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Employee Benefits Corner

Use of Forfeitures Getting Class-Action Attention

By Elizabeth Thomas Dold and David N. Levine

The Internal Revenue Service (IRS) has long been in charge of setting forth rules for the timing and use of forfeitures in a defined contribution plan. Recently, in fact, the IRS has issued proposed regulations to clarify these rules, which are to be effective in 2024. So, the timing of recent class-action lawsuits filed against 401(k) plans for their use of forfeitures to reduce employer contributions is rather interesting. A summary of the IRS rules is set forth below, along with a review of the class-action filings, and action steps for plan sponsors to consider if they are charging participant accounts to help cover plan expenses.

The Rules

Many defined contribution plans require participants to complete a period of service before becoming fully vested in matching or nonelective employer contributions. If a participant leaves a company before completing the service required for full vesting, his or her non-vested account may be forfeited. These forfeitures are then typically used (1) to reduce employer contributions, (2) to pay plan expenses, or (3) to be reallocated among participants as additional accruals in accordance with nondiscrimination rules.[1]

Notably, in 2018, the IRS updated the 401(k)/(m) regulations to modify their position to allow forfeitures to be used to reduce qualified nonelective contributions (QNECs), qualified matching contributions (QMACs), and safe harbor contributions. The IRS snapshot explaining this issue stated that prior to the amended regulations, a plan could use forfeitures to satisfy expenses or make matching or discretionary profit-sharing contributions but could not use forfeitures as QNECs or QMACs.[2]

Historically, plan sponsors have had flexibility in the use of forfeitures, and the main concern was that the forfeitures were used or allocated timely, which was highlighted in a 2010 IRS Employee Plans Newsletter.[3]

The Newsletter expressly provides that Rev. Rul. 84-156 states that forfeitures may be used to pay for a plan's administrative expenses and/or to reduce employer contributions. (The Ruling actually provides for first using forfeitures to pay for plan expenses, and the remainder used to reduce employer contributions does not violate Code Sec. 401(a)(8) that pension plans cannot use forfeitures to increase benefits under the plan, which is not a 401(k) plan rule.) Department of Labor

(DOL) examinations have been focused on forfeitures, but more so related to missing participants than this new angle.

The recent IRS proposed regulations under Reg. §1.401-7(b) expressly provide plan sponsors with discretion on the use of forfeitures in the 401(k) plan document, which has generally been viewed as clarifying the historic rule:

> (b) Forfeitures under a qualified defined contribution plan. In the case of a trust forming a part of a qualified defined contribution plan (as described in section 414(i)) that provides for forfeitures, the plan must provide that: (1) Forfeitures will be *used for one or more* of the following purposes: *(i) To pay plan administrative expenses; (ii) To reduce employer contributions under the plan; or (iii) To increase benefits in other participants' accounts in accordance with plan terms*; and (2) Forfeitures will be used no later than 12 months following the close of the plan year in which the forfeitures were incurred under plan terms.

This language replaces the existing regulations in Reg. §1.401-7(a) that focused only on Code Sec. 401(a)(8) rule for pension plans (rather than 401(k) plans)—stating that forfeitures for a pension plan must be used as soon as possible to reduce employer contributions.

Moreover, in the Preamble to the Proposed Regulations, the IRS encourages plan sponsors to add flexibility as to the use of forfeitures, stating (emphasis added):

> Although nothing in the proposed regulations would preclude a plan document from specifying *only one use for forfeitures*, the plan may fail operationally if forfeitures in a given year exceed the amount that may be used for that one purpose. For example, if (1) a plan provides that forfeitures may be used solely to offset plan administrative expenses, (2) plan participants incur $25,000 of forfeitures in a plan year, and (3) the plan incurs only $10,000 in plan administrative expenses before the end of the 12-month period following the end of that plan year, there will be $15,000 of forfeitures that remain unused after the deadline established in these proposed regulations. Thus, the plan would incur an operational qualification failure because forfeitures remain unused at the end of the 12-month period following the end of that plan year. *The plan could avoid this failure if it were amended to permit forfeitures to be used for more than one purpose.*

Notably, there was no indication in the proposed regulations that this rather common plan document approach was prohibited, and in fact, many plan documents have this level of discretion and received a favorable IRS opinion or determination letter.

Class Actions

But along comes several class-action lawsuits in 2023 that raise a number of Employee Retirement Income Security Act of 1974 (ERISA) violations related to the use of 401(k) plan forfeitures. Specifically, the cases filed in the U.S. District of California, in both the Northern and Southern Districts of California, allege that the use of forfeiture results in: (1) a breach of ERISA's fiduciary duties, (2) a violation of ERISA's anti-inurement provision, and (3) engaging in self-dealing and transactions prohibited by ERISA.[4]

The concern at center stage is the plan sponsor's decision to use forfeitures to reduce employer contributions (an employer obligation) while charging participant accounts for plan administrative expenses. The claim is that the plan sponsor had the discretion to use forfeiture to pay the plan's administrative expenses or reduce the plan sponsor's contributions to the plan. Although the plan sponsor had the discretion to use the forfeited funds to pay plan administrative expenses and thereby reduce or eliminate the amounts charged to the participants' accounts to cover such expenses, the plan sponsor consistently declined to do so. As a result, the class asserts various ERISA claims (what one might call everything but the kitchen sink) because the plan sponsor elected to reduce its own obligation and proceeded to charge participant accounts fees to cover the plan expenses.

Next Steps

A fresh look at the plan's forfeiture provisions, and forfeiture process, in light of the litigation and the new proposed regulations is recommended. If you are already updating the plan document, it might be a good time to clarify the use and timing of forfeitures. Hardwiring of an ordering rule for the use of forfeitures might help address some of these new ERISA concerns—by eliminating plan discretion and just following the plan provisions. For example, forfeitures are first used to reduce employer contributions, and if amounts are still remaining, then such amounts are used to reduce plan expenses, and lastly, forfeitures are allocated to participants' *pro rata* based on compensation. Depending on the amount of forfeitures involved over the years (and the related charge to participant accounts for plan expenses), some plan sponsors might be more interested in a "wait and see" approach, as it is a bit early to tell if any of these cases will gain traction.

ENDNOTES

1. *See* Rev. Rul. 81-10, 1981-1 CB 172.
2. *See www.irs.gov/retirement-plans/issue-snapshot-plan-forfeitures-used-for-qualified-nonelective-and-qualified-matching-contributions.*
3. *web.archive.org/web/20170220173720/https:/www.irs.gov/pub/irs-tege/rne_spr10.pdf.*
4. *See* class-action complaints *Hutchins v. HP Inc.*, 401(k) Plan; *McManus v. The Clorox Company*; *Perez-Cruet v. Qualcomm Incorporated*, Employee Savings and Retirement Plan; *Rodriguez v. Intuit Inc.*, 401(k) Plan; and *Dimou v. Thermo Fisher Scientific Inc.*, 401(k) Retirement Plan.