Comments and Notes

CATCH 22 VESTING WITHOUT A SAFE HARBOR

I. INTRODUCTION

The enactment of the Employee Retirement Income Security Act of 1974 [1] (hereinafter referred to as ERISA) created new minimum vesting standards [2] which must be satisfied to obtain qualified plan status. Application of these standards to the antidiscrimination rules [3] is achieved by compliance with the special vesting coordination rules.[4]

A proposed regulation [5] has been promulgated in an attempt to provide a procedure for coordinating the vesting requirements with

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1. 29 U.S.C. §§ 1001-1381 (1976) [hereinafter cited as ERISA].
2. I.R.C. § 411 (1976 & Supp. IV 1980).
3. I.R.C. § 401(a)(4) (Supp. IV 1980) states:

A trust . . . forming part of a stock bonus, pension, or profit-sharing plan of an employer for the exclusive benefit of his employees or their beneficiaries shall constitute a qualified trust . . .

(4) if the contributions or the benefits provided under the plan do not discriminate in favor of employees who are—(A) officers, (B) shareholders, or (C) highly compensated.

4. I.R.C. § 411(d)(1) (1976) coordinates section 411 with section 401(a)(4) by way of the following special rules:

(d) Special rules.—

(1) Coordination with section 401(a)(4).—A plan which satisfies the requirements of this section shall be treated as satisfying any vesting requirements resulting from the application of section 401(a)(4) unless—

(A) there has been a pattern of abuse under the plan (such as a dismissal of employees before their accrued benefits become nonforfeitable) tending to discriminate in favor of employees who are officers, shareholders, or highly compensated, or

(B) there have [sic] been, or there is reason to believe there will be, an accrual of benefits or forfeitures tending to discriminate in favor of employees who are officers, shareholders, or highly compensated.

5. Proposed Treas. Reg. § 1.411(d)-1 (45 Fed. Reg. 24,201, April 9, 1980, amended 45 Fed. Reg. 39,869, June 12, 1980). The amendment of June 12, 1980 eliminated paragraph (d) of the originally proposed regulation. The proposed regulation, as amended, reads as follows:

§ 1.411(d)-1 Coordination of vesting and discrimination requirements.

(a) *General rule*—A plan which satisfies the requirements of section 411(a)(2) shall be treated as satisfying any vesting schedule requirements resulting from the application of section 401(a)(4) unless the plan is discriminatory within the meaning of section 411(d)(1) and this section. A plan is discriminatory if there is a pattern of abuse or there is discriminatory vesting as determined under paragraphs (b) and (c) of this section, respectively. Under section 401(a)(4), a plan which discriminates in favor of employees who are officers, shareholders, or highly compensated (hereinafter

the antidiscrimination rules. In essence, the proposal identifies a facts and circumstances test as the method for determining whether vesting is discriminatory.[6] If a plan satisfies this facts and circumstances test, the plan will be treated as satisfying any vesting requirements resulting from the application of the antidiscrimination rules which prohibit discrimination in favor of officers, shareholders, or highly compensated employees.[7]

Five examples have been released to illustrate the facts and circumstances test.[8] The examples provide guidance as to whether a plan's vesting schedule is discriminatory.[9] Since the examples fail to

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referred to as "prohibited group"), is not a qualified plan under section 401(a).

(b) *Pattern of abuse*—(1) *Definition.* A plan is discriminatory under section 411(d)(1)(A) and shall not be considered to satisfy the requirements of section 401(a)(4) if there has been a pattern of abuse under the plan tending to discriminate in favor of the prohibited group (hereinafter referred to as "pattern of abuse").

(2) *Test for pattern of abuse.* The determination of whether there has been a pattern of abuse shall be made on the basis of the facts and circumstances of each case. An example of a pattern of abuse is the systematic dismissal of employees before their accrued benefits vest.

(c) *Discriminatory vesting*—(1) *Definition.* A plan is discriminatory under section 411(d)(1)(B) and shall not be considered to satisfy the requirements of section 401(a)(4) if there have [sic] been, or there is reason to believe there will be, an accrual of benefits or forfeitures tending to discriminate in favor of the prohibited group by operation of the vesting schedule (hereinafter referred to as "discriminatory vesting").

(2) *Test for discriminatory vesting.* The determination of whether there is, or there is reason to believe there will be, discriminatory vesting shall be made on the basis of the facts and circumstances of each case. A reasonable disparity between the vested benefits paid to or accrued by the prohibited group and the vested benefits paid to or accrued by other employees will not result in a finding that there is discriminatory vesting.

(e) *Defined benefit plans*—A defined benefit plan which satisfies the benefit accrual requirements of section 411(b) shall still be subject to the nondiscrimination requirements of section 401(a)(4) with regard to its benefit accrual rates. Thus, even though a plan satisfies the section 411(b) requirements, the plan may still be discriminatory under section 401(a)(4) with respect to its benefit accruals.

(f) *Effective date*—This section shall apply to plan years beginning 30 days after the publication of this section in the FEDERAL REGISTER as a Treasury decision.

(Signed) Jerome Kurtz
Commissioner of Internal Revenue

6. Proposed Treas. Reg. § 1.411(d)-1(c)(2), *infra* note 5.

7. I.R.C. § 401(a)(4) (Supp. IV 1980).

8. Int. Rev. News Release No. 80-85 (August 4, 1980), *reprinted in*, [1980 Rulings] Mertens, *Law of Federal Income Taxation*, M.A. 737.

9. I.R.C. § 401 (1976 & Supp. IV 1980).

provide for a safe harbor, such as the 4-40 vesting test,[10] their value is limited.

Public reaction to the proposed regulation has been swift, widespread, and negative—especially due to its failure to establish a 4-40 vesting safe harbor.[11] Congress responded to this protest by enacting an amendment to the fiscal 1981 and 1982 Treasury Appropriations Bills.[12] The amendment prohibited the allocation of funds for the

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10. *See* Rev. Proc. 75-49, 1975-2 C.B. 584 for the 4-40 vesting test which is currently employed by the IRS at the district level. The requirements of this test are satisfied if, under the plan, each participant

> who has completed at least four years of employment [as defined by I.R.C. § 411(a)(4) without regard to subparagraphs (A), (B), and (C) of section 411(a)(4)] with the employer, has a nonforfeitable right to a percentage of his accrued benefit derived from employer contributions which, at the end of any year, is not less than the percentage determined under the following table:

Completed Years of Service	Nonforfeitable Percentage
4	40%
5	45%
6	50%
7	60%
8	70%
9	80%
10	90%
11 or more	100%

11. *See* Colloquy Between Senator Matsunaga and Daniel I. Halperin, Deputy Assistant Secretary for Tax Policy, Regarding Proposed Vesting Regulations Under Section 411(d) of the Code, Senate Finance Committee Markup of Multiemployer Plan Legislation, June 12, 1980, 295 PENSION RPTR. (BNA) A-25, R-26 (June 16, 1980); July 10, 1980 Hearing on IRS Proposed Vesting and Discrimination Requirements for Qualified Plans, 299 PENSION RPTR. (BNA) A-17 (July 14, 1980). *See also*, H.R. REP. No. 127, 96th Cong., 2d Sess. 7201 (1980); amendment to 1981 Treasury appropriations bill (H.R. 7583) by Rep. John Erlenborn (R-Ill.), who stated, in part, on the House floor:

> My amendment is necessary because of the disregard of the Congressional intent now being shown by the Internal Revenue Service in their proposed vesting regulations published in the Federal Register of April 9 and June 12, 1980.
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> The volume of constituent letters most congressional offices have received on these proposals confirm the statement made in the June 1980 issue of Pension World that "the storm of protest should equal or surpass anything that has yet been seen on the ERISA battlefront."

127 CONG. REC. 7201 (1980).

12. *See* Act of Dec. 16, 1980, Pub. L. No. 96-536, § 116, 94 Stat. 3166, 3171 (1980), for the 1981 appropriations bill denying funding for disqualification of any plan which has vesting requirements equal to or more stringent than 4-40. *See also* H.R. 4121, 97th Cong., 1st Sess. § 103 (1981) (1982 Treasury Appropriations Bill denying funds for the disqualification of any plan which has vesting requirements equal to or more stringent than 4-40—passed by House on July 30, 1981 and referred to as the Treasury, Postal Service and General Government Appropriations Act of 1982). This bill was specifically adopted in the appropriations bill for the 1982 fiscal year, Act of Dec. 15, 1981, Pub. L. No. 97-92, § 101(a)(1), 95 Stat. 1183, (1981). *See also* Act of March 31, 1982, Pub. L. No. 97-161, 96 Stat. 22 (1982), which extended the operation of the Act of Dec. 15, 1981 until September 30, 1982.

purpose of disqualifying any plan or issuing an adverse determination letter to any plan which has equal or more stringent vesting requirements than a 4-40 schedule. Thus, plans with vesting schedules at least as stringent as 4-40 vesting have been accorded a temporary safe harbor.

