Accruing Benefits for Retired Employees:

The Incredible Shrinking Ruling

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This article reviews the Internal Revenue Service's position regarding the accrual of benefits by former employees in a defined benefit plan. A pre-ERISA ruling by the Service provided that former employees may not accrue benefits under a defined benefit plan. The Service has issued piecemeal guidance crafting numerous exceptions to its original pre-ERISA position, to the point where the exceptions have swallowed the general rule. There have also been important case law developments in recent years dealing with the limited protections accorded some of these benefit accruals under ERISA. This article examines the authorities dealing with post-employment accruals and suggests that the Service abandon any remaining restrictions on post-employment benefit accruals.

The ERISA web remains astonishingly tangled on what to our minds seem to be the most basic points of law. One of these tangled areas involves the question of whether a qualified defined benefit plan may continue to accrue benefits for former employees. A 1973 Internal Revenue Service ruling held that post-employment benefit accruals are not permitted, and since then has cast a long but uncertain shadow over the law. The Service has since published so many exceptions to its original ruling that there appears to be almost nothing left to the old position. But its skeletal remains continue to cast doubts on the permissibility of the most basic post-employment benefits, such as cost of living adjustments (COLAs) and certain kinds of window benefits. Recent case law has added to the confusion by shifting the grounds of the debate and suggesting that these benefits are permitted—but are not protected from elimination or cutback.

In this article we trace the law dealing with the limitations (or lack thereof) on accrual of post-employment benefits, beginning with pre-ERISA law and ending with some startling recent cases dealing with the application of the Code Section 411(d)(6) "anti-cutback" rule to benefits accrued by former employees.

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BACKGROUND

The limitation on post-employment benefit accruals has its roots in pre-ERISA law. Revenue Ruling 73-328, 1973-1 C.B. 201 involved a contributory defined benefit plan that provided former employees with additional years of credited service for years in which they continued making contributions to the plan. According to the 1973 ruling, these post-employment accruals disqualified the plan. While noting that the regulations provide that the term "employee" in the Code Section 401(a) regulations includes "former employees," the ruling concluded that the coverage of former employees is "allowed only for the purpose of providing pension benefits for the period during which the individuals were the employees of the employer and does not contemplate additional credit for periods after the employee's service." In effect, the ruling concluded that a plan would violate the "exclusive benefit" rule of Code Section 401(a)(2) if the plan allows a benefit to accrue for a former employee.

How far the limitation on post-employment accruals reached was unclear under Revenue Ruling 73-238. Plan practice tended to ignore a broad application of the proscription. Employers typically provided for ad hoc cost-of-living type increases to the benefits of former employees. Employers also typically provided benefits to retirees in the form of past service grants. Plans often counted as pensionable earnings various sorts of compensation payments that were not paid until after an employee terminated employment, such as bonuses for the last year of work. Similarly, plans often counted severance pay as pensionable earnings even if the severance pay was paid out over a period of time extending beyond termination of employment. The Service never specifically blessed these kinds of post-employment accruals in any formal way, but plans routinely were approved in determination letter applications with these kinds of provisions.

Revenue Ruling 73-238 was not the Service's first ruling to deal with the active participation in a pension plan by a former employee, and its conclusion was not at all predictable based on previous authorities. Indeed, in a 1966 published ruling, the Service seemed to espouse a much broader view of the law.

Revenue Ruling 66-175, 1966-2 C.B. 82 approved a provision in an industrywide multiemployer plan that allowed a former employee to make after-tax contributions to a plan in order to prevent a forfeiture of a previously accrued benefit. Limited to its facts, the ruling stands only for the proposition that post-employment credits are permitted for vesting purposes. The rationale expressed in the ruling was far broader, however, and seems at odds with the view expressed in the 1973 ruling. The ruling noted that the post-employment employee con-

tribution feature was acceptable because it was "analogous to a provision permitting participation on the part of former employees or employees on leave." The ruling went on to conclude that "such provisions are permitted in qualified plans by Code Section 1.401-1(b)(4) of the regulations provided they do not result in prohibited discriminations, are uniformly applied, and do not result in duplication of benefits." The reference to the notion of benefit "duplication" suggested that additional benefit accruals could be provided to former employees without violating the exclusive benefit rule. Curiously, Revenue Ruling 66-175 was not cited, either favorably or unfavorably, when Revenue Ruling 73-238 was published.

