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Beginning in 1989, qualified retirement plans must conform with vesting changes required by the Tax Reform Act of 1986.[1] The Act generally requires the use of a vesting schedule restricting plan participants to either a five-year, "all or nothing" schedule,[2] or a three-to-seven year graded schedule that permits gradual vesting of accrued benefits through a series of stages corresponding to the attainment of years of service with the employer sponsoring the plan.[3] Actually, a third vesting model exists, one related to permitted plan participation criteria.[4] Typically, a qualified retirement plan may require no more than one year of service as a qualification for participation in the plan;[5] however, a retirement plan which requires two

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1. Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085 (1986). Section 113(e)(1) of the Act makes the new vesting requirements effective for plan years beginning after December 31, 1988, set out as Effective Date of 1986 Amendment note under I.R.C . § 411 (Supp. IV 1986).

2. I.R.C. § 411(a)(2)(A) (Supp. IV 1986). A plan participant with fewer than five years of service loses all of his or her accrued benefit upon permanent cessation of employment, but once five years of service are attained, the accrued benefit becomes "100 percent vested" and subsequent termination of employment results in no forfeiture of any portion thereof. Subsequent footnote and textual references to the Internal Revenue Code will also be expressed in the form "I.R.C. § ______."

3. I.R.C. § 411(a)(2)(B) (Supp. IV 1986). The nonforfeitable percentage is 20% after three years of service, with an additional 20% for each year thereafter, until 100% vesting occurs upon the attainment of seven years of service.

4. Technically, employees may be divided into two categories — participants and non-participants — for employee benefit plan purposes. I.R.C. § 410 (Supp. IV 1986) addresses minimum participation requirements and thus regulates how and when an employee changes from a non-participant to a participant. Section 411, which deals with minimum vesting standards, regulates an employee's rights to plan benefits that can accrue only after the employee becomes a plan participant. Both sections are incorporated by reference into § 401(a), which functions as a list of rules that must be met by a "qualified" retirement plan in order for certain favorable tax mechanisms to apply. I.R.C. §§ 401(a)(3), (a)(7) (Supp. IV 1986).

5. I.R.C. § 410(a)(1)(A) (Supp. IV 1986) permits a qualified plan to predicate participation status upon an employee's reaching age 21 and completing one year of service. Section 410(a)(3)(A) defines a year of service as being not less than 1,000 hours of service in a 12-

years of service prior to participation in the plan can also qualify if the plan grants one hundred percent vesting once the employee fulfills the two-year waiting period.[6] This rule effectively operates as a two year participation *and* vesting rule. The purpose of this article is to outline various reasons why many employers may prefer to choose the two year, one-hundred percent vesting alternative, particularly employers who operate small businesses with limited resources to devote to the increasingly complicated problem of maintaining compliance with the qualification criteria of the Employee Retirement Income Security Act of 1974 (ERISA).[7]

I. The Vesting Concept in Qualified Retirement Plans

A. Function and Operation of Vesting Schedules

Qualified retirement plans present a quite favorable package of tax benefits.[8] Substantial economic and administrative burdens, however, often accompany the implementation of such plans. Naturally, employers who undertake such arrangements would like to obtain the tax advantages available, as well as any potential non-tax advantages,[9] for the least possible cost, risk,[10] and administrative inconvenience. Accordingly, the design of a qualified retirement plan will often reflect consideration of certain portions of the generally applicable qualification criteria that permit a range of employer discretion.[11] The vesting concept has always occupied an important place

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month period. Consequently, the one year of service criterion has the effect of making many part-time employees permanent non-participants.

6. I.R.C. § 410(a)(1)(B)(i) (Supp. IV 1986).

7. Employee Retirement Income Security Act of 1974, Pub. L. No. 93-406, 88 Stat. 829 (1974) (hereinafter ERISA) (codified at 29 U.S.C. §§ 1001-1461 (1982)).

8. Deferral of income recognition is permitted for participants under I.R.C. § 402 (Supp. IV 1986), even though the employer gets an immediate deduction under I.R.C. § 404 (Supp. IV 1986). Also, since earnings from contributions are not taxed while kept in trust (as a result of § 501(a)), distributees may take advantage of favorable distribution taxation mechanisms like rollovers under § 402(a) and five- or ten-year income averaging under § 402(e); and in many instances, employment taxes can be avoided by virtue of § 3121(a)(5)(A).

9. Non-tax advantages include provision of retirement income security for key employees, enhancement of employee morale, increasing competitiveness in obtaining a competent and skilled work force, and discouraging efforts to organize unions.

10. In view of the growing complexity of laws and regulations affecting retirement plans, the possibilities for inadvertently violating the particulars of such laws and regulations create a unique category of business risk which must be competently managed to eliminate claims and actions by employees, ex-employees, or their beneficiaries, whose expectations include not just the delivery of promised benefits, but certain accompanying tax advantages as well. In addition, employers are becoming increasingly cognizant of the potential for government intervention, liability for breaches of fiduciary responsibility, and various fines and penalties. See *e.g.*, I.R.C. §§ 4971-4981A.

11. These include both participation standards under § 410 and vesting standards under § 411, as well as the integration of contributions or benefits with the Social Security system

in the array of criteria that allow employer discretion to permit individually designed pension plans.[12]

Accrued benefits that are forfeited by plan participants who are less than one-hundred percent vested when they terminate employment have a direct effect on the economic operation of a plan in one or both of two ways. First, an employer may apply such forfeitures as offsets against employer contributions otherwise mandated or desired under a plan.[13] Second, vesting forfeitures may be allocated to augment the accrued benefits of plan participants who remain with the employer.[14] Thus, forfeitures can reduce the employer's funding costs in providing a designated level of benefits, or they can increase the level of benefits that result from a designated amount of funding costs. The employer's perception in either instance is usually one of substantial economic savings, which no doubt accounts for the popular use of vesting schedules in qualified plans.

Many employers also view vesting schedules as a means to reward long and faithful service rendered by competent employees. A vested pension benefit provides a more effective incentive than the promise of a gold watch upon retirement. The concept of rewarding long and faithful service is also commonly applied in pension plans that use a "unit benefit" formula.[15] Because of statutory restrictions on the use of vesting schedules first implemented in 1974,[16] however, accrued benefit formulas in pension plans typically incorporate the service reward concept to a greater, and more uniformly ratable degree, than do vesting schedules.[17]

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under § 401(a)(5) and operation of a variety of benefit, forfeiture allocation, and contribution allocation formulas (absent discrimination against rank-and-file employees) under § 401(a)(4).