This comment adopts the position that 4-40 vesting should be recognized as a safe harbor, except in cases of flagrant discrimination.[13] If plan sponsors are to be encouraged to form new plans and

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13. The opinion that 4-40 vesting be adopted as a safe harbor has been included in two bills referred to the Committee on Ways and Means. Both bills, which call for substantial alteration of I.R.C. § 411(d)(1) (1976), are set forth below:

H.R. 7533, 96th Cong., 2d Sess. (1980). Proposed Amendment by Representatives Conable and Erlenborn to amend I.R.C. § 411(d)(1) as follows:

(1) Coordination with Section 401(a)(4).—

A plan which satisfies the requirements of this section shall be treated as satisfying any vesting requirements resulting from the application of section 401(a)(4) unless there has been a pattern of abuse under the plan (such as a dismissal of employees before their accrued benefits become nonforfeitable) tending to discriminate in favor of employees who are officers, shareholders, or highly compensated.

H.R. 7594, 96th Cong., 2d Sess. (1980). Representative Ashbrook introduced a substantial clarifying amendment to § 411(d)(1):

(1) COORDINATION WITH SECTION 401(a)(4).—

(A) IN GENERAL.—A plan which satisfies the requirements of this section shall be treated as satisfying any vesting requirements resulting from application of section 401(a)(4) unless—

(i) there has been a pattern of abuse under the plan (such as a dismissal of employees before their accrued benefits become nonforfeitable) tending to discriminate in favor of employees who are officers, shareholders, or highly compensated, or

(ii) there have [sic] been, or there is reason to believe there will be, an accrual of benefits or forfeitures tending to discriminate in favor of employees who are officers, shareholders, or highly compensated.

(B) APPLICATION OF SUBPARAGRAPH (A)(ii).—In the case of any plan, no accrual of benefits or forfeitures which tends to discriminate as described in clause (ii) of subparagraph (A) shall be considered to have taken place, and there shall be considered no reason to believe that any accrual of benefits or forfeitures which so tends to discriminate will take place, if—

(i) the total of present values of the benefits which are nonforfeitable of the employees each of whom is—

(I) an officer, or

(II) a shareholder who owns (determined by applying the attribution rules of 1563(e) without regard to section 1563(e)(3)(C)) more than 5 percent in value of the stock of the employer,

is less than the total of the present values of the benefits which . . . nonforfeitable of all other employees,

(ii) the class of employees having nonforfeitable benefits (considered without regard to other employees) would qualify under a classification described in section 410(b)(1)(B) by constituting a reasonable cross section of plan participants, or

(iii) the plan provides that an employee who has completed at least 4 years of service has a nonforfeitable right to a percentage of his accrued benefit derived from employer contributions which percentage is not less than the percentage determined under the following table:

to refrain from terminating existing ones, they must be assured that these plans will be able to comply with the rules pertaining to their continued qualified status. The rules currently applicable to this area provide at least some measure of reliability by guaranteeing a favorable determination letter for plans which adopt a 4-40 vesting schedule. The proposed regulation negates this practice and places a significant number of plans in jeopardy of losing their qualified status either prospectively or retroactively.[14]

An in-depth study of the facts and circumstances test is presented within this comment to illustrate the drawbacks of the proposed regulation. The following discussion focuses on the pertinent authorities in relation to the antidiscrimination provisions. In addition, this comment will highlight various other qualification tests which are used for purposes of administering the antidiscrimination rules. Finally, the proposed regulation will be analyzed.

II. PRE-ERISA: THE ANTIDISCRIMINATION RULES

Prior to the enactment of ERISA, there was no explicit requirement that a qualified plan include pre-retirement vesting provisions for the benefit of employees. Discrimination as to contributions or benefits in favor of persons who were officers, shareholders, persons whose principal duties consisted in supervising the work of other employees, or highly compensated employees was prohibited [hereinafter collectively referred to as "the prohibited group"].[15] Accordingly,

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Years of service:	Nonforfeitable percentage
4	40
5	45
6	50
7	60
8	70
9	80
10	90
11	100

SEC. 2. The amendments made by this Act shall apply with respect to plan years beginning after September 2, 1974.

Cf. Osgood, *Qualified Pension and Profit Sharing Vesting: Revolution Not Reform*, 59 B.U.L. REV. 452 (1979) [hereinafter cited as Osgood], wherein the author takes the position that 100% full and immediate vesting should be provided; and S. REP. NO. 383, 93d Cong., 1st Sess. 2, 153 (1973), *reprinted in* 1974 U.S. CODE CONG. & AD. NEWS 4890, 5034, where Senator Hartke supports 100% vesting after only five years of service.

14. I.R.C. § 7805(b) (1976); Dixon v. United States, 381 U.S. 68, 71, 80 (1965); Automobile Club of Mich. v. Commissioner, 353 U.S. 180, 184 (1957). *See also* Statement of Procedural Rules, 26 C.F.R. § 601.201 (1980); Rev. Proc. 67-1, 1967-1 C.B. 544, 553.

15. I.R.C. of 1954, ch. 1, § 401(a)(4), 68A Stat. 135 (amended in 1974 by ERISA § 1022(a), *supra* note 1).

certain pre-ERISA plans were required to adopt a vesting schedule if it appeared that these plans violated, or might violate, the antidiscrimination rules.[16]

Unless the antidiscrimination rules are satisfied, the plan and the trust are not qualified.[17] The antidiscrimination provisions were designed "to insure that stock bonus, pension, or profit sharing plans are operated for the welfare of employees in general, and to prevent the trust device from being used for the benefit of shareholders, officials or highly paid employees." [18] In addition, its purpose was to prevent plans from being used as a method of tax avoidance by the excessive deferral of income for highly compensated employees. Thus, the antidiscrimination rules prevent pension plans from providing excessive benefits for highly paid employees and from being used as a method of siphoning off profits to the prohibited group in a manner calculated to excessively avoid taxable income.[19]

Pre-ERISA case law and rulings emphasized the substantive aspects of a plan's operation. This emphasis was reflected in the review procedure which was used to conduct a case-by-case analysis of the work force of each employer seeking qualified plan status.[20] Strict attention was given to the employer's rate of employee turnover. Where turnover among the rank-and-file employees was extremely high and that of the prohibited group disproportionately low, a vesting schedule of sufficient amplitude to give the plan meaning for the rank and file would be imposed on an employer as a condition of

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16. *See, e.g.*, Rev. Rul. 65-266, 1965-2 C.B. 138. The antidiscrimination rules have been an important aspect of qualified plan regulation since the Revenue Act of 1942, ch. 619, § 162, 56 Stat. 798. For the committee explanation of the need for an antidiscrimination section, *see* H.R. REP. No. 2333, 77th Cong., 2d Sess. (1942), *reprinted in* 1942-2 C.B. 372, 413.

In spite of the lack of any Code section requiring vesting, most larger qualified plans had vesting schedules because they were thought to be an attractive element of the retirement plan fringe benefit. *See* Osgood, *supra* note 13, at 458-59 n.28, 463 n.51 (1979); Bankers Trust Co., *1976 Survey: ERISA Related Changes in Corporate Pension Plans* 4 (1976); Bankers Trust Company, *1976 Study of Corporate Pension Plans* 8-10 (1975) [hereinafter cited as *1976 Study*]. *See also* S. REP. No. 383, *supra* note 13, at 14, *reprinted in* 1974 U.S. CODE CONG. & AD. NEWS at 4901; H.R. REP. No. 807, 93d Cong., 2d Sess. 2, 53 (1974), *reprinted in*, 1974-3 (Supp.) C.B. 236, 288.

17. I.R.C. § 404(a) (1976 & Supp. IV 1980).

18. H.R. REP. No. 2333, 77th Cong., 2d Sess. (1942), *reprinted in*, 1942-2 C.B. 372, 450-51; S. REP. No. 1631, 77th Cong., 2d Sess. (1942), *reprinted in*, 1942-2 C.B. 606-07.

19. United States v. Hall, 398 F.2d 383, 389 (8th Cir. 1968), *on remand*, Hall v. United States, 303 F. Supp. 362 (D.N.D. 1969); Pepsi-Cola Niagara Bottling Corp. v. Commissioner, 48 T.C. 75, 83 (1967), *rev'd*, 399 F.2d 390 (2d Cir. 1968).

20. I.R.C. § 401 (1976 & Supp. IV 1980).

obtaining plan qualification.[21] Prohibited discrimination would be found where inequalities in vesting operated in a manner which would effectively exclude a sufficient number of employees from the practical benefits of the plan such that its value to the employee group as a whole would be illusory.[22] Whether a plan discriminates in favor of the prohibited group was a question of fact to be determined from all the attending circumstances viewed in light of the purpose for the antidiscrimination rules.[23]

III. MINIMUM VESTING STANDARDS UNDER ERISA AND THE ANTIDISCRIMINATION RULES

ERISA introduced into law comprehensive vesting provisions for the purpose of protecting employee plan benefits from forfeiture prior to retirement.[24] The newly codified minimum vesting standards list three vesting schedules, one of which must be adopted in order for a plan to receive qualified status.[25] In addition, ERISA enacted a

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21. *See, e.g.*, Ryan School Retirement Trust v. Commissioner, 24 T.C. 127, 134 (1955); Rev. Rul. 73-299, 1973-2 C.B. 137; Rev. Rul. 71-150, 1971-1 C.B. 123; Rev. Rul. 70-200, 1970-1 C.B. 101; Rev. Rul. 69-421, 1969-2 C.B. 200. *See also infra* note 39.

