Changes to Vesting Schedules or Service Crediting Methods

Wednesday, May 1, 2013

Robert M. Richter, J.D., LL.M.
Vice President, SunGard Relius
Take Aways

- Understand the administrative issues associated with various scenarios
- Be sensitive to these issues when drafting amendments to change vesting
- Have an outline that can be used as a resource
VESTING SCHEDULES
Statutory Maximum Schedules

- **DC plans**
  - 6-year graded
    - 2-20%; 3-40%; 4-60%; 5-80%; 6-100%
  - 3-year Cliff
    - 0 to 2 – 0%; 3 – 100%

- **DB plans**
  - 7-year graded
    - 3-20%; 4-40%; 5-60%; 6-80%; 7-100%
  - 5-year cliff
    - 0 to 4 – 0%; 5 – 100%
Exceptions

- 5-year cliff or 7-year graded can still apply to:
  - Matching contributions made for PY beginning before 1/1/02
  - Nonelective contributions (e.g., profit sharing) made before 1/1/07
  - ESOPs with outstanding loans as of 9/26/05
    - Effective date of PPA change is first PY after earlier of:
      - Date of repayment of loan
      - Scheduled repayment date of loan as of 9/26/05
Exceptions

- Governmental and church plans
- Hybrid (e.g., cash balance) DB plans
  - 3-year cliff
  - Delayed effective date for plans in existence on 6/29/05
- Top-heavy schedules: 6-year graded or 3-year cliff
- Full vesting at NRA
- Full vesting for those affected by partial termination
AMENDMENTS TO VESTING SCHEDULES
Amendments to Vesting Schedule

- Not as common in light of more restrictive schedules after EGTRRA and PPA
- 3 rules that may apply:
  - IRC § 411(a)(10) (3 YOS election)
  - IRC § 411(d)(6) anti-cutback Regulations
  - IRC § 401(a)(4) Regulations
Each participant with at least 3 YOS has right to elect to stay under pre-amendment schedule

- Election can be made within reasonable period of time of adoption of amendment
- Election not needed if new schedule is more liberal in each year

Applies to determine “nonforfeitable percentage”
- Means it applies to entire account (old and new contributions)
Election Period

- Begins no later than date the amendment adopted and ends on later of:
  - 60 days after adoption
  - 60 days after effective date
  - 60 days after written notice is provided
- 3 YOS is determined without regard to the permissible exclusions for vesting service (e.g., age 18 or effective date of plan)
411(d)(6) Regulations

• Regulations modified to reflect *Heinz* decision applying anti-cutback rule of IRC § 411(d)(6)
• No amendment can reduce nonforfeitable accrued benefit
• This effectively means participants are entitled to the greater vesting percentage of old vs. new schedule based on account balance at time of amendment
  • Old schedule does not apply to future contributions
  • Complicates recordkeeping
Example

- Plan is amended from 5-year graded schedule to 6-year graded schedule
  - Amendment can provide that Lauren is subject to new schedule only for future contributions
  - Amendment can provide that only new participants are subject to new schedule
- Assume for following examples that amendment applies to existing participants
Example

- Lauren has 3 YOS
- Lauren elects to remain on old vesting schedule
  - Old schedule applies to *both* old and future contributions
- What is Lauren’s vested % (based on 3 YOS)?

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Example

- Lauren has 1 YOS
  - What is Lauren’s vested % based on 1 YOS?
  - What is Lauren’s vested % based on 5 YOS?
  - Would answer change if Lauren had 3 YOS but did not elect to stay on old schedule?

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Example

- Schedule is amended as below
- Gary has 1 YOS as of amendment
  - What is Gary’s vested % based on 1 YOS?
  - What is Gary’s vested % based on 3 YOS?
  - What is Gary’s vested % based on 4 YOS?

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401(a)(4) Regulations

• Pattern of plan amendments must be nondiscriminatory
• Vesting schedule is an “other right or feature” subject to nondiscriminatory availability
  • Current and effective availability are generally facts and circumstances based test
• Statutory schedules are deemed equivalent
  • All HCEs on 6-year graded and all NHCEs on 3-year cliff is OK?
  • If employer reasonably believes there is a partial termination then full vesting for affected group is nondiscriminatory
Example

• Bio Engineering, Co. shuts down research division in CA
• Bio reasonably determines there is a partial termination
  • Bio does not file a determination letter request on partial termination
• Those affected by partial termination are disproportionate group of HCEs
  • Since it is statutory requirement, full vesting is not discriminatory
• What if Bio believes there is no partial termination but wants to fully vest affected participants?
COUNTING VESTING SERVICE
Year of Service

- 12-month Computation Period (CP) in which EE has at least 1,000 Hours of Service
- No requirement to be employed on a particular day
- Have YOS even if not employed at beginning or end of CP
  - No requirement to work 12 months
  - It is a 12 month computation period during which 1,000 hours of service are completed
Vesting Computation Period

- May be any 12 month period specified in plan
- Most plans use the plan year as the computation period for vesting purposes
What is an “Hour of Service”? 