The status of Revenue Ruling 66-175 after the publication of Revenue Ruling 73-238 was uncertain. Together, the two rulings could be read to stand for the proposition that post-employment credit is permitted for vesting purposes, but not benefit accrual purposes. A 1974 technical advice memorandum (TAM), however, declined to adopt this reconciliatory approach, but rather read the 1973 ruling as overruling the 1966 ruling. TAM 7403066900A (March 6, 1974) involved a plan covering state teachers. The plan included a provision counting reemployment by a nonprofit, nonsectarian private school within one year of termination with the state system as service that would entitle the individual to a future pension. This provision was in the nature of a vesting break-in-service provision and did not appear to increase the participant's "accrued benefit" under the plan. Nonetheless, citing Revenue Ruling 73-238 and without discussion of Revenue Ruling 66-175, the TAM concluded that the vesting service-bridging provision violated Code Section 401.

Another pre-ERISA ruling further complicated the mix. Revenue Ruling 62-139, 1962-2 C.B. 123 held that the "exclusive benefit" rule was not violated if a plan provided for a past service grant, even if it was with an unrelated employer. Read together with the 1973 ruling, the 1962 ruling apparently meant that for benefit accrual purposes, a plan could count pre-employment service with an unrelated employer, but not post-employment service.

SERVICE GUIDANCE AFTER ERISA

Enactment of ERISA did little to clear up the picture. With one limited exception, ERISA did not directly address the question of post-employment accruals in a defined benefit plan. ERISA did prohibit such accruals for defined contribution plans. This limitation, however, was achieved by virtue of the Code Section 415 limit and by limiting the "compensation" upon which contributions can be based to compensation paid as a current employee.[1] The rule for post-employment accruals under a defined benefit plan remained unclear, and has become

even more blurred by narrow Service guidance permitting certain post-employment benefit increases based on severance pay, COLAs, limitation changes, and service with a successor employer.

Severance Pay

ERISA touched on one limited aspect of the post-employment accrual question in the context of the ERISA service-counting rules. As originally formulated by the Labor Department, the ERISA service-counting rules, which are used in both the vesting and accrual rules, require some counting of post-employment time. The hours of service regulations required at least 501 "hours of service" to be counted if an individual was paid by a plan sponsor for the non-performance of duties and this rule applied "irrespective of whether the employment relationship has terminated."[2] This rule covered payments due to such things as layoff, military duty, or leave of absence. But there has been longstanding uncertainty whether this rule also required plans to count "hours of service" resulting from severance pay.

The Service's later guidance did little to clarify the uncertainty regarding the treatment of severance pay. Private Letter Ruling 8031091 (May 9, 1980), for example, provides that "hours of service" must be created with respect to severance pay benefits. Although the ruling did not so state, the question has always arisen whether its conclusion was based on the preamble to the Labor Department's final 1976 "hours of service" regulations. The preamble specifically listed "severance pay" as among the type of payments giving rise to "hours of service" under the "non-performance of duties" prong of the definition.[3] But our informal understanding gleaned from discussions with staffers who worked on the regulation back then is that the preamble's reference to "separation pay" was a typographical error. Severance pay had been specifically included in the text of earlier drafts of the "hours of service" regulation, but was deleted from the final, published version of the regulation. The preamble's reference to "severance pay" should have been eliminated to coordinate with the wording of the final regulation, but was mistakenly left in the published preamble.

To date, and despite this ambiguity, surprisingly, little law has been developed on the treatment of severance pay under the "hours of service" definition. The Service itself reversed course and in 1995 indicated that separation pay does not give rise to "hours of service" under the service-counting rules, despite the contrary conclusion reached in Private Letter Ruling 8031091. This informal answer appeared in the "Super Gray Book" prepared in connection with the 1995 Enrolled Actuaries Conference.[4]

COLAs

The Service revisited the question of post-employment benefit accruals in developing the nondiscrimination regulations under Code Section 401(a)(4) and 410(b). Most generally, the regulations provide for separate nondiscrimination testing of former employees.[5] The regulations thus implicitly allow some post-employment accruals, but their intended scope is unclear. Their examples of permitted post-employment accruals are limited to plan amendments providing ad hoc COLA type benefit increases to retired participants.[6] In none of the described cases were the post-employment accruals promised to the employee before the employee retired. The Service's apparent blessing of COLAs added gratuitously only after retirement seems hard to reconcile with its position that post-retirement accruals violate the exclusive benefit rule. The Service apparently intends to permit post-retirement benefit accruals in the form of COLAs—but absent any theoretical justification, how much more is unclear.