22. United States v. Hall, 398 F.2d at 390, *on remand*, Hall v. United States, 303 F. Supp. 362 (D.N.D. 1969); *see also* S. REP. No. 127, 93d Cong., 2d Sess. 1, 15 (1974), *reprinted in* 1974 U.S. CODE CONG. & AD. NEWS 4838, 4851.

23. Pepsi-Cola Niagara Bottling Corp. v. Commissioner, 48 T.C. at 83 (1967), *rev'd*, 399 F.2d 390 (2d Cir. 1968).

24. 29 U.S.C. §§ 1001-1381 (1976) constitutes the provisions of labor law regulating the entire pension system. Note that the sections of the labor title overlap significantly with the qualified plan rules of the Code. Of importance, note especially, 29 U.S.C. § 1053 (1976), which corresponds almost verbatim to the vesting rules of I.R.C. § 411 (1976 & Supp. IV 1980).

25. I.R.C. § 411(a)(2) (1976) lists three schedules for a trust to be qualified under I.R.C. § 401(a) (1976 & Supp. IV 1980).

> (2) Employer contributions.—A plan satisfies the requirements of this paragraph if it satisfies the requirements of subparagraph (A), (B), or (C).
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> (A) 10-year vesting.—A plan satisfies the requirements of this subparagraph if an employee who has at least 10 years of service has a nonforfeitable right to 100 percent of his accrued benefit derived from employer contributions.
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> (B) 5- to 15-year vesting.—A plan satisfies the requirements of this subparagraph if an employee who has completed at least 5 years of service has a nonforfeitable right to a percentage of his accrued benefit derived from employer contributions which percentage is not less than the percentage determined under the following table:

Years of service:	Nonforfeitable percentage
5	25
6	30
7	35
8	40
9	45
10	50

fourth qualifying option known as the class year plan [26] and further provided for the permissible adoption of any vesting schedule more liberal than the statutory minimums.[27]

In general, ERISA's three schedules require that an employee's accrued benefit be at least fifty percent vested after ten years of service and 100% vested after fifteen years of service. Each schedule limits the amount of backloading (greater accrual in later years),[28] and permits an unlimited amount of front-loading.

Vesting, as the term is used in ERISA, refers to an employee's accrual of generally nonforfeitable pension benefits. Once vested,

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11	60
12	70
13	80
14	90
15 or more	100

(C) Rule of 45.—

(i) A plan satisfies the requirements of this subparagraph if an employee who is not separated from the service, who has completed at least 5 years of service, and with respect to whom the sum of his age and years of service equals or exceeds 45, has a nonforfeitable right to a percentage of his accrued benefit derived from employer contributions determined under the following table:

If years of service equal or exceed—	and sum of age and service equals or exceeds—	then the nonforfeitable percentage is—
5	45	50
6	47	60
7	49	70
8	51	80
9	53	90
10	55	100.

(ii) Notwithstanding clause (i), a plan shall not be treated as satisfying the requirements of this subparagraph unless any employee who has completed at least 10 years of service has a nonforfeitable right to not less than 50 percent of his accrued benefit derived from employer contributions and to not less than an additional 10 percent for each additional year of service thereafter.

26. I.R.C. § 411(d)(4) (1976) provides the following special rule:

(4) Class year plans.—The requirements of subsection (a)(2) shall be deemed to be satisfied in the case of a class year plan if such plan provides that 100 percent of each employee's right to or derived from the contributions of the employer on his behalf with respect to any plan year are nonforfeitable not later than the end of the 5th plan year following the plan year for which such contributions were made. For purposes of this section, the term "class year plan" means a profit-sharing, stock bonus, or money purchase plan which provides for the separate nonforfeitability of employees' rights to or derived from the contributions for each plan year.

27. Technical Information Release No. 1334 (January 8, 1975), Question V-3, *reprinted in*, [1975 Rulings] Mertens, *Law of Federal Income Taxation* M.A. 57, 70; S. REP. No. 127, *supra* note 22, at 39, *reprinted in*, 1974 U.S. CODE CONG. & AD. NEWS 4838, 4855-56.

28. CONF. REP. No. 1280, 93d Cong., 2d Sess. 273, 274, *reprinted in*, 1974-3 C.B. 415, 434-35 [hereinafter cited as CONF. REP. No. 1280].

these benefits may only be forfeited under very limited circumstances.[29]

Although the minimum vesting standards purport to establish minimum vesting schedules as a separate requirement of law, the antidiscrimination rules apply coextensively with the minimum vesting standards as a separate and distinct condition for obtaining plan qualification.[30] Compliance with the minimum vesting standards will satisfy the nondiscrimination requirement, except in either of two cases:

> (A) there has been a pattern of abuse under the plan (such as a dismissal of employees before their accrued benefits become nonforfeitable) tending to discriminate in favor of employees who are officers, shareholders, or highly compensated, or
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> (B) there have [sic] been, or there is reason to believe there will be, an accrual of benefits or forfeitures tending to discriminate in favor of employees who are officers, shareholders, or highly compensated.[31]

The application of the minimum vesting standards in conjunction with the antidiscrimination rules offers little improvement over the subjective pre-ERISA review procedures. Because the antidiscrimination tests are applied by the administrator on a case-by-case basis as part of the general practice of obtaining an advance determination letter from the IRS,[32] disparities in the application of the rules continue to occur, generating great controversy and litigation in the vesting area.[33] In this regard, the intent of Congress is germane to the issue of whether a facts and circumstances test is to be employed when reviewing a plan's vesting schedule.

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29. Winer v. Edison Bros. Stores Pension Plan, 593 F.2d 307, 311 (9th Cir. 1979); ERISA § 203, 29 U.S.C. § 1053 (1976). *See* I.R.C. § 411(a)(3) (1976 & Supp. IV 1980) and Treas. Reg. § 1.411(a)-4 (1977) describing the limited circumstances where vested benefits are subject to forfeiture.

30. I.R.C. § 411(d)(1) (1976).

31. *Id.*

32. Employers and plan administrators who adopt or amend individually designed employee benefit plans often wish to avoid the severe consequences stemming from a later determination by the IRS that the plan is not qualified, with the result that either the contributions are not currently deductible by the employer or such contributions are currently taxable to the employees. To avoid these consequences, an "advance determination" letter can be obtained from the IRS by which the IRS determines whether or not the plan qualifies for exempt status under IRC § 401(a). For the procedure in applying for a determination letter, see Treas. Reg. § 601.201(o) (1976).

33. *See* Commissioner v. Pepsi-Cola Niagara Bottling Corp., 399 F.2d 390, 393 (2d Cir. 1968); Sanchez, Cain, Benson & Wood, *The Vesting Provisions of ERISA, (Part 1)*, 7 TAX ADVISER 408, 418 (1976) [hereinafter cited as Sanchez].

The legislative history does not furnish clear guidance as to the coordination of the minimum vesting standards with the antidiscrimination rules. On the other hand, the House Conference Committee Report expressly adopted the special vesting coordination rules,[34] as reflected in the House bill.[35] On the other hand, the conferees directed the IRS not to require a vesting schedule more stringent than 4-40 vesting except in cases of actual misuse.[36] Since the minimum vesting standards of ERISA do not contain a 4-40 vesting schedule, the intent of Congress to provide for a safe harbor is subject to question. This lack of clear guidance, however, becomes less significant in light of Congress' intentional refusal to appropriate funds for the enforcement of the regulation.[37] Notwithstanding the conferees' clear concern for the lack of uniform results in similar factual circumstances due to the case-by-case administration of the law in this area,[38] the coordination

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34. CONF. REP. No. 1280, *supra* note 28, at 276, *reprinted in*, 1974-3 C.B. at 437, reads, in part, as follows:

> *Discrimination.*—Under the conference substitute the rules of the House bill are adopted with respect to the relationship of the minimum vesting standards of the bill to the antidiscrimination rules of present law (sec. 401(a)(4) of the Internal Revenue Code). In general, a plan which meets the vesting requirements provided in this substitute is not to be considered as discriminatory, insofar as its vesting provisions are concerned, unless there is a pattern of abuse under the plan (such as the firing of employees before their accrued benefits vest) or there has been (or there is reason to believe there will be) an accrual of benefits or forfeitures tending to discriminate in favor of employees who are officers, shareholders or who are highly compensated.
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> In the past, however, the law in this area has been administered on a case-by-case basis, without uniform results in fact situations of a similar nature. As a result, except in cases where actual misuse of the plan occurs in operation, the Internal Revenue Service is directed not to require a vesting schedule more stringent than 40 percent vesting after 4 years of employment with 5 percent additional vesting for each of the next 2 years, and 10 percent additional vesting for each of the following five years. Also, this more rapid vesting would generally not be required except in a case where the rate of likely turnover for officers, shareholders, or highly compensated employees was substantially less (perhaps as much as 50 percent less) than the rate of likely turnover for rank-and-file employees. Of course, where there is a pattern of firing employees to avoid vesting, the limitations described above would not apply. Also, it generally is not intended that any plan (or successor plan of a now existing plan) which is presently under a more rapid vesting schedule should be permitted to cut back its vesting schedule as a result of this statement.

35. H.R. REP. No. 807, *supra* note 16, at 64-65, *reprinted in*, 1974-3 (Supp.) C.B. at 299-300.

36. CONF. REP. No. 1280, *supra* note 28, at 276, *reprinted in*, 1974-3 C.B. 415, 437.

37. *See supra* notes 12 & 13.

