose since the account balance and the years of service for vesting will be the same regardless of whether it is made. Therefore, surely for administrative ease and possibly to confirm that the cash out rules are subject to the operation of the breaks in service rules and do not provide or restore through the buy back any accrued benefit that would be forfeited in any event under the vesting schedule of the plan, a defined contribution plan is not required to permit repayment after the employee has incurred a one year break in service. This rule may be analogized to the rule that a participant who received a distribution that was not less than the present value of his accrued benefit need not be permitted to make a repayment. In other words, both of these provisions are probably designed merely to ease the administrative burden in providing an opportunity for buy backs, where a buy back would serve no function in determination of accrued benefits.

Beyond the one year break in service permitted limitation on a buy back in a defined contribution plan there is no limitation in the Code upon the duration after reemployment in which a buy back must be permitted. The conference committee report distinguished between involuntary and voluntary cash outs, requiring that a plan allow repayment of an involuntary cash out under the plan at any time after the employee reentered employment, while repayment of voluntary cash outs would have to be allowed only under the circumstances to be prescribed in the regulations.²⁶¹ The temporary regulations on minimum vesting standards fail to follow this directive of the conference report and instead permit either a defined benefit or a defined contribution plan to require that the repayment be made within two years after the employee's resumption of employment covered by the plan.²⁶² In other words, a defined benefit plan could only provide that repayment must be made prior to the expiration of 24 months after an employee's resumption of employment, whereas a defined contribution plan could provide as to an employee

²⁶¹ H.R. REP. NO. 93-1280, 93d Cong., 2d Sess. 272-73 (1974).

²⁶² Temp. Reg. § 11.411(a)-7(d)(4)(iv), 40 Fed. Reg. 51421, 51428 (Nov. 5, 1975).

who returned prior to incurring a one year break in service that the repayment must be made within the earlier of a subsequent one year break in service or expiration of 24 months after such employee resumed employment covered by the plan.

The temporary vesting regulations speak to the amount of the employer derived accrued benefit that is required to be restored under the buy back provision. It cannot be less than the amount in the account balance of the employee, both the amount distributed and the amount forfeited, unadjusted by any subsequent gains or losses. "Thus, for example, if an employee received a distribution of \$250 when he was 25% vested in an account balance of \$1,000, upon repayment of \$250 the account balance may not be less than \$1,000 even if, because of plan losses, the account balance, if not distributed, would have been reduced to \$500."²⁶³

Two points are significant in this provision: (1) The amount of the restoration does not vary with the subsequent fortunes of the trust fund in a defined contribution plan. (2) This example apparently assumes that upon the cash out the nonvested interest of the participant at that time was forfeited and that the repayment of the cash out causes a subsequent restoration of the prior forfeiture.

Pre-ERISA Cash Outs and Accrued Benefits

In defined contribution plans the results are clear: If vesting credit would have been ignored under the plan's pre-ERISA rules, it may continue to be ignored after ERISA if the plan so provides.²⁶⁴ For example, an account balance, *i.e.*, accrued benefit, that was forfeited prior to a one year break in service can stay forfeited. In a defined benefit plan the effect of a pre-ERISA cash out in a plan that allowed no buy back upon a reemployed participant's accrued benefit is uncertain. The possible rules here are explored in the context of the following hypothetical: A pre-ERISA defined benefit plan on a calendar year basis provides for forfeiture upon a cash out of a participant's vested accrued benefit, contains no repayment provision and provides that if a terminated and cashed out employee commences employment again after a separation from service, he is treated as a new employee for vesting, eligibility and accrued benefit. The plan is a calendar year plan and, as of January 1, 1976, is amended to provide for a cash out and buy back only as to a distribution which is in a plan year to which section 411 applies. Em-

²⁶³ Temp. Reg. § 11.411(a)-7(d)(4)(v), 40 Fed. Reg. 51421, 51428 (Nov. 5, 1975).

²⁶⁴ *Ibid.*

ployee *A*, with ten years of service in 1975 and 50 percent vested interest separates from service, receives a cash out of the actuarial equivalent of 50 percent of his accrued benefit. He returns to employment in 1977 completing a year of service in the 12 month period commencing with his reemployment commencement date. He is not permitted to make a buy back.

It is not at all difficult to conclude that as to years of service for purposes of vesting, if the plan so provides, *A*'s prebreak or preseparation from service years of service are wiped out under the "plan rules relating to break in service . . . as such rules were in effect from time to time under the plans."²⁶⁵ However, the exceptions in section 1.411(a)–5(b)(6) of the proposed regulations relate solely to years of service for purposes of vesting and there are no corresponding pre-ERISA break exceptions as to years of service for purposes of eligibility,²⁶⁶ which the term year of participation incorporates.²⁶⁷ Thus, as a starting point, employee *A*'s ten years of service for eligibility and for participation would be included in his pre-ERISA years of participation.

Section 1.411(a)–7(d)(4) of the proposed regulations,²⁶⁸ of course, does not require that there be a buy back as to a distribution in a plan year prior to the effective date of section 411. At the same time, however, sections 1.411(a)–7(d)(3), and (2) or (1) of the proposed regulations,²⁶⁹ state service can be disregarded only if at the time of the distribution there was a repayment provision in effect. In the posited hypothetical there was no repayment provision in effect at such time. Thus, under the proposed regulations, the pre-ERISA years of participation would not be forfeited or disregarded by reason of the cash out.

Section 411(b)(1)(D), which relates to accrual for service before the effective date of section 411, is not very helpful. It only provides that the three anti-backloading accrual rules do not apply to years of participation before the first plan year to which section 411 applies, but a defined benefit plan can satisfy the requirements of the accrued benefit requirement of section 411(b) only if the accrued benefit of any partici-

²⁶⁵ *Ibid.*

²⁶⁶ There is no corresponding section in section 410 to section 411(a)(4).

²⁶⁷ See I.R.C. § 411(b)(3)(A) ("the term 'year of participation' means a period of service (beginning at the earliest date on which the employee is a participant in the plan and which is included in a period of service required to be taken into account under Section 410(a)(5))").

²⁶⁸ Temp. Reg. § 11.411(a)–7(d)(4), 40 Fed. Reg. 51421, 51428 (Nov. 5, 1975).

²⁶⁹ Temp. Reg. §§ 11.411(a)–7(d)(1), (2), (3), 40 Fed. Reg. 51421, 51428 (Nov. 5, 1975).

pant as to his pre-ERISA participation is not less than the greater of (1) his accrued benefit determined under the plan as in effect prior to the day of enactment of ERISA or (2) an accrued benefit which is not less than one half the accrued benefit to which he would have been entitled if the three accrual formulas had applied to such years of participation. Arguably, under the first test, since the plan had a forfeiture by reason of its pre-ERISA cash out provision, the pre-ERISA accrued benefit would be zero.²⁷⁰ Thus, in the hypothetical on December 31, 1975 employee *A* would have had no accrued benefit under pre-ERISA plan provisions. The argument would be that "accrued benefit determined under the plan, as in effect from time to time"²⁷¹ incorporates the pre-ERISA plan rules regarding forfeitures on account of terminations.

The harder question is whether the second test (50 percent of the accrued benefit to which the participant would have been entitled if one of the three anti-backloading tests had applied to such year of participation) also incorporates—or should incorporate—the plan's pre-ERISA participation cash out or forfeiture rules. Section 1.411(b)-1(c)(1)(ii) of the proposed regulations²⁷² does not clearly incorporate the pre-ERISA forfeiture rules. Possibly the language of the proposed regulations in subparagraph (c)(2), which applies to each of the three formulae—"as if the participant separated from service with the employer on the day before the first day of the first plan year to which Section 411 applies"²⁷³—can be read as incorporating the pre-ERISA forfeiture rules, *i.e.*, on the day before ERISA applied *A* would have had no accrued benefit due to the plan's pre-ERISA forfeiture rule upon a termination and cash out. While this is one possible reading of the regulations, it is certainly not clear that this result obtains. Furthermore, it seems awkward to use section 411(b)(1)(D) to in effect incorporate the pre-ERISA break rules for purposes of determining an accrued benefit. The intended answer under the Code, if any, is unclear. Possibly it is that the participant has an accrued benefit for pre-ERISA participation, probably with an offset, however that is determined, for the prior cash out; but has no years of service for vesting purposes when he is reemployed in 1976. Arguably, that is what the Code requires; the regulations are unclear.

²⁷⁰ See Temp. Reg. § 11.411(b)-1(e)(1)(i), 40 Fed. Reg. 51,421, 51,433 (Nov. 5, 1975).

²⁷¹ I.R.C. § 411(b)(1)(D)(i).

²⁷² Temp. Reg. § 11.411(b)-1(c)(1)(ii), 40 Fed. Reg. 51,421, 51,432 (Nov. 5, 1975).

²⁷³ Temp. Reg. § 11.411(b)-1(c)(2)(iii)(A), 40 Fed. Reg. 51,421, 51,432 (Nov. 5, 1975).

Pre-One Year Break in Service Distributions and Offsets

A plan may not wish to forfeit upon a cash out the forfeitable interest of the terminated participant or it may make a distribution that would not qualify as one that permits the plan to disregard the years of service as to which the distribution was made in computing the employee's accrued benefit under the plan (such as a distribution made for reasons other than termination of the employee's participation in the plan or a distribution where the plan does not provide for a repayment provision). In both of these circumstances in a defined contribution plan, the basic question arises whether the plan may provide an offset to the participant's account balance for the distribution and, if so, how should that offset be determined. Section 11.411(a)-6(c)(1)(ii)(B) of the temporary regulations²⁷⁴ provides that if a defined contribution plan makes a distribution to a participant at a time when the participant is less than 100 percent vested in his employer contributions and there is no break in service prior to the relevant time the plan must provide that a separate account is established for the participant's interest in the plan as of the time of the distribution and that at any relevant time (prior to a break in service) the participant's vested portion of the separate account is not less than the following algebraic formula in which X is the vested amount:

$$X = P (AB + (R) \times (D)) - (R) \times (D).$$
 For purposes of applying the formula: P is the vested percentage of the relevant time; AB is the account balance at the relevant time; D is the amount of the distribution; and R is the ratio of the account balance at the relevant time to the account balance after the distribution.²⁷⁵

What this complicated formula is intended to accomplish is that for vesting purposes first the withdrawal or offset is added back to the account balance, the vesting formula is applied to the so increased account balance, and then from the total vested amount there will be subtracted an offset for the distribution already received. The algebraic use of the ratio of the account balances, R is to ensure that the offset will go up and down according to the fortunes of the plan's trust fund subsequent to the distribution or withdrawal.

