VESTING

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VESTING REQUIREMENTS

I. Background.

a. Qualified Plans. Section 411 of the Internal Revenue Code of 1986, as amended (the "Code") generally requires certain minimum vesting standards for the qualification of any defined benefit or defined contribution plan or its related trust.[1]

b. ERISA Plans. Section 203 of the Employee Retirement Income Security Act of 1974, as amended ("ERISA") generally requires certain minimum vesting standards for employee benefits plans covered by ERISA other than (1) welfare benefit plans, (2) "Top Hat" plans, (3) plans established and maintained by voluntary employee beneficiary associations, (4) plans established and maintained by fraternal beneficiary societies, (5) certain employee-funded pension trusts (established prior to June 25, 1959), (6) plans sponsored by labor, agricultural or horticultural organizations which do not at any time provide for employer contributions, (7) agreements providing payment to a retired partner or a deceased partner's successor in interest, (8) individual retirement accounts or annuities described in Code § 408 or retirement bonds described in Code § 409 (as effective for obligations issued before January 1, 1984), (9) excess benefit plans, and (10) certain unfunded arrangements to compensate retired employees for benefits which were forfeited under a pension plan maintained by a former employer. *ERISA § 201.*

II. General Rule. As more fully described below, (1) with respect to qualified plans, a trust shall not constitute a qualified trust under Section 401(a), and (2) with respect to an ERISA Plan, such plan will not comply with ERISA, unless the plan of which such trust is a part or the ERISA Plan, as the case may be, provides the following:

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[1] As a cautionary note, the Treasury Regulations promulgated under Section 411 of the Code have not been fully updated to reflect changes to the Code generally applicable to plan years beginning on or after January 1, 2006.

a. *Normal retirement benefits.* Employee's right to normal retirement benefit (as defined below) is nonforfeitable (as defined below) upon attainment of normal retirement age (as defined below).

b. *Employee contributions.* Employee's rights in his accrued benefit (as defined below) derived from his own contributions are nonforfeitable.

c. *Employer contributions.* Employer contributions become nonforfeitable in accordance with Code § 411(a)(2) and related treasury regulations.

d. *Restrictions on certain mandatory distributions.* If the present value of nonforfeitable benefits exceeds $5,000, then such amount may not be immediately distributed without the employee's consent.

e. *Accrued benefit requirements.* Accrued benefit requirement for pension plans under Code §§ 411(b) and 411(d)(6) are fulfilled.

f. *Termination requirements.* In general, upon termination or partial termination of a plan (or, to the extent such plan is not subject to the minimum funding requirements of Code § 412, complete discontinuance of contributions), the rights of all affected employees to benefits accrued through the date of such event, to the extent funded or credited to such employees' accounts, must be nonforfeitable.

III. Nonforfeitable Right to Normal Retirement Benefit upon Attainment of Normal Retirement Age.

a. *Definition of "Nonforfeitable."* A benefit is "nonforfeitable" at a particular time if, at that time and thereafter, it is an unconditional right. *Treas. Reg. § 1.411(a)-4T.*

1. *Special rules.* Rights are not treated as "forfeitable" solely due to the following characteristics:

A. Certain forfeitures in connection with employee's death. *Code §411(a)(3)(A); ERISA § 203(a)(3)(A)*;

B. Suspension of benefits in connection with reemployment of retiree upon notice to the employee. *Code § 411(a)(3)(B); ERISA § 203(a)(3)(B); DOL Reg. § 2530.203-3(b)(4)*;

C. Reduction in benefits due to retroactive plan amendment because of substantial business hardship. *Code §§ 411(a)(3)(C) and 412(d)(2); ERISA § 203(a)(3)(C)*;

D. Forfeitures of benefits derived from employer contributions upon withdrawal of mandatory contributions by employee. *Code § 411(a)(3)(D); ERISA § 203(a)(3)(D)*;

(i) "Mandatory contributions" mean amounts contributed to a plan by the employee which are required as a condition of employment, a condition of participation in such plan or a condition of obtaining benefits under the plan attributable to employer contributions. *Code § 411(c)(2)(C).*

E. Forfeitures of accrued benefit related to employee's service with employer prior to its obligation to contribute to a multiemployer plan if employer ceases to contribute to such multiemployer plan. *Coe § 411(a)(3)(E); ERISA § 203(a)(3)(E)(i)*;

F. Forfeitures of accrued benefit with respect to certain permitted reductions in benefits under a multiemployer plan. *Code §§ 411(a)(3)(F), 418D and 418E; ERISA*