12. To a large extent, the Code's allowance for a degree of employer discretion makes individually designed retirement plans complicated and difficult to operate. One is able to appreciate this point best by comparing the wordy and intricate plan document of a plan qualified under I.R.C. § 401(a) (Supp. IV 1986), which usually has dozens or scores of pages, with the relatively simple and short document executed to create an Individual Retirement Account under § 408.

13. Under I.R.C. § 401(a)(8) (Supp. IV 1986), a defined benefit pension plan must *not* use forfeitures to increase the benefits of remaining participants. Rather, forfeitures must be used to reduce the employer's subsequent contributions to the plan.

14. In defined contribution plans, forfeitures are typically used to increase the account balances of remaining participants.

15. An example of a unit benefit formula is one that promises a participant 2% of his or her average annual compensation for each year of service up to thirty years.

16. See segment I.C. of this article, *infra* for a description of the major vesting arrangements first permitted under the Employee Retirement Income Security Act of 1974 (ERISA).

17. With respect to participants having few years of service, accrued benefits formulas (unlike "all or nothing" vesting schedules) are precluded from denying benefit accruals altogether as a result of complex and specific rules contained in I.R.C. § 411(b) (Supp. IV 1986).

B. *Vesting and Plan Qualification*

Section 401(a)(7) of the Internal Revenue Code specifically incorporates the minimum vesting rules of I.R.C. Section 411 as necessary to the tax favored qualification of a retirement plan.[18] When ERISA was enacted in 1974, Congress expressed the following sentiment regarding minimum vesting standards:

> Coverage under a pension plan does not aid an individual if he later forfeits his right to his pension benefits upon voluntary or involuntary termination of employment. This is an important consideration in view of the fact that ours is a fairly mobile economy where employees tend to change jobs frequently, especially in their younger years. Moreover, the cyclical and technological nature of certain industries results in frequent layoffs over a work career for employees in those industries, as in aerospace and defense. The committee bill . . . deals with this problem by requiring pension plans to grant covered employees reasonable minimum vested rights to their accrued benefits.[19]

The concept of "reasonable minimum vested rights" encompassed much more than merely designating permitted alternative vesting schedules, however. It was necessary to include in Section 411 ancillary rules that address, among other things, permitted forfeitures based upon events other than termination of service;[20] how service credit is to be determined in computing where an employee is on a particular vesting schedule;[21] the rights of existing participants when the employer changes from one permitted vesting schedule to another;[22] how turnover under permitted vesting schedules is to be tested under the independent anti-discrimination rule of I.R.C. Section 401(a)(4);[23] and what circumstances in the nature of a plan termination will result in an acceleration of vesting rights notwithstanding a participant's position on a permitted vesting schedule.[24] Obviously, preservation of a plan's package of tax benefits and compliance with the non-tax features of ERISA involves vesting admin-

18. For purposes of non-tax regulation of retirement plans, § 203 of ERISA also contains minimum vesting standards that largely parallel those of I.R.C. § 411 (Supp. IV 1986).
19. H.R. 2, 93d Cong., 2d Sess., 120 CONG. REC. 4722-23 (1974). (The House Floor Explanation on ERISA § 203, Minimum Vesting Standards.)
20. I.R.C. § 411(a)(3) (Supp. IV 1986).
21. I.R.C. § 411(a)(4)-(7) (Supp. IV 1986).
22. I.R.C. § 411(a)(10) (Supp. IV 1986).
23. I.R.C. § 411(d)(1), (2) (Supp. IV 1986). With respect to contributions or benefits, I.R.C. § 401(a)(4) generally prohibits qualified plans from discriminating in favor of highly compensated employees to the detriment of rank-and-file employees.
24. I.R.C. § 411(d)(3).

istration that goes far beyond the mere selection of one of the statutorily designated vesting schedules.

C. *Available Vesting Schedules*

But use of the vesting tool begins with selection of a permitted vesting schedule, and from 1974 through 1988,[25] employers were generally allowed to implement a vesting schedule no less restrictive than one of the following alternatives: "10-year vesting," involving no vesting at all until a participant acquired ten years of service, at which time one-hundred percent vesting occurred;[26] "5-to-15-year vesting," which granted twenty-five percent vesting upon the attainment of five years of service, with an increasing percentage for each year of service thereafter up to fifteen years, at which point one-hundred percent vesting occurred;[27] "Rule of 45" vesting, which granted fifty percent vesting after five years of service graded up to one-hundred percent vesting after ten years, as long as the sum of the participant's age and service equalled or exceeded a statutorily designated number;[28] and "4-40" vesting, which granted forty percent vesting upon attainment of four years of service, graded to one-hundred percent vesting after eleven years.[29]

As a result of the Tax Equity and Fiscal Responsibility Act of 1982,[30] plans deemed to be "top heavy"[31] must incorporate a vesting schedule no less restrictive than either one of the following: a 6-year graded schedule;[32] or a schedule that allows no vesting for participants who have not attained three years of service but grants one-hundred percent vesting once three years is attained.[33]

The vesting choices accorded top heavy plans were not affected by the Tax Reform Act of 1986,[34] but vesting schedules for non-top

25. See *supra* note 1.
26. I.R.C. § 411(a)(2)(A) (1954).
27. I.R.C. § 411(a)(2)(B) (1954).
28. I.R.C. § 411(a)(2)(C) (1954).
29. Rev. Proc. 75-49, 1975-2 C.B. 584. The Internal Revenue Service required use of this vesting schedule if employee turnover inordinately worked to the detriment of rank-and-file employees under one of the "permitted" vesting schedules of I.R.C. § 411(a)(2) (1954). *See* § 411(d)(1).
30. Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248, 96 Stat. 324 (1982).
31. Generally, § 416(g) (1982 & Supp. IV 1986) defines a "top heavy" plan as one under which more than 60% of the accrued benefits inure to "key employees."
32. I.R.C. § 416(b)(1)(B) (1982). Twenty percent vesting is granted at attainment of two years of service, plus an additional 20% per year thereafter, until full vesting is achieved with six years of service.
33. I.R.C. § 416(b)(1)(A) (1982).
34. H.R. CONF. REP. NO. 841, 99th Cong., 2d Sess. II-426, *reprinted in* 1986 U.S. CODE CONG. & AD. NEWS 4075, 4514 (Conference Report incorporated the Senate Amendment).