38. CONF. REP. No. 1280, *supra* note 28, at 276, *reprinted in*, 1974-3 C.B. 415, 437. Caveat: A showing of actual discrimination is necessary to disqualify a plan on vesting grounds. *See* Gold Seal Products Co. v. United States, 32 A.F.T.R.2d 6014 (D.C. Ala. 1973), which held that the fact that a profit-sharing plan provided for only five-percent-per-year vesting and the fact that the employer had a high turnover expe-

rules perpetuate the practice of reviewing a plan's vesting schedule on an individualized basis. Hence, the IRS may continue to require more rapid vesting in circumstances where it is perceived that the minimum standards otherwise allowable under ERISA would not prevent a plan from operating in a discriminatory manner.

In an effort to clarify the relationship between the antidiscrimination rules and the minimum vesting standards, as well as to comply with the position taken in the Conference Report, temporary rules were issued in a 1975 Revenue Procedure.[39] This procedure contains guidelines to be applied by the IRS for purposes of an advance determination as to whether the vesting schedule of a plan satisfies the antidiscrimination rules. An advance determination is made without regard to the facts of actual operation of the plan except in extreme cases—for example, where employees are fired to prevent vesting. The most important aspect of the 1975 procedure is that for advance determination purposes, vesting faster than a 4-40 schedule is not required *per se*. However, if either the key employee test (relating to the number of key employees as a percentage of the prohibited group) or the turnover test (relating to the turnover rate for rank-and-file employees as compared to the rate of turnover of the prohibited group) is not met, 4-40 vesting is required. A refusal to adopt 4-40 vesting in these circumstances may result in a failure to obtain plan qualification. In the alternative, a determination letter with a caveat as to vesting in the event of actual or potential abuse may be issued.[40]

The key employee test and the turnover test proved to be overbearingly stringent and unrealistic in practice. Most larger corporations did not want to be forced into adopting 4-40 vesting; rather, they preferred schedules with slower or different structures from 4-40.[41] Virtually all small and recently established corporations, because of their size or insufficient employment history, failed the key employee or turnover tests. Therefore, in order to prevent receipt of an adverse determination letter, such businesses were compelled to adopt 4-40 vesting. Moreover, to avoid the risk of loss of qualified status due to discrimination in operation resulting from circumstances beyond the control of the plan sponsor (an example of which would be market decline or economic hardship in the industry), the choice of

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rience did not make a plan discriminatory when the facts established that such a factor did not result in discrimination.

39. Rev. Proc. 75-49, 1975-2 C.B. 584; Sanchez, *supra* note 33.

40. Rev. Proc. 75-49, 1975-2 C.B. 584; Sanchez, *supra* note 33.

41. *1976 Study*, *supra* note 16; Rev. Proc. 76-11, 1976-1 C.B. 550.

4-40 vesting was the only prudent alternative. Due to the stringent requirements of this procedure, public reaction was almost entirely negative.[42] The IRS responded to this negative reaction by announcing that it would reconsider its 1975 position. Pending this reconsideration, a 1976 modifying Revenue Procedure was issued.[43]

The 1976 Revenue Procedure was also concerned with actual or potential discrimination as to vesting in favor of the prohibited group. An applicant may obtain an advance determination letter by demonstrating that the plan's vesting schedule satisfies the antidiscrimination rules and, if applicable, the minimum vesting standards on the basis of any one of the following tests: [44] (1) The 1975 Revenue Procedure test, (2) the prior determination letter test, or (3) the facts and circumstances test.[45] In addition, the 1976 Procedure offers a fourth alternative. An applicant may request an advance determination letter stipulating that the determination is not controlling as to whether the vesting schedule of the plan satisfies the nondiscrimination requirements.[46] Similar to the 1975 Procedure, the 1976 Procedure reserves to the IRS the privilege of requiring plans to adopt vesting schedules more rapid than 4-40 vesting if there has been a pattern of abuse or actual misuse of the plan in operation.[47]

A recent case involving a roofing subsidiary's profit sharing plan addressed at length the 1976 Revenue Procedure.[48] The issue presented to the Tax Court was whether the subsidiary's plan discriminated, or there was reason to believe it would discriminate, as to the accrual of benefits or forfeitures in favor of the prohibited group. It was emphasized that a trust is not qualified unless the plan meets the minimum vesting requirements.[49] Although the subsidiary adopted a 5-to-15 year vesting schedule,[50] the court noted that a finding of nondiscrimination could be sustained only if the plan was in compliance with the antidiscrimination rules as applied through vesting coordination rules.[51] To determine whether the plan met the requirements of the special vesting coordination rules, the court found it necessary to analyze the facts surrounding the plan's operation pursuant

42. *1976 Study*, *supra* note 16; Rev. Proc. 76-11, 1976-1 C.B. 550.
43. Rev. Proc. 76-11, 1976-1 C.B. 550.
44. I.R.C. § 411(a)(2) (1976).
45. Rev. Proc. 76-11, *supra* note 41.
46. *Id.* at 551.
47. *Id.* at 551.
48. Tamko Asphalt Prods., Inc. v. Commissioner, 71 T.C. 824 (1979), *aff'd*, 658 F.2d 735 (10th Cir. 1981).
49. *Id.* at 830.
50. *Id.* at 826-827; *see also* I.R.C. § 411(a)(2)(B) (1976).
51. Tamko Asphalt Prods., Inc. v. Commissioner, 71 T.C. at 830.

to the appropriate Revenue Procedures.[52] After determining that the key employee test was inappropriate, the court resorted to application of the turnover test and the 4-40 vesting test. These tests as well as the prior letter test failed to qualify the plan.[53] The court articulated the crucial test as follows: "[T]here must be a demonstration based upon all the *facts and circumstances* that there has not been, and there is no reason to believe there will be, an accrual of benefits or forfeitures tending to discriminate in favor of a prohibited group." [54] The court found sufficient reason to believe that accrual of benefits and forfeitures would result in prohibited discrimination.[55] This decision was later upheld on appeal.[56]

The determination of whether a plan's vesting provisions meet the general qualification requirements is thus dependent upon the facts of each particular case.[57]

IV. FACTS AND CIRCUMSTANCES TEST

A plan must operate for the benefit of the employees in general.[58] If in terms of either contributions or benefits a plan discriminates in favor of employees who are officers, shareholders, or highly compensated, such a plan is not considered to be for the exclusive benefit of employees.[59] When making this determination, a facts and circumstances test is to be used:

> [All] of the *surrounding and attendant circumstances and the details* of the plan will be indicative of whether it is a bona fide stock bonus, pension, or profit sharing plan for the exclusive benefit of employees. *The law is concerned not only with the form of a plan but also with its effects in operation.*[60]

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52. *Id.* at 832.
53. *Id.* at 833-37.
54. *Id.* at 836 (emphasis added); *see also* Rev. Proc. 76-11, *supra* note 41.
55. Tamko Asphalt Prods., Inc. v. Commissioner, 71 T.C. at 837.
56. *See supra* note 48.
57. Rev. Rul. 71-151, 1971-1 C.B. 123.
58. Treas. Reg. § 1.401-1(b)(3) (1976); *see also* I.R.C. § 401(a) (1976 & Supp. IV 1980).
59. Treas. Reg. § 1.401-1(b)(3) (1976); *see also* I.R.C. § 401(a) (1976 & Supp. IV 1980); Rev. Rul. 74-165, 1974-1 C.B. 96, which states that vesting applies to benefits not contributions; United States v. Hall, 398 F.2d 383, 385 (8th Cir. 1968), *on remand*, Hall v. United States, 303 F. Supp. 362 (D.N.D. 1969).
60. Treas. Reg. § 1.401-1(b)(3) (1976) (emphasis added).

Thus, if there is a finding that variations from the plan substantially prejudice the benefits to be received by employees generally, the plan's qualified status stands to be lost.[61]

As a general maxim, the law searches out reality and is not concerned with form.[62] In dissecting a plan, each part may be found to be letter perfect; however, the IRS is directed to take a comprehensive view to determine if the whole is discriminatory. If, in effect, the plan operates to the benefit of the prohibited group and to the detriment of employees generally, the plan can be declared unqualified.[63]

Clearly, vesting is an important benefit in any qualified plan. The vesting provisions must be considered in reaching a decision as to whether a plan discriminates with respect to benefits.[64] For purposes of meeting the requirements for qualification,[65] discrimination as to contributions or benefits in favor of the prohibited group is forbidden.[66] However, variations in benefits are permissible if under all the attendant circumstances, the plan viewed as a whole benefits employees in general.[67]

Notwithstanding the great importance of vesting under ERISA, vesting provisions are only one part of a complete deferred compensation plan.[68] In determining whether the facts and circumstances of a particular case merit a finding of discrimination in favor of the prohibited group, the Tax Court recently decided that the Commissioner has no discretionary authority to determine discrimination as to contributions or benefits under the antidiscrimination rules.[69] Accordingly, when examining plan benefits for purposes of detecting actual or potential discrimination in operation of the plan under the rules, the courts also inquire into the following plan provisions:

1. Coverage (age and service requirements);
2. Contribution and accrual formulae (contributions as related to compensation both as to groups and individuals);
3. Integration;

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61. Central Motor Co. v. United States, 454 F. Supp. 54, 56 (D.N.M. 1976); Time Oil Co. v. Commissioner, 258 F.2d 237, 238 (9th Cir. 1958).
62. John Duguid & Sons, Inc. v. United States, 278 F. Supp. 101, 106 (N.D.N.Y. 1967).
63. Cornell-Young Co. v. United States, 469 F.2d 1318, 1326 (5th Cir. 1972).
64. United States v. Hall, 398 F.2d 383, 387 (8th Cir. 1968), *on remand*, Hall v. United States, 303 F. Supp. 362 (D.N.D. 1969).
65. I.R.C. § 401(a) (1976 & Supp. IV 1980).
66. Treas. Reg. § 1.401-4(a)(1)(i) (1963).
67. Treas. Reg. § 1.401-4(a)(2)(iii) (1963); *see also* Treas. Reg. § 1.401-11(d) (1968).
68. Loper Sheet Metal, Inc. v. Commissioner, 53 T.C. 385, 393 (1969).
69. E. F. Higgins & Co. v. Commissioner, 74 T.C. 1029 (1980).