Service with a Successor Employer

Regulations under Sections 401(a)(4) and 410(b) also permitted limited post-employment accruals with a successor employer. Under these rules, a plan may continue to count a former employee's service and compensation with a successor employer for benefit accrual purposes as long as (1) the plan sponsor has a legitimate reason to count the service or compensation under its plan (such as might happen when a plan sponsor sends employees to work for the joint venture) and (2) the employee is expected to return to work for the plan sponsor.[7]

In cases where the employee has permanently ceased working for the plan sponsor and has no reasonable prospect to return to work with the plan sponsor, additional accrual service can be credited in two cases. The first is where the successor employer provides some ongoing business benefit to the original employer.[8] The second is where the plan sponsor continues to treat the individual as an "employee" for significant purposes unrelated to the plan. In this case, a rebuttable presumption arises for the first two years that the individual will return to work with the plan sponsor.[9] Unfortunately, the regulation does not provide any examples of what it means to be "treated" as an employee for non-plan purposes, and it provides no examples of situations that will rebut the presumption that the individual will return to employment.

The nondiscrimination regulations set forth an even more liberal set of rules if a plan counts work with another employer for purposes of vesting and early retirement entitlement service. Here, the plan sponsor still must have a legitimate business reason to count the "imputed"

service for vesting and entitlement service. But there are no restrictions in counting this service, even if the employees are not expected to return to work with the plan sponsor.[10] The more liberal treatment of vesting and entitlement service under the nondiscrimination rules is consistent with a line of cases requiring plans to count early retirement "grow-in" service with a successor employer after a business disposition.[11] But regulations would appear to go beyond the case law. Decided cases require grow-in service only where such post-disposition grow-in is arguably an embedded part of the benefit accrued during the course of the employee's employment with the predecessor employer. But regulations appear to permit grow-in service entitlements added after such employment.

Likewise, Service regulations provide a more liberal set of rules if a plan merely counts in the plan formula the compensation paid to the individual by a successor employer after a business divestiture. Assume, for example, that an employer sells a division, but negotiates with the buyer to continue to recognize compensation paid by the buyer. This technique is sometimes referred to as "inflation-proofing" the previously accrued benefit, because it intends to keep the final pay aspect of the plan intact. Regulations under Code Section 414(s) (which defines "compensation" for certain qualified plan purposes) provide that the compensation paid to the participant by the successor employer can be counted under the selling employer's plan even if there is no ongoing business benefit flowing from the buyer to the seller after the sale of the division, and even if the participant has no prospect of returning to work with the seller.[12]

While all provide post-employment accruals in various cases, these regulations would seem to differ greatly in their underlying theory. In the first examples we discussed, post-employment accruals are allowed only for former employees whose service continues to provide a business benefit of some kind to the employer. There is an element of ongoing business nexus in these examples. In the next kind of example—imputed grow-in service with a successor employer for early retirement benefits and imputed post-employment compensation for purposes of inflation proofing the benefit—there is no nexus to the employer's current business. Nor do the regulations require that these second kind of post-employment accruals be embedded in the accrued benefit as earned by the employee before he or she terminates service. Rather, these examples appear to permit purely post-employment addition of accruals to a former employee's benefit. As with COLAs, the Service's liberal position in these cases is hard to reconcile with its earlier position that post-employment accruals are prohibited by the exclusive benefit rule.

