Back to Basics – Service Crediting Rules
By
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It seems so basic - crediting service for various qualified plan purposes. In fact, service crediting is one of the most fundamental concepts of plan administration. The principals apply to plan eligibility, vesting and sometimes the right to accrue a benefit. Yet some persons who administer qualified plans often misapply these “basic” concepts. They either never learned the rules or have misinterpreted them.

“So what?” you may say. “What’s the worst that could happen? So we miscount hours and fail to put someone in the plan on a timely basis. So what if we treat rehired employees as new employees.” Well, the worst that can happen can be pretty devastating to a plan sponsor. Plan disqualification is a potential, but a severe IRS penalty is more likely. Unfortunately, the IRS is well aware of the lack of care taken in the “service crediting” area. They find these errors in their audits and when investigating the telephone calls they get from unhappy plan participants.

So here it is - a primer on the basics of “service crediting” for plan eligibility purposes. This article also will touch on the break in service rules, “dual eligibility” and special concerns arising from “rehires.” Of course, similar service crediting rules apply for vesting and benefit accrual purposes. In an article of this length, I will only touch on the basic service crediting rules affecting eligibility and point out specific problem areas. If some of this peaks your interest, I suggest following up with a more comprehensive resource, such as the ERISA Outline Book.

Minimum Service Conditions for Plan Eligibility

A qualified plan must specify how and when an employee becomes eligible to participate under the plan. For example, a plan may require employees to satisfy certain minimum age and/or service requirements to participate under the plan.

With respect to the minimum service requirements, ERISA mandates the application of special service crediting rules. Generally, a plan may not require more than one year of service as a condition of participating in the plan. A plan can establish more liberal, or no, service conditions. Under a special rule, if a plan provides for immediate vesting, it may impose a two years of service condition for participating in the plan. However, a 401(k) plan may not use the two-year eligibility requirement with respect to elective deferrals under the plan. Thus, a 401(k) profit sharing plan can require two years of service for eligibility for the matching contributions and employer nonelective contribution but only one-year of service for eligibility to make elective deferrals under the plan.

Measuring a Year of Service

A plan generally measures a year of service by counting an employee's hours of service during an **eligibility computation period**. Often, a plan will require that the employee's actual hours of service be counted. Alternatively, a plan can use the equivalency method or the elapsed time method for crediting service. The plan document must state the method of counting hours of service.

READ THE PLAN DOCUMENT!
I cannot overemphasize the importance of reading the plan document. Although often difficult to read, the plan document contains all the applicable service crediting rules. Plans can take numerous approaches to crediting service to comply with the regulatory requirements. Failure to follow the terms of the plan can result in disqualification or the imposition of penalties. Too often administrators depend on summaries or plan specifications rather than the plan document itself. I cannot emphasis it enough - READ THE PLAN DOCUMENT!

Actual hours counting method. Under the actual hours counting method, an employee generally will earn a year of service if he/she completes at least 1,000 hours of service during an eligibility computation period. The plan may require less than 1,000 hours for a year of service.

A plan generally must credit an employee with <u>all</u> service with the employer, even service before the plan is established. In certain situations, a plan may disregard service under the break in service rules.

Eligibility computation period. The eligibility computation period is a period of 12 consecutive months. An employee need not be employed continuously during the 12-month eligibility computation period or to be employed on the last day of the computation period to receive credit for the year of service.

- **Initial period.** The first eligibility computation period always begins on the employee's employment commencement date ("ECD"). For example, if an employee's ECD is January 17, 2005, the first eligibility computation period runs from January 17, 2005, through January 16, 2006. An employee's ECD is the first day he/she receives credit for one hour of service with the employer.

- **Subsequent periods.** After the initial period, the plan may define the eligibility computation period either as the plan year ("shift-to-the-plan-year method") or as the 12-month anniversary period of the initial eligibility computation period ("anniversary year method"). No other method is acceptable.

- **Shift-to-the-plan-year method.** If the plan uses the shift-to-the-plan-year method, the second eligibility computation period begins with the first plan year that *begins* after the ECD.

- **Anniversary year method**. If the plan uses the anniversary year method, the second eligibility computation period will begin on the anniversary of the employee's ECD.

Plan Design Tip

The shift-to-the-plan-year method generally is considered simpler to administer because, after the initial eligibility computation period, all employees are tracked on a plan year basis. Under the anniversary year method, each employee has his/her own unique subsequent eligibility computation period.

Equivalency methods. The regulations provide short-cuts known as equivalency methods that a plan may use to determine an employee's hours of service, rather than counting an employee’s actual hours of service. The plan document must set forth the equivalency method.

The most common equivalency method is based on periods of employment. Under this method, hours are credited based on a unit of time. If the employee is credited with at least one hour of service during that unit of time, a fixed number of hours are credited for that unit. The units of time that may be used are days, weeks, semi-monthly payroll periods and months. The hours credited for these units are 10 hours for a day, 45 hours for a week, 95 hours for a semi-monthly payroll period, and 190 hours for a month. The employee's actual hours worked for that unit of time are irrelevant. Other equivalency methods are based on working time or earnings.