4. Distribution at early, normal or post-retirement;
5. Disability;
6. Pre- and post-retirement death benefits;
7. Insurance;
8. Transfer and rollover;
9. Investment; and
10. Loans.[70]

Only after a consideration of the cumulative effect of the entire plan will the courts make a discrimination determination.[71]

One of the earliest and most often quoted decisions involving the application of the facts and circumstances test is *Ryan School Retirement Trust v. Commissioner.*[72] When established, the Ryan School Retirement Trust originally covered 110 rank-and-file employees and five officer employees. Within seven years, adverse business conditions caused terminations resulting in a reduction in participation to ten persons, which included the five officers. The officer employees had been credited with fifty-eight percent of the total funds, much of which consisted of forfeitures from the original work force. The court decided that the plan did not operate to discriminate in favor of the officers as against the rank-and-file employees. In its decision, the court enunciated the following points:

> 1. *No Inherent Discrimination.* Discrimination was defined as "some real preferential treatment in favor of officers." Such discrimination did not obtain because "no provision in the plan itself was inherently discriminatory."
>
> 2. *Unforeseen Circumstances.* Discrimination was not present for there was no "ulterior motive to frame [the plan's] provisions to channel the major part of the funds to the officer group because of any events or circumstances which the management foresaw or expected to occur."
>
> 3. *Same Ratio of Increase.* Discriminatory preferential treatment was absent inasmuch as the remaining officers and rank and file employees experienced the same rate of

70. *Id.*; Liberty Mach. Works, Inc. v. Commissioner, 62 T.C. 621, 633, 634 (1974), *aff'd*, 518 F.2d 554 (8th Cir. 1975); Loper Sheet Metal, Inc. v. Commissioner, 53 T.C. 385, 389, 390, 394 (1969); Gold Seal Prods. Co. v. United States, 32 A.F.T.R.2d 6014 (D.C. Ala. 1973).

71. Cornell-Young Co. v. United States, 469 F.2d 1318, 1325 (5th Cir. 1972).

72. Ryan School Retirement Trust v. Commissioner, 24 T.C. 127, 133 (1955), which emphasized the minimum participation requirements of I.R.C. § 410(b)(1)(B) (1976). However, since these requirements are relevant to the facts and circumstances test in relation to the nondiscrimination requirements of I.R.C. § 401(a)(4) (Supp. IV 1980), it is cited as persuasive authority with respect to I.R.C. § 411(d)(1)(B) (1976).

increase in amount over the 7-year period. In other words, "the ratio between shares of each such rank and file employee and each officer was the same as at the beginning of the plan."

4. *Permanent/Impermanent Employees.* A plan is not discriminatory when it operates "to give all *permanent* employees (including both officers and rank and file employees) a preferred position over that group of employees among which turnovers are frequent." [73]

The quintessence of the *Ryan School* case is the proposition that a bias in the operation of a plan in favor of permanent as opposed to impermanent employees, which develops as a result of unforeseen circumstances, does not result in disqualification under the antidiscrimination rules.[74]

Subsequent cases have limited the *Ryan School* decision,[75] particularly on the ground of foreseeability.[76] Where it is possible to anticipate that only a few members of the nonprohibited group would remain to share in the plan, or where it was not possible that a substantial number of such employees would remain to derive substantial benefits, a plan is not qualified.[77] Accordingly, when it is known at the time of the establishment of a plan that allocations under the plan will discriminate in favor of the prohibited group against all other

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73. Ryan School Retirement Trust v. Commissioner, 24 T.C. 127, 134 (1955); Wisconsin Nipple & Fabricating Corp. v. Commissioner, 67 T.C. 490, 494 (1976), *aff'd*, 581 F.2d 1235 (7th Cir. 1978); *see also* Volchening, Inc. v. Commissioner, 13 T.C. 723 (1949), where the plan was held not discriminatory even though larger contributions were made for officers because such contributions bore a uniform relation to the basic or regular rate of compensation.

74. Ryan School Retirement Trust v. Commissioner, 24 T.C. 127, 134 (1955); Pulver Roofing Co. v. Commissioner, 70 T.C. 1001, 1009 (1978); Lansons, Inc. v. Commissioner, 69 T.C. 773, 785 (1978), *aff'd*, 622 F.2d 774 (5th Cir. 1980); Sherwood Swan & Co. v. Commissioner, 42 T.C. 299, 307 (1964), *nonacq.*, Rev. Rul. 66-251, 1966-2 C.B. 121, *aff'd*, 352 F.2d 306 (9th Cir. 1965).

75. E. F. Higgins & Co. v. Commissioner, 74 T.C. 1029 (1980); Pulver Roofing Co. v. Commissioner, 70 T.C. 1001 (1978); Lansons, Inc. v. Commissioner, 69 T.C. 773 (1978), *aff'd*, 622 F.2d 774 (5th Cir. 1980); Bernard McMenamy Contractor, Inc. v. Commissioner, 54 T.C. 1057 (1970), *aff'd*, 442 F.2d 359 (8th Cir. 1971); Ed & Jim Fleitz, Inc. v. Commissioner, 50 T.C. 384 (1968); Sherwood Swan & Co., 42 T.C. 299 (1964), *nonacq.* Rev. Rul. 66-251 1966-2 C.B. 121, *aff'd*, 352 F.2d 306 (9th Cir. 1965).

76. Bernard McMenamy Contractor, Inc. v. Commissioner, 54 T.C. 1057, 1063, 1064 (1970), *aff'd*, 442 F.2d 359 (8th Cir. 1971), deciding "that the deliberate adoption of a formula for allocating contributions under a profit-sharing plan that favors members of the prohibited group is discriminatory within the meaning of [the nondiscrimination requirements of section 401], irrespective of the reasons for adopting such a formula."

77. *Id.* at 1064; Lansons, Inc. v. Commissioner, 69 T.C. 773, 785 (1978), *aff'd*, 622 F.2d 774 (5th Cir. 1980).

participants, the plan is discriminatory, notwithstanding the occurrence of any unforeseen events or circumstances.[78]

Ryan still remains persuasive authority for avoiding coverage of impermanent employees. A plan is not discriminatory under *Ryan* as long as (1) the organization seeking tax-exempt status is willing to comply with suggestions made by the IRS for qualification purposes; and (2) there is no indication that the plan is a subterfuge to distribute profits to the prohibited group.[79] *Ryan* is also followed as support for the retention of qualified plan status where, due to extraneous factors, minor year-to-year fluctuations would result in a plan being qualified in one year and nonqualified in the next. Thus, the courts continue to cite *Ryan* as authority to permit fortuitous fluctuations of employee coverage.[80] Finally, in order to assert the unforeseeability rationale of *Ryan*, a plan must cover all employees, not primarily members of the prohibited group.[81] However, where changes in the essential character of either the taxpayer's business or work force can be expected, the unforeseeability rationale of *Ryan* and its progeny is not controlling.[82]

V. THE REASONABLE CROSS-SECTION TEST UNDER THE PROPOSED VESTING REGULATIONS

The facts and circumstances test constitutes the sum and substance of the proposed regulation concerning the coordination of vesting and discrimination rules.[83] The proposed regulation accentuates the importance of the facts and circumstances test in the vesting area. Thus, the proposed regulation is more stringent than the 1975 and 1976 Revenue Procedures.[84]

In its "Notice of Proposed Rulemaking," the Service emphasizes:

> If a plan has a favorable advance determination letter based on the facts and circumstances test of the proposed rules,

78. E. F. Higgins & Co. v. Commissioner, 74 T.C. 1029 (1980); Lansons, Inc. v. Commissioner, 69 T.C. 773, 785 (1978), *aff'd*, 622 F.2d 774 (5th Cir. 1980); Bernard McMenamy Contractor, Inc. v. Commissioner, 54 T.C. 1057, 1064 (1970), *aff'd*, 442 F.2d 359 (8th Cir. 1971).

79. Lansons, Inc. v. Commissioner, 69 T.C. 773, 786 (1978), *aff'd*, 622 F.2d 774 (5th Cir. 1980).

80. *Id.*; Pulver Roofing Co. v. Commissioner, 70 T.C. 1001, 1012 (1978).