Retroactive Limit Changes

The Service also has dealt with the subject of post-employment accruals in a couple of instances dealing with application of the statutory benefit limits. For example, regulations under Code Section 415 provide that the pension benefit of a retired employee whose benefit had been constrained by the Code Section can be increased to accord with any higher Code Section 415 limit arising from a COLA adjustment.[13] The increase in the benefit payable by the plan is clearly treated as a plan "accrual" for plan purposes in the year the increased 415 limit goes into effect.[14] The Service blessed a similar accrual arising from a statutory increase in the Code Section 401(a)(17) compensation limit. In 2002, EGGTRA increased the Code Section 401(a)(17) compensation limit from $170,000 to $200,000. Revenue Ruling 2003-11 provides that a plan may be amended to apply the increased compensation limit to retired participants.[15]

Plan Mergers

The Service also dealt with post-employment benefit accruals in connection with the merger of nonqualified plan benefits into a qualified plan. In Private Letter Ruling 9516005 (December 22, 1994), the Service considered a nonqualified deferred compensation plan that had been assumed in corporate acquisition. The plan covered retirees of the seller, and the buyer merged the nonqualified plan into the buyer's pension plan. The ruling concluded that the merger of this plan for retirees of the seller into the buyer's pension plan did not violate the exclusive benefit rule of Code Section 401(a). The ruling did not mention Revenue Ruling 73-238, but presumably the rationale was that qualified plan accruals for the retirees of the seller were like a past service grant from the perspective of the buyer.

SUMMING IT UP: REPEAL OR REVISION?

Reconciling the Service's approaches to post-employment accruals into a single coherent position is no easy task. On the one hand, a 1973 published ruling restricts accruals by former employees, but on the other, numerous later rulings and regulations seem to spell out exceptions for post-employment accruals in such diverse areas as COLAs, service with a successor employer, and retroactive benefit increases due to statutory limit changes.

One possibility is that the Service intended to repeal altogether the post-employment accrual restrictions of the 1973 ruling. As we have noted already, regulations under Sections 401(a)(4) and 410(b) provide

for separate nondiscrimination testing of former employees.[16] At the very least, these show that the principles of Revenue Ruling 73-238 do not bar all benefit accruals for former employees. Indeed, many interpret the separate testing requirement as an implicit but total repeal on restrictions on post-employment accruals. When read more closely, however, the regulation's examples are limited to plan amendments providing ad hoc COLA-type benefit increases to retired participants.[17] Rather than the broader reading espoused by some, this part of the regulation arguably only stands for the permissibility of post-termination COLA accruals.

Moreover, in guidance issued after regulations, and in the preamble to the Code Section 401(a)(4) regulations, the Service has continued to pledge fealty to the restrictions imposed by Revenue Ruling 73-238.[18] For example, Notice 92-31 proposes changes in certain safe harbors under the nondiscrimination regulations for post-employment accruals. But, states the Notice, "as under current law, any credit for imputed service must satisfy the requirement of Section 401(a)(2) that a plan be maintained for the exclusive benefit of employees." Acknowledging the conflict with Revenue Ruling 73-238, the Notice promised that the 1973 ruling would be modified to conform to the positions taken in the nondiscrimination rules. But to date no such modified ruling has been issued in the 11 years since the publication of the nondiscrimination regulations.

Trying to make sense of it all, it appears that the key factor in determining whether a benefit can be accrued by a former employee is how the benefit is crafted. A post-employment benefit increase is apparently acceptable if expressed in terms of the participant's original service and compensation with the employer. This would permit both permanent cost-of-living features in plans as well as ad hoc cost-of-living adjustments for retirees. This also explains why benefits can be increased for retirees because of increases in the Code Section 415 or 401(a)(17) limits. Extending this rationale, it should likewise be acceptable to apply to retirees other formula adjustments that base the benefit on a participant's pay and service with the plan sponsor. An example would be an amendment changing a formula from one based on 1 percent times final pay and service, to one based on 1.2 percent of final pay and service, and extending the change to retirees. Presumably, the same rationale would support an amendment affecting previously retired participants that recognized additional past years of service or prior pay with the plan sponsor that may have not been counted under the original formula.