It is important to note that this provision uses the term "break-in-

²⁷⁴ Temp. Reg. § 11.411(a)-6(c)(1)(ii)(B), 40 Fed. Reg. 51421, 51425-26 (Nov. 5, 1975).

²⁷⁵ *Ibid.*

service" and not a "1-year break-in-service." Literally, break in service means any separation from service and is not limited to a one year break in service. However, the writer is informed that the drafters of the proposed regulations did not intend to limit this rule to in service withdrawals prior to any separation from service, but meant to encompass cash outs prior to a one year break in service where the plan did not provide for a forfeiture upon a cash out, *i.e.*, use of the cash out and buy back rules. The pre-ERISA regulations permit distributions from qualified profit sharing plans "after a fixed number of years,"²⁷⁶ which the Service has historically interpreted to mean accumulations cannot be distributed in less than two years, unless all funds have been in for more than five years, in which case all accumulations can be withdrawn.²⁷⁷ Prior to ERISA, in service withdrawal provisions were more prevalent in thrift plans where an employee had to make mandatory contributions which the employer then matched.²⁷⁸ Some profit sharing plans also provided for hardship withdrawals.²⁷⁹ The Service took the position informally that such withdrawal provisions might not be permitted in some integrated defined contribution profit sharing plans.^{279a}

Practical Application of Breaks and Cash Out Rules and Possible Alternatives

The cash out and buy back rules are workable in defined benefit plans. However, the interplay between the one year break in service rules and cash out and buy back rules—especially as interpreted in the temporary regulations on minimum vesting—standards may pose a dilemma to defined contribution plan designers. The following discussion of the administrative problems created by the equally unsatisfactory alternatives giving rise to such a dilemma and some potential solutions outside the cash out and buy back rules (countenanced to varying degrees in the temporary regulations) can be highlighted by the following hypothetical: Employee A is a participant in a defined contribution plan in which all of his computation periods are based upon the plan year. He works 501 hours in the period January 1, 1977 through March 31, 1977 and separates from service when he was 25 percent vested in a current

²⁷⁶ Reg. § 1.401-1(b)(1)(ii).

²⁷⁷ See Rev. Rul. 54-231, 1954-1 C.B. 150, superseded by Rev. Rul. 71-295, 1971-1 C.B. 184; Rev. Rul. 68-24, 1968-1 C.B. 150.

²⁷⁸ MCGILL at 127.

²⁷⁹ See PUB. 778 pt. 5(m).

^{279a} Goodman, Q & A No. 2, following talk on *Developing Pension and Profit-Sharing Requisites*, P.H. PENSION & PROFIT SHARING ¶ 71,513.22. See Rev. Rul. 71-446, § 15.03, 1971-2 C.B. 187.

account balance of \$7,000. Under a mandatory cash out provision, he immediately receives \$1,750. *A* returns to employment on October 1, 1978 and works thereafter 501 hours by midnight December 31, 1978. He completed a year of service in calendar year 1979 and in calendar year 1980. On September 30, 1980, *A* finally decides whether he will repay to the plan the \$1,750 cash out that he received 42 months earlier. A quick recollection of the breaks and cash out rules should expose the administrative nightmares inherent in this fact pattern. First, *A* did not have a one year break in service in plan years 1976 or 1977 (but it took 18 months before the plan administrator could determine that *A* might not incur a one year break in service and 21 months before he was sure that *A* did not incur such break). Then *A* had 24 months after his return to repay the cash out.

The simple solution for the plan designer is to provide for no distribution and no forfeiture until after a participant incurs a one year break in service. In that case *A* would not have received a distribution nor have suffered a forfeiture. But suppose *A* had not returned to covered service in October 1977. The plan administrator still could not have determined whether *A* would incur a one year break in service in 1977 until 18 or 19 months after *A* separated from service. Without shaving it fine, the administrator first could safely determine in most industries that *A* would incur a one year break in service only if he had not returned to service by November 1, 1977—19 months after *A* separated from service. Therefore, if the plan matches distributions with forfeitures, the delay before a distribution will be too long in many instances. Participants in defined contribution plans historically have desired, even demanded, cash distributions, whether at retirement or separation from service, and plan administrators universally want to cash out in such plans smaller vested amounts as soon as possible. Thus, delaying distributions of nonforfeitable account balances until a participant incurs a one year break in service is an unsatisfactory alternative.

The temporary regulations on vesting clearly approve one method whereby a distribution safely can precede a one year break in service. Upon *A*'s receipt in April 1977 of his vested account balance of \$1,750, the plan could provide that *A* would forfeit the remaining \$5,250 of his \$7,000 account. Then if *A* decides on September 30, 1980 (less than two years after his reemployment on October 1, 1978), to make the repayment to the plan of \$1,750, the plan must restore \$5,250 to his account. Restoration of forfeitures in defined contribution plans, however, probably poses even worse potential administrative nightmares than waiting 18 months to make a distribution to a terminated participant of his vested interest. The hard questions are the permissible (and

practical) sources for such restorations and, if from the company, whether such restoration will be deductible.

First, it appears clear that the Service would not allow the plan to provide that *A*'s forfeiture in April of 1977 would be held in suspense until the expiration of any buy back period without allocating any interest in such suspense account to participants.²⁸⁰ Thus, it is not possible simply to hold *A*'s forfeitable interest in suspense and then forfeit it in 1980 and allocate it to the other remaining participants at that time if he fails to repay, or restore it to him in 1980 if he does repay.

In many profit sharing and stock bonus plans forfeitures are allocated to the accounts of remaining participants. Yet, taking away the amounts that had been allocated to the other participants in 1977 of *A*'s forfeiture from such participants' accounts in 1980 is not a permitted solution either. Aside from the inequities involved, and the fact that many participants might have retired or terminated and taken their vested accounts with them in the interim between April 1977 and October 1, 1980 when *A* made his repayment, the very fact that the 1977 forfeiture was added to the account balance of the then remaining participants would mean that to the degree that they were vested then and achieved greater vesting in subsequent plan years they had a nonforfeitable interest in such additions to their account which could not later be taken away.

Presumably, the plan administrator or the plan designer could provide that the restoration of *A*'s \$5,250 in 1980 could come from any forfeitures that arose in 1980. But in many plans there may be no forfeitures in 1980 or they may not be sufficient to equal the amount of all of the restorations in that year. At that point, the plan designer has two alternatives: (1) satisfy the remaining amount of the restoration from the current company contribution or (2) provide that the company will make an additional contribution equal to the remaining required restoration.

Attempting to satisfy the restoration to *A* from the current company contributions could in many easily imaginable circumstances result in no allocation to the other participants in the plan in 1980. Assume that 1980 is a low profit year and that the plan provides for a contribution based on, say, 10 percent or even 5 percent of net profits. If the dollar amount determined under such formula is no greater than the restoration—and bear in mind that the restorations in the aggregate could be quite larger than *A*'s \$5,250—then the restored forfeitures could easily eat up the entire contribution and preclude any of the other 1980 participants from receiving any benefits. Those participants in 1980 who

²⁸⁰ See Rev. Rul. 70-125, 1970-1 C.B. 87.

received no allocation could constitute a radically different cast of characters than participants who shared in the 1977 forfeiture. To avoid this problem of employee morale, surely most plan designers in defined contribution plans, who provide for restoration of forfeitures, will provide that they first come from forfeitures in the plan year of the restoration and subsequently from additional contributions by the company over and above the contribution that would otherwise have been made and allocated under the plan.

Unfortunately, this solution to the quagmire of restoration of forfeitures upon a buy back bears with it its own problems. It may be that by 1980 the employer would not have current or accumulated earnings sufficient from which to make an additional contribution. Additionally, and probably the more common situation, the company contribution to make up the restoration might not be deductible. For instance, where the employer has been making the maximum deductible contribution of 15 percent of compensation of participants (with no unused credit carryforward) to a profit sharing plan, it would not be able to deduct any additional amounts to restore forfeitures above the normal 15 percent of compensation contribution in 1980. Moreover, while the excess contribution in this instance would be deductible as a carryforward in subsequent years, deduction for such a carryforward is allowed only if the aggregate contribution in subsequent years together with the carryforward does not exceed 15 percent of compensation.²⁸¹ Hence, in such a plan the additional money to restore the forfeiture might not be deducted but could roll forever. A similar situation would arise where the employer maintains overlapping defined contribution and pension plans (in most circumstances, a defined contribution money purchase pension plan).²⁸² In such circumstances the maximum deductible contribution is 25 percent of the annual compensation of the employees covered under both plans. Additional employer contributions to restore forfeitures would not be deductible. Obviously these possibilities are not palatable or acceptable to most plan sponsors. In addition, simply the record keeping involving restoration of forfeitures could cause problems for many plan administrators. Consequently, forfeiture upon a cash out and restoration of such forfeiture upon a buy back is not a satisfactory alternative either.

In summary, the temporary regulations on minimum vesting standards

²⁸¹ I.R.C. § 404(a)(3)(A).

²⁸² The limitations of section 404(a)(7), are based on the compensation otherwise paid or accrued during the year by the employer "to all employees who, in such year, are beneficiaries of the funds accumulated under one or more of the overlapping trusts or plans." Reg. § 1.404(a)-13(a).

fully countenance (1) no distributions and forfeitures until after a one year break and (2) forfeitures upon a cash out followed by a subsequent restoration of forfeitures upon a buy back. Since neither of these alternatives are desirable, or possibly even acceptable (thereby giving birth to the acute dilemma), in many defined contribution plans, other alternatives must be considered. The first is simply to provide that in our hypothetical *A* would not incur a forfeiture of the \$5,250 until the expiration of the buy back period on October 1, 1980. While this may delay a forfeiture as long as 42 months in rare instances, in most instances participants probably do not return after separating and this approach has the decided advantage of avoiding restorations of forfeitures. The important question is whether such a delayed forfeiture is permitted by the statute and the temporary regulations on minimum vesting.