81. Pulver Roofing Co. v. Commissioner, 70 T.C. 1001, 1012, 1013 (1978); Greenwald v. Commissioner, 366 F.2d 538, 540 (2d Cir. 1966).

82. E. F. Higgins & Co. v. Commissioner, 74 T.C. 1029 (1980).

83. Proposed Treas. Reg. § 1.411(d)-1, 45 Fed. Reg. 24,201 (April 9, 1980), amended 45 Fed. Reg. 39,869 (June 12, 1980).

84. *See supra* text accompanying notes 39-57.

> [such] determination will protect the plan from a finding of discriminatory vesting in operation, provided the facts and circumstances have not materially changed since the determination letter was issued.[85]

Additionally, the facts and circumstances test applies not only to the initial qualification of a plan's vesting schedule under the tests of the Revenue Procedures, but also to the schedule's effects in actual operation.[86]

In recognition of the problems inherent in the case-by-case administration of this facts and circumstances test, the IRS has provided

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85. Proposed Treas. Reg. § 1.411(d)-1, 45 Fed. Reg. 24,201 (April 9, 1980), amended 45 Fed. Reg. 39,869 (June 12, 1980). The relevant commentary of the proposed regulations with respect to prior determination letters reveals the true import the IRS has attached to the facts and circumstances test in connection with the coordination of vesting and discrimination requirements for qualified plans. Therefore, the following commentary is recapitulated below to show the fervor of the IRS's stand in its re-emphasis of the facts and circumstances test.

> The test of Revenue Procedures 75-49 and 76-11 are applied only with respect to whether a plan could receive a favorable advance determination letter. The determination letter, by its terms, provided that the approval of the plan's qualified status by the Internal Revenue Service did not extend to the plan in operation. Therefore, separate tests for determining discrimination in vesting were necessary with respect to the issuance of a determination letter and with respect to testing the operation of the plan's vesting schedule.
>
> Thus, an employer could receive a favorable advance determination letter, but would have no protection against a finding that the plan's vesting schedule was discriminatory in operation. The proposed rules remove this separate testing of form and operation, and provide that the test for discriminatory vesting shall be made, in both situations, on the basis of the facts and circumstances. Thus, if a plan has a favorable advance determination letter based on the facts and circumstances test of the proposed rules, this determination will protect the plan from a finding of discriminatory vesting in operation, provided the facts and circumstances have not materially changed since the determination letter was issued.
>
> Additionally, plans which currently possess certain types of favorable determination letters will be treated as if their determination letter was processed under the facts and circumstances test contained in the proposed rules. The plans which will be given this treatment are those which received their favorable determination letter based on their satisfying one or more of the following tests:
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> 1. the key employee and/or the turnover test of Revenue Procedure 75-49;
> 2. the prior letter test of Revenue Procedure 76-11; or
> 3. the facts and circumstances test of Revenue Procedure 76-11. Thus, a plan described above would also be protected against a finding of discriminatory vesting in operation, based on its outstanding favorable determination letter, provided the facts and circumstances have not materially changed.

45 Fed. Reg. 39,869, 39,870 (June 12, 1980).

86. I.R.C. § 411(d)(1)(B) (1976).

explicit examples for guidance.[87] These examples depict five narrow fact patterns, four of which the IRS has determined not to be discriminatory in connection with the special vesting coordination rules. Most importantly, the examples advance another major test, designated as the reasonable cross-section test, to be employed when coordinating the antidiscrimination rules with the minimum vesting standards.[88]

Congress enacted the antidiscrimination rules "in order to insure that . . . plans are operated for the welfare of employees in general, and to prevent the trust from being used for the benefit of shareholders, officers, or highly compensated employees." [89] Consequently the antidiscrimination rules emphasize the functioning of a plan. Effectively, it makes qualification contingent upon whether the contributions or benefits provided under a plan discriminate in favor of the prohibited group.[90] In deciding this issue, not only must all of the facts and circumstances of the operation of a plan be considered, but also a fair cross-section of all employees in general must be vested.[91] Hence, to achieve a positive result under the proposed regulations, it is necessary to determine which combination of facts and circumstances vests a reasonable cross-section of employees.

A major factor in determining whether a plan benefits a fair cross-section of employees is the interpretation given to the term "highly compensated" in reference to the antidiscrimination rules. Plan sponsors, the IRS, and the courts must contend with great administrative difficulty caused by attempts to interpret and define this term. This issue was specifically addressed in *Pepsi-Cola Niagara Bottling Corp. v. Commissioner* [92] where the court focused on the facts and circumstances test to decide which employees should be considered highly compensated.

In the *Pepsi* case, the Commissioner originally denied qualified status to the employer's profit-sharing plan on the grounds that it dis-

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87. Int. Rev. News Release No. 80-85 (August 4, 1980), *supra* note 8. The proposed examples also articulate under example 1 a test based on accrued benefits. It states: "Where the vested employer-derived accrued benefits provided employees who are not officers or shareholders are at least equal to the total accrued employer-derived benefits provided officers and shareholders, the plan's vesting schedule is not considered to be discriminatory." *Id.*

88. H.R. REP. No. 2333, 77th Cong., 2d Sess. (1942), *reprinted in*, 1942-2 C.B. 372, 450.

89. Babst Servs., Inc. v. Commissioner, 67 T.C. 131, 136 (1976).

90. Treas. Reg. § 1.401-4(a)(2)(iii) (1963); Forsyth Emergency Servs., P.A. v. Commissioner, 68 T.C. 881, 890 (1977).

91. King v. United States, 376 F. Supp. 1313, 1317 (D. Neb. 1974).

92. Pepsi-Cola Niagara Bottling Corp. v. Commissioner, 48 T.C. 75, 79-82 (1967), *rev'd*, 399 F.2d 390 (2d Cir. 1968).

criminated in favor of highly compensated employees by failing to comply with the eligibility requirements.[93] The Tax Court reviewed all of the facts and circumstances and decided that the plan was not discriminatory based on its own construction of the term highly compensated.[94] On appeal the case was reversed.[95] The court of appeals, in construing the term highly compensated, noted that terms like "high" and "highly" clamor for a referent. "A 500 foot hill, would look high in Central Park, but not among the Grand Tetons." [96] Because Congress specifically conferred upon the Commissioner the power to define and to administer the application of these terms, the court determined that the distinction between highly compensated and lower compensated should be based entirely on the circumstances of each case.[97] Applying that perspective, the plan in *Pepsi* was found discriminatory even though the compensation differ-

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93. 48 T.C. at 83. Based on a community standard the court determined that certain employees were not highly compensated.

94. *Id.*

95. Commissioner v. Pepsi-Cola Niagara Bottling Corp., 399 F.2d 390, 393 (2d Cir. 1968). *See also* Rev. Rul. 69-398, 1969-2 C.B. 58; Rev. Rul. 56-497, 1952-2 C.B. 284, 286, *obsoleted by*, Rev. Rul. 80-16, 1980-1 C.B. 82; Jack E. Golsen v. Commissioner, 54 T.C. 742 (1970), *aff'd*, 445 F.2d 985 (10th Cir. 1971), *cert. denied*, 404 U.S. 940 (1971); Harwood Assocs., Inc. v. Commissioner, 63 T.C. 255, 263 (1974).

96. Commissioner v. Pepsi-Cola Niagara Bottling Corp., 399 F.2d 390, 393 (2d Cir. 1968). *See also* Myron v. United States, 382 F. Supp. 590, 599 (C.D. Cal. 1974); Loevsky v. Commissioner, 55 T.C. 1144, 1150 (1971), *aff'd per curiam*, 471 F.2d 1178 (3d Cir. 1973), *cert. denied*, 412 U.S. 919 (1973). Treas. Reg. § 1.410(b)-1 (1980), concerning the minimum coverage requirements, sets forth rules with respect to the terms highly compensated and discrimination at subsection (d) as follows:

> (d) Special rules—(1) Highly compensated. The classification of an employee as highly compensated for purposes of section 410(b)(1)(B) and § 1.410(b)-1(b)(2) is made on the basis of the facts and circumstances of each case, taking into account the level of the employee's compensation and the level of compensation paid by the employer to other employees, whether or not covered by the plan. Average compensation levels determined on a local, regional, or national basis, are not relevant for this purpose. Further, the classification of an employee as highly compensated is not made solely on the basis of the number or percentage of employees whose compensation exceeds, or is exceeded by, the employee's.
>
> (2) Discrimination. The determination as to whether a plan discriminates in favor of employees who are officers, shareholders, or highly compensated is made on the basis of the facts and circumstances of each case, allowing a reasonable difference between the ratio of such employees benefited by the plan to all such employees of the employer and the ratio of the employees (other than officers, shareholders, or highly compensated) of the employer benefited by the plan to all employees (other than officers, shareholders, or highly compensated). A showing that a specified percentage of employees covered by a plan are not officers, shareholders, or highly compensated, is not in itself sufficient to establish that the plan does not discriminate in favor of employees who are officers, shareholders, or highly compensated.