The regulation also makes it clear that additional value can be delivered to a former employee involved in a business divestiture if the additional "benefit" deals in the form of vesting credit or early retirement

subsidy credit. Additional normal retirement accruals based on service with a successor employer in a business divestiture also are permitted to a limited extent if the successor business "provides some ongoing business benefit to the original employer."[19]

QUESTIONS REMAIN

Even after trying to draw a straight line through a tangled mass of guidance, questions remain on what principle, if any, may be deduced from it all. Consider, for example, an early retirement window benefit that is extended to participants who terminated employment within some time limit before the window benefit was first announced. This kind of provision is common because it attempts to avoid the problem of determining when the new benefit was first "seriously considered," which might have triggered some fiduciary duty to announce the upcoming benefit enhancement to employees. If this benefit is extended to already terminated employees, and grants three additional years of service for benefit accrual purposes, the question arises whether any of the three already-described exceptions to Revenue Ruling 73-238 would apply. The benefit enhancement in this case is not expressed in terms of a cost-of-living increase or in terms of the participant's prior service and compensation with the plan sponsor; rather, the additional benefit is enhanced by counting mythical service with the employer.

NEW TWIST BY SHEET METAL WORKERS

We have so far discussed the question of post-employment accruals only as a plan qualification question. While examining Service guidance under other Code provisions (such as the nondiscrimination rules), we have discussed it only as the basis for inferring that, at least in some cases, the Service will allow that post employment accruals do not violate the exclusive benefit requirement of section 401(a)(2).

Almost no case law sheds light on this basic qualification issue. But two recent cases have given rise to a separate question concerning post-employment accruals: are the accruals protected under the anti-cutback rule of section 411(d)(6), and are they deductible?

In *Board of Trustees of the Sheet Metal Workers' National Pension Fund v. Commissioner*, 318 F.3d 599 (6th Cir. 2003), *aff'g* 117 T.C. 220 (2001), the Fourth Circuit and the Tax Court examined whether a COLA that was extended to retired employees after their retirement was protected against takeaway under Code Section 411(d)(6). Consistent with its apparent blessing of COLAs under the Section 401(a)(4) regulations, the government never questions whether such COLAs were permitted in the first place. And the Tax Court noted in

passing that a "retiree may enjoy COLAs added after retirement."[20] Having briefly dealt with this threshold issue, the Tax Court held, and the Fourth Circuit affirmed, that Code Section 411(d)(6) only protects benefits that were "stockpiled" during an employee's working years. According to the Fourth Circuit and the Tax Court, a benefit is only a "stockpiled" benefit that is protected as an "accrued benefit" if the plan participant had been promised the benefit before the individual terminated employment. These COLAs were not in this category, and thus could be eliminated by a plan amendment.

Describing the ERISA "accrued benefit" requirements in contract-like terminology, the Fourth Circuit referred to the COLA benefit as a "gratuitous benefit" that could be withdrawn without impairing the promised benefit. A similar result was reached in the U.S. District Court in Maryland in 1992 in another case dealing with an amendment eliminating a cost-of-living benefit extended to retirees. *Scardelletti v. Bobo*, 1997 U.S. Dist. LEXIS 14428 (D.Md. 1997).

The holdings of the *Sheet Metal Workers* and *Scardelletti* cases are surprising. While we expect further developments on this issue, we think they have at least one immediate implication. Employers extending benefit increases to retirees should consider clarifying in the plan document whether they intend these benefits to be unprotected from take-away, as permitted by these cases, or whether to add Code Section 411(d)(6)-type protection to these benefits in the form of a plan amendment. Of course, in light of the absence of consideration given for such "gratuitous benefits," the question arises whether such protections would be enforceable in light of the Fourth Circuit's contract-like analysis, but this issue is beyond the scope of this article.

We would also note that the Fourth Circuit's "gratuitous benefit" analysis of post-retirement COLAs reminds us of old case law under Section 162, holding that a mere gratuity is not deductible as an "ordinary and necessary" business expense under that section.21 If it still existed, this restriction would apply to the deductibility of contributions for "gratuitous" post-employment COLA grants and other benefit enhancements, under the threshold language of Section 404(a), which provides that contributions to a qualified plan are deductible only if "otherwise" deductible under Chapter I of the Code, including, of course, Section 162. We believe that the Service is unlikely to mount a serious challenge to the deductibility of such payments, however. The Tax Court was always skeptical of the idea that payments to individuals with a past employment connection were "gratuitous" and thus nondeductible.22 The idea was discarded virtually altogether by the Supreme Court for income inclusion purposes in Duberstein v. Commissioner, 363 US 278 (1960). While the principles for income inclusion under Section 62 of the Code do not necessarily correspond

with those for deductions under Section 162, in fact the "nondeductible gratuity" line of cases does not seem to survive the Duberstein decision. As with the question of whether "gratuitous" benefits may ever be protected from cutback by plan amendment, however, a full exploration of this question is beyond the scope of this article.

