Kilpatrick

APRIL 21, 2023

Use of Forfeitures in Defined Contribution Plans

by R. Sterling Perkinson

In a 2010 newsletter, the IRS announced that forfeitures under a 401(k) plan or other defined contribution plan must be promptly used and not allowed to accumulate over several years. In February, the IRS proposed regulations that once finalized will formalize this position. Plan sponsors should review their forfeiture accounts to ensure that forfeitures are being used promptly in accordance with the proposed regulations.

Occurrence of Forfeitures. Matching contributions and profit sharing contributions under a defined contribution plan may be subject to a vesting schedule. If participants terminate employment prior to meeting the service requirements to become fully vested, the unvested portion of the account will be subject to forfeiture.

A forfeiture of unvested amounts does not occur automatically upon an employee's termination of employment. Instead, the forfeiture may be triggered when the participant obtains a distribution of any vested portion of his or her account (including a "deemed distribution" if the participant has no vested balance), or when the participant incurs five consecutive one-year breaks in service. When a forfeiture is triggered, the unvested amounts are moved from the participant's account to the forfeiture account under the plan, which is an unallocated account.

Use of Forfeitures. The terms of the plan must specify how forfeitures are to be used, which may include the following:

Paying administrative expenses. Any administrative expenses of the plan can be paid out of a forfeiture account. Administrative expenses generally include expenses for recordkeeping, administration, and compliance. Expenses incurred in connection with decisions relating to the formation, design and termination of plans would not be administrative expenses, but expenses incurred in implementing these decisions would generally be administrative expenses.

Reducing employer contributions. Forfeitures can be used to fund employer matching contributions or profit sharing contributions, which reduces the contributions that the employer would otherwise need to make to the plan. In 2018, the IRS issued regulations that clarified that forfeitures can also be used to fund qualified matching contributions (QMACs) and qualified nonelective contributions (QNECs) that are used to correct nondiscrimination testing and certain other compliance issues.

Providing additional allocations. Forfeitures may also be allocated to plan participants. Any allocations to plan participants would need to satisfy nondiscrimination rules and limits on allocations under Section 415 of the Internal Revenue Code.

Deadline for Using Forfeitures. The proposed regulations require that all forfeitures be used no later than 12 months following the close of the year in which the forfeitures occurred. This means that the amount of forfeitures used during a year must be at least equal to the forfeiture balance as of the end of the prior year.

The proposed regulations provide a transition rule under which any forfeitures that occurred in plan years beginning before January 1, 2024, will be treated as having been incurred in the first plan year beginning on or after January 1, 2024. Accordingly, for a plan that operates on a calendar year basis, any forfeitures that have been incurred prior to January 1, 2024, will need to be used by December 31, 2025.

Other Unallocated Amounts. The proposed regulations address only the use of forfeitures and not other amounts that are unallocated under a defined contribution plan, such as revenue sharing payments that are credited back to a plan by a recordkeeper. Although not covered by the proposed regulations, plan sponsors should review whether uses of other unallocated amounts are appropriate in view of the IRS's position on forfeitures.

Plan Amendments. Plans may need to be amended to comply with the proposed regulations on use of forfeitures. The IRS cautioned that plans that provide for use of forfeitures only to pay administrative expenses may need to be amended to permit forfeitures to be used for other purposes to avoid a qualification failure that may result if the amount of forfeitures exceeds the administrative expenses payable by the plan in a year.

Further, the proposed regulations appear to require plans to reflect the deadline for using forfeitures, even if the plan already includes appropriate terms for how forfeitures maybe used.

The proposed regulations do not specify a deadline for a plan amendment. Generally, plan amendments due to changes in regulatory requirements are due by the end of the second calendar year after the requirement first appears on the IRS's Required Amendments List, unless another deadline is specified in regulations or other guidance.