heavy plans were substantially altered. Such plans may use vesting schedules no less restrictive than either: "5-year vesting," with no vesting at all until a participant acquires five years of service, at which time one-hundred percent vesting occurs;[35] or "3-to-7-year vesting," which grants twenty percent vesting upon the attainment of three years of service, with an additional twenty percent per year thereafter until one-hundred percent vesting is granted after seven years of service.[36]

In addition, the Tax Reform Act of 1986 altered the special participation/vesting rule of I.R.C. Section 410(a)(1)(B) so that no employer willing to grant one-hundred percent vesting upon an employee's initial participation in a qualified plan can predicate entry into participation status upon more than *two* years of service. The prior Code provision allowed predication to be based upon three years of service.[37] Choosing the Section 410(a)(1)(B) alternative may be likened to selection of no vesting schedule at all. In effect, an employer so choosing selects a two-year "all or nothing" vesting schedule. In this respect, the Section 410(a)(1)(B) alternative resembles the vesting schedules mentioned above, which grant no vesting at all until either ten or five years of service have been earned (at which time one-hundred percent vesting must occur). This latter comparison ends, however, upon our noting that the Section 410(a)(1)(B) alternative, unlike the "all or nothing" vesting schedules, makes it impossible for a participant to incur any forfeiture of accrued benefits upon termination of employment, since accrued benefits do not commence until an employee becomes a participant in the plan, at which time he or she would become 100% vested in the first dollar of accrued benefit.

II. Major Technical Difficulties Involving Vesting Schedules

A. Crediting of Service Problems

Adoption of a vesting schedule that leads to forfeiture of accrued benefits according to the years of service earned by a participant inevitably leads to complexities involving the crediting of years

35. I.R.C. § 411(a)(2)(A) (Supp. IV 1986).

36. I.R.C. § 411(a)(2)(B) (Supp. IV 1986).

37. Employers wishing to subject new participants to a vesting schedule allowing 100% vesting later than upon the attainment of two years of service would not be permitted to predicate plan participation upon attainment of more than one year of service, § 410(a)(1)(A) (Supp. IV 1986). Note that benefit accrual cannot commence for an employee until he or she becomes a participant, but benefit accrual, once established, can be forfeited upon untimely severance of service as a result of application of a vesting schedule. See *supra* note 5.

of service.[38] Frequently, complications result when the employer attempts to compute service years for employees who are terminated but are later re-employed. This is a common occurrence in industries that reduce employment during economic downtrends by ordering layoffs that are later reversed by rehiring former employees — often according to seniority — when economic conditions rebound. The service crediting problems that arise for such employers can be examined under permissive rules that distinguish between the crediting of pre-break years of service to "post-break" contributions or benefits and the crediting of post-break years of service to "pre-break" contributions or benefits.[39]

These rules are contained in I.R.C. Section 411(a)(6) and (7) and can be illustrated by an example involving a plan participant who terminates employment after attaining three years of service applicable to a seven year graded vesting schedule.[40] If the former employee is rehired after a period of one-year breaks in service, his or her re-entry into active plan participation status will generate an inquiry into the number of years of service to be credited under the plan's vesting schedule, since upon renewal of participation status additional benefit accruals will commence and any second potential termination of employment may result in forfeitability of at least a portion of the new accrued benefits. New years of service earned after re-employment will count on the plan's vesting schedule toward newly acquired accrued benefits, but will the three years of service earned prior to the original termination of employment also count?[41]

Under Section 411(a)(6)(B), the employee's three pre-break years of service can be ignored until the employee has completed a year of service after being rehired. Nonetheless, since a year of ser-

38. The "year of service" concept applies simultaneously to participation status (usually a one-time determination), vesting (the degree to which one's plan interest is non-forfeitable upon separation from employment), and benefit accrual (generally the extent to which a participant will receive an allocation of employer contributions and thus create or augment a plan interest during a plan year). *See* 29 C.F.R. § 2530.200b-1(a) (1987).

39. If an employee returns to service too soon after separating from employment, his or her status as a plan participant ought not, logically, be adversely affected. It was thus necessary to create a standard to identify a reasonably substantial interruption of what normally is full-time employment status. This standard is the "one-year break in service," defined in I.R.C. § 411(a)(6)(A) (1982 & Supp. IV 1986) as a twelve-consecutive month period designated in the plan during which a participant has not completed more than 500 hours of service.

40. See *supra* note 36 and accompanying text.

41. For vesting purposes only, in order for any years of service to count, they must not be disregarded under plan provisions incorporating any of the six possible exclusions of service set forth in I.R.C. § 411(a)(4) (1982 & Supp. IV 1986). For example, a plan may ignore years of service during any period for which the employer did not maintain the plan. *See* I.R.C. § 411(a)(4)(C) (1982 & Supp. IV 1986).

vice for vesting purposes is comprised of one thousand hours of service,[42] and benefit accrual would normally be predicated upon the same one thousand hours standard,[43] Section 411(a)(6)(B) would not likely prevent application of the three prior earned years of service to determine the participant's vested percentage of his or her post-break accrued benefits. This is because the creation of such post-break accrued benefits would normally coincide with fulfillment of the one-year "lookback" period required by Section 411(a)(6)(B).