On the one hand, section 411(a)(7)(B) provides that a plan may disregard service as to a cash out and does not specify at what time the plan has to commence to disregard such service in the defined contribution plan for purposes for determining the account balance. On the other hand, section 411(a)(7)(C) does provide that upon a repayment the employee's accrued benefit shall be recomputed by taking into account the service so disregarded. It would appear that this section anticipates that prior to the repayment the employee's accrued benefit has been computed without taking into account the disregarded service, *i.e.*, forfeited. Yet it is not implicit in such wording or in the concept of the cash out and buy back provisions that the plan must not take into account the service to which the cash out is attributable prior to the repayment. Nevertheless, the temporary vesting regulations clearly speak in the context of a defined contribution plan only to a forfeiture and subsequent restoration.²⁸³

The harder question is, however, the manner in which the minimum vesting or nonforfeitability provisions themselves apply here. First, if the plan wishes to provide that *A* will not forfeit the remaining \$5,250 that was in the \$7,000 account upon his cash out until he fails to buy back by October 1980, apparently he must obtain a vested interest in account containing such \$5,250 as he completes years of service after his reemployment, subject to a later forfeiture if he fails to make a repayment within two years after his reemployment. The reason for this is twofold: (1) If there is no vesting in the account until *A* forfeits it, it is difficult to distinguish such account from a mere suspense account

²⁸³ Temp. Reg. § 11.411(a)-7(d)(4)(v), 40 Fed. Reg. 51421, 51428 (Nov. 5, 1975).

in which there is no allocation of any interest therein to participants. (2) In a defined contribution plan the definition of accrued benefit is account balance and, thus, the nonforfeitable percentage must apply to the account balance, including the account for the \$5,250, which, under this approach, the plan would subsequently forfeit despite interim vesting if *A* did not repay the cash out.

On the surface it would appear that such vesting is subject to divestiture upon our failure to repay the cash out and would not qualify as a nonforfeitable interest. Following traditional Tax Court case law²⁸⁴ and section 1.402(b)-1(a)(2)(i) of the regulations and section 11.411(a)-4(a) of the temporary regulations,²⁸⁵ any vested interest that *A* attained in the \$5,250 prior to October 1, 1980 but which could be forfeited at that point upon a failure to repay the cash out would not qualify as nonforfeitable. However, both the Code and the temporary regulations on minimum vesting standards specifically provide that an accrued benefit can qualify as nonforfeitable under section 411(a) notwithstanding the fact that it may be lost, or in practical terms forfeited, upon certain subsequent events, such as death in some circumstances or upon certain withdrawals of mandatory employee contributions.²⁸⁶ While the cash out rules are not specifically referred to as a listed exception to the term nonforfeitable in these provisions, the conference report, in discussing the exceptions to nonforfeitable for loss of an accrued benefit upon death, or withdrawal of mandatory employee contributions, et cetera, follows these exceptions with a discussion of the cash out rules in numbered sequence.²⁸⁷ Thus, if the Treasury desired to permit this approach, it could find ample grounds to do so.

Even delaying the forfeiture after a cash out until the repayment period expires carries with it some complexity, since the vesting schedule would have to take into account an offset for the prior cash out in order to achieve equitable results. Furthermore, to achieve fairness, such a formula would undoubtedly have to be identical to the in service withdrawal variable offset discussed above. In such circumstances the actual forfeiture in 1980 of a separate account in which the \$5,250 would have been placed could be greater or less than \$5,250. Indeed, carrying this approach a step further, if the \$5,250 had been left to the trust fund and the trust fund declined in value, it is possible that the buy back by *A* in

²⁸⁴ *Liberty Machine Works, Inc.*, 62 T.C. 621 (1974), *aff'd per curiam*, 518 F.2d 554 (1975); *Hazel W. Pollnow*, 35 T.C. 715 (1961).

²⁸⁵ Temp. Reg. § 11.411(a)-4(a), 40 Fed. Reg. 51421, 51423 (Nov. 5, 1975).

²⁸⁶ I.R.C. § 411(a)(3); Temp. Reg. § 11.411(a)-4(b), 40 Fed. Reg. 51421, 51423-24 (Nov. 5, 1975).

²⁸⁷ H.R. REP. NO. 93-1280, 93d Cong., 2d Sess. 271-72 (1974).

1980 by repaying his \$1,750 might restore to him a lesser amount than \$5,250. To avoid this situation and to fit within the restoration of an amount no less than the original forfeiture requirement in the temporary vesting regulations, the plan administrator would have to direct the trustee to segregate the potential forfeiture into a separate fixed income or bank savings account.

Forfeiture at End of Plan Year of Reemployment

Ultimately, the approach of delaying the forfeiture until 1980 and applying a vesting formula to the separate account for the potential forfeiture if there is no buy back, with an offset for the buy back in applying such tentative vesting, carries with it substantial administrative problems. While these problems are probably in the aggregate still less than the problems of deferring distribution until a one year break or of restoring forfeitures, the uncertainty that would go with this approach until its recognition, if ever, by the Department of the Treasury probably precludes its use at this time.

A variant that avoids most of administrative problems of the delayed forfeiture approach would be to provide that a forfeiture occurs not upon the cash out but upon a failure to buy back by the earlier of the end of the plan year of the participant's return or completion of 1,000 hours of service in such plan year. Following our example, *A* would forfeit his \$5,250 at the latest on December 31, 1977 if he has not made a buy back and restored the \$5,250 forfeiture. The assumption here would be that most participants who would ever make a buy back would do so immediately upon their return. It is submitted that this approach can be worked within the framework of the temporary vesting regulations, but it still does not totally avoid the potentiality of restored forfeitures.

Probably the simplest defined contribution plan design approach in attempting to achieve administrative flexibility in providing for (1) distributions upon a separation from service, but (2) no forfeitures until a one year break in service, is simply not to use the cash out and buy back rules at all. In other words, *A* would not forfeit the \$5,250 even if he did not make a buy back by October 1980. Indeed, the plan for purposes of administrative ease might want to provide that *A* could not make a buy back.

The first question, before exploration of the technical aspects of this approach, is whether the cash out and buy back rules are the exclusive means through which lump-sum distribution upon a separation from service can be made. Sections 411(a)(7)(B) and (C) by no means appear to constitute limitations upon a plan's ability to provide a cash

out, but only appear to spell out the circumstances in which the nonforfeitable accrued benefit (remaining account balance in a defined contribution plan) may be forfeited. The conference committee report, however, seems to say that cash outs can only be made if they are in compliance with the cash out and buy back rules.²⁸⁸ It seems clear now from the recognition of in service withdrawals (and distributions prior to a one year break) provided in the temporary vesting regulations that the cash out and buy back rules are not limitations upon a plan's right to make a cash out. Furthermore, from the in service withdrawal rules it appears clear that a plan can take into account an offset for a withdrawal without complying with cash out and buy back requirements. Accordingly, in *A*'s case the plan could provide that *A* would not forfeit the \$5,250 upon his cash out in April 1977 of \$1,750, and instead would forfeit the \$5,250 only if he incurred a one year break in service prior to achieving any further vested interest in such amount. If he returned prior to a one year break in service, then he would continue to vest in the \$5,250, along with any new allocations, subject to an offset for the prior distribution. The only sensible and equitable formula for calculating such offset is that provided in the temporary regulations on minimum vesting for distributions or withdrawals prior to a (one year) break in service. The writer understands that the drafters of the regulations fashioned this rule just for this purpose in recognition of the unwieldiness of the cash out buy back approach to defined contribution plans. From this vantage point the algebraic formula applicable to defined contribution distributions prior to a one year break in service (where there is no forfeiture of the nonvested account balance upon the cash out) and the cash out buy back rule (permitting forfeitures upon a cash out and requiring restorations of such forfeitures) should be mutually exclusive. Of course, if the separation from service lengthens into a one year break in service the account balance that was not vested at the time of the separation from service and cash out could be forfeited.

If a participant were to separate from service on several occasions prior to becoming fully vested and received a lump-sum distribution each time as to his then vested account balance, reemployment after each separation could result in a multiplicity of separate accounts for the remaining forfeitable interest in the participant's general account

²⁸⁸ "A cash-out could be made from the plan without the employee's consent only if the payment (a) was made due to the termination of the employee's participation in the plan, (b) constituted the value of the employee's entire interest in the plan, and (c) did not exceed an amount . . . based on the reasonable administrative needs of the plan, and, in any event, not in excess of \$1750." *Id.* at 272.

each time he separated from service and received a distribution of his then vested interest. A simple answer here is to permit only one distribution of the participant's nonforfeitable interest upon separation from service prior to full vesting. If he should leave thereafter he would not receive a distribution, but his general account and prior separate account would simply be maintained until he incurred a one year break in service or returned.

A former Treasury official who reviewed the proposed and temporary vesting regulations has stated that under the temporary regulations that the separate account under the offset approach in defined contributions need only be established at the time of reemployment and not at the time of the previous distribution on account of a separation from service to a one year break in service.²⁸⁹ However, it is submitted that at least by the close of the plan year in which a participant separates from service with a distribution of his then vested amount, a separate account should be established. Otherwise, upon his reemployment in the subsequent plan year and completion of at least 501 hours of service, and the establishment of a separate account, the earnings of that separate account for the plan year in which he separated from service would have to be made up either from current forfeitures or from additional company contributions. This is because if no account were established at the end of the preceding plan year (even if no forfeiture were made as to the nonvested account balance itself), all of the trust earnings would have been allocated to the other accounts. Upon the subsequent establishment of a separate account, trust earnings could not be taken away from the other accounts, accordingly, the earnings would have to be made up from some source. If the nonvested account had been forfeited, it too would have to be restored. As a result, it is surely simpler to establish a separate account at the end of the plan year if a participant has not yet incurred a one year break in service if he received a distribution of his then vested benefit upon his separation from service earlier in the plan year.

In summary, while it may be difficult to explain the pre-one year break in service offset formula to participants, and probably to plan administrators, it appears the cheapest price to pay for immediate distributions of a participant's nonforfeitable interest upon his separation from service in defined contribution plans where the plan sponsor requires provision for such distributions.

