

Vanguard commentary

Avoiding pitfalls in retirement plan forfeitures

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Plan sponsors possess great flexibility in using forfeitures in the administration of their defined contribution retirement plans. Forfeited funds may be used to pay for employer contributions or plan expenses instead of using employer assets. Forfeitures generally exist in plans with vesting schedules, and Internal Revenue Code (IRC) rules, plan terms, and, in some cases, the exercise of fiduciary discretion determine their use. Plan sponsors, however, sometimes encounter challenges in determining when forfeitures occur and how to use them appropriately. Specifically, some sponsors haven't established effective procedures for the timing and use of forfeitures.

At first glance, the concept and treatment of forfeitures in qualified retirement plans appear to be relatively simple to understand. However, a review of IRC rules and historical guidance reveals that forfeitures may not be as straightforward as expected and could pose compliance risk. In part to simplify the administration of forfeiture use and to provide formal guidance, the Internal Revenue Service (IRS) issued proposed regulations related to the use of forfeitures and the required timing of such use on February 27, 2023. The proposed rules impose a single deadline by which forfeitures must be used in all defined contribution plans, namely within 12 months after the close of the plan year in which they are incurred. While final regulations have not been issued, the proposed rules now apply, and plan sponsors may rely on the guidance.

Periodically, employer-sponsored retirement plans have experienced heightened scrutiny of forfeitures during IRS audits. Failure to use or allocate forfeitures on a timely basis highlights the need for proper forfeiture management processes. Some plan sponsors have been surprised to find that their plan documents do not align with their plan operations. Ensuring that forfeitures occur in a timely way, are used according to the terms of the plan document, and are compliant with IRC and relevant guidance will mitigate compliance and litigation risk.

This commentary will help defined contribution plan sponsors consider the administration of forfeitures within their plans. It also outlines the timing and approved uses of forfeitures and provides additional considerations for forfeiture-related events.

What are forfeitures?

Unearned benefits

Forfeitures are plan assets generally created by participants who have not earned the right to receive their entire account balance in the plan. Participants often earn the right to receive a percentage of their employer-provided contributions as a reward for their length of service with an employer, according to the plan's vesting schedule. As an employee's service increases, the percentage of the earned right to the benefit (that is, vested percentage) also increases, ultimately to 100%.

Benefits attributable to participant salary deferrals, participant after-tax contributions, qualified nonelective contributions (QNEC), and qualified matching contributions (QMAC) are always 100% vested and, therefore, nonforfeitable.

Determining nonvested amount

Upon a participant's termination of service with an employer, the vested and nonvested percentage of a participant's account balance can be determined and any nonvested benefit amounts become subject to forfeiture. The terms of the plan document determine when such nonvested amounts actually become forfeitures.

Forfeiting nonvested amounts

The most common timing rule for forfeiting nonvested amounts provides that the nonvested portion of a terminated participant's account balance be forfeited after the participant incurs five consecutive one-year breaks in service. A plan that

intends to operate in this manner should have this provision stated in the plan document. A plan document without this provision should not be interpreted as having adopted this rule, but rather the plan would have to follow the forfeiture timing provisions within the plan document.

Waiting five years to forfeit a participant's nonvested account balance may be administratively cumbersome. Therefore, in accordance with IRC rules, many plans provide for accelerated forfeitures. A plan may immediately forfeit the nonvested portion of the account balance with the distribution of a terminated participant's entire vested account balance (including elective deferrals). However, where such accelerated forfeitures occur, participants rehired within five years of termination may repay their plan distributions in order to restore or "buy back" their previously forfeited benefits.

In cases where a participant has terminated and is 0% vested in their account balance (for example, 0% vested in any employer contributions and has no elective deferrals), the plan can deem the participant as being cashed out, thereby triggering an immediate forfeiture of the nonvested account balance. Similarly, upon rehire, these participants may be deemed as having repaid their plan distributions and would have their previously forfeited benefits restored to their account balance.

How can forfeitures be used?

Plan sponsors must understand the proper use of forfeitures in the plan. The IRC and relevant IRS guidance basically provide that forfeitures may be used in three ways:

- Pay reasonable plan expenses.
- Reduce future employer contributions.
- Allocate among participants as additional contributions.

The plan document must clearly define how the plan will use forfeitures. For administrative flexibility and to ensure forfeitures can be exhausted within the time frame required, a plan may include more than one of these methods. Details about each of the three methods follow.

Pay plan expenses

Plan forfeitures may be applied to pay any reasonable expenses incurred in the operation of the plan. After the plan fiduciaries determine the reasonableness of a fee and its eligibility to be paid with plan assets, they may use forfeitures to pay part or all of this expense.

Reduce future employer contributions

Plans may use forfeitures to reduce future employer contributions. Under this method, forfeitures satisfy some or all of the employer contribution funding rather than the plan sponsor funding the entire contribution with new money to the plan.

A plan sponsor may not use forfeitures to fund elective deferral contributions. Since forfeitures are already plan assets,

the IRS considers using forfeitures to fund a contribution of elective deferrals to be impermissible prefunding.

As previously discussed, certain rehired participants who repay plan distributions may buy back any previously forfeited account balance. In this case, the plan sponsor may reinstate previously forfeited amounts using available forfeitures.

Allocate to participants

Plan sponsors may allocate forfeitures as an additional employer contribution. The plan document should clearly describe the method of allocation (for example, pro rata to participants) and any allocation eligibility requirements (for example, to be eligible, participants must be employed on the last day of the plan year).