97. Commissioner v. Pepsi-Cola Niagara Bottling Corp., 399 F.2d at 394.

ential between the lowest paid of the covered group and the highest paid of the uncovered group was approximately $1,000.[98]

While discrimination in favor of highly compensated employees is prohibited, there are specific rules which permit a plan to condition benefits and participation on salary without being considered discriminatory within the meaning of the antidiscrimination rules or the classification test of the minimum participation standards.[99] A plan may be limited to salaried employees and not automatically discriminate in favor of officers, shareholders, or highly compensated employees,[100] but a classification which is limited to salaried employees may be found discriminatory, depending upon which salaried employees are included in the plan. Accordingly, a salaried-only classification is not considered discriminatory *per se*.[101] Plans which compute benefits on a uniform relationship to the total compensation, or the basic or regular rate of compensation of its employees, are also not discriminatory *per se*.[102] Improper discrimination has been found however, when, without sound basis, a distinction is made between highly compensated and lower compensated employees to the detriment of the latter.[103] In considering this distinction, courts have based comparisons on various compensation ranges such as average compensation, median salary, highest salary, and lowest salary.

Generally, where the participating group is compensated at a significantly higher scale than the nonparticipating group, prohibited discrimination is consistently found. This is true especially where there is a great disparity in the size of the covered group as compared to the noncovered group.[104] On the other hand, if no discrimination in favor of the prohibited group actually results, the plan will not be deemed discriminatory, notwithstanding an ostensible failure to pass a fair cross-section test.[105] In all cases, however, the determination as to whether or not discrimination exists in favor of the prohibited group is a question of fact to be determined from the surrounding

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98. *Id.* at 393.

99. I.R.C. § 401(a)(5) (Supp. IV 1980); Treas. Reg. § 1.401-4(a)(2) (1963).

100. I.R.C. § 401(a)(5) (Supp. IV 1980); Treas. Reg. § 1.401-4(a)(2) (1963); *see also* Myron v. United States, 382 F. Supp. 590, 595 (C.D. Cal. 1974).

101. Loevsky v. Commissioner, 55 T.C. 1144, 1149 (1971), *aff'd per curiam*, 471 F.2d 1178 (3d Cir. 1973), *cert. denied*, 412 U.S. 919 (1973); Babst Servs., Inc. v. Commissioner, 67 T.C. 131, 137, 138 (1976).

102. I.R.C. § 401(a)(5) (Supp. IV 1980).

103. John Duguid & Sons, Inc. v. United States, 278 F. Supp. 101 (N.D.N.Y. 1967).

104. Wisconsin Nipple & Fabricating Corp. v. Commissioner, 67 T.C. 490, 494 (1976), *aff'd*, 581 F.2d 1235 (7th Cir. 1978).

105. Federal Land Bank Ass'n v. Commissioner, 74 T.C. 1106 (1980).

facts and circumstances.[106] A plan will satisfy the antidiscrimination rules if there is a determination that the plan, when viewed as a whole, benefits employees in general and does not discriminate in favor of the prohibited group.[107]

Although the majority of rulings in regard to compensation pertain to the coverage requirements, they provide persuasive authority for an effective analysis of the same issue with respect to vesting rules. A 1970 ruling germane to the compensation issue indicates how a case will be reviewed.[108] To understand the ruling, the following three questions must be answered:

A. How many persons are officers, shareholders, or supervisors?
B. Is the compensation of the participating (vested) group substantially similar to that of the excluded (nonvested) group?
C. Are those in the middle and lower brackets covered (vested) in more than nominal numbers?

The 1970 ruling provided by inference six tests for determining whether a plan benefits a fair cross-section of employees.[109] This ruling was later distinguished in two 1974 rulings [110] which implied a seventh test based on the total work force for making this same determination. Together, these tests provide a useful checklist for applying the reasonable cross-section test.[111]

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106. Fujinon Optical, Inc. v. Commissioner, 76 T.C. 499 (1981); Pulver Roofing Co. v. Commissioner, 70 T.C. 1001, 1007 (1978); Babst Servs., Inc. v. Commissioner, 67 T.C. 131, 138 (1976).

107. I.R.C. § 401 (1976 & Supp. IV 1980); Treas. Reg. § 1.401-1(b)(3) (1976); Treas. Reg. § 1.401-4(a)(2)(iii) (1963); *see also* Federal Land Bank Ass'n v. Commissioner, 74 T.C. 1106 (1980); Forsyth Emergency Servs., P.A. v. Commissioner, 68 T.C. 881, 890 (1977).

108. Rev. Rul. 70-200, 1970-1 C.B. 101. *See also* Rev. Rul. 66-12, 1966-1 C.B. 72; Rev. Rul. 68-244, 1968-1 C.B. 158; Fujinon Optical, Inc. v. Commissioner, 76 T.C. 499 (1981).

109. Rev. Rul. 70-200, *supra* note 21.

110. Rev. Rul. 74-255, 1974-1 C.B. 93; Rev. Rul. 74-256, 1974-1 C.B. 94. *See also* Babst Servs., Inc. v. Commissioner, 67 T.C. 131, 139 (1976).

111. A useful seven test checklist for applying the reasonable cross-section test follows:
(1) facts and circumstances test;
(2) exclusive benefit test;
(3) prohibited group test;
(4) substantial similarity of compensation test;
(5) compensation range test;
(6) more-than-nominal-number test;
(7) total work force test.
See Rev. Rul. 70-200, *supra* note 21; Rev. Rul. 74-255, *supra* note 110; Rev. Rul. 74-256, *supra* note 110.

These seven tests indicate several areas to be emphasized in developing a plan that meets the reasonable cross-section test. First, all the surrounding circumstances and attendant facts must be considered. Second, a plan, both on its face and in its actual operation, must be maintained for the exclusive benefit of employees in general. Third, a plan's vesting schedule must not operate to discriminate in favor of the prohibited group. Fourth, a plan's vesting schedule should be designed and implemented so as to cover employees in all compensation ranges. Fifth, a strong argument for nondiscriminatory compliance can be presented where the compensation of vested, as contrasted to nonvested employees, is substantially similar. Sixth, the compliance argument gains further support if the employees in the middle and lower brackets are vested in more than nominal numbers. And seventh, to avoid a determination of discrimination in favor of the prohibited group, a greater proportion of an employer's total work force should be vested.[112]

The fair cross-section test is a valid procedure for determining whether a plan discriminates in favor of the prohibited group.[113] Different approaches in applying this test for discrimination have been utilized by the courts. Courts often determine that plan participation (and by analogy vesting) is dominated by employees who are members of the prohibited group, by comparing the contributions as a percentage of salary for the prohibited and non-prohibited group.[114] Another approach applies the fair cross-section test by comparing the individual accounts of plan participants to the accounts of the prohibited group.[115] Finally, where only a small percentage of employees in lower compensation ranges are represented in a plan and where the entire middle compensation ranges are completely unrepresented in the plan, a court may find that the plan does not vertically dissect the entire compensation ladder of an organization. Therefore, the fair cross-section test would not be met.[116]

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112. *See supra* note 111.

113. Federal Land Bank Ass'n v. Commissioner, 74 T.C. 1106 (1980).

114. Liberty Mach. Works, Inc. v. Commissioner, 62 T.C. 621, 632 (1974), *aff'd*, 518 F.2d 554 (8th Cir. 1975); Loper Sheet Metal, Inc. v. Commissioner, 53 T.C. 385, 391 (1969); Volchening, Inc. v. Commissioner, 13 T.C 723, 729 (1949).

115. Liberty Mach. Works, Inc. v. Commissioner, 62 T.C. 621, 632 (1974), *aff'd*, 518 F.2d 554 (8th Cir. 1975). *See also* Suner v. United States, 440 F.2d 516 (7th Cir. 1971); Quality Brands, Inc. v. Commissioner, 67 T.C. 167, 172 (1976); Bernard McMenamy Contractor, Inc. v. Commissioner, 54 T.C. 1057, 1064 (1970), *aff'd*, 442 F.2d 359 (8th Cir. 1971).

116. Liberty Mach. Works, Inc. v. Commissioner, 62 T.C. 621, 632 (1974), *aff'd*, 518 F.2d 554 (8th Cir. 1975).

Hence, if a plan vests for a vertical dissection of employees in general rather than for the prohibited group, discrimination may be avoided.[117]

Although the failure of a plan to vest a fair cross-section of employees may indicate that the plan discriminates in favor of the prohibited group, it is not dispositive. The fair cross-section test is but one factor to consider in determining whether a plan satisfies ERISA standards without violating the antidiscrimination rules. Thus, the mere failure of a plan to vest a reasonable cross-section of employees is inconsequential if no discriminatory manipulation in favor of the prohibited group can be demonstrated.[118]

VI. PROPOSED VESTING REGULATION: CATCH 22 VESTING WITHOUT A SAFE HARBOR

The statutory vesting schedules set forth in the minimum vesting standards [119] have not solved the difficult interrelationship between vesting and the antidiscrimination rules. The proposed regulation attempts to unify the testing of a plan in both its design and operation by application of a facts and circumstances test. In addition, the proposed regulation incorporates a reasonable cross-section test by way of five specific examples.

