JOURNAL
of
PENSION
BENEFITS

ISSUES IN ADMINISTRATION, DESIGN, FUNDING, AND COMPLIANCE
Volume 30 • Number 4 • Summer 2023

LEGAL DEVELOPMENTS

IRS Updates Regulations for Use and Timing of Forfeitures

This column presents a questions and answers format regarding the proposed regulations on forfeitures.

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Over the years, the Internal Revenue (IRS)/Treasury had an item on their annual guidance plan to update the existing regulations on forfeitures. Well, that guidance is finally here in the form of proposed regulations and it comes with very welcomed transition relief for plan sponsors that have not been as diligent with timely forfeiting and using forfeitures. The proposed regulations [88 Federal Register 12282 (2/27/2023)] impact both defined contribution and defined benefit plans and are described below, in question-and-answer format.

When Are the Regulations Effective?

These are proposed regulations, so they are not effective until they are finalized. The proposed regulations state that the effective date is intended to be the 2024 plan year.

Can the Regulations Be Relied on Now?

Yes, the proposed regulations expressly state that they may be relied on until the final regulations are issued.

Which Internal Revenue Code Sections Address Forfeitures?

First is Internal Revenue Code (Code) Section 401(a)(7), which requires that qualified plans comply with Code Section 411(a), which contains the vesting and forfeiture rules. Section 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 Section 411, conditions under which forfeited amounts must be restored upon a participant's repayment of a withdrawal, and other rules related to vesting.

Second is Code Section 401(a)(8), which provides that a defined benefit plan 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.

Third is Code Section 414(i), which 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 which may be allocated to the participant's account.

What Are the Existing Treasury Regulations That Are Being Changed?

For pension plans, Treasury Regulation Section 1.401-7(a) generally provides that the pension plan must expressly provide that forfeitures arising from 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. The regulation further provides that the amounts so forfeited must be used as soon as possible to reduce the employer's contributions under the plan. 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 forfeiture under the plan is made only once during each taxable year of the employer. The regulation does not reflect the funding requirements that take into account forfeitures under Code Sections 412, 430, 431, and 433.

For defined contribution plans, the guidance is not expressly provided in regulations. Rather the guidance is set forth in Revenue Ruling 80-155, legislative history, and an IRS newsletter. Specifically, Rev. Rul. 80-155 [1980-1 CB 84] 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 ruling further states 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. Moreover, the legislative history for the Tax Reform Act of 1986 (which replaced "pension plans" with "defined benefit plans" in Code Section 401(a)(8)) provided that "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."

Lastly, a 2010 Newsletter of the Employee Plans office of the IRS's Tax Exempt and Government Entities Division [*Retirement News for Employers*, Vol. 7, Spring 2010] (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. The Newsletter 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."

What Is the Impact of the Proposed Regulations for Defined Contribution Plans?

First, the proposed regulations clarify that forfeitures arising in any defined contribution plan (401(k), profit-sharing plan, 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 SECURE 2.0 Act) and the restoration of conditionally forfeited participant accounts that might otherwise require additional employer contributions. For example, when the balance of a participant's account is forfeited before he or she incurs five breaks-in-service because he or she receives (or is deemed to receive) a payment of his or her full vested interest. The rules require that, if the participant later returns to service before the five-year-break occurs and repays the distribution (assuming that he or she was not unvested at termination), the forfeited account must be restored. [Treas. Reg. §1.411(a)-7(d)]

Second, the proposed regulations address the timing of use or 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 for all types of defined contribution plans and to alleviate administrative burdens that may arise in using or allocating forfeitures that are incurred late in a plan year. (This deadline is consistent with the deadline to correct excess contributions.)

Third, the proposed regulations provide an important transition 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. This allows these forfeitures to be used (or allocated) no later than 12 months after the end of the 2024 plan year, that is, by the end of the 2025 plan year.

What Is the Impact of the Proposed Regulations for Defined Benefit Plans?

The proposed regulations update the rules relating to the use of forfeitures in defined benefit plans to reflect the enactment of the minimum funding requirements applicable to those plans. In addition, the requirement in existing regulation Section 1.401-7(a) that forfeitures under pension plans be used as soon as possible to reduce employer contributions is eliminated, because it is inconsistent with those minimum funding requirements. Rather, 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.

Are Comments Being Requested on the Proposed Regulations?

Yes, the proposed regulations expressly request comments on if: (1) 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) any issues arise concerning other unallocated amounts (in addition to forfeitures) with respect to qualified retirement plans, and, if so, whether guidance should be provided addressing those issues.

What Are the Appropriate Next Steps for Sponsors of Defined Benefit Plans?

Perhaps none, as the plan actuary should have been properly taking into account plan forfeitures when calculating the minimum funding contributions. But it is always worth double checking with them that they are in compliance with the proposed regulations.

What Are the Appropriate Next Steps for Sponsors of Defined Contribution Plans?

Plan sponsors should review their plan document terms and forfeiture procedures with their recordkeeper to ensure they are consistent with the proposed regulations. We want to make sure that the use of the available forfeitures is set forth in the plan document, and that the forfeitures are allocated or used for expenses or contributions within the 12-month period following the end of the plan year. This will require some tracking of forfeitures to ensure they are allocated or used timely. As noted above, the transition rule of the proposed regulations permits any failure to use an historic forfeiture to be corrected by treating it like it occurred in the 2024 year and to use the forfeiture appropriately by the end of the 2025 year.

For individually designed plans, we anticipate that the regulations will be on the "Required Amendment List" for 2024, which would require the adoption of conforming plan amendments by December 31, 2026 (that is, two years after the change appears on the list). 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. For example, the preamble encourages plan sponsors to permit multiple uses for forfeitures in order to be able to have sufficient uses to enable the forfeitures to be allocated or used timely.

What If the Plan Sponsor Discovers That Forfeitures Have Not Been Forfeited or Allocated Timely from Their Defined Contribution Plan?

Plan sponsors should take advantage of the generous transition relief set forth in the preamble to the proposed regulations, and clean up any late forfeitures by the end of the 2025 plan year. ■