1. An hour for which an EE is paid for performance of duties 
2. An hour for which an EE is paid for non-performance of duties (e.g., vacation pay, sick pay) 
3. An hour for which an EE receives an award for back pay
Credit for Nonperformance

• Some reasons for pay for nonperformance of duty:
  • vacations
  • holidays
  • illness or incapacity, including disability
  • layoff
  • jury duty
  • military duty
  • leave of absence

• It does not matter whether the employment relationship has terminated at the time of the payment
Limits on Nonperformance Credit

• Don’t have to credit more than 501 HOS for any given computation period for nonperformance
• No need for credits for payments under a plan to comply with:
  • workers compensation
  • unemployment compensation
  • disability insurance laws
• These are credited hours and differ from maternity and paternity absences (hours credited just to avoid a break in service)
Credit for Nonperformance

- David works 900 hours of service
- David goes on short term disability leave for 4 weeks (160 hours)
  - Insurance company pays David while on leave and disability benefits are reportable on W-2 (i.e., it is employer provided coverage)
- David has 1060 hours of service for vesting
Two options for counting HOS
- Count actual hours
  - Easy to do for workers paid by the hour
  - Nearly impossible for salaried professional
- Use equivalency
- Plan document must specify method being used
Available Equivalencies

- **Working hours**
  - Disregard nonperformance hours
  - 870 working hours = 1 YOS

- **Regular hours**
  - Disregard nonperformance & overtime
  - 750 regular hours = 1 YOS

- **Earnings method**
  - Divide compensation by lowest hourly pay rate

- **Employment period method (next slide)**
Employment Period Method

- 1 day = 10 HOS
- 1 week = 45 HOS
- \(\frac{1}{2}\) month = 95 HOS
- 1 month = 190 HOS
- 1 shift = Entire length of shift
Change in Computation Period

- DOL Reg. § 2530.203-2(c)
- Applies where using hours of service method
- Vested percentage can be no less on *any date* after the change than it would be absent the change
- Deemed satisfied if first computation period under amendment begins before last day of preceding computation period
Examples

- Computation period is PY
- PY is 7/1 to 12/31
- Amendment to change PY to CY effective 1/1/13
- Determination of YOS – method 1
  - 7/1/12 – 6/30/13
  - 1/1/13 – 12/31/13
- Determination of YOS – method 2
  - 1/1/12 – 12/31/12
  - 1/1/13 – 12/31/13
**Computation Period Example**

- Amendment effective 1/1/13 to change from 7/1 to CY PY
- 2 Methods to determine vesting

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A Change in Computation Period?

- New CY plan with initial short plan year of 7/1/12 – 12/31/12
- Plan provides that vesting computation period is the PY
- No authority to have a computation period of less than 1 YOS
Elapsed Time Method

• Based on period of time that elapses while EE is employed

• Period of Service
  • Starts on Date of Hire
  • Ends on “severance from service” date = the earlier of date of severance (e.g., quit) or one year after a leave of absence

• Period of Severance
  • Starts on the “severance from service” date
  • Ends when employee returns to service
Elapsed Time (cont’d)

• Service spanning rule
  • If employee returns to work within 1 year, then must be credited with that year
  • Period of Severance can also be Period of Service

• 1-Year Period of Service for vesting is number of whole years
  • 12 months (30 days equals month) OR 365 days
  • Fractional periods are added up

• Break in Service (BIS) = a period of severance that isn’t counted as a period of service
Michele has following employment history:
  • Hired March 1, 2011
  • Quits October 2011
  • Rehired January 2012
  • Quits February 2012
  • Rehired December 2012

Michele has 2 Periods of Service on March 1, 2013
  • Did not have 1-year break
Included Service

• If ER is maintaining a predecessor ER’s plan, the plan must count service with the predecessor ER
• If the ER is not maintaining a predecessor ER’s plan, the plan may credit predecessor service on a nondiscriminatory basis
• Service with related employers (e.g., controlled groups or affiliated service groups)
• Service with all employers who have adopted a multi-employer or multiple employer plan
Excluded Service

- Rule of parity (5 1-year breaks)
- 1-year holdout rule
- Service prior to age 18
- Service when employee declined to make mandatory contributions
- Service during which plan, or “predecessor plan,” is not maintained
  - Plan deemed adopted as of first day of PY even if not actually adopted until mid-year
  - Merger based on component plans
Merger

