Proposed Regulations on How to Use Forfeiture Accounts: Helpful Guidance and a Great Reminder to Plan Sponsors

by Kenneth F. Ginder on March 7, 2023

On February 27, 2023, the IRS published proposed regulations on the use of forfeitures in qualified retirement plans.[1] For defined contribution plans, the regulations provide welcome clarity on what forfeitures can be used for and the date by which forfeitures must be used. In addition, they provide a helpful transition rule and, *most importantly*, serve as a reminder that forfeiture accounts must be used promptly to avoid an operational failure that will place the plan's tax-qualified status at risk.

In the Spring of 2010, the IRS warned plan sponsors in its "Retirement News for Employers" about the improper use of forfeiture accounts. The IRS explained that a common mistake it finds in defined contribution plans is that plan administrators place forfeitures in a separate plan account, "allowing them to accumulate over several years."[2] The IRS stated that the "Internal Revenue Code does not allow this practice" and that forfeitures "must be used or allocated in the plan year incurred." Later in the article, however, the IRS further stated that forfeitures used to pay plan expenses or reduce employer contributions should be used promptly in the year "they occurred or *in appropriate situations* no later than the immediately succeeding plan year." (*Emphasis added*.) The IRS did not explain what would constitute an "appropriate situation."

More than a decade after the IRS issued its newsletter guidance, it is not uncommon to find defined contribution plans with forfeiture accounts that have been accumulating for years. The proposed regulations serve as a helpful reminder that forfeitures must be used promptly. In addition, the proposed regulations would help with the administration of defined contribution plans in three ways:

1. Uses for Forfeitures: The proposed regulations clarify that forfeitures can be used for one or more of the following purposes: (i) to pay plan administrative expenses,

[1] Although this post focuses on defined contribution plans, the proposed regulations would also affect defined benefit plans, reflecting changes in law since the original regulations (Treas. Reg. §1.401-7) were issued in 1963.

[2] These accounts are often referred to as forfeiture accounts or suspense accounts.

(ii) to reduce employer contributions under the plan, or (iii) to increase benefits in other participants' accounts in accordance with plan terms.

2. <u>Timing for Use of Forfeitures</u>: The proposed regulations clarify that forfeitures must be used no later than 12 months after the close of the plan year in which the forfeiture occurs. Administrators will likely welcome this rule. It is simple and straightforward, and there is no need to determine whether an "appropriate situation" exists in order to use the forfeiture in the year following the year it arises.

3. <u>Transition Period</u>: The proposed regulations include a helpful transition rule related to the 12-month deadline. Under the transition rule, forfeitures incurred during any plan year that begins before January 1, 2024, will be treated as having been incurred in the first plan year that begins on or after January 1, 2024. Presumably the IRS included this generous transition period because it is aware that there are many plans with large forfeiture accounts, built up over numerous years, and it wants to provide plan sponsors with time to address this forfeitures issue.

The regulations are proposed to apply for plan years beginning on or after January 1, 2024; however, taxpayers may rely on the proposed regulations for periods preceding the applicability date. Therefore, sponsors can use these proposed rules now.

In light of the proposed regulations, we recommend that plan sponsors:

1. Review the terms of their plan document regarding the use of forfeitures;

2. Determine if their plan has forfeitures and, if so, the plan year(s) the forfeitures arose; and

3. Analyze whether forfeitures are being administered in accordance with the terms of the plan and current law (in particular, whether forfeitures are being used timely and for proper purposes).

If you conclude that forfeitures are not being administered properly, there are opportunities to correct the error and we would be happy to assist.

We also recommend considering whether the terms of your plan should be amended. For example, if your plan document only allows forfeitures to be used to pay plan administrative expenses, or if it requires that forfeitures be used in the year incurred, amending the plan to expand the use of forfeitures or extend the time by which forfeitures must be used, as provided in the proposed regulations, would reduce the risk of an operational failure.

If you have questions regarding your plan's forfeiture account, please contact a member of Verrill's Employee Benefits and Executive Compensation Group.

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