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Use of Retirement Plan Forfeitures: The IRS Proposed Regulations, Recent Litigation, and the DOL's Position

by Anna Mikhaylina on December 7, 2023

In five recently filed class action lawsuits,[1] 401(k) plan participants allege that plan fiduciaries violated ERISA by using plan forfeitures to offset employer contributions instead of paying plan expenses. The use of forfeitures to offset employer contributions is a long-standing practice expressly approved by IRS proposed regulations issued in early 2023 (the "2023 Proposed Regulations").[2] However, because most retirement plans are subject to both the Internal Revenue Code (the "Code") and ERISA, plans that comply with the IRS regulations could nevertheless be in violation of ERISA. To date, DOL guidance and case law do not address the forfeitures scenario in the pending lawsuits.

This post first briefly describes what a forfeiture is, what the 2023 Proposed Regulations provide, and what the pending lawsuits allege, then explores why the DOL's position on the use of forfeitures might differ from the IRS's. With the applicability date for the 2023 Proposed Regulations approaching, this post is also a reminder for plan sponsors to confirm that their retirement plans, in operation, comply with the regulations and that the plan documents reflect how the plans are operated.

What are forfeitures? Forfeitures are employer contributions that did not fully vest. For example, if a defined contribution plan imposes a six-year vesting schedule for a participant to acquire rights in 100% of the employer contributions allocated to the participant's account, and the participant terminates employment prior to completing six years of vesting service, the nonvested portion of the employer contributions is subject to

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[1] *Dimou v. Thermo Fisher Scientific, Inc., et al.*, S.D. Cal. No. 3:23-cv-01732 (9/19/2023), *Rodriguez v. Intuit, Inc.*, *et al.,* N.D. Cal. No. 5:23-cv-05053 (10/02/2023), *Perez-Cruet v. Qualcomm Incorporated et al.*, S.D. Cal. No. 3:23-cv-01890 (10/16/2023), *McManus v. The Clorox Company, et al.*, N.D. Cal. No. 4:23-cv-05325 (10/18/2023), and *Hutchins v. HP Inc., et al.*, N.D. Cal. No. 5:2023-cv-05875 (11/14/2023).

[2] The regulations are proposed to apply for plan years beginning on or after January 1, 2024. So, the deadline for the use of forfeitures arising in a plan year beginning during 2024 will be 12 months after the end of that plan year. The IRS specified that taxpayers may rely on the 2023 Proposed Regulations for periods preceding the applicability date. See our March 7, 2023 post for a detailed discussion of the regulations.

forfeiture. The terms of the plan will dictate when the nonvested portion becomes a forfeiture.

Under the Code and ERISA, a plan may provide that the nonvested portion of a terminated participant's account balance will be forfeited as of the earlier of:

(1) the date the participant incurs five consecutive one-year breaks in service, or
(2) the date the participant takes a complete distribution of the vested portion of their account balance.

While allowing forfeitures to arise faster, the latter option also requires the plan to provide for reinstatement of the forfeited amount if the participant becomes reemployed before incurring five consecutive one-year breaks in service and repays to the plan the amount distributed.

What do the 2023 Proposed Regulations provide regarding the use of forfeitures?
The 2023 Proposed Regulations specify that:

- forfeitures may be used for <u>one</u> 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; and
- forfeitures must be used no later than 12 months after the close of the plan year in which the forfeiture occurs.

The preamble to the 2023 Proposed Regulations also advises that:

- nothing would preclude a plan document from specifying <u>only one</u> use for forfeitures, but the plan may have an operational failure if forfeitures exceed the amount that may be used for that one purpose, and that the plan could avoid such failure if it were amended to permit forfeitures to be used for more than one purpose; and
- plan administrators must keep records necessary to demonstrate compliance with the qualification requirements of Code section 401(a), including records related to the use of forfeitures.

Notably, the complaints in the five recent lawsuits read like a primer on how to comply with the 2023 Proposed Regulations because it appears that:

(1) the plan documents allowed forfeitures to be used for plan expenses and employer contributions;
(2) plan records show how the forfeitures were used; and
(3) forfeitures were not held more than 12 months after the close of the plan year in which they occurred.

If a plan complies with the 2023 Proposed Regulations, there will be no threat to the plan's tax-qualified status resulting from how forfeitures are used, but compliance with the fiduciary requirements of ERISA is not automatically assured.