§§ 203(a)(3)(E)(ii), 4244A, 4245, and 4281;

G. Forfeitures due to inability to locate beneficiary (i.e., state escheat laws). *Treas. Reg. § 1.411(a)-4(b)(6)*;

H. Forfeitures of matching contributions if the contribution to which they relate are treated as excess contributions to highly-compensated employees (as described in Code § 401(k)(8)), excess deferrals (i.e., deferrals over the annual limit of $16,500, as described in Code § 402(g)(2)), permissible withdrawals of automatic contributions (as described in Code § 414(w)) or excess aggregate contributions (i.e., excess matching contributions to highly compensated employees, as described in Code § 401(m)(6)). *Code § 411(a)(3)(G); ERISA § 203(A)(3)(F)*.

2. Examples of "forfeitable" rights: (1) rights subject to subsequent events or occurrences, (2) rights subject to adjustments in excess of reasonable actuarial reductions, and (3) rights conditioned on the sufficiency of plan assets. *Treas. Reg. § 1.411(a)-4T.*

b. *Definition of "normal retirement benefit."*

1. The "normal retirement benefit" is the greater of:

A. the "periodic benefit" an employee receives under the plan commencing upon early retirement (if any); or

B. the "periodic benefit" an employee receives under the plan commencing at the

"normal retirement age." *Treas. Reg. § 1.411(a)-7(c)(1).*

2. Determination of the greater "periodic benefit":

   A. Where the benefits upon early retirement and at the normal retirement age are both payable as an annuity in the same form, the greater periodic benefit is determined by comparing the amounts of such annuity payments;

   B. Where the annuity benefit payable upon early retirement is not in the same form as the annuity benefit payable at normal retirement age, the greater periodic benefit is determined by converting the annuity benefit payable upon early retirement into the same form of annuity benefit payable at normal retirement age and comparing the amounts of the converted early retirement annuity with the amount of the normal retirement benefit; and

   C. Where a plan is integrated with the Social Security Act or other Federal or State law, the determination of the periodic benefit payable upon early retirement should be adjusted for any increase in benefits occurring on or after such early retirement which would be taken into account under the plan. *Treas. Reg. § 1.411(a)-7(c)(2).*

3. Normal retirement benefits under a plan are determined without regard to ancillary benefits not directly related to retirement benefits (e.g., medical benefits or disability benefits that are not in excess of the disability benefits which would be payable to an employee upon a separation from service at normal retirement age). *Treas. Reg. § 1.411(a)-7(c)(3).*

4. A "social security supplement," i.e., a benefit for plan participants that commences before the age and terminates before the age when participants would be entitled to unreduced old-age insurance benefits under title II of the Social Security Act and that does not exceed such old age insurance benefits, is disregarded for purposes of determining early retirement benefits. *Treas. Reg. § 1.411(a)-7(c)(4)*.

c. *Definition of "normal retirement age."*

1. The "normal retirement age" at which benefits become nonforfeitable is the earlier of:

A. the normal retirement age set forth in the plan document (which may not be an age that is earlier than the earliest age that is "reasonably representative of the typical retirement age for the industry in which the covered workforce is employed"); or

B. the later of (i) the employee's attainment of age 65 or (ii) the fifth anniversary of the employee's commencement of participation in the plan (excluding for this purpose any years which may be disregarded in calculating years of service for purposes of vesting). *Code § 411(a)(8)*.

2. Whether a normal retirement age set forth in a plan is "reasonably representative of the typical retirement age for the industry in which the covered workforce is employed" is determined, pursuant to IRS Notice 2007-69, as follows:

A. A normal retirement age of 62 or greater falls within the safe harbor and is deemed to be "reasonably representative of the typical retirement age for the industry in

which the covered workforce is employed";

B. Whether a normal retirement age between 55 and 62 is "reasonably representative of the typical retirement age for the industry in which the covered workforce is employed" is determined based on a review of the relevant facts and circumstances; and

C. A normal retirement age under age 55 is generally presumed to be earlier than the earliest age that is "reasonably representative of the typical retirement age for the industry in which the covered workforce is employed" except in the case of qualified public safety employees for whom a normal retirement age of 50 or later is deemed to be "reasonably representative of the typical retirement age for the industry in which the covered workforce is employed."