But plan sponsors should also be aware that, under IRC rules, allocated forfeitures would be aggregated with other employer contributions in determining a participant's annual additions. Thus, the IRC annual addition limit could affect the amount of forfeitures allocated to a participant.

Forfeitures from multiple sources

Some plans provide participants more than one employer contribution that is subject to a vesting schedule (for example, employer match and employer profit sharing). A plan with multiple employer contribution sources may specify that the forfeitures attributable to each type of contribution will be applied in a distinct manner. However, for maximum flexibility, many plans permit forfeitures attributable to any type of employer contribution to be used for any plan-defined purpose. In any case, the plan sponsor should be familiar with the provisions of the plan to ensure consistency between the plan document and the operation of the plan.

Fiduciary responsibility

As noted above, a plan may permit forfeiture use in several ways. If the plan document allows this and doesn't establish a hierarchy, the plan sponsor uses discretion in determining how to manage forfeitures. Under the Employee Retirement Income Security Act (ERISA), exercising discretion over the administration of a plan is a fiduciary duty and requires plan fiduciaries to follow the terms of the plan. When providing direction to the plan's recordkeeper, the fiduciary should be mindful of the plan's forfeiture rules and act in the best interests of participants and beneficiaries, which in turn will mitigate the risk of fiduciary breach claims.

Despite IRS guidance and the proposed regulations, participants in recent years have filed a number of lawsuits against employers and plan sponsors relating to the use of forfeitures to offset employer contributions. As the future of many of these lawsuits remains unclear, prudent plan fiduciaries may want to review their forfeiture practices and plan document language with their counsel.

When are forfeitures used?

Plan administrators must be prepared to use forfeitures within time frames established by the IRC and further formalized by the IRS in proposed regulations issued in February 2023.

Annual use

All funds in a defined contribution plan should be allocated to participants on at least an annual basis. In the spring 2010 edition of *Retirement News for Employers*, the IRS noted that audit experience illustrates that some plans inappropriately allow forfeitures to accumulate for several years, when, in fact, forfeitures are to be exhausted within 12 months following the end of the plan year in which they are incurred, according to the IRS's recently proposed regulations. To mitigate risk, and to comply with these proposed rules, plan sponsors should review the plan language and associated administrative procedures to ensure they use forfeitures within the specified time period.

The proposed regulations apply to plan years beginning in 2024, and while the IRS has not yet issued final regulations, plan sponsors may rely on the guidance.

Clear plan provisions

If a plan document is silent or ambiguous regarding how and when forfeitures must be used, the plan sponsor should determine how and when forfeitures will be used and amend the plan document to be clear as well as consistent with the plan's operation.

Additional considerations

Beyond the basics already outlined, forfeitures present plan sponsors with a few additional considerations.

Corrections

One of the guiding correction principles of the Employee Plans Compliance Resolution System (EPCRS) is to keep assets in the plan. Thus, forfeitures can sometimes result from correction activity (for example, forfeiture of erroneous employee or employer contributions). Forfeitures that result from this type of activity may be used in the same way as any other forfeiture in the plan.

Plans with full vesting

Confusion can arise when a plan that provides full and immediate vesting and does not contain forfeiture language encounters forfeitures due to corrections or other activity. The sponsor must then determine the best use of the forfeitures without any specific plan language. In such a case, the plan should be amended to authorize how forfeitures may be used and to require they be used no later than 12 months after the close of the plan year in which they arose.

Plan termination

Plan terminations may also present some forfeiture challenges. First, a terminated plan must 100% vest all current participants, including terminated participants who have not yet incurred five consecutive one-year breaks in service. Next, if a plan terminates with unallocated amounts in the plan's forfeiture account, the plan sponsor must decide how to use these forfeitures. This could occur, for example, when a plan provides that forfeitures are used to reduce future employer contributions and no future contributions are anticipated due to the plan termination. Using the remaining forfeitures to pay final plan expenses or allocating these forfeitures to participants may be the most viable solution. The plan document may need to be amended to provide for use of the forfeitures under these circumstances. Strict adherence to the timing rules for the use of forfeitures as described above should help to minimize the amount of forfeitures remaining upon plan termination.

Final thoughts

Plan sponsors have options regarding plan forfeitures. The plan document should contain clear forfeiture provisions that align with the plan sponsor's intent and comply with IRS guidance.

As a first step, plan sponsors should understand when forfeitures will occur, how to use them, and when to use them. Lack of awareness could lead to compliance violations.

Considering the proposed regulations issued by the IRS in February 2023, sponsors should evaluate the intent and operation of the plan with respect to forfeitures. Plan sponsors who ensure that the plan document includes clear, conforming language for how and when forfeitures will be used and that administrative procedures agree with the terms of the plan will be better able to demonstrate compliance. Taking the time to complete such a review may also save the plan sponsor from an unexpected and costly plan correction.

Should significant discrepancies be discovered, plan sponsors may rely on consultants, counsel, or the many compliance tools the IRS offers to assist in correcting plan failures, including the EPCRS and the *401(k) Plan Fix-It Guide*.

One of the best ways to mitigate forfeiture compliance risk is for plan sponsors to know their plan and operate accordingly.

Vanguard Strategic Retirement Consulting helps sponsors resolve challenges and manage their plan more effectively.

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