On the other hand, I.R.C. Section 411(a)(6)(D) might have a detrimental effect. If the participant had first terminated employment with *no* vested accrued benefit, this provision would permit prior service to be ignored if: the number of consecutive one-year breaks in service equal or exceed (a) five years and the employee has attained no more than five years of service; or (b) the number of years of prior service if the employee has attained more than five years of service.[44] Because the participant in our example was twenty percent vested in his or her old accrued benefit at the time of original termination of employment, he or she would not lose the three prior earned years of service by virtue of this rule.[45]

The rules of I.R.C. Section 411(a)(6)(B) and (D), adopted in many qualified plans, set forth a complicated method to credit service toward newly earned accrued benefits following a re-hiring. These rules, however, do not address the problem of whether post-break service may be applied to increase vesting in a participant's pre-break accrued benefit. Assume our hypothetical participant had an account balance (accrued benefit)[46] of $10,000 when he or she originally terminated employment. Since the participant had only three years of service applicable to a seven year vesting schedule, his or her *vested* accrued benefit would be only twenty percent, or $2,000. Thus, upon original termination of service the plan administrator could deliver to the terminated employee a check for $2,000 and set the remaining $8,000 aside for eventual reallocation among remaining participants as a forfeiture. When the person in question is later re-hired after one or more years of break in service, additional years of service earned would advance the newly re-participating employee further on the vesting schedule respecting *both* newly

42. I.R.C. § 411(a)(5)(A) (1982 & Supp. IV 1986).
43. 29 C.F.R. § 2530.200b-1(a) (1987).
44. I.R.C. § 411(a)(6)(D)(i) (1982 & Supp. IV 1986).
45. Note the effect of the rule in I.R.C. § 411(a)(6)(D) upon the five-year "all or nothing" vesting option of § 411(a)(2)(A).
46. I.R.C. § 411(a)(7)(A)(ii) (1982 & Supp. IV 1986).

earned accrued benefits *and* prior earned accrued benefits (the $10,000 account balance). If vesting increases in the old accrued benefit, this effect would be inconsistent with creating an $8,000 forfeiture upon initial termination of service.

The problem is remedied, with complications, in one of two ways authorized under I.R.C. Section 411(a)(6) and (7). Section 411(a)(6)(C) permits the plan to disregard the new years of service (as applied to the old accrued benefit only),[47] if the employee participated in a defined contribution plan, or insured defined benefit plan, *and* incurred five consecutive one-year breaks in service. The primary result of administering a plan under this rule is that forfeitable accrued benefits must be held in suspense for the requisite five-year period before forfeiture allocations can proceed.[48] What happens to the $8,000 held in suspense if the employee returns to service before five consecutive one-year breaks in service transpire? The remaining account balance would continue to share in the plan trust's earnings, and the newly re-participating employee's vesting growth in the segregated account would be determined from time to time by reference to one or the other of two formulas expressed in the Treasury Regulations for Section 411.[49]

I.R.C. Section 411(a)(7) approaches the problem of what to do with potentially increasing vesting in an old, pre-break accrued benefit by, in effect, permitting the plan to ignore the old accrued benefit itself, rather than by cancelling the new years of service as Section 411(a)(6)(C) does.[50] Section 411(a)(7) makes no distinction in the operation of its rule based upon the type of qualified plan, so that

47. I.R.C. §§ 411(a)(6) and (7) contain no rules permitting the plan to disregard prebreak years of service properly earned as applied to pre-break accrued benefits. Thus, the $2,000 vested accrued benefit would remain nonforfeitable. Likewise, post-break years of service cannot be ignored with respect to post-break accrued benefits.

48. Immediate forfeiture of the $8,000 upon the participant's initial termination of service would leave the employee, upon his or her return to service, with the prospect of increased vesting in an unfunded accrued benefit. Such a consequence would not be consistent with maintaining the plan's qualification status. *See* Treas. Reg. § 1.411(a)-7(d) (as amended by T.D. 8038, 1985-2 C.B. 130).

49. Treas. Reg. § 1.411(a)-7(d)(5)(iii) allows a plan to adopt either X=(AB (RxD))-(RxD) or X=(AB D)-D. X is the participant's vested amount; P is the vesting schedule percentage at the relevant time; AB is the participant's account balance at the relevant time; D is the amount of the distribution taken by the participant upon original termination of employment; and R is the ratio of the account balance at the relevant time to the account balance after the distribution.

50. I.R.C. § 411(a)(7)(B) (1982 & Supp. IV 1986) does this by permitting the employer to disregard the service performed to create the old accrued benefit *after* the employee receives a distribution of his or her entire vested interest. Thus, the rule does not affect the employee's original vested interest; rather, the rule affects only his or her ability to increase vesting in the original accrued benefit later upon re-participation following a break in service.

non-insured and insured defined benefit plans alike, as well as all defined contribution plans can use Section 411(a)(7). Nevertheless, like I.R.C. Section 411(a)(6)(C), I.R.C. Section 411(a)(7) imposes a distinct technical requirement based upon whether the departing participant incurs a period of five consecutive one-year breaks in service. That is, if the employee returns to service within such period, he or she must be given the opportunity to repay the vested distribution originally made.[51] Upon repayment, the plan must resurrect the old accrued benefit.[52] In addition, the Treasury Regulations for I.R.C. Section 411 permit the old accrued benefit to be reconstructed from an additional employer contribution, plan earnings, or vesting forfeitures ripe for allocation.[53] Consequently, an employer could choose a method that would coalesce with the I.R.C. Section 411(a)(6)(C) implicit requirement to carry forfeitable accrued benefits in a suspense account until the period of five consecutive one-year breaks in service has passed, by requiring that its defined contribution plan set the unvested accrued benefit aside until the five year repayment period has lapsed. Such a rule would assist the employer and plan to avoid the happenstance expense of reconstructing an old accrued benefit.[54]

Unlike Section 411(a)(6)(C), Section 411(a)(7) imposes an additional requirement to the effect that the original distribution of an employee's vested interest in excess of $3,500 cannot be made without the employee's permission.[55] If an employee has a vested interest exceeding $3,500 at the time of separation from service and wishes to avoid potential taxation that would result from a distribution,[56] he or she may refuse to consent to a distribution. In that event, the rule of Section 411(a)(7) could not be invoked to solve the problem of crediting post-break service to pre-break accrued benefits. The plan would have to rely on Section 411(a)(6)(C), assuming it was the kind of plan covered by that rule.

51. I.R.C. § 411(a)(7)(C) (1982 & Supp. IV 1986).

52. *Id.*

53. Treas. Reg. § 1.411(a)-7(d)(6)(iii)(C) (as amended in 1985).

54. Since Treas. Reg. § 1.411(a)-7(d)(4)(v) requires resurrection of the accrued benefit to its original level, potential liability would not altogether be eliminated if the accrued benefit is devalued after the employee's original termination from service. The plan must recredit the returning employee to at least the value of his or her accrued benefit at the original distribution date, even if the trust subsequently experiences investment losses.