IV. Employee Contributions.

a. *Nonforfeitable right to accrued benefits from employee contributions.* To the extent an employee's employment is terminated prior to attainment of normal retirement age, such employee's rights in his accrued benefit derived from his own contributions must be nonforfeitable and such accrued benefit generally must equal:

1. For defined contribution plans, the balance of any separate account for the employee (or, if no such account, the pro-rata portion of his total accrued benefit attributable to his contributions as compared with total contributions). *Treas. Reg. § 1.411(c)-1(b); ERISA § 204(c)(2)(A).*

2. For defined benefit plans, the annual benefit, in the form of a single life annuity commencing at

normal retirement age, equal to the amount of the employee's accumulated contributions multiplied by the appropriate conversion factor. *Treas. Reg. § 1.411(c)-1(c); ERISA § 204(c)(2)(B).*

A. *Exception.* The benefits accrued on any voluntary employee contributions to a defined benefit plan shall be treated as accrued benefits from employee contributions under a plan other than a defined benefit plan. *Code § 411(d)(5).*

V. Employer Contributions.

a. *Nonforfeitable right to accrued benefits from employer contributions.* To the extent an employee's employment is terminated prior to attainment of normal retirement age, a plan must permit vesting of employer contributions in accordance with one of the below options with respect to all of an employee's years of service[2]:

1. *For defined benefit plans (and defined contribution plans for plan years beginning on or prior to December 31, 2006).*[3,4]

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[2] A plan is not precluded from satisfying the vesting requirements for different groups of employees under different standards; *provided* that such structure is not meant to evade the requirements of Code § 411(a)(2); *provided, further*, that a plan may not be retroactively modified so that an alternate standard applies to all prior years of service. *Treas. Reg. § 1.411(a)-3.*

[3] For contributions to defined contribution plans for plan years beginning on or prior to December 31, 2006, see *Code § 411(a)(2)*; *ERISA § 203(a)(2)* prior to their amendment by the Pension Protection Act of 2006.

[4] Following the Small Business Job Protection Act of 1996, multiemployer plans no longer are subject to special vesting rules under Code § 411. For the special rules for multiemployer plans prior to the effective date of the

A. *Five year cliff vesting.* Each employee obtains a nonforfeitable right to 100% of accrued benefit from employer contributions after five years of service. *Code § 411(a)(2)(A)(ii)*; *ERISA § 203(a)(2)(A)(ii)*; or

(i) Example: Employee is eligible to participate in Plan A after completion of one year of service and has a nonforfeitable right to 100% of her accrued benefit from employer contributions after five years of service while participating. Plan A fails the above test because nonforfeitable right requires six years of service. *Treas. Reg. § 1.411(a)-3T(f)(ex2).*

B. *Three to seven year graded-vesting.* Each employee accrues a nonforfeitable right to 20% of his or her accrued benefit from employer contributions for each year of service between three and seven. *Code § 411(a)(2)(A)(iii)*; *ERISA § 203(a)(2)(A)(iii).*

Small Business Job Protection Act of 1996, see *Code § 411(a)(2)(C)* prior to its removal.

(i) Example: Plan B provides that employee shall vest into employer-derived accrued benefit as follows:

Years of Service	Nonforfeitable Percentage (%)
1	0
2	10
3	25
4	45
5	65
6	75
7	100

Plan B fails to provide three to seven year graded-vesting because the percentage that is nonforfeitable in the sixth year of service is less than 80%. *Treas. Reg. § 1.411(a)-3T(f)(ex1).*

2. *For defined contribution plans for plan years beginning after December 31, 2006 and matching contributions related to contributions after December 31, 2001.*[5,6]

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[5] For vesting with respect to matching contributions after December 31, 2001, but on or prior to December 31, 2006, see *Code § 411(a)(12)* prior to its removal by the Pension Protection Act of 2006.

[6] For plans maintained pursuant to collective bargaining agreements ratified before August 17, 2006 (the date of ratification of the Pension Protection Act of 2006), these provisions are effective on the later of January 1, 2007 and the termination date of such agreement, but in any event no later than January 1, 2009.

A. *Three year cliff vesting.* Each employee obtains a nonforfeitable right to 100% of accrued benefit from employer contributions after three years of service. *Code § 411(a)(2)(B)(ii)*; *ERISA § 203(a)(3)(B)(ii)*; or

B. *Two to six year graded vesting.* Each employee accrues a nonforfeitable right to 20% of employee's accrued benefit from employer contributions for each year of service between two and six. *Code § 411(a)(2)(B)(iii)*; *ERISA § 203(a)(3)(B)(iii)*.