CONCLUSION

The rules regarding post-employment accruals have been in flux for more than 30 years. The Service's pronouncements in this question were unclear before ERISA, and have grown even murkier over recent years. Since there is little or no policy reason to prevent plans from increasing benefits for former employees, the Service gradually has blessed a wide variety of exceptions to the broad prohibition set forth in Revenue Ruling 73-238. The post-employment accruals that clearly pass muster are those where the benefit enhancement represents some percentage increase in the benefit that was accrued during active employment. The Service now would be well served to revisit Revenue Ruling 73-238 and to modify or withdraw the ruling altogether. To our way of thinking, the complete abandonment of Revenue Ruling 73-238 makes some sense. Why should it matter how a plan sponsor describes the method of increasing a benefit for a former employee? The particular plan technique is just a matter of words, and the bottom line is that an increased benefit is delivered to an individual who had an employment nexus with the employer.

NOTES

1. Treas. Reg. § 1.415-2(c)(4). This regulation refers to compensation "paid or made available to an employee within the limitation year. . . . "

2. 29 C.F.R. § 2530.200b-2(a)(2).

3. 41 Federal Register 56464 (Dec. 28, 1976).

4. 1995 Enrolled Actuaries Meeting, Questions for IRS/Treasury and Summary of Responses, Question and Answer 30.

5. Treas. Reg. § 1.401(a)(4); Treas. Reg. § 1.410(b)-3(b).

6. Treas. Reg. § 1.401(a)(4)-10.

7. Treas. Reg. § 1.401(a)(4)-11(d)(3)(iv)(A)(1). The regulations take the position for nondiscrimination testing purposes that an individual who qualifies under the imputed service rules will be construed as an active employee rather than as a former employee.

8. Treas. Reg. § 1.401(a)(4)-11(d)(3)(iv)(A)(1).

9. Treas. Reg. § 1.401(a)(4)-11(d)(3)(iv)(A)(2).

10.Treas. Reg. § 1.401(a)(4)-11(d)(3)(iv)(A).

11.*See Gillis v. Hoechst Celanese Corp.*, 4 F.3d 1137 (3rd Cir. 1993); *Adams v. Bowater*, 2003 U.S. DIST. LEXIS 9234 (D. Maine 2003).

12.Treas. Reg.§ 1.414(s)-1(f)(2)(iv).

13.Treas. Reg. § 1.415-5(a)(3).

14. Notice 89-92, 1989-2 C.B. 410.

15. 2003-3 I.R.B. 285.

16.Treas. Reg. § 1.401(a)(4);Treas. Reg. § 1.410(b)-3(b).

17.Treas. Reg. § 1.401(a)(4)-10.

18. IRS Notice 92-31, 1992-29 I.R.B. 6; Prop.Treas. Reg. § 1.401(a)(4)-11 (preamble discussion).

19. Treas. Reg. § 1.401(a)(4)-11(d)(3)(iv)(A).

20. 117 T.C. 220, 228 (2001).

21. *See, e.g., Peters v. Smith*, 221 F.2d 721 (3d Cir. 1955). In *Peters*, the Third Circuit upheld the nondeductibility of amounts paid to purchase an annuity for payment of a nonqualified pension to a retiree, noting "the employer in providing the questioned payments did not indicate unequivocally whether such action was intended as additional compensation for past services, or merely as an expression of philanthropic attitude or as a bid for employee good will, or as some combination of these."

22. *See, e.g., John C. Nordt Co. v. Commissioner*, 46 T.C. 431 (1966) *Fifth Avenue Coach Lines, Inc. v. Commissioner*, 31 T.C. 1080 (1959) (issue 1), *aff'd and rev'd on other issues* 281 F.2d 556 (2d Cir. 1960), *Weyenberg Shoe Mfg. Co. v. Commissioner*, TC Memo 1964-322.