It may be noted that once a reemployed participant becomes fully vested there is no longer any need to maintain a separate account for his

²⁸⁹ Note, *Several ERISA Drafting Problems and Solutions*, 6 PENSION PLANNER No. 2, 6 (March 1976).

interest which was not vested at the time he first separated from service and received a distribution of his vested benefit. At that time any separate account and his general account would be merged. The add back and the offset approach require only that the participant have on his reemployment prior to a one year break in service a nonforfeitable interest in the separate account that is no less than that which would be determined under the offset approach. ERISA does not preclude his having a greater vested amount and some plan administrators for ease of administration prefer simply to vest a reemployed participant in the separate account applying the vesting formula to such account without an add back and offset for the prior distribution. While such a provision would give a reemployed participant a greater interest in that separate account than he would enjoy under the add back and offset approach, it makes no difference if he stays reemployed until he is fully vested since at that point that entire account would be merged into his general account. On the assumption that a former participant will be reemployed only if he shows promise of staying for a considerable length of time, this may be a simple answer to the problem of distributions upon separation from service prior to a one year break in service.

Another approach to avoid the dilemma of distributions only after a one year break in service versus restoration of forfeitures upon a buy back (which most plan sponsors probably will not be able to accept in a trade off) is to provide for immediate vesting. In that case the cash out does not have to be restored.

While participants may currently desire cash outs of their vested interest, particularly in defined contribution plans, upon a separation from service, it should be noted that under the proposed regulations on lump-sum distributions in many circumstances lump-sum distribution treatment will not be available under several of the different approaches suggested above. On the one hand, section 402(e)(4)(A) and section 1.402(e)(4)(A) of the proposed regulations²⁹⁰ define the term "lump-sum distribution" as the distribution or payment within one taxable year of the recipient of the balance to the credit of an employee which becomes payable to the recipient on account of his separation from service. Accordingly, if a plan provided that only vested amounts become payable to the recipient upon separation from service (with nonvested amounts remaining in his account and forfeited subsequently if he has a one year break in service and retained until normal retirement age if he does not have such a break), then arguably the only balance which is payable on account of separation from service consists of such

²⁹⁰ Prop. Reg. § 1.402(a)(4)(A), 40 Fed. Reg. 18898, 18802-03 (1975).

vested amounts and, therefore, they should come within the definition of lump-sum distribution. On the other hand, however, section 1.402(e)-2(d)(1)(vii) of the proposed regulations²⁹¹ provides that the term "balance to the credit of the employee" includes any amount that is forfeited under the plan as of the close of the recipient's taxable year within which the distribution is made, except that in the case of an employee who has separated from service and incurs a break in service within the meaning of section 411, such term does not include an amount that is forfeited at the close of the plan year, coincident with or beginning within such taxable year, by reason of such break in service.

In any plan in which vesting and forfeitures turn upon the plan year, which is a calendar year, and an employee completes more than 500 hours of service prior to his separation from service, the forfeiture by reason of the break in service will arise in the plan year following the close of the plan year, coincident with or beginning within such taxable year in which the distribution is made unless the distribution is made after the close of the plan year in which the participant separates from service. For example, if distributions are not made within a specified time after the separation from service, but instead are made within, for example, 60 days after the close of the plan year in which the participant separates from service, then lump-sum distribution in most instances would be available. It may be noted that many defined contribution plans avoid the problem of interim valuations that would arise from distributions prior to plan yearend by making distributions only after the close of the plan year so that the gain or loss for such year can be determined.²⁹² At the same time such plans frequently permit advances prior to the end of the plan year, which may offset the subsequent distribution in part. It is uncertain whether such advances would be treated as loans, which presumably they are for tax purposes, or as distributions. In any event, if this proposed regulation is promulgated in substantially the same form, the participant who works, say, three or four months in a plan year, thereby completing more than 500 hours of service, would generally not be able to receive a lump-sum distribution of his then vested amount and obtain favorable tax treatment unless the distribution occurred after the end of the plan year, which could be as much as nine months later. It is unlikely that Congress contemplated this result.

Unless the employee rolled the cash out into a conduit IRA or another

²⁹¹ Prop. Reg. § 1.402(e)-2(d)(1)(vii), 40 Fed. Reg. 18898, 18908 (1975).

²⁹² Other defined contribution plans give participants the choice as to whether the distribution is to be based upon the preceding valuation of the trust fund or the next succeeding valuation (in which case there may be a holdback pending such valuation).

qualified trust within 60 days after the distribution,²⁹³ he would be taxed upon the distribution, as discussed above, in some instances under the lump-sum distribution rules of section 402. No reduction for taxes thus paid would be allowed to the reemployed participant upon the buy back. Presumably such buy back would be treated as "consideration for the contract contributed by the employee" under section 72(m)(2)(B), and hence nontaxable upon subsequent distribution. Until the participant was fully vested, the trustee would have to maintain a separate nonforfeitable account as to the buy back.²⁹⁴

Insurance Contract Plans and Cash Outs

While the cash out and buy back rules pose relatively few problems as to trustee defined benefit plans—which discount in advance for turn-

²⁹³ I.R.C. § 402(a)(5). Such rollover use of a conduit IRA requires, however, that the distribution qualify as a lump-sum distribution within the meaning of section 402(e)(4)(A). This leads directly back into the quagmire of whether the participant has received the balance to his account when the forfeitable portion thereof has not yet been forfeited pending his separation from service lengthening into a one year break in service prior to his return. The impossibility at the end of the plan year of determining whether the distribution will, in fact, qualify as a lump-sum distribution calls to mind the tax principle that where character of income—generally ordinary income or capital gains—cannot be determined at the end of the tax year of the recipient, inclusion is deferred until the next tax year of the recipient when the character can be determined. *See* Dill Co., 33 T.C. 196, 200 (1959), *aff'd*, 294 F.2d 291 (3d Cir. 1961); Virginia Iron Coal & Coke Co., 37 B.T.A. 195, 199, *aff'd*, 99 F.2d 919 (4th Cir. 1938), *cert. denied*, 307 U.S. 630 (1939); Rev. Rul. 58-234, 1958-1 C.B. 279. It also may be noted that a substantial, but not unchallenged, body of cases hold that a taxpayer only has to include in gross income the net amount of a payment received in a tax year where all or part of the payment is returned by the taxpayer in the year of receipt. *See, e.g.*, Curran Realty Co., Inc., 15 T.C. 341, 343 (1950); Albert W. Russel, 35 B.T.A. 602, 604 (1937); Fender Sales, Inc., 22 T.C.M. 550 (1963), *rev'd on other grounds*, 338 F.2d 924 (9th Cir. 1964), *cert. denied*, 382 U.S. 813 (1965), and cases cited therein. *See generally* Webster, *The Claim of Right Doctrine: 1954 Version*, 10 Tax L. Rev. 381, 392 (1955). By perhaps somewhat tenuous analogy, then, an employee who attempted to roll a distribution of the entire nonforfeitable balance to his account into a conduit IRA in a plan in which the plan year was a calendar year and who in the subsequent year returned to service prior to a one year break in service and rolled the amount in the conduit IRA back into his employer's trust, has some basis to argue that in the year of the distribution he was not taxable since it was not possible to determine at that time whether or not he qualified for conduit IRA treatment and in the second tax year in which the taxability of the income could be determined, he rolled it back into its source, the qualified plan trust, prior to the end of the tax year. The fact that such legal gymnastics might have to be resorted to suggests strongly that either the proposed regulations or the statute itself, if necessary, should be modified.

²⁹⁴ T.I.R. No. 1334 (Jan. 8, 1975), 759 CCH ¶ 6873 at V-7.

over or severance or are not maintained as an overlapping plan with a profit sharing plan covering the same employees so that the deduction limitation of section 404(a)(7) could not be triggered by a restoration of forfeitures—insurance contract plans share many similarities with individual account or defined contribution plans and not surprisingly, in the context of cash outs and breaks in service, share some of the same administrative problems as well as present special problems of their own.

An insurance contract plan is an insured defined benefit plan which (1) is funded exclusively by the purchase of individual insurance contracts for each participant with level annual premium payments payable over a period commencing with the date that he became a participant in the plan and ending no later than his retirement age, and (2) provides benefits under the plan equal to the benefits provided under each contract at plan normal retirement age and guaranteed by the insurance carrier to the extent that premiums have been paid.²⁹⁵ The accrued benefit under an insurance contract plan is not determined under either of the three backloading rules of sections 411(b)(1)(A) through (C), but instead must be no less than the cash surrender value of the contract, determined as though the funding requirements as to the plan had been fully satisfied.²⁹⁶ Thus, upon severance of employment, a participant's accrued benefit depends upon his own individual contract, which is analogous to the individual account of a participant in a defined contribution plan. This is probably the basis for the rule that in an insurance contract plan, after a one year break in service, years of service after the break do not have to be taken into account for purposes of determining the nonforfeitable percentages of the benefit accrued, *i.e.*, cash surrender value, prior to the break.²⁹⁷ However, the correlation in the breaks and buy back rules as to insurance contract and defined contribution plans is not complete, because an insurance contract plan may not use the defined contribution plan rule that a buy back must be made before the participant has incurred a one year break in service commencing after the withdrawal or cash out, and an insurance contract plan may require, just as any other defined benefit plan may, the payment of interest at 5 percent per annum from the beginning of the first plan year in which the withdrawal was made to the date upon which the employee pays back the cash out.²⁹⁸

²⁹⁵ I.R.C. §§ 411(b)(1)(F), 412(i).

²⁹⁶ I.R.C. § 411(b)(1)(F); H.R. REP. NO. 93-1280, 93d Cong., 2d Sess. 275 (1975).

²⁹⁷ I.R.C. § 411(a)(7)(C).

