

Publications

IRS Proposed Regulation Addresses Rules Relating to Plan Forfeitures

ATTORNEYS & PROFESSIONALS

Louis T. Mazaweylmazawey@groom.com

202-861-6608

Malcolm Sleemslee@groom.com

202-861-6337

PUBLISHED

03/02/2023

SOURCE

Groom Publication

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Historically, the topic of forfeitures has raised many questions for qualified plan administrators- specifically, how and when they can be used. But there has been little formal guidance from the Department of Treasury and IRS (“Treasury”) regarding requirements relating to the use of, and timing to use, such forfeitures. Treasury took a step toward addressing some of those questions by issuing proposed regulations^[1] on February 27, 2023 (the “Proposed Rule”).

Defined Contribution Plan Forfeitures

In an Employee Plans newsletter issued in Spring 2010, the IRS took the position that the Code did not allow defined contribution plan administrators to place forfeited amounts into a plan suspense account and allow them to accumulate over several years. They further stated that forfeitures in a suspense account should not generally remain unallocated beyond the end of the plan year in which they occurred. The newsletter advised that the plan document should specifically describe how and when a plan can use or allocate plan forfeitures, and if the plan used forfeitures to reduce plan expenses or employer contributions, the plan document and plan procedures should ensure that 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.”

Elaborating on this informal guidance, the Proposed Rule now provides a strict rule that forfeitures incurred under a defined contribution plan must be used within 12 months following the close of the plan year. Treasury indicates in the preamble to the rule that this single deadline, applicable to all defined contribution plans, is intended to simplify administration while providing administrative relief related to the use or allocation of forfeitures that are incurred late in a plan year.

Given the IRS’s new position, one possible approach to protect against issues arising in the context of plan audits or an IRS audit would be for plan sponsors to work with recordkeepers to maintain separate forfeiture accounts by plan year (i.e., Forfeiture 2024, Forfeiture 2025, etc.) and appropriately monitor the accounts to ensure that the prior year forfeiture account is zeroed out prior to the end of the following plan year.

The Proposed Rule contains a transition rule under which forfeitures incurred during a 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 (and therefore, would need to be used no later than 12 months after the end of the 2024 plan year).

Under the Proposed Rule, defined contribution plans may use forfeitures to:

1. pay plan administrative expenses;
2. reduce employer contributions under the plan; or
3. increase benefits in other participants' accounts in accordance with plan terms.

Defined Benefit Plan Forfeitures

Under existing law, defined benefit plans generally cannot allocate forfeited funds to increase benefits payable to other participants, and a Treasury regulation (Section 1.401-7(a)) currently provides that forfeited amounts must be used as soon as possible to reduce the employer's contributions under the plan.

The Proposed Rule reiterates that a defined benefit plan must expressly provide forfeitures may not be applied to increase participant benefits. However, the requirement in existing Section 1.401-7(a) that forfeitures be used as soon as possible to reduce employer contributions would be eliminated, as Treasury believes the minimum funding requirements in the Code do not allow the use of forfeitures to reduce employer contributions in that manner. But the Proposed Rule would allow forfeitures to be taken into account as part of the plan's reasonable actuarial assumptions for minimum funding purposes.

Proposed Applicability Date and Transition Rule

The Proposed Rule would apply for plan years beginning on or after January 1, 2024, but taxpayers may rely on the proposed regulations until the applicability date.

Request for Comment

Treasury has specifically asked for comments addressing whether the rules for the use of forfeitures can be further simplified to reduce administrative costs and burdens; and whether any issues arise concerning other unallocated amounts (in addition to forfeitures) with respect to qualified retirement plans, and whether guidance should be provided addressing any such issues.

If you have questions about the Proposed Rule, or are interested in submitting a proposed comment to Treasury by the May 30 deadline, please contact your Groom attorney.