3. *Special rules.*

A. For any pension plan that requires between one and two years of service prior to eligibility to participate, each participant must have a nonforfeitable right to 100% of the accrued benefit from employer contributions at the commencement of participation. *Code § 410(a)(1)(B).*

b. *Changes in Vesting Schedule.* An amendment which changes the vesting schedule under a plan is not permitted unless:

1. an employee's nonforfeitable percentage of the accrued benefit derived from employer contributions (determined as of the later of (A) the date of adoption of the amendment or (B) the effective date of the amendment) is not less than such nonforfeitable percentage calculated under the plan without regard to such amendment; and

2. an employee with at least three years of service is permitted to elect to have his nonforfeitable percentage continue to be calculated under the

plan without regard to such amendment. *Code § 411(a)(10); ERISA § 203(c)(1)(A).*

c. *Definition of "year of service" and "hour of service."*

1. A "year of service" generally means the calendar year, plan year or any other 12-consecutive month period designated by the plan during which the participant completed 1,000 hours of service[7], but may exclude the following:

A. Years of service before employee reaches age 18;

B. Years of service during a period for which employee declined to contribute to a plan requiring employee contributions;

C. Years of service with an employer during any period for which the employer did not maintain the plan or a predecessor plan;

D. Years of service (i) before a 1-year break in service until such employee has competed a year of service after such break, (ii) with respect to a defined contribution or insured defined benefit plan, after the occurrence of five consecutive 1-year breaks in service or (iii) with respect to nonvested participants, before the occurrence of consecutive 1-year breaks in service in excess of the greater of (x) five and (y) the aggregate years of service before such breaks;

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[7] "Years of service" may also be determined by the "elapsed time" method. *Treas. Reg. § 1.410(a)-7.*

(i) "1-year break in service" means a calendar year, plan year or other 12-consecutive month period designated by the plan during which the employee has not completed more than 500 hours of service. *Code § 411(a)(6)(A); ERISA § 203(b)(3)(A).*

(ii) "Nonvested participant" means a participant without any nonforfeitable right under the plan to an accrued benefit from employer contributions. *Code § 411(a)(6)(D)(iii); ERISA § 203(b)(3)(D)(iii).*

E. Years of service before January 1,1971, unless the employee has had at least 3 years of service after December 31, 1970;

F. Years of service before the first plan year to which Code § 411 or ERISA § 203, as applicable, applies, if such service would have been disregarded under the rules of the plan with regard to breaks in service as in effect on the applicable date; and

G. With respect to multiemployer plans, years of service (i) with an employer after complete withdrawal or a partial withdrawal in connection with decertification of a collective bargaining representative and (ii) with an employer after termination of the multiemployer plan. *Code § 411(a)(4)(G); ERISA § 203(b)(1)(G).*

2. An "hour of service" can be determined by two alternative methods:

A. *First*, based on the hours that (i) an employee is paid, or entitled to payment, for the performance of duties or due to certain leaves of absences (e.g., vacation, holiday, illness, incapacity, etc.) or (ii) back pay is awarded or agreed to by the employer. *DOL Reg. § 2530.200b-2(a)*; or

B. *Second*, based on assumptions with respect to (i) working time, (ii) period of employment or (iii) earnings. *DOL. Reg. § 2530.200b-3.*

(i) Note – If these assumptions are used to determine hours of service, such assumptions must be included in the applicable plan. *DOL Reg. § 2530.200b-3.*

3. *Special rules.*

A. *Seasonal Industries*. In seasonal industries, where the customary period of employment is less than 1,000 hours per calendar year, a "year of service" shall be the period determined under the regulations prescribed for such industry by the Secretary of Labor. *Code § 411(a)(5)(C).*

B. *Maritime Industry*. In the maritime industry, 125 days of employment shall be equivalent to 1,000 hours of service. *Code § 411(a)(5)(D).*

C. *Maternity/Paternity.* Solely for purposes of preventing the occurrence of a break in service year, employees absent from work due to maternity or paternity leave shall be eligible for up to 501 "hours of service"

credited to them in connection with such leave. Employees may be required to provide information supporting the reasons for and duration of such leave. *Code § 411(a)(6)(E); ERISA § 203(b)(3)(D)(ii).*

D. *Veterans*. A re-employed veteran's qualified military service shall constitute service with the employer for purposes of nonforfeitability of plan benefits and the veteran must not be treated by a plan as having a break in service by reason of his qualified military service. *Code § 414(u)(8).*

E. *Family Medical Leave Act*. Unpaid FMLA leave may not be treated as or count towards a break in service (although such unpaid FMLA leave periods need not be treated as credited service for vesting, benefit accrual or eligibility purposes. *29 CFR 852.215(d)(4).*

