



Retirement Plan Forfeitures

Under the Spotlight



By Joseph Topp, CPA

An unheralded IRS rule change, amplified by a surge in ERISA litigation, has prompted plan sponsors to reevaluate how they handle forfeiture balances in their participant-directed employee retirement plans.

What are forfeitures?

Employer contributions, such as profit-sharing (nonelective) and matching contributions to a defined contribution plan, may be subject to a vesting schedule. The nonvested portion of a participant's account balance when they terminate employment and receive their distribution is the primary source of forfeiture dollars. Another example of a source of forfeiture dollars is the nonvested portion of a "lost" participant's account balance when the plan disburses the vested portion of the account according to the plan document (e.g., IRA rollover, escheatment, etc.). The plan's forfeitures represent assets of the plan; therefore, plan fiduciaries have an ERISA duty to prudently manage these assets for the exclusive benefit of the plan's participants. The plan documents will detail permissible uses of forfeitures, which may include any or all of the following:

1. Reducing employer contributions
2. Paying nonsettlor plan expenses
3. Reallocating as additional employer contributions to all participants

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IRS issues forfeitures regulations

Previously, the IRS's informal guidance was that plan forfeitures were to be used in the year they were generated. Early in 2023, the IRS issued revised regulations for using forfeitures in tax-qualified retirement plans (REG-122286-18). The 2023 rule now requires plan sponsors to use forfeitures by the end of the plan year following the year in which the forfeitures were generated. To assist plan sponsors in complying, the IRS provided a transitional relief period that allows plan sponsors to use any forfeitures accumulated during or before 2024 but no later than the end of the 2025 plan year.

Newest litigation target

The latest target for ERISA litigation in the qualified retirement plan space is focused on plan sponsors' use of forfeiture dollars. Late in 2023, a plaintiff's law firm sued four large employers over their use of plan forfeiture dollars.

ERISA Section 404(a)(i)(A) states that plan assets must be used for the exclusive purpose of providing benefits to participants and defraying reasonable plan expenses of administering the plan. The initial spate of cases has focused on plan sponsors who have elected to use forfeitures to offset employer contributions rather than applying them against plan administrative expenses, which otherwise were charged to participant accounts or reallocated to all current plan participants. The plaintiff argued that this decision by the plan sponsor, reducing their cost to fund the required contribution, served the company's interests over those of the plan participants.

Several similar cases have been filed in 2024, and the industry waits for the guidance the courts will provide. To date, there have not been any court rulings issued, but several cases have survived initial motions to dismiss. With growing scrutiny on this subject, it would be prudent for plan sponsors to begin evaluating their procedures for handling these plan assets.

Protections for plan sponsors

Your plan document will govern the options you have for the permitted use of the plan's forfeitures. Typically, the document will specify all of the IRS permissible uses, thus allowing the plan sponsor flexibility each time they use their accumulated forfeitures. The decision to choose between two plan-document permitted uses for forfeitures is likely to be viewed as a fiduciary decision. If your organization always uses forfeitures to reduce plan expenses or reallocates them back to participants, your exposure is limited to acting in accord with the IRS's prescribed timeline. If your organization's intended practice is to use forfeitures to reduce the employer contribution, you might want to consider amending your plan document to remove the flexibility for plan fiduciaries to choose how to use these balances, by either eliminating all other options or specifying the sequence in which the forfeiture dollars will be used. This amendment to your plan document is a settlor function and could provide protection for the plan's fiduciaries when executing the use of your plan's forfeitures going forward.

Conclusion

Forfeitures represent an asset of the plan; therefore, ERISA requires plan sponsors to manage them for the exclusive benefit of the plan participants. Consider the following steps to ensure your organization has a prudent process in place for handling these plan assets.



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1. Review your plan document to determine that the permitted uses of forfeitures align with your organization's intentions.
2. Consider amending the document to specify the sequence in which forfeitures will be used to offer some protection to the plan's fiduciaries.
3. Collaborate with your plan's recordkeeper to ensure you are administering this aspect of your plan in compliance with IRS regulations.

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