The pending lawsuits. ERISA requires fiduciaries to act solely in the interest of plan participants and beneficiaries and for the exclusive purpose of providing benefits and defraying reasonable administrative expenses of the plan. The participants in the pending lawsuits, among other theories of recovery,[3] argue that the plan fiduciaries violated ERISA because they chose to use forfeitures to reduce employer contributions instead of using them to pay plan expenses that are otherwise paid from the accounts of participants. The terms of the plan documents give the fiduciaries discretion to use forfeitures either to reduce employer contributions or pay plan expenses.

Why the DOL position on the use of forfeitures might differ from the IRS's. The inherent tension with forfeitures is that forfeitures originate as the employer's funds, but they also are plan assets subject to ERISA. While ERISA requires plan fiduciaries to act solely in the interest of plan participants and beneficiaries and for the exclusive purpose of providing benefits and defraying reasonable expenses, the DOL has not provided any formal guidance applying this duty specifically to forfeitures. A DOL news release on September 28, 2023, however, may hint at what the DOL's position might be in applying this duty to forfeitures. The news release, regarding a consent order and judgment ordering Sypris Solutions Inc. ("Sypris") to restore $575,000 to its 401(k) plan participants' accounts, states:

> The department alleged that from 2012 through 2015, the 401(k) plans' governing documents required defendants to use forfeiture funds to pay plan expenses, but instead, defendants used the forfeiture funds to reduce employer contributions to the plans.

To prevail in this case, the DOL could have asserted only a failure to follow plan terms (which is a separate fiduciary duty under ERISA), but the DOL appears to have also asserted a failure to act solely in the interest of participants and beneficiaries. The news release goes on to state:

> By doing so, the employer benefited by reducing its contributions to the plans, at the expense of plan participants who saw their plan account balances reduced by payments of plan expenses from plan assets and not from forfeitures.[4]

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[3] The participants also allege the plan fiduciaries violated ERISA's anti-inurement provision and engaged in self-dealing and prohibited transactions.

[4] Also noteworthy, the wording of the news release is curious in that it suggests that forfeitures are not plan assets.

Notably, in the pending lawsuits, the question is slightly different – whether there is a fiduciary breach for failure to act solely in the interest of participants and beneficiaries where the plan document permits forfeitures to be used to reduce employer contributions or pay plan expenses, and the plan fiduciary chooses to use forfeitures to reduce employer contributions instead of paying plan expenses.

If the DOL were to agree with the plaintiffs in the pending litigation, the agency would seem to be requiring forfeitures to cover plan expenses fully before using them to reduce employer contributions if the plan permits both uses. However, such a requirement has never been imposed by guidance under ERISA. If the DOL were to disagree with the plaintiffs, it could invoke the U.S. Supreme Court-approved “incidental benefit” concept to shield fiduciaries from liability for using forfeitures in any of the ways permitted by the 2023 Proposed Regulations.

Under the Supreme Court precedent, an employer may receive benefits incidental to operating a retirement plan – for example, attracting and retaining employees, and reducing the likelihood of lawsuits by employees – without violating ERISA.[5] In its Advisory Opinions, the DOL has approved a variety of incidental benefits, such as allowing plan sponsors to use plan assets to confirm the plan’s qualified status (Advisory Opinion 2001-01A), to reduce funded status volatility (Advisory Opinion 2006-08A), and most recently, to generate reputational benefits relating to the promotion of racial equity (Advisory Opinion 2023-01A). However, the relationship of these incidental benefits to the plan assets is either much more attenuated than that of benefits arising from the use of forfeitures, or much more limited. And the DOL might not be comfortable viewing a benefit as “incidental” if the benefit is realized directly or indirectly at the expense of plan participants.

What little there is in the Sypris news release suggests the DOL might take the former position. We may soon find out if the DOL files an amicus brief in one or more of the pending lawsuits. In the meantime, we recommend focusing on compliance with the 2023 Proposed Regulations and keeping an eye on the outcomes of the forfeitures litigation.

Should you have any questions regarding the use of forfeitures, please contact a member of our Employee Benefits & Executive Compensation Group.

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[5] *See, e.g., Lockheed Corp. v. Spink*, 517 U.S. 882 (1996), and *Hughes Aircraft Company v. Jacobson*, 525 U.S. 432 (1999).