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Employee Benefits Corner

Proposed Regulations on Allocation of Forfeitures

By Elizabeth Thomas Dold and David N. Levine

The Internal Revenue Service (IRS) and Treasury issued proposed regulations to address the proper treatment of timing and use of allocation of forfeitures.[1] The proposed regulations are effective with the 2024 plan year and provide invaluable transition relief for unallocated forfeitures. A review of the existing forfeiture rules and the new proposed rules (which are largely a clarification of the existing rules) for defined benefit and defined contribution plans are set forth below.

Legal Background

Code Sec. 401(a)(7) provides that a trust forming part of a stock bonus, pension, or profit-sharing plan of an employer for the exclusive benefit of its employees or their beneficiaries will not constitute a qualified trust under Code Sec. 401(a) unless its related stock bonus, pension, or profit-sharing plan satisfies the requirements of Code Sec. 411 (relating to minimum vesting standards).

Code Sec. 411(a) generally provides that an employee's right to accrued benefits derived from employer contributions must become nonforfeitable after a specified period of service. It also provides exceptions to this general rule under which an employee's benefit is permitted to be forfeited without violating Code Sec. 411, conditions under which forfeited amounts must be restored upon a participant's repayment of a withdrawal, and other rules related to vesting.

Defined Benefit Plans

For a defined benefit plan, Code Sec. 401(a)(8) provides that a trust will not constitute a qualified trust unless the plan provides that forfeitures must not be applied to increase the benefits any employee would otherwise receive under the plan. Reg. §1.401-7(a) generally provides that the pension plan must expressly provide that forfeitures arising from the severance of employment, from death, or for any other reason may not be applied to increase the benefits any employee would otherwise receive under the plan at any time prior to the termination of the plan or the complete discontinuance of employer contributions under the plan, and that the amounts so forfeited must be used as soon as possible to reduce the employer's contributions under the plan.[2] However, it also states that a pension plan may anticipate the effect of forfeitures in determining costs under the plan and that a qualified plan will not be disqualified merely because a determination of the amount of forfeitures under the plan is made only once during each taxable year of the employer. Since the issuance of this 1963 regulation, the Code has expanded to provide for minimum funding requirements under Code Secs. 430, 431, and 433. All of these provisions require the use of reasonable actuarial assumptions to determine the effect of expected forfeitures on plan liabilities.[3] Any difference between actual forfeitures and expected forfeitures is reflected in future contributions required under Code Sec. 412 pursuant to the funding method used for the plan under Code Sec. 430, 431, or 433.

Defined Contribution Plans

Code Sec. 414(i) provides that a defined contribution plan is a plan that provides for an individual account for each participant and for benefits based solely on the amount contributed to the participant's account, and any income, expenses, gains, and losses, and any forfeitures of accounts of other participants that may be allocated to the participant's account.

Plan sponsors of defined contribution plans should review the plan document terms and forfeiture procedures to ensure they are consistent with the proposed regulations, and that the use of forfeitures and the timing of forfeitures meet this 12-month rule.

Reg. §1.401-1(b)(1)(ii) provides that a profit-sharing plan must provide a definite predetermined formula for allocating the contributions made to the plan among the participants and for distributing the funds accumulated under the plan.

Rev. Rul. 80-155[4] provides that profit-sharing plans, stock bonus plans, and money purchase pension plans are required to provide for distributions in accordance with amounts stated or ascertainable and credited to participants. The revenue ruling further provides that amounts that are to be allocated or distributed to a particular participant are ascertainable only if the plan provides for a valuation at least annually.

The legislative history of the Tax Reform Act (TRA) of 1986 explained that, prior to TRA 86, forfeitures under a money purchase pension plan could not be used to increase benefits, but were required to be applied to reduce future employer contributions or to offset administrative expenses of the plan, and that forfeitures in a defined contribution plan that is not a money purchase pension plan could be reallocated to the remaining participants under a nondiscriminatory formula, used to reduce future employer contributions, or used to offset administrative expenses of the plan.[5] The Conference Report states that, following these changes, "forfeitures arising in any defined contribution plan (including a money purchase pension plan) can be either (1) reallocated to the accounts of other participants in a nondiscriminatory fashion, or (2) used to reduce future employer contributions or administrative costs."

A 2010 Newsletter of the Employee Plans office of the IRS' Tax Exempt and Government Entities Division[6] (the 2010 Newsletter) noted that some defined contribution plan administrators place forfeited amounts into a plan suspense account, allowing them to accumulate over several years, but that the Code does not allow this practice. It advised that a plan document should have provisions detailing how and when a plan will use or allocate plan forfeitures, and it described deadlines for the use or allocation of forfeitures. Moreover, the newsletter advised that generally "[n]o forfeitures in a suspense account should remain unallocated beyond the end of the plan year in which they occurred," and that "[f]or those plans that use forfeitures to reduce plan expenses or employer contributions, there should be plan language and administrative procedures to ensure that current year forfeitures will be used up promptly in the year in which they occurred or in appropriate situations no later than the immediately succeeding plan year."

