Appropriate use of plan forfeitures

Background

As they administer their retirement plans, plan sponsors often must deal with plan forfeitures, which may occur when participants terminate employment before becoming fully vested. At first glance, managing forfeitures in a qualified retirement plan or 403(b) plan may appear simple, but the process can prove challenging. For example, the plan document must clearly define when and how the plan will use forfeitures. In addition, a plan sponsor should have established procedures for the timing and use of forfeitures to ensure compliance with plan terms and conditions.

The use of forfeitures has most recently been highlighted during Internal Revenue Service (IRS) audits. Some plan sponsors have been surprised to find that their plan documents don’t match how they actually administer plan forfeitures. Ensuring that forfeitures occur on a timely basis and are used according to the terms of the plan document will help mitigate compliance risk.

How forfeitures occur

Forfeitures, which may be used to pay for employer contributions and/or plan expenses, commonly result from any of these four circumstances:

- **Non-vested benefits** — When an employee terminates employment prior to completing the number of years of service required for full vesting, the non-vested portion of employer contributions may be forfeited. Many defined contribution plans allow for various types of employer contributions. Depending on a plan’s terms, employees may need to complete a certain number of years of service before they can fully vest in employer contributions. As an employee accumulates more years of service with an employer, the vested percentage of the benefit increases until it reaches 100%. Salary deferrals and other employee contributions are always 100% vested and, therefore, non-forfeitable. In addition, matching contributions may be forfeited when an employee has a permissive withdrawal from an automatic enrollment plan.

- **Corrections** — Forfeitures also can result from correction activity. For example, excess matching contributions can be forfeited if the plan fails certain nondiscrimination tests. Forfeitures that result from these activities can be used the same way as any other forfeitures in the plan. These types of forfeitures should be used in accordance with the terms of the plan document — i.e., reallocated to participants or held in an unallocated suspense account and used to reduce employer contributions for the current year or, if necessary, for subsequent years.

- **Missing participants** — Participants who cannot be located can temporarily forfeit their plan benefits. Some plans allow a missing participant’s account to be forfeited after a diligent search. Forfeitures that result from this type of activity can be used in the same way as any other forfeitures in the plan. The plan is required to restore the participant’s benefit if the participant is subsequently located.

- **Plans with full vesting** — The plan document may not address forfeitures that result from plan corrections or missing participants when the plan provides full and immediate vesting. The plan sponsor will have to decide the best use of forfeitures in a nondiscriminatory manner.

Timing of forfeitures

In addition to the different circumstances that can result in forfeiture, plan sponsors also must consider the following:

- **Five-year rule** — The five-year rule provides that the non-vested portion of the account balance of a participant who has terminated employment will be forfeited after five consecutive one-year breaks in service. It’s important to check the plan document and follow the forfeiture timing provisions within the document.

- **Upon distribution** — Many plans provide for accelerated forfeiture of the non-vested portion of a participant’s account balance once a distribution of the entire vested account has occurred following termination of employment. When such accelerated forfeiture occurs, participants rehired within five years must be allowed to repay the distributed amount in order to reinstate their plan benefits.

- **0% vested cash-out** — In cases where the participant has terminated and is 0% vested in his account balance (i.e., 0% vested in any employer contributions), the plan can deem the participant as cashed out, thereby triggering an immediate forfeiture of the non-vested account balance. If rehired within five years, such a participant may be deemed as having repaid his or her plan distributions and may have the previously forfeited benefits restored to the account balance.
Using plan forfeitures

It’s important that plan sponsors understand the proper use of forfeitures according to the plan document. Revenue Ruling 84-156 provides that forfeitures may be used to pay for a plan’s administrative expenses and/or to reduce employer contributions. As such, forfeitures generally may be used in four ways:

- Reallocate forfeitures to eligible participants
- Offset, or add to, other employer contributions due under the terms of the plan
- Restore previously forfeited amounts to a rehired participant’s account, subject to plan terms
- Offset a plan’s administrative expenses; please note that “settlor” expenses (expenses incurred as part of the employer’s role as settlor of the trust) should never be paid by the plan or trust

IRS regulatory requirements

If a suspense account is used, plan sponsors should ensure that all forfeitures for a plan year are promptly used according to plan terms. In the spring 2010 issue of the IRS newsletter, Retirement News for Employers, the IRS provided informal comments regarding the maintenance and use of forfeiture suspense accounts by defined contribution plans. This article acknowledged the common practice of placing forfeitures in a plan suspense account and emphasized that forfeitures should be used or allocated in the plan year in which they’re incurred. The IRS cited Revenue Ruling 80-155, which provides that a defined contribution plan will not be qualified unless all funds are allocated to participants’ accounts in accordance with a definite formula defined in the plan. The IRS believes the revenue ruling generally precludes a plan from carrying over plan forfeitures to subsequent plan years, as doing so would defy the rule requiring that all monies in a defined contribution plan be allocated annually to plan participants. Plans that use forfeitures to reduce plan expenses or employer contributions should include plan language and administrative procedures to ensure that current year forfeitures will be used up promptly in the current plan year or, in appropriate situations, no later than the immediately succeeding plan year.

Newly proposed regulations

On January 18, 2017, the IRS issued proposed regulations that permit forfeitures to be used to fund safe harbor contributions, Qualified Non-Elective Contributions (QNEC) and Qualified Matching Contributions (QMAC). The IRS has stipulated that the proposed regulations may be relied upon immediately, even though final regulations have not yet been published.

Plan document provisions

In general, our IRS preapproved plan documents and our 403(b) plan documents contain a combination provision that allows forfeitures to be used first to pay expenses and then to offset contributions. Any remaining amounts are then reallocated. The provision is designed to prevent the perpetual carryforward of suspense account balances. Plan sponsors are encouraged to compare the terms of their plan documents to actual plan administration to ensure that plan forfeiture accounts are being administered in accordance with plan terms.

Correcting excess forfeiture accounts

The IRS has established the Employee Plans Compliance Resolution System (EPCRS) to allow plan sponsors to correct plan failures on a voluntary and timely basis. It’s generally better to voluntarily correct a potential plan operational failure than to have the issue identified during an IRS audit. If a plan sponsor has potentially not used or allocated forfeiture account balances in a timely manner, plan sponsors may generally correct the issue through an EPCRS correction program. Depending on plan terms, it may be possible to use prior-year forfeitures to offset current year employer contributions or to pay current year expenses.

Avoiding potential future issues

Plan sponsors should review their plans’ forfeiture provisions and monitor forfeitures to ensure that they’re promptly used and/or allocated. Your account manager at Lincoln can assist by providing you with a forfeiture report as part of your annual review package. In addition, experienced technical consultants are available at Lincoln to help you align your plan administrative procedures with the terms of your plan document. Lincoln Retirement Plan Services representatives are available to provide information to plan sponsors so they can manage their plans effectively.

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