- Plan A established 1/1/2000
- Plan B established 1/1/2010
- Employer A and B not related
- Plans merge 1/1/2013
- For A EEs may exclude service prior to 1/1/2000
- For B EEs may exclude service prior to 1/1/2010
Predecessor Plan

• “Predecessor plan” if new plan established within 5 years of termination of any other plan
  • No distinction as to type of plan
• GR: If EE covered by “predecessor plan,” service while covered under predecessor counts
• Exception: Can exclude EE’s service under prior plan if number of 1-year breaks between establishment of plans equals or exceeds service while covered under prior plan
Example of Predecessor Plan Covered Service

- Employer XYZ terminates Plan A 12/31/97
- Employer XYZ establishes new Plan B 1/1/2001
  - Old plan is “predecessor plan” because less than 5 years
- Joe not covered by Plan A so can exclude service prior to 1/1/2001 because prior plan not maintained for Joe
- Moe was covered by Plan and had 3 YOS as of 12/31/97
  - If Moe had 3 or more BIS from 12/31/97 to 1/1/2001 then Plan B not maintained until 1/1/2001
  - If Moe had less than 3 BIS then Plan B is maintained as of Plan A’s establishment
Excluded Service for Vesting

- After 5 BIS, future service is excluded in determining vesting of prior contributions
  - This is why plans provide for a forfeiture after 5 BIS – vested % of the existing account will not be increased
  - This rule does not affect vesting of future contributions
Distribution of Partially Vested Account

- If distribution is made and vesting percentage can increase (e.g., in-service distribution of partially vested account)
- Two methods to determine vested amount (X):
  - \( X = P(AB + D) - D \)
  - Maintain separate account and \( X = (P(AB + (R \times D)) - (R \times D) \)
- \( P = \) Vested % at relevant time
- \( AB = \) Account Balance at relevant time
- \( D = \) Amount of distribution
- \( R = \) Ratio of \( AB \) to \( AB \) after distribution
- Relevant time = Time of determination of vesting
Examples

• Jennifer has vested interest of $100K and is 60% vested
• She withdraws $60,000 as in-service distribution
• Jennifer is now 80% vested
• Her total account balance is $42K ($40K + 2K earnings)
• What is Jennifer’s vested account balance under each of the 2 methods?
Easy Method

- $X = P(AB + D) - D$
- Vested amount = [80% ($42K + $60K)] - $60K
- Vested amount = $21,600
  - 80% vested in $2,000 earnings

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<td>Vested %</td>
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Harder Method

• \[ X = (P(AB + (R \times D)) - (R \times D) \]

• Vested amount = \[ [80\% \times ($42K + ((42/40) \times $60K)) - (42/40 \times $60K)] \]

• Vested amount = $21,000
  • 50% vested in $2,000 earnings

• Requires separate accounting for old vs. new contributions

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• Treas. Reg. § 1.401(a)-7(f)
• Hour of Service to Elapsed Time – Service equals:
  • YOS before the computation period in which amendment is made, plus
  • Greater of:
    • Service for computation period as of date of amendment
    • Period of Service for entire computation period using Elapsed Time (treat as new hire)
HOS to Elapsed

- Calendar plan year
- YOS for vesting purposes is 1,000 hours of service
- Amendment to elapsed time method adopted and effective 6/1/12
- EE hired May 1, 2009
- Worked 1,000 hours of service in 2009, 2010 and 2011
- What is his vested percentage in years as of 6/1/12?
  - 3 + 1 for 2012 if EE ends up working 1000 hours OR does not have period of severance for 2012
Change to Service Method

- Elapsed Time to Hours of Service – Service equals:
  - YOS for each Period of Service before the computation period in which amendment is made, plus
  - For computation period when amendment is made, YOS based on equivalency method for any period prior to the date of the amendment
    - Only relevant if amendment is effective during a computation period
    - Change from elapsed time to hour of service method effective April 2013 for CY plan
    - For period from January 2013 – April 2013 use HOS equivalency method stated in plan
• Calendar plan year
• YOS for vesting purposes is 1,000 hours of service
• Amendment to hour of service method adopted and effective 6/1/12
• Hired May 1, 2009
• What is his vested percentage in years as of 6/1/12?
  • 3 periods of service for 12 months ending May 2010, 2011 and 2012
  • 1 YOS for 2012 if 1000 hours in CY
    • Period from 1/1/12 to 6/1/12 use an HOS equivalency method set forth in plan
Best Practices

• Know why the employer wants to make a change to vesting
• Review the different options and impact on administration
• Draft the amendment paying close attention to:
  • The effective date of the amendment
    • Try to avoid changes in the middle of a computation period
  • The participant subject to the amendment
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