F. *Service with Related Employer*. A participant's service with another employer that is a member of the sponsoring employer's "controlled group" (see *Code §§ 414(b) and (c) and 1563(a)*) must be treated as service with the employer for vesting purposes. *Treas. Reg. § 1.411(a)-(5)(b)(3)(iv)(B).*

G. *Service with Predecessor Employers.*

(i) If a predecessor employer's plan is assumed, a participant's service with the predecessor employer must be treated as service with the sponsoring employer for vesting purposes. *Code § 414(a)(1).*

(ii) In certain instances, even when a plan was not maintained by the predecessor employer, service with such predecessor employer will be treated as service with the sponsoring employer. *Code § 414(a)(2); Treas. Reg. § 1.411(a)-5(b)(3)(iv)(A).*

(iii) Service credited under a predecessor plan must be treated as service with the sponsoring employer for vesting purposes under a successor plan, but subject to a "break in service" rule similar to that described in V.c.1.D above. For this purpose, a successor plan is any tax-qualified plan in which the employee participates within the five-year period immediately following the date of termination of another such plan. *Treas. Reg. § 1.411(a)-5(b)(3)(v)(B); see also PLR 200337015 (June 17, 2003).*

H. *Pre-Participation and Imputed Service*. Pursuant to Code § 401(a)(4), a plan is permitted to grant pre-participation service credit (e.g., for service with another employer) or impute service (by means of equivalencies (see V.c.2.B above)) for purposes of calculating vesting for periods of service for another employer so long as (i) the plan treats all similarly-situated employees in like fashion, (ii) there is a legitimate business reason for crediting such service, and (iii) crediting the service does not discriminate significantly in favor of

highly compensated employees. *Treas. Reg. § 1.401(a)(4)-(11)(d)(3)(iii).*

VI. Restrictions on Certain Mandatory Distributions.

a. A qualified plan may not require immediate distribution of an account without the employee's consent if the "present value" of the nonforfeitable accrued benefit (calculated by using the applicable mortality table and applicable interest rate set forth in Code § 417(e)(3) and determined without regard to any portion of such benefit which is attributable to rollover contributions) exceeds $5,000. *Code § 411(a)(11); ERISA § 203(e)(1).*

VII. Accrued Benefit Requirements.

a. *Separate accounting.*

1. Each defined benefit plan must require separate accounting for the portion of each employee's accrued benefit derived from voluntary employee contributions.

A. "Voluntary employee contributions" are all employee contributions which are not mandatory contributions within the meaning of Code § 411(c)(2)(C). *Treas. Reg. § 1.411(b)-1(e)(1).*

2. Any plan other than a defined benefit plan must require separate accounting for each employee's accrued benefit. *Code § 411(b)(3).* To the extent an employee has had a break in service, the pre-break and post-break accrued benefits must be computed to take into account any difference in vesting percentages thereof. *Treas. Reg. § 1.411(b)-1(e)(2).*

b. *Required amount of accrued benefit for defined benefit plans.* A defined benefit plan must satisfy one of the below methods for determining the amount of the accrued benefit. *Code*

§ 411(b).[8] A plan may, however, satisfy different methods with respect to different classifications of employees; provided that such classifications are not structured to evade the requirements of Code § 411(b). *Treas. Reg. § 1.411(b)-1(a)(1).*

1. *3-percent method*. Accrued benefit upon an employee's separation from service is not less than:

   A. Three percent of the normal retirement benefit that employee would have been entitled to receive assuming participation from the earliest possible entry age through the earlier of age 65 or the normal retirement age multiplied by the number of years of participation (not to exceed 33 ⅓ years).

      (i) If the normal retirement benefit is based on average compensation, such average shall be determined as if employee continued to earn annually the average rate of compensation which he earned during consecutive years of service, not to exceed ten, for which his or her compensation was the highest. *Code § 411(b)(1)(A).* The number of consecutive years of service shall be set forth in the plan. *Treas. Reg. § 1.411(b)-1(b)(1)(ii)(A).*

   B. Example: Plan C provides a retirement benefit, commencing at age 65, of $100

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[8] For requirements regarding benefits with respect to years prior to the first plan year in which Code § 411 applies, see *Code § 411(b)(1)(D), Treas. Reg. §§ 1.411(b)-1(b)(3)(ii)(D) and 1.411(b)-1(c).*

per year for each year of participation. The earliest entry age is 21, the normal retirement age is 65, and there are no limits on the number of years of credited service. In order to satisfy the 3% test, a participant's annual benefit accrual under Plan C must be 3% of $4400 ($100 times 44 possible years of participation) or $132. Because this is greater than that Plan's actual annual accrual of $100, Plan C does not satisfy the 3% test. Note, however, that if Plan C had instead provided that only the first 30 years of participation are taken into account, then, in order to satisfy the 3% test, a participant's annual benefit accrual would only need to be $90 (i.e., 3% of $3,000 ($100 for 30 years)) and Plan C would pass the 3% test.

