

## Vested Interests

Historically, vesting schedules have been a strategic tool for employers to balance the costs of retirement benefits while promoting employee loyalty and retention. Employers have aimed to retain employees by implementing a service-based vesting schedule for employer contributions to the plan. A recent survey shows that vesting schedules aren't as effective at retaining workers as you might think; however, they can help manage costs for employers.

### Here's What You Really Need to Know:

- Participants are always fully vested in their contributions, but plan sponsors may leverage either a cliff or graded vesting schedule applicable to employer contributions to the plan.
- Roughly two-thirds of plan sponsors cite vesting schedules as a mechanism to retain employees.<sup>i</sup> However, recent research shows that there is a lack of awareness amongst plan participants about their plan's vesting requirements, which may not be leading to the intended result of retention for many employers.
- The use of plan forfeitures, which are unvested employer contributions and earnings, have recently been the target of litigation.

Let's Dive In...

### What is Vesting?

According to the Internal Revenue Service (IRS)<sup>ii</sup>, "vesting" in a retirement plan means ownership. Specifically, this means that each employee will own a certain percentage of their employer contributions in their retirement accounts over time. Amounts that are not vested, which can be earned through working a set number of hours each year or by working a set number of years of service, may be forfeited into a separate plan account known as the forfeiture account. The forfeiture generally occurs when employees take a distribution from their account balance or upon termination from employment. Vanguard reports that more than half of the plans it administers impose vesting requirements on employer contributions.<sup>iii</sup> Recall that participants are always fully vested (or 100% vested) in their own contributions to the plan.

### How Vesting Works

Qualified defined contribution plans can offer various vesting schedules as determined by the plan document. These schedules can range from immediate vesting, which means all contributions belong to the employee from the start, to vesting after a specific number of years of service, or a gradual vesting schedule that increases the employee's vested percentage for each year of service with the employer. While this may sound straightforward, the IRS acknowledges that it can become complex. Additionally, employers may use

different methods for counting and tracking the service worked to earn vesting credit with the plan. Regardless of the method, all employees must be 100% vested by the time they reach either of these events (1) the normal retirement age under the plan or (2) if the plan is terminated.

The table below shows the differences between a cliff vesting schedule and a graded vesting schedule. For cliff vesting, the account becomes 100% vested after a set number of years, whereas a graded vesting schedule has gradual increases over a set number of years. This example reflects a three-year cliff vesting schedule and a six-year graded vesting schedule.

| Years of Service | Cliff Vesting | Graded Vesting |
|------------------|---------------|----------------|
| 1                | 0%            | 0%             |
| 2                | 0%            | 20%            |
| 3                | 100%          | 40%            |
| 4                | 100%          | 60%            |
| 5                | 100%          | 80%            |
| 6                | 100%          | 100%           |

## Dual Motivations Behind Vesting Schedules: Retention and Cost Management

Employers who use vesting schedules are generally motivated by two main goals: (1) as a retention strategy, believing that employees will stay longer if a portion of their 401(k) benefits depends on it and (2) cost management, by recouping some of their 401(k) contributions if employees leave before they are fully vested, which is particularly impactful in high turnover settings. In fact, implementing a vesting schedule was cited as a strategy to recruit and retain employees by roughly two-thirds of plan sponsors in the Plan Sponsor Council of America’s 67<sup>iv</sup> Annual Survey of Profit-Sharing and 401(k) Plans.

Following up on the actual impacts of vesting may show otherwise. A new research report by Vanguard<sup>v</sup> determined that participants in Vanguard-administered plans did not show increased rates of participants quitting, or leaving employment, after vesting in the employer contributions. The researchers compared workers with three-year cliff vesting schedules (no vesting in employer contributions until the end of three years of service) compared to those with immediate vesting and found similar separation patterns in both groups of employees. Additionally, the study revealed that participants with three-year cliff vesting were not significantly more likely to quit just after their third employment anniversary.

While the Vanguard research may demonstrate that vesting does not provide a systematic retention benefit, the research also noted that many participants are unaware of their plan’s vesting requirements, which may explain the lack of retention effects. This suggests that better communication and education about the plan’s vesting schedule could potentially improve its effectiveness as a retention tool.

# Key Findings from Vanguard Research

- **Vesting and Retention:** Vesting does not systematically improve employee retention. However, there is an average of 2.5% recovery of employer contributions per plan which may substantially help with budgeting for plan expenses or reduction of the employer match depending on what the plan document allows for using forfeiture dollars.
- **Participant Costs:** The cost of forfeited balances is significant for participants. Forfeitures occur in 30% of job separations and are most common among lower-income participants. This typically represents 40% of the affected participants' final account balance.
- **Employer Tradeoffs:** Given the lack of retention benefits, employers face a tradeoff in optimizing their benefit structures. Forfeiture savings can help manage costs, while immediate vesting can enhance wealth accumulation for lower-income employees with higher turnover rates.

## Forfeiture Litigation

While there are trade-offs to vesting schedules and associated plan design, a vesting schedule may pose an unintended risk depending on how the forfeiture account is leveraged. Recent litigation regarding forfeiture accounts in retirement plans has focused on how plan sponsors use unvested contributions. Several lawsuits allege that plan fiduciaries who elect to use forfeitures to offset employer contributions instead of giving those dollars back to plan participants are violating ERISA. Several cases are ongoing and could set important precedents for how forfeitures are managed in the future. This is a good reminder for plan sponsors that oversee a plan with a vesting schedule to ensure they check the plan document to understand the permitted use of forfeiture funds for their plan. Forfeitures should only be used based on the criteria outlined in the plan document.

## Action Items for Plan Sponsors

1. Understand your plan to be aware if a vesting schedule is part of your plan design. This can be found in the plan document and summary plan description (SPD).
2. If the plan does have a vesting schedule, understand who is responsible for determination and calculation of vesting. Generally, this is completed by the plan sponsor, recordkeeper, or a third-party administrator (TPA). If this duty falls on the plan sponsor, ensure that vesting percentages are provided to the recordkeeper so that they have up-to-date vesting information for plan participants.
3. Communicate vesting requirements to participants. Participants should have awareness of the vesting schedule that applies to their plan. This may encourage retention as employees can make better informed decisions about their employment.
4. Remember that the decisions on the use of plan forfeitures to offset employer contributions (rather than give back to participants or pay plan expenses) has been a target of recent litigation; be sure to know what your plan document allows and requires, and proceed accordingly.

<sup>i</sup> Plan Sponsor Council of America, 67th Annual Survey of Profit-Sharing and 401(k) Plans.

<sup>ii</sup> , Internal Revenue Service.

<sup>iii</sup> How America Saves 2024, Vanguard, available at: [institutional.vanguard.com/insights-and-research/report/how-america-saves.html](https://institutional.vanguard.com/insights-and-research/report/how-america-saves.html).

<sup>iv</sup> Plan Sponsor Council of America, 67th Annual Survey of Profit-Sharing and 401(k) Plans.

<sup>v</sup> Does 401(k) vesting help retain workers?, Vanguard, available at:

[https://corporate.vanguard.com/content/dam/corp/research/pdf/does\\_401k\\_vesting\\_help\\_retain\\_workers.pdf](https://corporate.vanguard.com/content/dam/corp/research/pdf/does_401k_vesting_help_retain_workers.pdf).



**Christopher D. Cervantes, C(k)P®, CFP®, CIMA®, NQPA®**

Founder & Managing Partner  
5700 Tennyson Parkway, Suite 250  
Plano Texas 75024  
214.800.4451

Christopher.Cervantes@valorousadvisors.com  
[www.valorousadvisors.com](http://www.valorousadvisors.com)