²⁹⁸ *Ibid.*

Deductibility of Restored Forfeitures

Restoration of forfeitures may pose a deduction problem as to insurance contract plans similar to that of a defined contribution profit sharing plan or perhaps even more severe. The deduction limitation on contributions to a pension plan, including an insurance contract plan, generally will be the greater of the amount necessary to satisfy the minimum funding standard provided under section 412(a) or an amount equal to the normal cost of the plan plus an amount necessary to amortize past service credits in equal annual payments (until fully amortized) over ten years.²⁹⁹ The restored forfeiture would certainly appear more analogous to a credit for past service rather than to a part of the normal cost of the plan in the year of the restoration. If that is the case, the restoration would be amortized in equal annual payments over ten years. Yet, when the forfeiture arose and was used by the company to reduce the current contributions under the insurance contract plan, the forfeiture in most instances would have been used to reduce the current plan year's normal cost which would have been entirely deductible in one tax year. Under the minimum funding standard the restoration of forfeiture again would probably not constitute a part of the normal cost of the plan of the plan year and would accordingly either constitute a past service liability (generally amortized over no more than 30 years) or more likely could be viewed as an experience loss, which, however, is amortizable in the case of a nonmultiemployer plan over a period of 15 years,³⁰⁰ which is an even longer period than the maximum deduction amortization period for a past service liability of ten years. In summary, while there is not the problem of the deduction for a restoration of a forfeiture being deferred indefinitely, as can be the case in a defined contribution plan, there remains the problem that the restoration while paid entirely in one tax year, would be deductible only over a ten year period or probably a 15 year period. If a matching of payments to the plan with the deductions were sought, it would appear that the level annual premium payments requirement would not be met in that there would be greater premium payments for ten or 15 years and then the level premium payment for the balance of the participant's work career until normal retirement age. Even a single, one shot premium payment to restore the forfeiture would need to be expressly dealt with in the regulations concerning the requirements for an insurance contract plan.

²⁹⁹ I.R.C. § 404(a)(1)(iii).

³⁰⁰ I.R.C. § 412(b)(2)(iv).

Duplication of Benefits Upon Reinstatement

In addition to the problem of deducting restoration of forfeitures, insurance contract plans present a problem that does not arise in defined contribution plans, namely that upon reentry into a plan after discontinuance of participation, as by severance of employment, the plan may not permit a duplication of benefits.³⁰¹ In a defined contribution plan there would be no duplication because a participant's accrued benefit would consist only of the annual additions to his account and even a restoration of a forfeiture for a deferred vested account after a one year break in service would not, in a practical sense, produce a greater account balance than if the participant had remained in the plan. The minor exception that the restored forfeiture in a defined contribution plan cannot be less than the original amount of the forfeiture, even though the fund has decreased in value,³⁰² should not be viewed as a duplication of benefits. In the case of a target benefit plan (a plan with a defined benefit formula under which initial contributions are determined based upon actuarial assumptions, and then an individual account balance is established for each participant's contributions), it may be necessary in order to avoid a duplication of benefits to base the annual contribution to the participant following his reemployment upon his age at original entry and not upon his age at reemployment. On the other hand, an insurance contract plan that provided for a flat benefit, or a benefit based on a specific percentage of final pay, could in theory result in a duplication of benefits where a participant had a deferred vested accrued retirement benefit. In other words, if a participant separated from service and his nonforfeitable accrued benefit or cash surrender value were retained by the plan as a deferred vested benefit, and he then returned and accrued a normal retirement benefit based upon his final pay in addition to the deferred vested benefit, there would be a duplication of benefits. Presumably it would be necessary to develop an offset or reduce the benefit that he accrued after reemployment by the deferred vested benefit. A still harder problem would arise where the participant had already received a cash out of his nonforfeitable benefit which he did not repay to the plan. In such circumstances, in theory, if there were no reduction of the benefit that he accrued after his return to service, he would have received a duplication of benefits if the prior cash out were considered a benefit.

³⁰¹ PUB. 778, pt. 4(p).

³⁰² Reg. § 1.401-7(a).

Policy Loans and the Offset Approach

As a result of these problems, it is probable that in many insurance contract plans the plan designer will not want to follow the cash out and restoration of benefit approach he perhaps would adopt in other types of defined benefit plans. The offset approach in a defined contribution plan suggests a likely model. In most defined benefit plans an offset approach would probably entail too many actuarial difficulties to be commonly used. However, in most insurance contract plans a ready technique is available. Most individual insurance contracts used in such plans contain policy loan provisions. Accordingly, a plan could provide that upon a participant's separation from service the plan administrator will borrow on the policy an amount equal to the participant's then vested accrued retirement benefit or vested cash surrender value. The plan administrator then would distribute the proceeds of such policy loan to the participant and if he returned prior to a one year break in service, the plan could permit either that he repay the policy loan at 5 percent interest (assuming that such interest rate were equal to the interest charged by the insurance carrier on the policy loan) or perhaps not be permitted to repay the cash out at all. In the latter case, the accrued retirement benefit of the participant would at all times be reduced by the value of the policy loan with the insurance company rate of interest being added to the principal amount of the loan each plan year. In those circumstances one would apply the vesting rate to the total cash surrender value and then deduct from the vested amount the outstanding policy loan with accrued interest. Similarly, at retirement the annuity would be reduced by the amount of the policy already received plus accrued interest. Under this approach, one would suspect that in any instance in which the policy loan interest rate is higher than the 5 percent permitted under statute that the participant would not be permitted to repay the cash out from the policy loan proceeds.

As shown above, the policy loan approach should be a viable concept where the participant in an insurance contract plan returns prior to a one year break in service. Where he returns after a one year break in service, there may be a problem if his deferred vested accrued benefit simply consisted of the insurance contract on a paid up basis reduced by a policy loan made by the plan administrator for the amount of the forfeiture. Similarly, the situation where the participant has actually received a cash out through one policy loan and, after a one year break in service, the plan administrator cashed in the policy for the remainder of the cash surrender value which was then returned to the employer, resolution of the duplication of benefit problems will have to be found in explicit answers by the Service.

In Kind Cash Out and Buy Back

A possible approach to solving the above problem would be for the plan administrator to distribute a portion of the insurance contract or annuity to the participant when he separates from service. That portion would possess, of course, a cash surrender value equal to the employee's vested cash surrender value at that time. Then, if the employee were permitted upon reemployment to repay his cash out solely by giving back the contract to plan administrator (without any outstanding policy loan), many of the problems of cash outs and buy backs in an insurance contract plan would be resolved. Turning first to the plan administrator's side, in order to avoid a suspense account and to comply with the mandate that in a defined benefit plan forfeitures be used to reduce employer contributions,³⁰³ presumably the plan administrator at the time of the cash out would take out a policy loan on the remaining policy equal to the remaining cash surrender value. He would then use this cash surrender value to reduce current contributions. If the employee returned to employment prior to a one year break and made the repayment within two years after the reemployment commencement date, then the plan administrator could repay the outstanding policy loan plus interest on the remaining portion of the policy and that, plus the repaid policy, would put the employee in the same position as when he left. There may be some problem as to lapse during this conceivably quite long waiting period pending the repayment. On the employee's side, distribution of an annuity would not be taxable under section 402 provided that the employee surrendered any cash surrender value rights within 60 days after the distribution to him.

If the plan administrator were not permitted to take out a policy loan on the remaining cash surrender value at the time of the cash out and a participant returned prior to a one year break in service, we would run into the problem of the delayed forfeiture since, if the forfeiture had not occurred, the participant would vest further in the cash surrender value prior to repayment of the cash out as he completed further years of service. Thus it is necessary to forfeit him at no later than just prior to completion of 1,000 hours of service in the plan year of his reemployment. Forfeiting the participant without doing something with the cash surrender value probably would constitute a suspense account.

The above approach of requiring the buy back to be solely in the form of the annuity contract is probably not permitted by the proposed

³⁰³ Temp. Reg. § 11.411(a)-7(d)(4)(v), 40 Fed. Reg. 51421, 51428 (Nov. 5, 1975).

and temporary regulations, but should be included as an alternative in the final regulations.

**Changes in Covered Service Status in
Multiple Employer Plans and Plans
Excluding Union Members**

A multiemployer plan is defined in ERISA as a plan to which more than one employer is required to contribute and which is maintained pursuant to one or more collective bargaining agreements between a union and more than one employer, and under which plan contributions for a plan year by each employer is less than 50 percent of the aggregate amount of plan contributions for that plan year made by all employers making such contributions. Benefits payable to each participant must be determined without regard to the cessation of contributions made by the employer who employed that participant except to the extent that such benefits accrued as a result of service with such employer before it was required to contribute to the plan.³⁰⁴ This definition limits the term "multiemployer plan" to plans which are the result of collective bargaining. There are other nonnegotiated plans where the employing firms are not financially related and contributions, usually at uniform rates, are payable into one common fund and benefits are payable on a common scale to eligible claimants from the pooled assets of the fund.³⁰⁵ Such plans will be referred to as "polyemployer plans."

Many nonnegotiated plans cover employees of religious, charitable and educational institutions, but in the business field several state banking associations and savings and loan associations had developed plans covering employees of their various member banks or savings and loan associations.³⁰⁶ It is doubtful, however, that the labor regulations here are directed towards such plans. These regulations use the term "multiple employer plans" to refer to both multiemployer plans and other polyemployer plans involving more than one unrelated employer that does not meet the test for classification as multiemployer.³⁰⁷ In addition, all employees of all corporations which are members of a controlled group of corporations as well as all employees of trades or businesses (whether or not incorporated) which are under common control are

³⁰⁴ ERISA § 3(37).

³⁰⁵ MCGILL at 78.

³⁰⁶ *Id.* at 79.

³⁰⁷ Prop. Labor Reg. § 2530.210(b), 40 Fed. Reg. 41654, 41667 (Sept. 8, 1975); Preamble, Prop. Labor Reg. 41660.

treated as employed by a single, fictional employer.³⁰⁸ Such plans will be referred to as "controlled group plans."