Elapsed time method. As an alternative to counting an employee’s actual hours of service or using an equivalency method, a plan may credit service based on the employee's periods of employment under the "elapsed time" method. The elapsed time method looks to the amount of time that has elapsed between the employee's commencement date and his severance date. The elapsed time method is a regulatory attempt to ease administration.

When a plan uses the elapsed time method, the employee's actual hours are not determined and will not affect the outcome. For example, if an employee is credited with less than a 12-month period of service under the elapsed time method, he/she does not satisfy a year of service requirement even if he/she would have been credited with at least 1,000 hours of service if the plan had used an hours-of-service crediting method.

When do you credit a year of service?

Generally, an employee who satisfies the conditions for receiving a year of service is credited with such year <u>at the end</u> of the applicable 12-month eligibility computation period. For example, if the initial computation period begins September 17, 2004, and ends September 16, 2005, the employee receives credit for one year of service as of September 16, 2005, if he/she is credited with the required number of hours of service during that 12-month period. The year of service is credited on September 16, 2004, regardless of when the employee actually completes the 1,000th hour of service.

Plan Entry Date

Once an employee satisfies the minimum age and service requirements, an employee must become a participant within certain statutory timeframes. Of course, a plan may exclude an employee from the plan for reasons other than age and service.

Unless excluded from the plan for reasons other than age or service, an employee who satisfies the plan’s minimum age and service conditions must enter the plan on the appropriate entry date, as defined under the plan. The plan’s entry date must guarantee that once an employee satisfies the plan’s minimum age and service conditions, the employee will enter the plan by the earlier of:

- the first day of the next plan year; or
- six months following the date the employee satisfies the age and service requirements.

Probably the most common design is for a plan to use semi-annual entry dates so an employee's participation will never be postponed beyond the statutory entry date rule. Semi-annual entry dates usually are defined as the first day of the plan year and the first day of the seventh month of the plan year. For example, semi-annual entry dates under a calendar year plan would be January 1 and July 1. Under a September 30 plan year end, the semi-annual entry dates would be October 1 and April 1. Generally, under the semi-annual entry date approach, an eligible employee becomes a participant on the semi-annual entry date immediately following (or coincident with or immediately following) his completion of the age and service requirements.

A plan may be designed with any alternative entry date system that satisfies the statutory requirements. Some plans use more frequent entry dates than semi-annual, such as quarterly entry dates, monthly entry dates or even daily entry dates. All of these alternatives would be permissible because an employee will become a participant no later than the date required under the statutory entry date rules. A plan can always have more liberal entry rules in favor of the employee.

Service Requirement of Less Than One Year

Be careful with plans that require less than one year of service to become a participant. Little regulatory guidance is available in this situation. When a plan imposes a less-than-one-year of service condition with an hours of service requirement, the plan must be carefully drafted so that the plan does not violate the minimum statutory standards of one year of service. Some plans will use a “fail-safe” type provision under which an employee who otherwise might “fall through the cracks” under the less-than-one-year service provision as drafted will still timely participate if he/she satisfies the statutory one year of service requirement.

Break in Service Rules

In some cases, a plan may disregard service for eligibility purposes if an employee incurs a “break in service.” There are three separate of break in service rules - the “one-year break in service” rule; the “rule of parity;” and the “two-year eligibility break in service” rule. A plan is not required to contain break in service rules for eligibility purposes. READ THE PLAN DOCUMENT!

A break in service generally is an eligibility computation period during which the employee is credited with 500 or fewer hours of service. A termination of employment is not necessary to incur a break in service. For example, an employee's work schedule may change so that during an eligibility computation period the employee is credited with 500 or fewer hours of service. The employee would have a break in service for that period.

Leave of absence exceptions

The law requires service credit for maternity and paternity leave and for Family and Medical Leave Act (FMLA) leave. If an employee is on an unpaid leave of absence due to maternity or paternity reasons, the plan must credit the employee with hours of service during that absence (up to a maximum of 501 hours). The credit for hours of service under this rule is solely for determining whether the employee has incurred a break in service. These hours are not counted toward a year of service. Similarly, the FMLA allows employees of an employer to take job-protected unpaid leave for up to 12 weeks, in any 12 months, because the employee needs to care for a family member with a serious health condition, or because the employee's own condition makes the employee unable to perform the functions of his or her job. Any period of unpaid FMLA leave is not treated as a break in service for purposes of eligibility to participate in a plan.

"One-year break in service" rule. Under the one-year break in service rule, if an employee incurs at least <u>one</u> break in service, the plan may <u>temporarily</u> disregard the employee's prior service for eligibility purposes. The employee will receive credit for that prior service only if he/she completes another year of service. This rule sometimes is referred to as the “one-year holdout rule.”