55. I.R.C. § 411(a)(7)(B) (1982 & Supp. IV 1986).

56. I.R.C. § 402(a)(1). The employee might also avoid taxation by taking the distribution and rolling it over within 60 days to an Individual Retirement Account under I.R.C. § 402(a)(5) (Supp. IV 1986). Nevertheless, the employee may wish to leave the interest intact under the plan if the plan's trust investment performance is attractive, especially if the employee is only years, rather than decades, away from his or her retirement year.

An overall examination of the rules of I.R.C. Section 411(a)(6) and (7) reveals that the complexities imposed by these rules result directly from the concept of vesting forfeitures. Employers, and particularly small employers who may wish to avoid administrative difficulties in the operation of their qualified retirement plans, can avoid reliance on Section 411(a)(6) and (7) by adopting the vesting approach of Section 410(a)(1)(B), which permits the employer to prevent any employee from obtaining participation status for at least two years[57] while granting all participants one-hundred percent vesting in all accrued benefits. By eliminating the possibility for forfeitures, a plan relying on Section 410(a)(1)(B) can avoid computations linking pre-break and post-break years of service, extended maintenance of separate suspense accounts for old accrued benefits, and either catch-up vesting computations under algebraic formulas[58] or recomputed accrued benefits under Section 411(a)(7)(C).

B. *The Problem of Partial Terminations*

Although the rules of I.R.C. Section 411(a)(6) and (7) add a measure of complexity to the operation of a qualified plan, they can be followed with precision when given appropriate attention by a knowledgeable plan administrator. Furthermore, these rules only demand full attention in cases involving the rehiring of former employees, a common situation for many employers but by no means a frequent concern for all employers. By contrast, the problem of partial plan terminations is governed by no fixed and precise operative rules and is not affected in its complexity by whether an employee who terminates service is ultimately re-hired.

As set forth in I.R.C. Section 411(d)(3), upon a termination, partial termination, or complete discontinuance of contributions under a retirement plan, all affected employees must become fully vested in their accrued benefits.[59] This requirement should pose no problems when a plan is completely terminated, since such a termination would require a deliberate act by the employer, and all plan participants would simultaneously enjoy full vesting. Unfortunately, a partial termination is often not a specifically planned event, but rather an inadvertent consequence of a reduction in an employer's

57. Entry into participation status may be delayed slightly more than two years by operation of § 410(a)(4).

58. *See supra* note 49.

59. In other words, if a participant would otherwise be less than fully vested under a vesting schedule permitted under I.R.C. § 411(a), the participant's vesting will be accelerated to 100% once § 411(d)(3) is invoked.

workforce, determined under a "facts and circumstances" test.[60] Occasionally, economic conditions will force an employer to close operations at a particular location or even shut down an entire division, resulting in involuntary termination to a substantial group of employees. On other occasions a workforce shrinkage is not so specifically identified, but rather simply manifested via general layoffs or position eliminations that affect a variety of functions or departments. In any event, a substantial enough reduction in workforce can lead to a finding that a partial termination has occurred, and the affected (eliminated) employees must accordingly be granted full vesting, notwithstanding the position of individuals on the qualified plan's vesting schedule.[61]

Because all the facts and circumstances connected with a business contraction are examined, the rulings and cases involving partial terminations due to workforce reductions offer no clear, objective guidelines for determining when a partial termination will be found. Indeed, a partial termination has been determined in one situation involving only a 19.4 percent reduction in workforce,[62] while under other conditions a forty-seven percent reduction was deemed insufficient to find a partial termination.[63]

Technically, there is no reason to suppose that small businesses are any less susceptible to inadvertent partial terminations than large ones. For example, consider the case of a small business having only four full-time employees, including the founder-owner of the business. Assume each of the four employees is a participant in a qualified retirement plan sponsored by the employer. If, due to adverse business conditions, the employer is compelled to discharge two of the employees, the workforce would be reduced by fifty percent. Under a majority of authorities,[64] such a reduction would at least raise the partial termination issue, and, depending on other pertinent

60. Treas. Reg. § 1.411(d)-2(b)(1) (as amended by T.D., 7501, 1977-2 C.B. 133). As these regulations indicate, a partial termination can also result from a plan amendment that affects the rights of a group of employees.

61. Employees who remain will continue to be vested in their accrued benefits only as allowed by the vesting schedule. That is, full and immediate vesting is granted only with respect to the part of the plan (represented by the accrued benefits of the departing employees) that is terminated. Treas. Reg. § 1.411(d)-2(b)(3) (as amended by T.D. 7501, 1977-2 C.B. 133).

62. I.R.S. Priv. Ltr. Rul. 7902030 (Oct. 10, 1978).

63. I.R.S. Gen. Couns. Mem. 39344 (May 31, 1983).

64. *See, e.g.*, Tipton and Kalmbach, Inc. v. Commissioner, 83 T.C. 154, 160 (1984) (stressing that as long as a significant percentage of plan participants are discharged, a finding of partial termination may be made, despite the employer's lack of intent to deprive participants of benefits — for example, when terminations are based upon a decrease in business).

facts and circumstances,[65] the plan could easily be found to require that the two discharged employees be given full vesting upon their departure. If, in fact, the employees were given less than adequate distributions as a result of the plan administrator's simply processing the distributions under the plan's vesting schedule, the plan's qualification status would be jeopardized.

A "complete discontinuance of contributions" under a plan could lead to the same result.[66] Such a discontinuance would be distinguished from a mere temporary cessation of contributions, could not be avoided with only nominal contributions, and is, like partial terminations, subject to a facts and circumstances test.[67] Since all participating employees would be adversely affected by a complete discontinuance of contributions, the edict of Section 411(d)(3) requiring full vesting would apply to all participants. A risk of disqualification would therefore exist with respect to employees who receive less than optimum severance distributions due to the application of a vesting schedule, while the employer may be in the process of incurring a technically-determined but inadvertent complete discontinuance of contributions.[68]

I.R.C. Section 411(d)(3) presents administrative difficulties that require considerable monitoring of plan and employer operations. These difficulties result directly from the concept of vesting forfeitures. Plans adopting the one-hundred percent vesting-upon-participation approach of Section 410(a)(1)(B) thus further avoid the Section 411(d)(3) threat to their qualification status.