A grandfather provision under the proposed regulation grants continued qualification to plans which received favorable determination letters under one or more of the following tests, provided that the facts and circumstances have not materially changed:

1. The key employee test and/or the turnover test of the 1975 Revenue Procedure;[120]

2. The prior letter test of the 1976 Revenue Procedure;[121] or

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117. Container Serv. Co. v. United States, 478 F.2d 770, 771 (6th Cir. 1973); Orthopaedic Assocs. v. United States, 487 F. Supp. 868, 872 (E.D. Tenn. 1980); Fujinon Optical, Inc. v. Commissioner, 76 T.C. 499 (1981); Federal Land Bank Ass'n v. Commissioner, 74 T.C. 1106 (1980); Pulver Roofing Co. v. Commissioner, 70 T.C. 1001, 1013 (1978); Forsyth Emergency Servs., P.A. v. Commissioner, 68 T.C. 881, 891 (1977); Wisconsin Nipple & Fabricating Corp. v. Commissioner, 67 T.C. 490, 494 (1976), *aff'd*, 581 F.2d 1235 (7th Cir. 1978); Babst Servs., Inc. v. Commissioner, 67 T.C. 131, 139-40 (1976); Liberty Mach. Works, Inc. v. Commissioner, 62 T.C. 621, 632 (1974), *aff'd*, 518 F.2d 554 (8th Cir. 1975); Bernard McMenamy Contractor, Inc. v. Commissioner, 54 T.C. 1057, 1063 (1970), *aff'd*, 442 F.2d 359 (8th Cir. 1971); Loper Sheet Metal, Inc. v. Commissioner, 53 T.C. 385, 391 (1969).

118. Federal Land Bank Ass'n v. Commissioner, 74 T.C. 1106 (1980).

119. I.R.C. § 411(a)(2) (1976).

120. *See supra* text accompanying notes 39-43.

121. *See supra* text accompanying notes 44-57.

3. The facts and circumstances test of the 1976 Revenue Procedure.[122]

It is significant that the 4-40 vesting test has not been included in the above exceptions. It is even more significant that no comparable safe harbor replaces the 4-40 vesting test in the proposed regulation.[123]

The statutory language interrelating the special vesting coordination rules with the antidiscrimination rules has been interpreted with great difficulty.[124] Interpretation lies in a subjective area in which the opinions of reasonable men may reasonably differ.[125] Consequently, strong disagreement in borderline situations is inevitable.

If the regulation is adopted as proposed, the expressed Congressional desire to achieve a degree of certainty for plan sponsors through the uniform application of the antidiscrimination rules in coordination with the minimum vesting standards would be completely thwarted. By failing to provide for a 4-40 vesting safe harbor, the proposed regulation deviates from both the policy of ERISA and the congressional direction expressed in the Conference Committee Report.

The clearly stated policy of ERISA is "to vest the accrued benefits of employees with significant periods of service." [126] The facts and circumstances test of the proposed regulation will not fulfill this general policy of vesting significant periods of service. Businessmen need certainty with which to conduct their tax planning. The effect of the proposed regulation may be to prevent the employer from establishing a pension or profit-sharing plan for its employees. This is especially true with respect to the small employer with only a limited number of participating employees. A fortuitous matching of facts and circumstances will not effectuate the policy of ERISA. Rather, it will thwart the Congressional purpose underlying the qualification of deferred compensation plans which is to provide for the general welfare of employees.

The clear intent of Congress regarding the coordination of the minimum vesting standards with the antidiscrimination rules is difficult to discern. Although the Conference Committee Report recog-

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122. *See supra* text accompanying notes 44-57.

123. Proposed Treas. Reg. § 1.411(d)-1, 45 Fed. Reg. 24,201 (April 9, 1980), amended 45 Fed. Reg. 39,869 (June 12, 1980).

124. I.R.C. §§ 411(d)(1) (1976), 401(a)(4) (Supp. IV 1980), respectively. *See also* Tamko Asphalt Prods., Inc. v. Commissioner, 71 T.C. 824 (1979), *aff'd*, 658 F.2d 735 (10th Cir. 1981).

125. *See, e.g.*, 3 PENSION PLAN GUIDE (CCH) ¶ 26,000 (Three Speeches, Isidore Goodman, Chief of the Pension Trust Branch, IRS).

126. ERISA § 2(c), *supra* note 1.

nizes a need for a safe harbor,[127] this intent was not enacted as part of ERISA. To the contrary, the vesting provisions of ERISA closely follow the conferees' adoption of the House bill.[128] The House bill requires the IRS to impose more rapid vesting if it appears that there has been or there is reason to believe there will be a pattern of discrimination in favor of the prohibited group.[129] In addition, the Conference Report addresses the special vesting coordination rules added by ERISA.[130] Thus, at first glance, by not including the 4-40 vesting test, the proposed regulation seems to follow the intent of Congress as stated in the Conference Report and as provided for under ERISA.

However, a closer reading of the Conference Report reveals that 4-40 vesting is the strictest standard to be required where there has been or there is reason to believe there will be an accrual of benefits or forfeitures in favor of the prohibited group.[131] Congress directed that the IRS should not go farther than to require 4-40 vesting "except in cases where actual *misuse* of the plan occurs in operation." [132] If there is a pattern of *abuse* or an accrual of benefits or forfeitures tending to discriminate in favor of the prohibited group, any vesting schedule will be found discriminatory.[133] It seems that the conferees effectively used the words abuse and misuse interchangeably. However, the proposed regulation ascribes a different meaning to these words. It requires more stringent vesting standards for plans that fall short of the pattern of abuse situations provided for under the special vesting coordination rules.[134] The resulting uncertainty created by the proposed regulation is perpetuated through discretionary administrative application.[135] By requiring a facts and circumstances test, the proposed regulation ignores the 4-40 vesting safe harbor directive of the Conference Report. Furthermore, the proposed regulation is contrary to the prior reliance on the Conference Report, which was used as authority in both the revenue procedures and the case law to

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127. CONF. REP. No. 1280, *supra* note 28, at 276, *reprinted in*, 1974-3 C.B. at 437.

128. H.R. REP. No. 807, *supra* note 16, at 64-65, *reprinted in*, 1974-3 C.B. (Supp.), at 299-300.

129. *Id.*

130. CONF. REP. No. 1280, *supra* note 28, at 276, *reprinted in*, 1974-3 C.B. at 437.

131. *Id.*

132. *Id* (emphasis added).

133. *Id.*

134. I.R.C. § 411(d)(1)(A) (1976).

135. *See* Givner, *Using the Nondiscriminatory Classification Test in Designing Qualified Plans*, 58 *TAXES* 784 (1980). *See also* Babst Servs., Inc. v. Commissioner, 67 T.C. 131, 142 n.4 (1976) (Drennen, J., dissenting).

support the 4-40 vesting test.[136] Congressional reaction in the 1981 and 1982 budget bills supports this view.[137]

The proposed regulation presses a dilemma upon both large and small businessmen. Again, a literal reading of the proposed regulation (with examples) necessitates adherence to a facts and circumstances test. In ascertaining the meaning of the facts and circumstances test, one is directed to use a reasonable cross-section test. However, when a general definition of the reasonable cross-section test is sought, one is redirected to apply a facts and circumstances test.

Vesting plans should most properly benefit those employees with significant service. However, in instances of flagrant discrimination, constituting abuse or misuse, application of a facts and circumstances test is appropriate. It is for Congress, not the IRS, to determine public policy and to change the law. The Conference Committee Report clearly indicates that Congress intended that the 4-40 vesting test serve as a safe harbor, if there is no finding of abuse or misuse. Without such a safe harbor, a degree of certainty cannot be achieved which will serve to encourage employers to provide plans for their employees. It cannot be overemphasized that in evaluating a plan as to violation of the antidiscrimination rules, it is appropriate to look at the plan as a whole rather than to focus on the single element of vesting. Given this pragmatic consideration, Congress has indicated that 4-40 vesting should be used as a safe harbor, limiting the extent of IRS invasion of plans unless there is a pattern of misuse or abuse of the antidiscrimination rules.

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136. *See* Rev. Proc. 75-49, 1975-2 C.B. 584, and 76-11, 1976-1 C.B. 550; *see also supra* text accompanying notes 36-53. *See especially* Tamko Asphalt Prods., Inc. v. Commissioner, 71 T.C. 824, 831-32 (1979), *aff'd*, 658 F.2d 735 (10th Cir. 1981), which, in part, states:

> [The IRS] was clearly within [its] authority, as mandated by Congress, in prescribing certain administrative procedures for the purpose of testing an employee benefit plan against the nondiscrimination standard of section 411(d)(1)(B). It was from these congressional reports that [the IRS] developed the more rapid vesting standard . . . commonly known as 4-40 vesting . . . discussed by Congress under Conf. Rept. 93-1280, ... Pursuant to these Congressional directives [the IRS] formulated Rev. Proc. 75-49, . . . and Rev. Proc. 76-11, . . . in order to implement section 401(a)(4) and section 411(d)(1)(B).

See also Rev. Proc. 76-11, 1976-1 C.B. 550, that went so far as to stipulate that "Rev. Proc. 75-49, [which contained the 4-40 vesting test,] was issued by the Service to implement sections 401(a)(4) and 411(d)(1)(B) of the Code on the basis of guidelines set forth in the Conference Committee Report accompanying the Employee Retirement Security Act of 1974."

137. *See supra* note 12.

In conclusion, the proposed vesting regulation usurps Congressional authority under the pretext of IRS rulemaking. As a consequence, it destroys the foundation laid by Congress for long-range financial and tax planning in the pension area.

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