If a plan uses the one-year holdout rule, the employee must complete a year of service following his return to employment in order to enter the plan. The rules for measuring a year of service following a one-year break in service are the same as those used to determine a year of service under the normal eligibility rules. The first computation period is the 12 month period following re-employment. If the employee fails to complete a year of service in that initial 12-month period, the plan measures future periods on the anniversary year method or the shift-to-the-plan-year method, as provided in the plan document under its normal eligibility computation periods.

If the employee completes another year of service following the re-employment date, the plan must re-credit the prior service as of the first day of the computation period in which the employee completes the additional year of service. Thus, the employee will retroactively enter the plan.

Retroactive entry can be an administrative burden

The one-year break in service rule always results in retroactive entry if the employee completes the additional year of service. The retroactive entry rule can be administratively burdensome. An employee rehired late in the plan year (e.g., December 1 in a calendar year), may have to be re-entered into the plan on a retroactive basis and share in allocations for that year (e.g., top-heavy minimum).

The use of the one-year break in service rule in a 401(k) plan also can be problematic. How do you let someone make deferrals retroactively? Presumably, a plan can apply the one-year break in service rule only to the non-401(k) portions of the plan. The plan document should provide administrative guidance on this issue.

Rule of parity. Under the so-called "rule of parity," the employee loses the prior service for eligibility purposes on a permanent basis following the break in service period. As a result, the employee must start over in satisfying the service requirement, as if he/she were a new employee. For the rule of parity to apply: 1) the employee must be a plan participant when the break in service period begins; 2) the employee generally must incur a minimum of five consecutive breaks in service; and 3) the employee must be zero percent vested in his/her accrued benefit under the plan. Once a participant becomes partially-vested (e.g., 20% vested under the plan's vesting schedule), the only break in service rule that that may apply is the "one year break" rule discussed earlier.

Two-year eligibility break in service rule. If a plan uses the two-year eligibility rule, it may require that the employee complete both years before incurring a break in service. If the employee has a break in service before completing the second year of service, the employee loses credit for the prior service and must start again as if he/she were a new employee.

Rehired Employees

A plan must include specific provisions that address the participation of employees who are re-employed by the employer. If an employee is re-employed, the administrator must first determine if the plan imposes any break in service rules. If there is no break in service rule that applies, and the employee had already satisfied the eligibility requirements, the employee must re-enter the plan on **the date of re-employment**.

Reentry of rehired employees

The failure to allow immediate reentry is a common administrative error that can jeopardize the qualification of the plan. Many plan administrators will delay plan reentry of a rehired employee until the next plan entry date. This is impermissible unless a break in service rule applies or the employee has not satisfied the eligibility requirements. If the employee had not satisfied the eligibility requirements before his termination, the employee would first have to complete those requirements before he/she becomes a participant in the plan. Unfortunately, most employers do not heed the advice of NEVER REHIRE ANYBODY!

Dual eligibility

A plan may include different eligibility requirements for different groups of employees, or have different eligibility requirements for different features of the plan.

When a new business sets up a plan or when an established business sets up a plan for the first time, it may wish to have very liberal entry rules for the current employees and more restrictive rules for future employees. For example, a corporation formed in 2004 might adopt a plan, effective in 2004, under which all employees hired by a certain date (e.g., December 31, 2004) are eligible immediately, but future hires are subject to a one-year of service requirement.

Under an existing plan, the employer might wish to amend the plan to impose more restrictive eligibility rules for future employees, but "grandfather in" the current employees under the present rules.

Some plans impose different eligibility rules for different plan features. For example, a 401(k) plan that also includes a profit sharing contribution formula, might allow employees to participate in the 401(k) portion of the plan after three months, but impose a one year of service requirement for the profit sharing portion of the plan.

Coverage rules may present a problem

“Dual eligibility" plan provisions, although not a violation of the minimum eligibility standards, may create a coverage problem. As a general rule, "dual eligibility" will rarely create a coverage problem where the most restrictive requirements do not exceed one year of service. However, if the plan has allowed some employees with less than one year of service into the plan, but other employees must satisfy a one-year of service requirement, coverage may be a problem if certain participants continue to fail to satisfy the one-year of service requirement.

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The service crediting rules generally apply to all qualified plans. The plan administrator must be aware of the specific provisions of the plan affecting how employees are credited with service and when an eligible employee will participate after satisfying the plan’s service conditions. Errors are common. Plan administrators that discover mistakes need to take corrective action. The IRS’ EPCRS program provides a good alternative to plan disqualification or an audit CAP sanction.

About the Author

John P. Griffin, J.D. and LL.M. (Taxation), has over 25 years experience in the employee benefits field. Currently, John is a principal with the ASC Institute (ASCi). Prior to joining ASCi, John was a principal with the pension consulting firm Global Benefit Advisors, LLC (GBA), a Vice President with Pension Publications of Denver, Inc. (PPD) and a senior consultant with the benefit consulting practice of Coopers & Lybrand. Prior to entering private consulting, John worked in the Employee Plans Division in the National Office of the Internal Revenue Service (IRS) as a Tax Law Specialist. John also has seven years of experience with the U.S. Department of Labor.