

EMPLOYEE BENEFITS LAW

INFORMATION MEMO

MARCH 27, 2023

Proposed Forfeiture Regulations Provide Clarity and Serve as a Helpful Reminder to Plan Sponsors

The Internal Revenue Service (IRS) has proposed regulations to clarify the permissible uses of plan forfeitures in qualified retirement plans. This memo provides insight into: (1) types of benefit forfeitures permitted in qualified retirement plans; (2) uses of those forfeitures under current law; (3) the IRS's proposed regulations regarding the use of plan forfeitures; and (4) implications of the proposed regulations on qualified retirement plan sponsors and administrators.

Background: Types of Retirement Plan Forfeitures

The Internal Revenue Code (the Code) permits the forfeiture of a participant's accrued benefit derived from employer contributions in certain circumstances, including:

- **Termination of Employment** – If an employee terminates employment or incurs a break in service, the unvested portion of the employee's benefit may be forfeited.
- **“Bad Boy” Termination** – If a plan allows vesting earlier than minimum requirements under law, the plan documents may include a “bad boy” clause, which provide for the divestiture of a terminated employee's vested and unvested benefits, provided that the employee engaged in serious misconduct or post-termination competitive activities.
- **Withdrawal of Mandatory Contributions** – If a plan requires mandatory contributions, it may provide that participants, who are less than 50% vested, forfeit their rights to the employer-derived benefit, provided that the participant withdrew an amount attributable to the mandatory contributions. The plan must allow the participant to cure the forfeiture by repaying the amount withdrawn (plus interest, in the case of a pension plan).
- **Cessation of Contribution Under Multiemployer Plan** – If an employer ceases contributions to a multiemployer plan, then the multiemployer plan may forfeit benefit accruals derived from employment with the delinquent employer prior to the cessation of contributions. Multiemployer plans may also forfeit benefits if they are insolvent.
- **Death** – A plan may provide that the benefit attributable to employer contributions is not payable if the participant dies, except in the case of a qualified joint and survivor annuity or a qualified preretirement survivor annuity.

How to use Forfeited Benefits: An Overview of Permissible Uses Under Current Law

After a forfeiture occurs, the forfeited amounts turn into unallocated plan assets. The Code is relatively silent on how to use these assets arising from forfeitures.

The IRS, however, has provided more detail on forfeiture usage through the issuance of regulations. The current IRS regulations require defined benefit plans to use forfeited benefits “as soon as possible to reduce the employer's contributions under the plan.” The IRS also permits defined benefit plans to allocate forfeitures towards administrative expenses of the plan, such as recordkeeping fees, third-party administrator fees and fees paid for preparation of annual compliance testing and year-end reporting.

The IRS requires defined contribution plans to allocate forfeitures “to participants’ accounts in accordance with a definite formula.” The current IRS regulations do not clearly specify whether defined contribution plans may allocate forfeitures to administrative expenses.

In its Spring 2010 newsletter entitled “Retirement News for Employers,” the IRS stated that many retirement plans place forfeitures into a plan suspense account, allowing the forfeitures to accumulate over several years. The IRS proclaimed such a practice to be impermissible under the Code. The IRS based that pronouncement on Revenue Ruling 80-155, which requires plans to value distributable plan assets, including forfeitures, annually, reasoning that placement of forfeitures in a separate account removes the forfeitures from this requisite annual valuation.

The IRS, however, never proposed a regulation based on its reasoning in the Spring 2010 newsletter until now. As a result, many retirement plans have continued to place forfeitures in a separate account where the forfeitures have been accumulating for years.

The Proposed Regulations: Clarifying Permissible Use of Plan Forfeitures

On Feb. 27, 2023, the IRS published proposed regulations in the Federal Register that seek to clarify the rules relating to the use of forfeitures in qualified retirement plans, including a deadline for the use of forfeitures in defined contribution plans.

For defined contribution plans, the IRS proposes the following:

- Authorize defined contribution plans to use forfeitures, in accordance with plan terms, to:
 - pay plan administrative expenses,
 - reduce employer contributions under the plan, or
 - increase benefits in other participants’ accounts.
- Require defined contribution plans to use forfeitures no later than 12 months after the close of the plan year in which the forfeitures occurred.

The IRS reasoned that the proposed regulations are required to clarify the uncertainty of forfeiture usage by defined contribution plans under current regulations and to ensure that plan assets are properly valued each year. Pursuant to a transition rule, the IRS would allow defined contribution plans to treat forfeitures incurred during any plan year that begins before Jan. 1, 2024 as having been incurred in the first plan year that begins on or after Jan. 1, 2024, which would require allocation on or before the plan year beginning on or after Jan. 1, 2025.

For defined benefit plans, the IRS proposes the following:

- Repeal the requirement in the current IRS regulations that requires defined benefit plans to apply forfeitures “as soon as possible” to reduce employer contributions.
- Direct defined benefit plans to incorporate plan forfeitures into their actuary’s reasonable assumptions underlying the calculation of the minimum funding level for the plan.
- Set the effective date for the above proposals as the first day of the plan year on or after Jan. 1, 2024.

Proposed Regulations’ Impact: How Your Plan Might Be Effected

The most consequential impact of the IRS’s Feb. 27, 2023 proposed regulations is the requirement that defined contribution plans use their forfeitures within 12 months of the close of the plan year

in which the forfeiture occurred. Sponsors and administrators of defined contribution plans should review their current administrative practices to ensure that forfeitures are being used for a permissible purpose and in accordance with the 12-month timing rule. Plan sponsors also should review the terms of their plan document regarding forfeitures and consider making appropriate amendments, if necessary, to align the terms of the plan with the requirements of the proposed regulation.

Defined benefit plan sponsors and administrators should ensure that they are not immediately reducing employer contributions with actual forfeitures but, rather, determining employer contribution requirements based on the minimum funding formulas set forth in the Code, which incorporate the plan's actuary's reasonable forecast of expected forfeitures in determining plan assets.

If you have any questions related to the proposed regulations from the IRS, plan design options concerning the same or the information presented in this memo, please do not hesitate to contact [John M. Harras](#), any attorney in Bond's [employee benefits and executive compensation practice](#) or the Bond attorney with whom you are regularly in contact.