2. *133 ⅓% rule.* (i) Accrued benefit payable at normal retirement age (determined under the plan) is equal to the normal retirement benefit (determined under the plan) and (ii) the annual rate at which any individual who is or could be a participant can accrue the retirement benefits payable at normal retirement age under the plan for any later plan year is not more than 133 ⅓% of the annual rate for any plan year (x) beginning on or after such plan year and (y) before such later plan year.

A. For purposes of this rule:

(i) Amendments to plan for current plan year will be treated as if in effect for all years;

(ii) Change in accrual rate which does not apply to any individual who is

or could be a participant in a current year is disregarded;

(iii) Potential for payments prior to normal retirement age is disregarded (e.g., early retirement benefit);

(iv) Social security benefits and other relevant factors used to compute benefits are treated as remaining constant.

(v) Failure to accrue benefits under the plan for years of service after normal retirement age shall not result in failure to satisfy the 133 ⅓% rule.

(vi) 133 ⅓% rule shall not be satisfied if computation of retirement benefits changes solely by reason of an increase in the number of years of participation.

Code § 411(b)(1)(B); Treas. Reg. § 1.411(b)-1(b)(2).

B. Examples:

(i) Example: Plan D provides an annual retirement benefit, commencing at age 65, based on a percentage of a participant's average compensation for the five-year period for which his compensation was highest. The percentage is 2% for each of the first 20 years of participation and 1% for each year thereafter. Plan D satisfies the 133 ⅓% rule

because the rule only restricts increases – not decreases – in the accrual rate in later years.

(ii) Example: Plan E provides an annual retirement benefit, commencing at age 65, of a participant's average compensation for his final five years of compensation. The percentage is 1% for each of the first five years of participation, 1⅓% for each of the next five years of participation, and 1½% for each year thereafter. Plan E does not satisfy the 133 ⅓% rule because the rate of accrual for years in excess of 10 (1½%) exceeds 133 ⅓% of the 1% rate of accrual for years one through five.

3. *Fractional rule.* Accrued benefit upon employee's separation from service is not less than the following fraction of the annual benefit commencing at normal retirement age to which employee would have been entitled if he continued to earn not less than his prior ten-year average compensation annually until normal retirement

age. The fraction noted above equals:

$$\frac{\text{Total Number of Years of Participation Prior to Separation from Service}}{\text{Total Number of Years of Participation if Separation from Service Occurred at Normal Retirement Age}}$$

Code § 411(b)(1)(C).

A. For purposes of this rule:

(i) Social security benefits and other relevant factors used to compute benefits are treated as remaining constant. *Code § 411(b)(1)(C).*

(ii) Failure to accrue benefits under the plan for years of service after normal retirement age shall not result in failure to satisfy the fractional rule. *Treas. Reg. § 1.411(b)-1(b)(3)(ii)(C).*

B. Example: Plan F provides an annual retirement benefit commencing at age 65 of 1% of career average annual compensation per year of service. At age 55 a participant with 15 years of service has career average annual compensation of $30,000 and trailing ten year average annual compensation of $35,000. The participant's accrued benefit at age 55 is 15% of $30,000 or $4,500. The accrual required under the fractional rule is 15/25 of the projected age 65 benefit (i.e. 25% of $32,000 (the projected career average

annual compensation at age 65 if the participant continues earning compensation at the trailing ten year average rate)), or $4,800. So Plan F would not satisfy the fractional rule.