Sections 202(a)(1)(A) and 203(b)(1) of ERISA³⁰⁹ require that all service with the "employer or employers maintaining the plan" must be taken into account for the minimum participation and minimum vesting standards. In addition, sections 210(a)(1) and (2) of ERISA provide that the minimum participation and the minimum vesting and accrual standards are to be applied as if all employees of each of the employers, where a plan is maintained by more than one employer, were employed by a single employer, except the application of any rules as to breaks in service (for purposes of vesting and benefit accrual) are to be made under labor regulations. Somewhat confusingly, the term year of participation for purposes of benefit accrual is defined as a period of service beginning at the earliest date on which the employee is a participant in the plan, without reference to whether the plan of the employer or of the employers is to be considered.³¹⁰

The proposed labor regulations provide that generally the term "employer or employers maintaining the plan" will include those employers for whom an employee has completed one or more years of service under the attribution rules contained in sections 2530.210(b), (c) and (d) of the proposed labor regulations.³¹¹ Those sections refer to multiple employer plans, controlled groups of corporations and commonly controlled trades or businesses. The latter two sections are governed by Treasury regulations and are relatively simple to state: All employees of corporations that are members of a controlled group of corporations and all employees of trades or businesses (whether or not incorporated) that are under common control are to be treated as employed by a single employer.³¹²

Multiple Employer Plans

It is in the multiple employer plans that the labor regulations chart a new course. Section 2530.210(b) of the proposed labor regulations³¹³ provides that a plan maintained by more than one employer will be

³⁰⁸ Prop. Labor Reg. §§ 2530.210(c), (d), 40 Fed. Reg. 41654, 41667 (Sept. 8, 1975); Preamble, Prop. Labor Reg. 41660.

³⁰⁹ See I.R.C. §§ 410(a)(1)(A), 411(a)(4).

³¹⁰ ERISA § 204(b)(3)(A); I.R.C. § 411(b)(3)(A).

³¹¹ Prop. Labor Reg. §§ 2530.210(b), (c), (d), 40 Fed. Reg. 41654, 41667 (Sept. 8, 1975).

³¹² I.R.C. §§ 414(b), (c). See Temp. Reg. §§ 11.414(b)-1 and 11.414(c)-1, (c)-2, 40 Fed. Reg. 51421, 51435-37 (Nov. 5, 1975).

³¹³ Prop. Labor Reg. § 2530.210(b), 40 Fed. Reg. 41654, 41667 (Sept. 8, 1975).

treated as if all of the maintaining employers constituted a single employer "so long as an employee maintains continuity of either employer or plan coverage." This rule applies to both multiemployer plans and polyemployer plans. Presumably such term does not cover master plans or prototype plans sponsored by banks or insurance companies. This attribution rule requires credit for participation, vesting and accrual purposes when a participant moves from one employer to another employer within service covered under the multiple employer plan, *i.e.*, when continuity of plan coverage is satisfied. On the other hand, the continuity of employer test is applied differently as to multiemployer plans. While past service must be credited for participation and vesting purposes when an employee moves from uncovered to covered service for the same employer, past service for accrual of benefits is not required in such circumstances under the rationale that section 204(b)(3) of ERISA requires counting service for accrual of benefits only from the first date of participation in the plan.³¹⁴ This rule would mean that when an employee, who has not been a member of a union but has been employed for a number of years with the same employer, becomes a member of a union with which the employer has collectively bargained and to which the employer participates in a multiemployer plan, such employee then would receive past service credit for participation and vesting purposes in the multiemployer plan, but in a defined benefit plan would not receive credit, *i.e.*, an accrued benefit, for prior years of service.

The proposed labor regulations also provide that when an employee moves from covered to uncovered service for the same employer, he will continue to receive credit for such uncovered service towards vesting in the benefits accrued while a participant in the plan.³¹⁵ Thus, if a member of a union ceases to be a union member while still employed by the same employer—for example, because he becomes a supervisor—he will continue to receive credit towards vesting in the union, *i.e.*, multiemployer plan, and when he reaches normal retirement age (or earlier under the plan vesting schedule) he will be fully vested in the benefit under the union plan. A major record keeping problem arises in determining whether continuity of employment exists where the union employee worked for several employers, *e.g.*, a longshoreman working from the hiring hall.

As to a multiemployer plan, only service with the employers maintain-

³¹⁴ Preamble, Prop. Labor Reg. 41660.

³¹⁵ See Prop. Labor Reg. § 2530.210(e)(1)(iii), 40 Fed. Reg. 41654, 41667 (Sept. 8, 1975).

ing the plan is taken into account.³¹⁶ Thus, if one of the employers which is a party to the collective bargaining agreement is also a member of a controlled group of corporations, service with the other members of a controlled group who are not maintaining the multiemployer plan may be disregarded.³¹⁷

A plan is permitted to treat, in a multiple employer context, service performed where there is neither continuity of employment nor continuity of plan coverage as in a break in service.³¹⁸ Thus, a participant with no degree of vested rights to employer derived contributions in such circumstances may forfeit accrued benefits for past service when the number of his breaks in service due to such lack of continuity equals or exceeds the number of his prior years of service.

The Department of Labor realized that these highly complex rules would be difficult for many plans—particularly multiemployer plans—to apply due to the record keeping problems. But it thought that the most significant problems could be solved through the reporting and disclosure requirements of ERISA.³¹⁹

The Subcommittee on Labor Standards of the House Committee on Education and Labor, in exercise of its oversight responsibility under ERISA, reported out of committee House bill 7597, on November 10, 1975.³²⁰ That bill contains a technical change under which section 202(a)(3)(A) of ERISA would be amended to “make clear that in the case of multiemployer plan, only employment within the scope of the applicable collective-bargaining agreement shall be considered in computing ‘years of service.’” Accordingly, House bill 7597 would amend section 202(a)(3)(A) to provide that for purposes of such section in the case of a multiemployer plan “only employment within the scope of the applicable collective bargaining agreement shall be considered in computing ‘year of service.’” This provision is interesting in that it would affect participation, and not vesting, which is surely the more significant problem. Moreover, this provision betrays the all too common myopic focus of the House Committee on Labor and Education on multiemployer plans only. Such a provision, while granting (probably unintentionally) limited relief to multiemployer collectively bargained

³¹⁶ Preamble, Prop. Labor Reg. 41660.

³¹⁷ Prop. Labor Reg. § 2530.210(e)(1)(iii), 40 Fed. Reg. 41654, 41667 (Sept. 8, 1975).

³¹⁸ Prop. Labor Reg. § 2530.210(e)(4).

³¹⁹ Preamble, Prop. Labor Reg. 41660-61.

³²⁰ H.R. 7597, 94th Cong., 1st Sess. (1975). H.R. REP. NO. 94-646, 94th Cong., 1st Sess. 3 (1975).

plans, would not provide similar relief to single employer plans that excluded union employees.

Plans Excluding Union Employees

ERISA contains a new provision that allows employers in meeting the minimum participation standards and the long existing breadth of coverage standards to ignore employees who are covered under a collective bargaining agreement to which the employer is a member and which has discussed, in good faith, retirement benefits.³²¹ In essence, this means that an employer which is a party to a collective bargaining agreement (which may or may not provide for a multiemployer plan) may establish a retirement plan for nonunion employees. Some employers, who are members to such collective bargaining agreements and have in the past covered union employees due to the strict representative cross-section test applied by the Service, may now amend their plans provided that only nonunion members are covered. In such circumstances, assuming that exclusion of union members does not constitute as to them a partial termination of the employer's nonunion plan with immediate vesting,³²² union employees will continue to receive credit towards vesting while employed by the same employer as to the benefits they accrued while participants. Those plans which cashed union members out when so switching to nonunion member coverage only would be well advised not to forfeit benefits as to such union members.

The same problem can arise in the converse. An employee who is a member of a union may rise to a nonunion status and immediately become available for a plan maintained by his employer which excludes union members. In such circumstances he must be given credit for vesting and participation purposes for service as a union member. Similarly, plans which provide for coverage for salaried only employees will have to maintain records as to nonsalaried employees in order to provide them vesting and participation credit for years of service performed while nonsalaried employees.

³²¹ I.R.C. § 410(b)(2)(A).

³²² Section 411(d)(3) provides that a trust must require that upon its termination or partial termination the rights of all affected employees to benefits accrued to the date of such partial termination to the extent funded as of such date are nonforfeitable. Section 11.411(d)-2(b) of the temporary regulations provides that whether or not a partial termination occurs when a group of employees who have been covered by the plan are subsequently excluded from coverage by reason of a plan amendment or by reason of discharge will be determined on the basis of all the facts and circumstances. 40 Fed. Reg. 51421, 51434 (Nov. 5, 1975).

Alternatives to Counting Hours of Service in Defined Contribution Plans

Eligibility to Participate

The simple alternative to counting hours of service for eligibility is use of a single entry date with a requirement of no more than six months of employment (and attainment of age 24½) and no requirement of completion of a given number of hours of service during that period. This approach, however, in addition to some of the mechanical problems discussed above, is awkward or even unworkable if part-time employees who work less than a 1,000 hours a plan year are present. Simply bringing into the plan all employees who have worked six months as of an entry date and completed an age requirement, say 24½, would also bring in employees who were not hired on the basis of working at least 1,000 hours a plan year, roughly 20 hours a week. While it would be possible to omit allocations and vesting as to such employees since they would not work 1,000 hours a year, this would entail counting hours of service in order to see whether they worked 1,000 hours for purposes of vesting or accrual, as well as possible employee morale problems. A possible solution, not addressed in ERISA, the legislative history or the present temporary and proposed regulations, is to require only six months of employment, regardless of the number of hours worked as of an entry date as to employees who are customarily employed on the basis of working 1,000 hours a plan year. The test then would be not how many hours the employee worked during this six month period, but whether he was employed on the basis of working at least 20 hours a week for at least 50 weeks a year. As a fail safe it would be necessary to provide that all other employees who are not employed customarily on the basis of working at least 1,000 hours a plan year would nevertheless come into the plan after any relevant eligibility computation period in which they actually did work 1,000 hours. Many administrators may prefer to shift-over this computation period, after the first one in which they failed to work 1,000 hours, to the plan's vesting computation period. Thereafter, employees customarily employed on the basis of working less than 1,000 hours a plan year or 20 hours a week could be tested each vesting computation period, or commonly the plan year, to see if they actually completed 1,000 hours. If they did, then they would come into the plan on the day following the end of the plan year (or other eligibility computation period) in which they did complete 1,000 hours. While this would entail counting hours, this would be the case only as to employees who were hired on the basis of customarily working less than 1,000 hours a plan year. The next question would be whether the different

eligibility classifications, *i.e.*, six months for employees employed on the basis of working 1,000 hours a plan year and one year of service for employees who are not employed on that basis, is discriminatory. One would hope that regardless of the technical arguments that could be made, the practicalities of permitting this approach would lead to its acceptance.