C. *Additional Vesting Problems*

Adoption of a vesting scheme that permits less than full vesting for some plan participants leads to a variety of additional technical difficulties. One difficulty that has been of particular concern to the

65. Treas. Reg. § 1.411(d)-2(b) states that *all* facts and circumstances bearing on the issue must be considered, and these *include* exclusion of a group of previously-covered employees by reason of termination.

66. A complete cessation of contributions is most likely to occur with respect to a profit-sharing plan, since such plans are permitted to grant discretion to the employer to determine whether, and to what extent, an annual contribution is made. Pension plans, on the other hand, are subject to the minimum funding standards of I.R.C. § 412 (1982 & Supp. IV 1986) which compel the employer to make appropriate, continuing contributions.

67. Treas. Reg. § 1.411(d)-2(d)(1) (as amended by T.D. 7501, 1977-2 C.B. 133).

68. Treas. Reg. § 1.411(d)-2(d)(2) states that a complete discontinuance of contributions, once determined, becomes effective not later than the last day of the taxable year of the employer following the last taxable year of the employer for which a substantial contribution was made under a profit sharing plan. No guidance is given in the regulations to assist an employer in determining what constitutes a "substantial contribution."

Internal Revenue Service is that involving the interaction of I.R.C. Section 411, which permits the use of specific vesting schedules, and Section 401(a)(4), which states that the contributions or benefits of a qualified plan must not discriminate in favor of highly compensated employees.[69] Even if an employer adopts a statutorily designated vesting schedule, it is possible (and in many instances, likely) that the degree of employee turnover experienced by the employer is such that highly compensated employees tend to vest more fully than rank-and-file employees. If rank-and-file employees quit or are discharged much more frequently than highly compensated ones, an otherwise permissible vesting schedule will operate in a discriminatory manner contrary to the requirement of Section 401(a)(4). This potential problem is acute enough to have caused Congress to include in Section 411 a direct reference to Section 401(a)(4).[70]

But how can the Internal Revenue Service and the plan administrator determine whether a permitted vesting schedule operates in a discriminatory manner? As is frequently the case in making qualification determinations for retirement plans, a "facts and circumstances" approach is necessary. Various attempts have been made by the Internal Revenue Service to formulate quasi-objective tests for measuring when and whether turnover of rank-and-file employees will result in the prohibited discrimination. The confusion generated by these attempts may have reached a peak, illustrated by IR 80-85,[71] at which the Internal Revenue Service basically takes the approach that, respecting vesting related violations of I.R.C. Section 401(a)(4), "we will know one when we see it."[72]

Thus, it is clear that if after six years of plan operation only one employee, the sole shareholder of the employer, has a vested accrued benefit, a presumption that the plan's vesting schedule is discriminatory will arise.[73] On the other hand, if the class of employees who have vested benefits at a particular time represents a "reasonable cross section" of all employees, a vesting schedule will be deemed

69. Highly compensated employees are defined in I.R.C. § 414(q) (Supp. IV 1986). The definition refers to specific compensation levels but also deals with an employee's status as an officer or shareholder of the employer.

70. I.R.C. § 411(d)(1) (Supp. IV 1986).

71. I.R.S. News Release IR-80-85 (Aug. 4, 1980).

72. Treas. Reg. § 1.411(d)-1(c) stands as underlying authority for this view by virtue of the general promulgation that findings of discriminatory vesting shall be made on the basis of the facts and circumstances of each case, allowing for a "reasonable disparity" between the vested benefits of the "prohibited group" (now, highly compensated employees as referenced in I.R.C. Section 401(a)(4) (Supp. IV 1986)) and the vested benefits of other employees.

73. I.R.S. News Release IR-80-85 (Aug. 4, 1980) (Example 5).

nondiscriminatory.[74] No guidance is given, however, to assist one in determining precisely what constitutes a reasonable cross section beyond situations that parallel those devised by the Internal Revenue Service to illustrate the concept.[75] Although one potential test for discrimination creates a "safe harbor" in cases involving total accrued benefits for prohibited group employees that are less than vested benefits for rank-and-file employees,[76] many smaller employers will be unable to rely on this test due to lack of a large rank-and-file workforce, particularly when the business by its nature has a high employee turnover rate. Of course, plans adopting the one-hundred percent vesting-upon-participation approach of I.R.C. Section 410(a)(1)(B) avoid the vesting discrimination problem altogether, since all plan participants are always fully vested.

Likewise, such plans avoid various procedural complexities associated with a number of other qualification features. These include the requirement that a participant who has three years of service be given an election to have his or her nonforfeitable percentage computed under a plan's former vesting schedule when a new vesting schedule is being implemented.[77] Written notice of such election must be given to each affected participant, and precise timing requirements for the election period must be observed.[78] Failure to comply with these requirements, even if inadvertent, could result in a plan's disqualification, since the new vesting schedule will not be deemed to satisfy Section 411(a)(2).[79]

I.R.C. Section 401(a)(19) is another qualification feature that would not apply to a plan adopting Section 410(a)(1)(B). This provision, applicable to "thrift" plans that involve matching employer and employee contributions, permits forfeiture of employer contributions upon a participant's withdrawal of employee contributions only if the participant is less than fifty percent vested under the plan's schedule. But such forfeitures are further complicated by I.R.C. Section

74. *Id.* (Examples 2-4).

75. The examples given in I.R.S. News Release IR-80-85 illustrate the concept result through hypothetical charts that list compensation ranges while showing the number of vested employees in each range compared to the total number of employees in that range. How employers with workforces varying significantly from the hypotheticals should determine compensation ranges, and what disparities in vested versus nonvested employees at each range will be tolerated, is not known.

76. *Id.* (Example 1).

77. I.R.C. § 411(a)(10)(B) (Supp. IV 1986). An employer does not always have a choice in changing its plan's vesting schedule. A change in the law can mandate amendment of vesting schedules, as occurred under the 1986 Tax Reform Act, or an employer might have to change a vesting schedule to meet the negotiated demands of an employees' organization.