4. *Exceptions.* Notwithstanding the requirements of sections (1) – (3) above:

A. *First two years of service.* A defined benefit plan does not fail the requirements of sections (1) – (3) above solely because accrual of benefits does not become effective until an employee has two continuous years of service. *Code § 411(b)(1)(E).*

(i) Example: Plan G provides for benefit accrual of one percent (1%) of average compensation for the highest three years of compensation beginning with the third year of service. Plan H provides for benefit accrual for employees who attain age 21 and complete one year of service. Plan G will not satisfy this exception because there is no accrual with respect to the first two years of service. Plan H will not satisfy this exception because employees with two years of service prior to age 21 will not immediately accrue benefits. *Treas. Reg. § 1.411(b)-1(d)(1).*

B. *Insured plans.* A defined benefit plan satisfies the requirements of section (1) – (3) above if it is (i) funded by insurance contracts and (ii) satisfies certain requirements with respect to insurance

contract plans (see *Code § 412(e)(3)*). *Code § 411(b)(1)(F).* To qualify for this exception, each employee's accrued benefits as of any applicable date must be not less than the cash surrender value of such employee's insurance contracts applicable to such employee. *Treas. Reg. § 1.411(b)-1(d)(2).*

C. *Decrease of accrued benefit due to age.* In general, a defined benefit plan will not satisfy the requirements of sections (1) – (3) above if an employee's accrued benefit is reduced on account of any increase in age or service. *Code § 411(b)(1)(G).*

D. *Continued accrual beyond normal retirement age.* A defined benefit plan will not satisfy the requirements of section (1) – (3) above if benefit accrual ceases (or the rate of accrual is reduced) because of the attainment of any age (provided that the failure to account for the subsidized portion of early retirement benefits for purposes of determining benefit accruals will not result in failure to satisfy the foregoing). *Code § 411(b)(1)(H).*

(i) This provision will not be deemed to have been violated:

(a) By any plan provision limiting (without regard to age) the amount of benefits or the number of years of service which are taken into account for purposes of benefit accrual (*Code § 411(b)(2)(H)(ii)*);

(b) If appropriate in-service or actuarial adjustments are made in cases of participants who retire after normal retirement age (*Code § 411(b)(2)(H)(iii)*);

(c) If the participant's accrued benefit as of any date would be equal to or greater than that of any similarly situated (i.e., identical with respect to period of service, compensation, position, date of hire, work history, etc.), younger individual who could be a participant (*Code § 411(b)(5)*); and

(d) With respect to certain interest rate provisions and other specific elements of certain defined benefit plans (*Code § 411(b)(5)(B)*).

c. *Required amount of accrued benefit for defined contribution plans.* Under a defined contribution plan, allocations to the employee's account cannot cease, and the rate at which amounts are allocated to the employee's account cannot be reduced, because of the attainment of any age. *Code § 411(b)(2).*

d. *Amendment to accrued benefit.* No amendment to a plan may decrease the accrued benefit of a participant other than as permitted by Code § 412(d)(2) or ERISA § 4281. *Code § 411(d)(6)(B).*

e. *Definition of "accrued benefit."*.

1. An employee's "accrued benefit" under a defined benefit plan is the annual benefit the employee would receive commencing at his normal retirement age in the form of a single life annuity, or its actuarial equivalent, determined in each case disregarding ancillary benefits (i.e., benefits not directly related to retirement benefits, such as medical benefits, most disability benefits, lump-sum life insurance benefits and incidental death benefits). *Treas. Reg. § 1.411(a)-7(a)(1).*

2. An employee's "accrued benefit" under a defined contribution plan is the employee's account balance. *Treas. Reg. § 1.411(a)-7(a)(2).*

f. *Effect of certain distributions.*

1. For purposes of determining an employee's "accrued benefit" under a plan, the plan may disregard service performed by the employee for which employee received:

A. a distribution of the present value of his entire nonforfeitable benefit (which amount did not exceed $5,000) upon the termination of his participation in the plan; or

B. a distribution of the present value of his nonforfeitable benefit attributable to such service, which he elected to receive upon the termination of his participation in the plan or any other circumstances permitted by regulation. *Code § 411(a)(7)(B).*

2. Notwithstanding subsection 1, a plan may not disregard service for purposes of determining an employee's "accrued benefit" in the case of an employee who received a distribution and later

resumed service under the plan (and such distribution was less than the present value of his benefit) unless the plan provides the employee with the opportunity to repay the full amount of such distribution (with applicable interest, in the case of a defined benefit plan). The repayment provisions under the plan may require such repayment to be made, in the case of an employee who separated from service, within five years after the date of re-employment (or, if earlier, the close of five consecutive one-year breaks in service) and, in the case of an employee whose withdrawal was not as a result of his separation from service, within five years after the date of such withdrawal. *Code § 411(a)(7)(C).*