Of course, if an employer has no employees who work less than 20 hours a week or 1,000 hours a year, then it would be possible to have a single entry date (either the first of the plan year or the date on which the employee is first employed) for all employees, not counting hours of service. Even if the approaches of a single entry date or dual eligibility requirements for employees customarily employed 1,000 hours or more in a plan year and those not so employed, alternatives are not feasible in a particular plan, counting hours of service for eligibility and use of, for example, dual entry dates would not appear to be a great administrative burden in most cases.

Allocation of Employer Contributions

The handy rule in defined contribution plans of making allocations only to participants who are still employed on the last day of the plan year is discussed in some detail above. This alternative, which in essence consists—as did most of the pre-ERISA rules—of determining an employee's status at a single point in time, is the only alternative to counting hours of service for allocation or accrual of benefit purposes. To the extent that such a technique is available, it will be available to profit sharing plans, stock bonus plans, money purchase pension plans and, presumably, target benefit plans, in other words, to any plan that bases its accrued benefit upon the account balance. For it is only where the accrued benefit is based on the account balance, and not on years of participation, that the 1,000 hours of service requirement for eligibility (which is incorporated into the term year of participation) does not apply.

Vesting

The topic of not counting hours of service for eligibility has been addressed in the preamble to the proposed labor regulations on computation periods for hours of service, years of service and breaks in service, and in Treasury Information Release Number 1334. Similarly, the question of allocations in defined contribution plans has been addressed previously by commentators, frequently unofficially by representatives of the Service and of the Department of the Treasury and, at the time of

the preparation of this article, is widely understood by practitioners to be an available approach. However, little or no public attention has been addressed to alternatives in the context of vesting to counting hours of service. Of course, the easy alternative of granting one year of service for vesting purposes if an employee is employed for one hour during a vesting computation period is available. Many practitioners in drafting revised and restated plans covering a large number of participants are taking this approach for administrative ease.

There may, however, be a practical alternative to counting hours of service or to granting credit for a year of service if only one hour is worked in many pre-ERISA plans covering a relatively small number of participants, say, less than 25. In many districts, particularly in recent years, such plans were forced to adopt vesting schedules providing for graded vesting resulting in 100 percent vested benefits after no more than ten years of participation. Such plans almost universally provided for a year of vesting credit only if an employee completed a full year of participation under the plan. Also, frequently in such plans an employee who separated from service and who was reemployed started over as a new employee on the vesting schedule. Many such plans can maintain their existing vesting schedule based on full years of participation (and even starting anew on the graded vesting schedule upon reemployment after a break in service) so long as they also adopt a fail safe provision under which a participant would be 100 percent vested after ten years of service (perhaps not counting plan years prior to the one in which he attained age 22 or prior to plan year as to which the plan was adopted).

The basis for preserving the pre-ERISA rules of such plans, subject to immediate vesting after ten years of service with the above limitations, is that ERISA requires only that the plan meet one of the three minimum vesting schedules, and section 411(a)(2)(A) allows as one of these alternatives a 100 percent nonforfeitable interest after ten years of service. If a plan provides greater vesting than this, then it may provide limitations upon such vesting credit, such as employment on the last day of the plan year and based only on years of participation. Example 1 of section 11.411(a)-4(c) of the temporary regulations describes a plan under which an employee is fully vested in his employer derived accrued benefit after five years of service, but may forfeit such accrued benefit if he violates a "bad boy" clause prior to completing ten years of service. The illustration concludes that the plan would meet the minimum requirements of section 411 "because the forfeitures under this provision are limited to rights which are in excess of the minimum required to be nonforfeitable under section 411(a)(2)(A)." Similarly, if a plan provides for more vesting than the ten year notch vesting, it

may impose any limitations acceptable under prior law, that are non-discriminatory, without violating section 411, so long as it provides for 100 percent vesting after ten years of service, utilizing any of the exceptions to the years of service look back rule that are available, such as disregarding years of service prior to the plan year in which the participant attains age 22 or years of service prior to the plan year as to which the plan was adopted. While hours of service must still be counted for this fail safe ten years of service rule, in most instances, this would require keeping track of years of service only in two plan years: (1) the plan year in which the participant is first employed and (2) the plan year in which he terminates. If he is a full-time employee employed on the basis of working more than 1,000 hours a plan year in every plan year except possibly the first and last plan year of his employment that he is employed full-time he will have completed a year of service. Hence, it is possible with minimum changes to maintain the existing plan's vesting rules, subject to a ten year fail safe.

Of course, it would be much simpler to move to the ten year notch years of service full vesting rule. Even with giving participants who had completed five years of service an election whether to stay under the old vesting schedule, this would still be the easier alternative. However, due to the new anti-discrimination rules centering around the four-forty test and employee turnover, most plans could not move to the ten year notch vesting schedule, because then they would have to run the gauntlet of the 200 percent turnover test, and failing it would come under the four-forty vesting requirement based on years of employment. However, since such plans are maintained until ten years of service, a vesting schedule as favorable as the prior vesting schedule upon which an advance determination letter has been granted, they avoid the four-forty test under the prior letter rule.

Breaks in Service

The approach of maintaining the plan's pre-ERISA years of participation graded vesting schedule, backed up by a ten years of service cliff vesting rule, demands careful attention to the break in service rules. An initial question is whether a participant, who has some vested interest under the plan's years of participation graded vesting schedule, is a non-vested participant for purposes of the requirement of tacking prebreak service subject to the rule of parity contained in section 411(a)(6)(D). Following the rationale of the bad boy clause example, the term nonforfeitable right would be limited to a right required under the minimum vesting standards and, hence, the rule of parity for purposes of tacking prebreak service would continue to apply as to the ten year notch fail

safe rule until the participant was 100 percent vested under the ten years of service rule. Until that point he would be a nonvested participant within the meaning of ERISA. The next question is whether the years of participation graded vesting schedule of the plan would have to adopt a similar tacking rule or could continue to use a pre-ERISA provision under which a reemployed participant is treated as a new employee for purposes of vesting as well as eligibility. Presumably, if that was the pre-ERISA rule of the plan, it could continue such a rule as to the graded vesting schedule under the above reasoning that since more vesting was being given than required by the statutory minimum, any nondiscriminatory limitations could be imposed upon what was given in excess of the statutory minimum. Apparently, however, a pre-ERISA plan may not, in an amendment effective after January 1, 1974, amend its breaks in service rules as to a years of participation vesting schedule (while meeting the statutory requirements such as tacking prebreak service subject to the rule of parity for the ten year notch years of service vesting schedule), for example, to wipe out prebreak years of participation if it did not previously do so. For section 1017(f)(2) of ERISA provides that a qualified plan cannot amend its breaks in service rules, effective after January 1, 1974, to provide a nonforfeitable percentage of any employee's rights to his employer derived accrued benefit which is less than what it was under the pre-ERISA breaks rules of the plan, as in effect on or after January 1, 1974, or under the break in service rules provided by section 411(a)(6).

Forfeitures

Even if a defined contribution plan takes the approach outlined above of maintaining its existing years of participation graded vesting schedule without counting hours of service subject to a ten years of service notch full vesting fail safe, years of service will have to be counted in the year of termination and possibly the subsequent plan year for purposes of determining when a forfeiture arises. While such a plan could forfeit the nonvested interest under the years of participation vesting schedule prior to a one year break, should the participant be reemployed prior to a one year break, a separate account would have to be established and the prior forfeiture plus earning restored to that account (perhaps only for the ten year notch vesting rule), due to the addback and offset rule of the regulations. To avoid this administrative nightmare, it would appear necessary in most defined contribution plans which adopt the approach of using the ten year notch fail safe to provide for no forfeitures until a one year break in service has occurred and use some variant of the addback and offset approach if immediate distributions of amounts

vested under the graded vesting schedule upon separation from service are desired.

Summary

It is likely that most defined contribution plans that were subject prior to ERISA to a requirement of graded vesting which resulted in 100 percent vesting after no later than ten years of participation, would be well advised to adopt the vesting, accrual and possibly even single entry approaches under which counting hours of service is largely avoided. The forfeiture rules will have to be changed and probably some changes would have to be made in the entry dates. It is ironic, however, that it is possible to maintain in this context essentially the same provisions of the pre-ERISA plan with extensive drafting and, in the opinion of the writer, after extensive study on the part of the drafter. Employers fail to comprehend why they must incur considerable expense to maintain the same provisions in effect that their pre-ERISA plan had, since what they had in many instances was more, in all practical effect, than are the ERISA requirements. Yet, an employer must incur these often considerable expenses to avoid the administrative nightmares of hours of service record keeping requirements.

Class Year Plan

Class year plans offer an alternative vesting approach for defined contribution plans which avoids entirely the years of service and breaks in service imbroglis. Section 411(d)(4) defines the term "class year plan" as any profit sharing, stock bonus or money purchase pension plan which provides for separate nonforfeitability of employee's rights derived from employer contributions for each plan year. That section also provides that the minimum vesting requirements as to employer contributions of section 411(a)(2) are "deemed to be satisfied" by a class year plan if it provides that 100 percent of each employee's right to employer contributions made on his behalf as to any plan year for which such contributions were made. This provision makes no reference to years of service, breaks in service or hours of service, and read literally would require that a class year contribution be nonforfeitable not later than the end of the fifth plan year following the plan year in which it was made regardless of whether the employee previously had incurred a break in service, and even without regard to the number of years of service that he had completed. However, by use of the term "employee," the statute provides a basis for forfeiture where a participant has separated from service and is no longer an *employee* at the end of the fifth

plan year. Section 11.411(d)-3(b)³²³ of the temporary regulations provides, however, some limitations on the broad sweep of section 411(d)(4). It states that the rights of an employee who separates from service prior to the time that a particular class year has matured and who is not reemployed in the plan year of separation may be forfeited. The clear implication is that the years of service, hours of service and breaks in service rules, as well as cash out and buy back rules applicable to other defined contribution plans do not apply to class year plans. Thus, for example, it would appear that in a class year plan in which the plan year is based on the calendar year, if Employee *A* were to separate from service on January 2, 1976 having completed 16 hours of service and was reemployed on December 31, 1976 and completed an additional eight hours of service, he would not incur a forfeiture as to any unmatured class despite the fact that he had incurred a one year break in service as to 1976. Conversely, if Employee *B* quit on December 30 of the same year, having completed well in excess of 1,000 hours of service, the plan could provide that all of his unmatured class year accounts would be forfeited. Note also that if Employee *C* entered the plan in 1976 and satisfied any minimum service requirements for an allocation in that plan year, but failed to meet them in subsequent years (less than 1,000 hours a year), yet did not separate from service before December 31, 1981, he would become fully vested in the 1976 class, even though he may not have completed more than one year of service. Indeed, he could have incurred five consecutive one year breaks in service, if he dropped to not more than 500 hours of service per plan year. In short, the class year plan avoids the hours of service, years of service and breaks in service problems because it works on a completely different principle; in effect, an elapsed time rule.