Impact of Proposed Regulations

Defined Contribution Plans

The proposed regulations clarify that forfeitures arising in any defined contribution plan (including in a money purchase pension plan) may be used for one or more of the following purposes, as specified in the plan: (1) to pay plan administrative expenses, (2) to reduce employer contributions under the plan, or (3) to increase benefits in other participants' accounts in accordance with plan terms. The use of forfeitures to reduce employer contributions includes the restoration of "inadvertent benefit overpayments" (a term that was added with the Setting Every Community Up for Retirement Enhancement (SECURE) 2.0 Act) and the restoration of conditionally forfeited participant accounts that might otherwise require additional employer contributions, for example, the restoration of accounts conditionally forfeited under Reg. §1.411(a)-7(d) (relating to certain distributions and cash-outs of accrued benefits).

The Preamble explains that having the plan document designate a single use of forfeitures could result in an operational failure, raising plan qualification concerns. For example, if the plan says forfeitures are used to pay plan expenses, and the plan incurs expenses of only $10,000 but has a forfeiture account of $25,000 to use, this could result in an operational failure.

The proposed regulations also address the timing of the allocation of forfeitures. The proposed regulations generally require that plan administrators use forfeitures no later than 12 months after the close of the plan year in which the forfeitures are incurred. This deadline is intended to simplify administration by providing a single deadline for the use of forfeitures that applies to all types of defined contribution plans and to alleviate administrative burdens that may arise in using or allocating forfeitures if forfeitures are incurred late in a plan year. This deadline is similar to the deadline to correct excess contributions.

Lastly, the proposed regulations provide a transition rule related to the 12-month deadline. Under this rule, forfeitures incurred during any plan year that begins before January 1, 2024, are treated as having been incurred in the first plan year that begins on or after January 1, 2024. Accordingly, those forfeitures must be used no later than 12 months after the end of that first plan year (*e.g.*, allocated by end of the 2025 plan year). Therefore, any forfeitures that remain unallocated should be corrected by the end of the 2025 plan year in order to avoid plan qualification issues.

Defined Benefit Plans

The proposed regulations update the rules relating to the use of forfeitures in defined benefit plans to reflect the enactment, after the issuance of Reg. §1.401-7, of new minimum funding requirements applicable to defined benefit plans. In addition, the requirement in existing Reg. §1.401-7(a) that forfeitures under pension plans be used as soon as possible to reduce employer contributions would be eliminated because it is inconsistent with those minimum funding requirements. Instead, reasonable actuarial assumptions are used to determine the effect of expected forfeitures on the present value of plan liabilities under the plan's funding method. Differences between actual forfeitures and expected forfeitures will increase or decrease the plan's minimum funding requirement for future years pursuant to the plan's funding method.

Effective Date and Requested Comments

The regulations are proposed to be effective for plan years beginning on or after January 1, 2024. However, plan sponsors may rely on these proposed regulations for periods preceding the applicability date.

Notably, comments are requested on the following: (1) if the rules for the use of forfeitures in defined benefit and defined contribution plans can be further simplified to reduce administrative costs and burdens; and (2) if any issues arise concerning other unallocated amounts (in addition to forfeitures) with respect to qualified retirement plans, and, if issues do arise, whether guidance should be provided addressing those issues.

Next Steps

Plan sponsors of defined contribution plans should review the plan document terms and forfeiture procedures to ensure they are consistent with the proposed regulations, and that the use of forfeitures and the timing of forfeitures meet this 12-month rule. Moreover, if any plans have participant accounts that have not been forfeited, but should have been, then plan sponsors are encouraged to take advantage of the transition relief and forfeit amounts and allocate/use such forfeitures by the end of the 2025 plan year. Note, for individually designed plans, we anticipate that the final regulations will be on the "required amendment list (RAL)," which would set forth the applicable December 31 deadline for adopting plan amendments (*e.g.*, if on 2023 RAL, then one has until 12/31/2025 for any plan amendments). However, there is no express anti-cutback relief for these regulations and therefore plan amendments prior to the effective date may be in order if changes are being contemplated.

Plan sponsors of defined benefit plans are not anticipated to have any required plan document changes or plan operational changes, as the plan actuary typically calculates the minimum funding contributions in conformance with these proposed regulations.

ENDNOTES

1 88 FR 12282 (Feb. 27, 2023).

2 *See also* Reg. §1.401-1(b)(1)(i) (pension plans are not definitely determinable if funds arising from forfeitures on termination of service, or other reason, may be used to provide increased benefits for the remaining participants).

3 *See* Code Secs. 430(h), 431(c)(3), and 433(c)(3).

4 1980-1 CB 84.

5 H.R. Rept. No. 99-841, at II-442 (1986).

6 Retirement News for Employers, Vol. 7, Spring 2010.