78. Temp. Treas. Reg. § 1.411(a)-8T (1977).

79. I.R.C. § 411(a)(10)(B) (1982 & Supp. IV 1986).

411(a)(3)(D), which requires that the withdrawn employee contributions must have been mandatory contributions,[80] and that the plan contain a complicated "buy back" provision allowing a plan participant to reinstate the forfeited employer-derived accrued benefit upon the participant's repayment of the withdrawn employee contributions.[81] As was the case with Section 411(a)(7), forfeitures in this context are thus accompanied by considerable administrative bother and potential inadvertent noncompliance with mandated procedures and notices.[82]

Plans adopting I.R.C. Section 410(a)(1)(B) also need not be burdened by rules for excluding vesting years of service that may apply differently to various categories of employees.[83] By making all employees one-hundred percent vested upon attainment of participation status, there is no need to count years of service for vesting purposes. Consequently, there would be no need to deal with technical exclusions affecting the crediting of vesting service years. Furthermore, defined contribution plans using the Section 410(a)(1)(B) approach may better facilitate the participants' use of a plan loan provision. Such provisions permit a participant to borrow from the qualified trust on the strength of the security available from the participant's vested accrued benefit.[84] I.R.C. Section 72(p) treats participant loans as taxable distributions *unless* certain restrictions regarding the amount and terms of the loans are observed.[85] These restrictions include a limitation on the dollar amount of a loan based upon the extent of the employee-borrower's nonforfeitable accrued benefit.[86] Thus, delays in attaining such benefits due to vesting schedules can correspondingly delay participants' access to loans under plans that include loan provisions as a convenience to employees.

Finally, if a plan adopts the Section 410(a)(1)(B) approach, the employer will not have its contribution deduction delayed or jeopardized in a taxable year when the plan might lose its qualifications status. Under I.R.C. Section 404(a)(5), a contribution made to a plan during a nonqualification year is not deductible for that year unless the contribution is correspondingly included in the gross in-

80. I.R.C. § 411(a)(3)(D)(i) (1982 & Supp. IV 1986).
81. I.R.C. § 411(a)(3)(D)(ii) (Supp. IV 1986).
82. *See supra* notes 51-54 and accompanying text.
83. I.R.C. § 411(a)(4) (Supp. IV 1986).
84. Such loan provisions, properly regulated, are authorized under I.R.C. § 4975(d).
85. I.R.C. § 72(p)(2) (Supp. IV 1986).
86. I.R.C. § 72(p)(2)(A)(ii) (Supp. IV 1986).

comes of the participants. I.R.C. Section 402(b)(1) states that for nonqualified trusts, contributions are to be included in the gross income of participants in accordance with I.R.C. Section 83. This latter Code section provides that the granting of a property interest (for example an accrued benefit in an employee benefit plan trust) by a recipient of services (employer) to a provider of such services (employee-participant) results in an inclusion in gross income only to the extent that the interest granted is either transferable by the recipient or not subject to a substantial risk of forfeiture.[87] Interests in employee benefit plans are generally not transferable by virtue of typical compliance with the qualification feature requiring that plan benefits may not be assigned or alienated.[88] As a result, for employee benefit plans the income recognition issue under Section 83 is predicated upon the "substantial risk of forfeiture" concept, which in turn is governed by the plan's vesting schedule. Accordingly, the employer's deduction for contributions made during a year when the plan happens to be disqualified is directly affected by the extent to which the participants in the plan are vested in such contributions. If the plan has no vesting schedule, the immediate availability of the employer's deduction is preserved.[89]

III. Evaluation of the Purported Benefits of Vesting Schedules

A. Costs Savings

It should be clear from the foregoing review of the technical implications of vesting schedules that an employer, and particularly a smaller employer desiring to minimize plan complexities and administrative costs, should consider using a vesting schedule only if such demonstrably results in substantial offsetting benefits.

Under the vesting schedule choices available prior to the 1986 Tax Act,[90] it may have been easy to simply *assume* that protracting vesting over a decade or more would eventually result in costs savings that would make undertaking the necessary administrative burdens worthwhile. Now that the majority of plans are forced to

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87. I.R.C. § 83(a) (Supp. IV 1986).

88. I.R.C. § 401(a)(13)(Supp. IV 1986).

89. This is so as long as a plan having more than one participant maintains separate accounts for each participant. I.R.C. § 404(a)(5) (Supp. IV 1986). This requirement may be a problem for many defined benefit pension plans but poses no difficulty for defined contribution plans, which must account separately for each participant's annual addition under I.R.C. § 415(c) (Supp. IV 1986).

90. *See supra* notes 25-29 and accompanying text.

choose schedules that operate in a three-to-seven year range,[91] such costs savings assumptions should be carefully re-examined. This is especially so in view of the additional "probationary" year prior to participation that can be imposed by employers who implement I.R.C. Section 410(a)(1)(B).

Employee turnover patterns are the key to making an appropriate choice respecting vesting. *Actual*, historical employee turnover patterns, not assumed or imagined circumstances, should be examined. The employer can choose a period of time ending at the present,[92] determine the number and identity of employees who terminated full employment during that period, and project the data into the future while considering any likely future trends or events that could alter the historical pattern. For example, the analyst would want to consider the impact of any substantial business expansion or contraction of the employer likely to occur in the near future.

Employers already having a qualified plan will find this analysis easier, since data on employee turnover relevant to operation of a former vesting schedule should already exist. The analyst can simply take this data and re-apply it hypothetically under the new vesting schedule choices. Employers implementing a qualified plan for the first time will find it necessary to extend the application of turnover data to include assumed plan contributions that will determine hypothetical accrued benefit allocations for the departed employees.

Small employers, especially those in very competitive industries that typically pay lower wages, may be surprised at how few cost savings are available under currently permitted vesting schedules. To illustrate, consider a small employer maintaining a fairly constant full-time workforce of ten employees, including the owner-founder of the business. The employer now wishes to implement a qualified profit-sharing plan. Assume the following data is collected from a seven-year lookback of employee turnover. During the past seven years the employer has hired twenty-five persons, and eight of these are still employed.[93] Of the seventeen persons who quit or were discharged, seven terminated employment before earning one year of

91. Under the 1986 Tax Reform Act, multi-employer plans covering employees under a collective bargaining agreement can still use a ten-year "all or nothing" vesting schedule. I.R.C. § 411(a)(2)(C) (Supp. IV 1986).

92. Since the longest permitted vesting schedule available to most employers is now the seven-year graded schedule of § 411(a)(2), a seven-year examination period stretching back from the present may be a logical period of time to use.