While on its face section 411(d)(4) does not provide for forfeitures on account of separations from service prior to the plan year in which the class year matures, *i.e.*, becomes nonforfeitable, the report of the House Committee on Ways and Means in explaining the substantially similar provision of its House bill 12855 described the five year full vesting rule provided for class year plans as assuring "an employee who terminates his employment under a class year plan that he will not forfeit his rights to more than 4 years of employer contributions."³²⁴ In short, Congress anticipated forfeitures under class year plans on account of termination of employment prior to maturity of a class year. Consequently, the temporary regulations in providing for forfeiture of an

³²³ 40 Fed. Reg. 51,421, 51,435 (Nov. 5, 1975).

³²⁴ H.R. REP. No. 93-807, 93d Cong., 2d Sess. 66 (1974).

unmatured class year upon a separation from service in a plan year and a failure to return to employment in the same plan year are likely to be upheld as valid. Interestingly, the temporary regulations do not adopt a one year break in service approach, which may be indicative of Treasury's attitude towards Congress' fashioning of the breaks rules.

The inapplicability of the breaks in service rules to class year plans is supported by a close reading of the Code. Section 411(a)(4)(D) states that all of an employee's years of service with an employer are to be taken into account except (among other items) service which is not required to be taken into account under the breaks in service rules contained in section 411(a)(6) "[i]n computing the period of service under the plan for purpose of determining the nonforfeitable percentage under paragraph (2)," which sets forth the three minimum vesting schedules. However, a class year plan is deemed to meet section 411(a)(2) where it provides for full vesting as to any class year no later than the end of the fifth plan year following the plan year for which contributions were made. This deemed satisfaction of section 411(a)(2) accordingly bypasses completely the years of service and, consequently, breaks in service rules which are tied into section 411(a)(2) via section 411(a)(4). This analysis is confirmed by the fact that section 411(d)(4) makes no reference to either years of service or years of participation.

The cash out and buy back rules contained in section 411(a)(7) would not apply to a class year plan because such rules set forth the circumstances in which service can be disregarded in determining an employee's accrued benefit or account balance in this case. Since forfeitures occur in a class year plan without regard to service or whether a one year break in service has occurred but instead are triggered by a separation from service without reemployment in the plan year of separation, these rules are inapplicable. However, the analogous cash out and buy back rules applicable to withdrawal of mandatory employee contributions do apply to a class year plan; most class year plans provide for employer contributions geared to mandatory employee contributions.

Under section 411(a)(3)(D)(iv) a withdrawal of employee contributions (which may trigger a forfeiture of geared employer contributions subject to a right to buy back the forfeited amounts)³²⁵ in a class year plan is treated as a withdrawal of such contributions on a plan year by plan year basis in succeeding order of time.

Neither the Code nor the temporary regulations set forth the application to class year plans of the rule that forfeitures of geared employer contributions on account of withdrawal of mandatory employee con-

³²⁵ I.R.C. §§ 411(a)(3)(D)(i)(B), (i)(A).

tributions are permitted only as long as the participant does not have a nonforfeitable right to at least 50 percent of his accrued benefit derived from employer contributions applies.³²⁶ Possibly, the comparison is between the dollar value of all matured classes and the dollar value of all unmatured classes. If the alternative approach of basing the 50 percent test on a class year by class year basis is followed, forfeiture of geared employer contributions always would occur upon a withdrawal of employee contributions from an unmatured class year; conversely, each matured class year would be 100 percent vested so that no forfeiture ever would occur. Since class years are either 0 percent or 100 percent vested, use of 50 percent terminology renders the latter interpretation awkward. Nevertheless, the conference report adopts the construction of applying the 50 percent test for purposes of section 411,³²⁷ presumably on the rationale that for the purposes of section 411(a)(3)(D) a *withdrawal* of employee contributions is applied on a class year by class year basis, so that forfeitures would apply on a year by year basis. Such an approach is probably consistent with the overall concept of class year plans. However, section 401(a)(19) provides that a trust cannot be qualified if it permits a forfeiture of employer accrued benefits solely because of withdrawal of employee contributions, unless at the time of the withdrawal the participant had a nonforfeitable right to less than 50 percent of his accrued benefit, as determined under section 411. Section 401(a)(19) contains no analogous class year by class year provision and the section 411(a)(7)(A)(ii) definition of accrued benefit in a defined contribution plan as the employee's account balance does not speak to separate accounts for separate class years.

Presumably, if a participant in a class year plan with mandatory contributions separates from service and at the same time withdraws his contributions for unmatured class years causing a forfeiture of geared employer contributions for those years, and returns to employment after the close of the plan year of separation but before incurring a one year break in service, he cannot restore the forfeited employer contributions by repaying his withdrawals since they would be independently forfeited under section 11.411(d)-3(b) of the temporary regulations.

Applied literally, the add back and offset approach of section

³²⁶ I.R.C. § 411(a)(3)(D)(i)(A); Temp. Reg. §§ 11.411(a)-4(b)(4)(i), 40 Fed. Reg. 51,421, 51,423 (Nov. 5, 1975), 11.401(a)-19(b)(2), 40 Fed. Reg. 51,445, 51,446 (Nov. 5, 1975).

³²⁷ H.R. REP. NO. 93-1280, 93d Cong., 2d Sess. 275 (1974) ("forfeitures . . . would be permitted on a class-year-by-class-year basis, for *any year* for which the employee withdraws his own mandatory contributions to the plan, if he is *less than 50 percent vested with respect to that year*") (emphasis added).

11.411(a)-6(c)(1)(B) of the temporary regulations would require that separate accounts be set up for unmatured class years where an employee separated from service and, prior to a one year break in service, received distributions of matured class year balances or, as would be the more frequent case, a participant makes an in service withdrawal of a matured class year. Since the approach of the temporary regulation of treating the entire interest at the time of the pre-one year break in service as a single separate account conflicts directly with the class year by class year approach of class year plans, hopefully the final regulations will expressly carve out an exception from the add back and offset floor for class year plans.

Conclusion

Basically, Congress intended in the hours of service rules to provide a criterion for determining whether an employee could be excluded from a retirement plan as a seasonal or part-time employee. The break in service rules in turn were intended to place an employee, who separated from and returned to service, at the same point on the vesting schedule upon his return that he was in before he incurred his break. Both goals are worthy and in themselves do not generate severe administrative problems. After all, as far as the hours of service rules go, 1,000 hours of service is roughly the same as five months' full-time employment or 20 hours of employment a week for 50 weeks. Therefore, distinguishing between full-time employees and seasonal or part-time employees on the basis of 1,000 hours of service a year is not unreasonable. Retaining vesting credit after a break in service in itself is equitable and it would not be a major task to require prospectively that prebreak and postbreak service count for vesting purposes.

The intense, arguably unwarranted, problems that arise in plan administration of the hours of service and break in service rules are generated by application of the hours of service requirements to full-time employees, particularly when they terminate employment during a plan year. Keeping hours of service records for full-time employees as to vesting and as to breaks in service for forfeitures and distributions is new and often appears, at this point, to be especially burdensome. There is something to be said for the simplicity of the previously common plan administrative practice and plan design under which an employee was not admitted until the first entry date after, say, one complete year of employment, *i.e.*, 12 months of full-time employment; he vested only for full years of such employment; he incurred a forfeiture at the end of the plan year in which he terminated employment; and he received

no allocation in a profit sharing plan, and sometimes accrual when a defined benefit plan, unless he was employed on the last day of the plan year.

The objection may be raised that the cost of such simplicity was, and is, too great, in that it could preclude vesting credit and allocation of a company contribution or accrual of a benefit for the last plan year in which the participant worked even though he terminated late in the plan year. But this objection loses much, if not all, of its weight when it is realized that the drafters of the minimum standards regulations in the Department of Labor, and, in the writer's experience, Treasury officials who reviewed the Service vesting and participation regulations both anticipate that many plans will, and perhaps they even believe should, simplify plan administration by providing that an employee will enter on the first day of the plan year after he has satisfied any minimum age requirements (without a minimum service requirement), will obtain a year of service for vesting purposes if he is employed at least one hour during the plan year and will not incur a break in service until a plan year in which he is employed for no hours. In short, the Department of Labor and the Department of the Treasury *sub rosa* acknowledge that the hours of service approach to full-time employees who terminate employment and for entry into a plan create substantial administrative problems which many plans will avoid by, in effect, eliminating an hours of service requirement in effect for participation or vesting and forfeitures. This is but the opposite extreme of requiring 12 months of full-time employment for participation or vesting credit. In the abstract, neither approach is more or less equitable than the other. It is unfortunate that Congress set forth minimum standards that in most plans simply are too difficult to administer for full-time employees. The 1,000 hours is adequate for distinguishing between part-time or seasonal employees and full-time employees, but together with a 500 hours breaks rule, is incredibly difficult to administer for full-time employees. Congress apparently chose this model from multiemployer union plans. It perhaps did not realize that frequently such plans do not require minimum service for participation and employees who terminate employment with one employer frequently stay under the multiemployer plan and simply go to another employer who is also a party to the same collective bargaining agreement. Once you attempt to apply this type of approach to single employer plans, it breaks down, as the length of this article and the complexities of the various temporary and proposed regulations amply manifest. Yet it is these rules more than any other which require that all nonmultiemployer retirement plans be completely rewritten, no doubt at substantial legal expense in the aggregate.