FAQ: FORFEITURE ACCOUNTS[1]

What is a forfeiture?

Forfeitures most typically occur when a terminated participant who is not fully vested in the employer contribution portion of his or her account receives a plan distribution. For example, a 60% vested participant with an employer contribution account balance of $1,000 would receive a distribution of $600, and $400 would be placed in the plan’s forfeiture account. Forfeitures are also generated upon ACP test failures where the corrective matching contribution refunds required are not 100% vested. Forfeiture dollars are placed in a forfeiture account for later use by the plan sponsor. If the employer contribution is not subject to a vesting schedule, forfeitures generally do not accrue within the plan.

How is my plan’s forfeiture account used?

Revenue Ruling 84-156 states that forfeitures may be used to pay for a plan’s administrative expenses and/or to reduce employer contributions. How a specific plan's forfeiture account is used is always determined, however, by the applicable provisions of the plan document. Typically, forfeiture accounts are first used to pay the administrative expenses of the plan, such as accounting, auditing, consulting or recordkeeping fees. If there are forfeitures remaining after payment of expenses, the plan document will also dictate how these should be used. Generally, plan documents provide that forfeitures in excess of plan expenses will either reduce the employer contribution or be allocated to participants as an additional contribution. Employer contributions offset by the forfeiture account are not tax deductible. Forfeitures cannot be used to offset employee deferrals, and the funds in a forfeiture account cannot be distributed back to the employer.

By when must assets in a forfeiture account be used?

As a general rule, forfeitures must be used or allocated during the plan year in which the forfeiture is incurred. In Revenue Ruling 80-155, the IRS takes the position 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. Therefore, a plan may not carry over plan forfeitures to subsequent plan years, as doing so would contradict the rule requiring all money in a defined contribution plan to be allocated annually to plan participants. Treasury Regulation §1.401-7(a) also notes that forfeitures must be used as soon as possible to reduce employer contributions. Except under limited circumstances, forfeitures should not be held unallocated in a suspense account.

How can I be sure that my plan's forfeiture account is being used correctly?

Plan sponsors usually must coordinate the allocation of the plan's forfeiture account with their recordkeeping vendors. As a general guideline, satisfaction of the following three requirements will usually equate to proper forfeiture account use:

The plan document must specify how a forfeiture account is to be used. Most typically, forfeitures are used to pay plan expenses. Any remaining forfeitures are then allocated to participants as an employer contribution offset or a separate contribution all together.

Forfeitures in a suspense account must not remain unallocated beyond the end of the plan year in which they occurred.

Forfeitures must not be carried over for use in a subsequent plan year.

My plan did not allocate the forfeiture account in a timely manner. What should we do?

If your plan did not allocate its forfeiture account in a timely manner, this failure can generally be corrected by reallocating all forfeitures in the plan's forfeiture suspense account to plan participants who should have received them had they been allocated on time. The plan sponsor, with the assistance of its recordkeeping vendor, should also revise prior plan year forfeiture allocation reports to reflect the corrected forfeiture allocation and pay any amounts due to terminated participants. Depending on plan provisions or the facts and circumstances of a particular situation, it may be appropriate to use the non-current-year forfeitures as employer contributions for the current plan year. Plan sponsors may apply the correction principles of the Employee Plans Compliance Resolution System (EPCRS) if the mistake is being fixed within two years of the end of the plan year during which the mistake occurred. After this time, the Voluntary Correction Program (VCP) must be used unless the failure can be classified as insignificant. VCP must also be used if the plan document provisions regarding forfeitures are defective and need to be corrected retroactively by a plan amendment.

Where can I find additional information?

Your consultant at the Multnomah Group can assist you with any remaining forfeiture account questions that you may have.

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