AdvisorFacts

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Take A Fresh Look At Plan Eligibility & Vesting

The defined contribution retirement plan has entered a new era of inclusion, and some of your plan sponsor clients might benefit from taking a fresh look at their plan's eligibility and vesting rules. Years ago, many employers viewed their defined contribution retirement plan as a supplemental benefit primarily for rewarding long-tenured employees and management who wanted to augment the benefit provided by the pension plan. As 401(k) plans have evolved to become the primary retirement savings vehicle and concerns regarding the retirement savings crisis have increased, retirement plan philosophies have shifted. Now, most pension plans are gone and employers must offer a defined contribution plan that is competitive in retaining and recruiting employees. As a result, many employers have shifted their focus from restricting plan participation to making sure everyone has an opportunity to save for retirement – even very new employees.

In a recent survey of human resources professionals, 57% said they anticipate that retirement savings benefits will increase in importance for retaining employees in the next 3-5 years, and 70% anticipate an increase in importance of a retirement plan for recruiting employees.[1]

Recently the U.S. Government Accountability Office (GAO) released a report on the negative impact that certain eligibility and vesting choices could have on employees' account balances.[2] As a plan advisor, you can help your plan sponsor clients revisit their plan's eligibility and vesting requirements to ensure their plan is competitive and driving their desired participant savings outcomes.

In this article, we'll review the options available to employers and look at the impact these choices may have on plan participants.

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Eligibility Options

The laws governing retirement plans do not require that an employer cover all employees. The most common method used to limit plan participation is to set eligibility requirements based on an employee's age or length of service. Over 80% of plans surveyed have policies restricting eligibility to join the plan.[2]

Age: An employer can require that employees attain a certain age (up to 21) before they are eligible to participate in the plan.[3] Some employers find this rule useful in excluding young staff who work fewer hours and are unlikely to participate or who have high turnover rates. The GAO study found that 41% of plans exclude employees younger than age 21, and more than half the plans they surveyed had a minimum age requirement.[2] Employers are not allowed to set a maximum age requirement, such as requiring employees to be under age 55 to participate in the plan.

Service: Employers may also require a certain period of employment or "service" before employees are allowed to participate in the plan or receive employer contributions. For employee deferral contributions to a 401(k) plan, the maximum service requirement is one year.[3] For employer matching or profit sharing contributions, an employer can require two years of service.[3] (If two years of service are required, the employer will not be able to attach a vesting schedule to the matching or profit sharing contributions.) A year of service will be defined in the plan document but is commonly defined as a 12-month period during which the employee worked at least 1,000 hours.

Class: An employer can also choose to exclude certain "classes" of employees from participating. For example, employees covered by a collective bargaining agreement and nonresident aliens with no U.S. source income may be excluded, as can leased employees and even highly compensated employees.

Vesting Options

Vesting in a retirement plan account in its simplest terms means "ownership." An employee who is 100% vested owns all of his or her account and will receive the entire balance when taking distributions from the account. An employer can require that employees satisfy a minimum period of service before they become vested in certain types of contributions.

Employee Contributions: Employee deferral contributions must always be 100% vested and are nonforfeitable.

Employer Contributions: Employer matching or profit sharing contributions can be subject to a vesting schedule. The longest vesting schedules that an employer can adopt are the three-year cliff and the six-year graded vesting schedules.[4] An employer also has the option to adopt a shorter, more generous vesting schedule.

Vesting Schedule	3-Year Cliff % Vested	6-Year Graded % Vested
Year 1	0%	0%
Year 2	0%	20%
Year 3	100%	40%
Year 4	100%	60%
Year 5	100%	80%
Year 6	100%	100%

If an employee does not meet the vesting service requirement before terminating employment, the unvested portion of the employer contributions made on the employee's behalf will be forfeited. Employers commonly use vesting schedules to reward employees who stay with the company a longer period of time.

Impact of Eligibility and Vesting Choices

A GAO report has projected the dollar impact that certain eligibility requirements and vesting schedules could have on employees' account balances (based on certain assumptions).[2] You may want to share some of these figures with employers to illustrate the impact their choices could have on their employees' ability to save for retirement:

$51,758	• Impact of a one-year delay in eligibility for a 30-year-old worker
$81,743	• Impact for a worker who twice separates from employment (at age 20 and age 40) without satisfying a three-year cliff vesting schedule

$85,857	• Impact of an 18-year-old worker waiting until age 21 before participating in the plan
$411,439	• Impact of being ineligible to save in an employer's plan for one year on 11 occasions (the average number of jobs over a baby boomer's career)

In light of these findings and the fact that many workers switch jobs multiple times over their career, the GAO has recommended that Congress consider lowering the minimum age for plan eligibility and redefine what constitutes a year of service to bring part-time workers into an employer's plan. They also recommended that the Treasury consider assessing whether the current vesting policies are appropriate for today's mobile workforce.[2]

Advisor Tips for Discussing Eligibility and Vesting

Following are some important things to keep in mind when you are discussing plan eligibility and vesting options with employers.

- An employer is not required to impose age or service requirements or a vesting schedule.
- If the employer's objective is to recruit new employees or to help employees begin saving for retirement as soon as possible, immediate eligibility, at least for employee deferral contributions, and 100% vesting of employer contributions may be desirable.
- An employer can set different eligibility requirements for different types of contributions, sometimes referred to as dual eligibility (e.g., immediate eligibility for elective deferrals, one year for matching contributions).
- By excluding employees who haven't met the plan's eligibility requirements, employers can reduce administrative costs and, perhaps more importantly to some employers, the amount of employer contributions.
- Excluding employees who generally work fewer hours and are not likely to participate in the plan can help some 401(k) plans pass required nondiscrimination testing and increase the amount that highly compensated employees can save. In other plans, however, including more employees produces more favorable test results.
- Some plans use dollars forfeited by employees who are not fully vested to cover plan expenses.
- The plan's third party administrators or other plan design expert can create projections using the employer's demographic information to illustrate how changing the eligibility or vesting requirements can impact participation rates and plan costs.

Footnotes

[1]Society for Human Resource Management, SHRM Survey Findings: 2016 Strategic Benefits – Leveraging Benefits to Retain and Recruit Employees, November 2016

[2]U.S. Government Accountability Office, 401(k) Plans – Effects of Eligibility & Vesting Policies on Workers Retirement Savings

[3]IRC Sec. 401(a)(1)

[4]IRC Sec. 411(a)(2)(B)