93. Assume the current workforce of ten employees consists of these eight, plus the owner-founder, plus one other employee hired prior to the beginning of the seven-year examination period.

service,[94] seven before earning two years of service,[95] one before earning three years of service,[96] one before earning four years of service,[97] and one before earning five years of service.[98]

Under the best of circumstances (from the employer's perspective), only three employees could have suffered total forfeitures in a seven-year period.[99] Fourteen persons would never have even become plan participants under a Section 410(a)(1)(B) adoption, and eight employees would have become one-hundred percent vested plan participants, irrespective of which vesting choice had been made. Now assign wage and contribution rates to the three hypothetically affected employees. Take their rates of pay, say an average of $15,000 per year each, and assume a typical contribution rate of seven percent of compensation per year.[100] Since benefit accruals would not commence until an employee became a plan participant, the three employees together would have no more than a total of six years of service for benefit accrual purposes.[101] Thus, under the best scenario, there would be a total, forfeitable accrued benefit of seven percent of $15,000 times six years of service, or $6,300, for an annual average forfeiture of one-seventh of $6,300 or $900 per year over the seven-year period.

If the three employees in question had been participants in a plan using Section 410(a)(1)(B), three fewer years of service for benefit accrual purposes would have been credited. Although the employees would have departed with one-hundred percent vesting in their accrued benefits, the total vested accrued benefits would have been only $3,150. Consequently, the true "savings" under the plan using the most restrictive vesting schedule as compared to Section

94. These persons could have been excluded from plan participation under § 410(a)(1)(A).

95. These persons, as well as the first seven, could have been excluded from plan participation under § 410(a)(1)(B).

96. This person would have become a plan participant in any event, but could have lost at least a majority of his or her accrued benefit under any available vesting schedule.

97. Again, this person would have become a plan participant, but could have had a 100% vested accrued benefit if the plan was using the three-year "all or nothing" schedule of § 416(b)(1)(A). All other potentially available schedules would have resulted in a loss of at least a majority of his or her accrued benefits.

98. This plan participant could have lost all of his or her accrued benefit under the § 411(a)(2)(A) schedule, 60% of the accrued benefit under the § 411(a)(2)(B) schedule, and only 40% under the § 416(b)(1)(B) vesting schedule.

99. Assuming adoption of the five-year "all or nothing" schedule of § 411(a)(2)(A).

100. The actual allocation rate for the owner-founder could be substantially greater if the plan is integrated with the Social Security system under authority of §§ 401(a)(5) and 401(l)(2).

101. Assuming application of the one-year of service participation requirement as authorized by § 410(a)(1)(A).

410(a)(1)(B) amounts to only $450 per year in this illustration. When the employer considers that properly effected forfeitures typically get re-allocated to the accrued benefits of *all* participants in a profit sharing plan, the marginal benefit given to the ten remaining participants would not justify the administrative complexities resulting from adoption of a vesting schedule.

The above illustration indicates that the forfeiture value of a particular vesting schedule is predicated directly upon both the number of terminating employees *and* the extent to which terminating employees quit service in precisely the range of service years covered by a vesting schedule. If an employee terminates service either prior to attainment of participation status *or* subsequent to the maximum service period covered by the vesting schedule, the vesting schedule has no impact respecting the employee's economic status under the plan. In other words, and in view of the Section 410(a)(1)(B) alternative, vesting schedules really only have an economic impact during a maximum five-year service period from service year two until service year seven. If the plan adopts the Section 411(a)(2)(A) five-year "all or nothing" schedule, the effective range of impact shrinks to only three years. Additionally, adoption of the three year schedule of Section 416(b)(1)(A) reduces the range to a mere year. Obviously, an employer should carefully examine its experienced turnover trends in view of this limited range of vesting schedule effectiveness.[102]

B. Intangible Considerations in the Selection of Vesting Devices

As mentioned previously, many employers who might wish to include a service reward concept in their qualified retirement plans can do so most effectively by adopting the unit benefit concept when designing their accrued benefit formulas.[103] With the current maximum vesting schedule effectiveness range of one to five years, the service reward concept should no longer be a serious consideration

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102. Great variations exist from one industry or occupation to another respecting employee turnover. The Bureau of Labor Statistics studied occupational separations during a twelve month period between 1980 and 1981 and found that 20% of *all* employed persons left their occupation and transferred to another or stopped working for any reason except death. Nineteen occupations (e.g., child care workers, food industry employees, file clerks, and construction laborers) had separation rates exceeding 33%. Twenty occupations (e.g., health care professionals, lawyers, and accountants) had separation rates of less than 9%. Employees from each group would likely fall outside the range of vesting schedule effectiveness. *See* Eck, *New Occupational Separation Data Improve Estimates of Job Replacement Needs*, 107 MONTHLY LAB. REV. 3, 8 (1984).

103. *See supra* notes 15-17 and accompanying text.

when choosing vesting alternatives.

One consideration that has motivated small business owners in the past to adopt a vesting schedule is the prospect that the owner herself or himself can personally benefit from a share of vesting forfeitures allocable to the owner's accrued benefit. Again, such personal benefit diminishes greatly according to the character of employee turnover and the number of other employee-participants who must also share in such forfeitures. Given a proper analysis of the owner's personal stake in potential forfeitures versus the additional administrative complexity, many business owners would likely not want to adopt a vesting schedule.

Since so many plans have included vesting schedules in the past,[104] employers who now choose to grant one-hundred percent vesting upon plan participation can represent to their workforces that their benefit package contains the atypically "generous" feature of full and immediate vesting. Presumably, this would contribute to an employer's competitiveness in attracting new employees and enhance the morale of newly hired workers who are about to enter participation status.

IV. Conclusion

The I.R.C. Section 410(a)(1)(B) alternative permitting a two year participation delay if full vesting is granted each participant deserves careful consideration while employers contemplate the limited vesting schedule choices remaining after the 1986 Tax Reform Act. The Section 410(a)(1)(B) approach may be particularly attractive to small business employers, who are likely to be inordinately burdened with the many administrative complexities that accompany vesting schedules. In any event, an employer that uses a vesting schedule after 1988 should do so only after a thorough cost savings analysis has demonstrated that substantial economic benefits will result to the employer or plan participants.

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104. One survey of 763 employers adopting defined contribution plans indicates that in 1987 only 11% of plans involving fewer than 500 participants provided for full and immediate vesting. THE WYATT COMPANY, 1987 SURVEY OF RETIREMENT AND CAPITAL ACCUMULATION PLANS (1987), at 8.