VIII. Termination Requirements.

a. *Rule.* Upon termination or partial termination of a plan (or, to the extent such plan is not subject to the minimum funding requirements of Code § 412, complete discontinuance of contributions), (i) the rights of all affected employees to benefits accrued to the date of such event, to the extent funded or credited to such employees' accounts, must be nonforfeitable and (ii) the plan must require allocation of all previously unallocated funds (*e.g.*, unallocated forfeitures) to the employees covered by the plan on the date of such event. *Code § 411(d)(3); Treas. Reg. § 1.411(d)-2(a)(2).*

1. *Zero dollar cash-out*. Under the plan termination rule above, unvested accrued benefits of former employees which, as of the date of the plan's termination, have not yet been forfeited (because the requisite five-year break in service period under the plan has not yet elapsed) would become vested in connection with the termination (because, if the former employee were to be re-employed prior to the end of the five-year period, the employee would be entitled to payment with respect to his accrued benefits as of the date of the plan's termination). See *GCM 39310 (1984)*. In order to avoid this result, a well-drafted plan will

provide that a terminated employee with no vested plan benefits will be deemed to have received a cash-out of $0 as of the date of his termination (which is equal to his accrued vested benefits under the plan as of such date). The plan would also need to provide that if such employee was to be re-employed within five years, he will be deemed to have repaid his deemed cash-out distribution.

b. *Exception.* Termination requirements do not apply with respect to benefits or contributions which, due to non-discrimination requirements, may not be used for designated employees in the event of early termination of the plan. *Code § 411(d)(3)(B).*

c. *Definition of "termination."*

1. "Termination" occurs on (A) with respect to plans subject to Title IV of ERISA, the date on which the plan is voluntarily terminated pursuant to ERISA § 4041 or terminated by the PBGC pursuant to ERISA § 4042, or (B) with respect to other plans, the date on which the plan is voluntarily terminated. *Treas. Reg. § 1.411(d)-2(c)*

d. *Definition of "partial termination."*

1. *General definition.* Whether or not a "partial termination" of a plan occurs (and the time of such event) shall be determined based on the facts and circumstances of the particular case which may include (A) the exclusion, by reason of a plan amendment or severance by employer, of a group of employees who had previously been covered by the plan, or (B) plan amendments which adversely affect rights of employees to vest in benefits under the plan. *Treas. Reg. § 1.411(d)-2(b)(1).*

2. *Special rule.* If a defined benefit plan ceases or decreases the future benefit accrual, a partial

termination shall be deemed to occur if a potential reversion to the plan sponsor is created or increased. *Treas. Reg. § 1.411(d)-2(b)(2).*

3. *IRS guidance (Rev. Ruling 2007-43).* The facts and circumstances which would constitute a "partial termination" were clarified by the IRS in Revenue Ruling 2007-43. Such revenue ruling indicates the following:

   A. *Presumption.* If the turnover rate is 20% or greater, there is a rebuttable presumption that a partial termination has occurred.

   B. *Factors to rebut the presumption*. Factors include, among other things:

      (i) Comparison of turnover rate to rate in other periods;

      (ii) Extent to which terminated employees are replaced; and

      (iii) Characteristics of new employees (e.g., job function, job classification or title, comparable compensation).

C. *Definition of "turnover rate."*

$$\frac{\text{Number of participating employees (both vested and nonvested) who had an employer-initiated severance from employment during the applicable period}}{\text{Sum of (1) participating employees (both vested and nonvested) at the start of the applicable period and (2) employees who became participants during the applicable period}}$$

(i) The "applicable period" is a plan year (or, in the case of a plan year that is less than 12 months, the plan year plus the immediately preceding plan year) or a longer period if there are a series of related severances from employment.

(ii) "Employer-initiated severance" generally includes termination of employment other than due to death, disability or retirement on or after normal retirement age, but does <u>not</u> include termination of employment of employees who transfer to an unaffiliated company which maintains a plan that is a continuation of such employees' prior plan (i.e., a

portion of the prior plan is spun off).

e. *Definition of "complete discontinuance of contributions."*

1. *Test.* "Complete discontinuance of contributions" will be determined based on the facts and circumstances in each particular case. Potential factors affecting such analysis include:

A. Whether the employer is calling an actual discontinuance a suspension to avid full vesting due to discontinuance;

B. Whether contributions are recurring and substantial; and

C. Whether there is any reasonable probability that the lack of contributions will continue indefinitely. *Treas. Reg. § 1.411(d)-2(d)(1)(i).*

2. *Timing.* Complete discontinuance of contributions of a profit-sharing plan becomes effective not later than the last day of the taxable year of the employer following the last taxable year of such employer for which a substantial contribution was made under the profit-sharing plan. *Treas. Reg. § 1.411(d)-2(d)(2).*