



**Vanguard**<sup>®</sup>

# Avoiding pitfalls in retirement plan forfeitures

Vanguard commentary

February 2017

Plan sponsors possess great flexibility in using forfeitures in the administration of their defined contribution retirement plans. Forfeited funds, instead of employer assets, may be used to pay for employer contributions or plan expenses. Forfeitures generally exist in plans with vesting schedules, and Internal Revenue Code (“IRC”) rules, plan terms, and, in some cases, the exercise of fiduciary discretion determine their use. Plan sponsors, however, sometimes encounter challenges in determining when forfeitures occur and how to use them appropriately. Specifically, some sponsors may not have established effective procedures for the timing and use of forfeitures.

Vanguard Strategic  
Retirement Consulting

At first glance, the concept and treatment of forfeitures in qualified retirement plans appear to be relatively simple to understand. However, a review of IRC rules reveals that forfeitures may not be as straightforward as expected, and could pose compliance risk.

In recent years, employer-sponsored retirement plans have experienced heightened scrutiny of forfeitures during Internal Revenue Service (“IRS”) audits. Failures to use or allocate forfeitures on a timely basis highlight the need for a proper forfeiture management process. Some plan sponsors have been surprised to find that their plan documents do not align with their plan operations. Ensuring that forfeitures occur timely and are used according to the terms of the plan document will mitigate compliance risk.

This commentary will help defined contribution plan sponsors consider the administration of forfeitures within their plans. It also outlines the timing and approved uses of forfeitures and provides additional considerations for forfeiture-related events.

## What are forfeitures?

**Unearned benefits.** Forfeitures are plan assets generally created by participants who have not earned the right to receive their entire account balance in the plan. Participants typically earn the right to receive a percentage of their employer-provided account balances as a reward for their length of service with an employer, according to the plan's vesting schedule. As an employee's service increases, the percentage of the earned right to the benefit (i.e., vested percentage) also increases, ultimately to 100%.

Benefits attributable to participant salary deferrals, participant after-tax contributions, qualified nonelective contributions ("QNEC"), and qualified matching contributions ("QMAC") are always 100% vested and, therefore, nonforfeitable.

**Determining nonvested amounts.** Upon a participant's termination of service with an employer, the vested and nonvested percentage of a participant's account balance can be determined and any nonvested benefit amounts become subject to forfeiture. The terms of the plan document determine when such nonvested amounts actually become forfeitures.

**Forfeiting nonvested amounts.** The most common timing rule for forfeiting nonvested amounts provides that the nonvested portion of a terminated participant's account balance be forfeited after the participant incurs five consecutive one-year breaks in service. A plan that intends to operate in this manner should have this provision stated in the plan document. A plan document without this provision should not be interpreted

as having adopted this rule, but rather the plan would have to follow the forfeiture timing provisions within the plan document.

Waiting five years to forfeit a participant's nonvested account balance may be administratively cumbersome. Therefore, in accordance with IRC rules, many plans provide for accelerated forfeitures. A plan may immediately forfeit the nonvested portion of the account balance with the distribution of a terminated participant's entire vested account balance (including elective deferrals). However, where such accelerated forfeitures occur, participants rehired within five years of termination may repay their plan distributions in order to restore or "buy back" their previously forfeited benefits.

In cases where a participant has terminated and is 0% vested in their account balance (e.g., 0% vested in any employer contributions and has no elective deferrals), the plan can deem the participant as being cashed out, thereby triggering an immediate forfeiture of the nonvested account balance. Similarly, upon rehire these participants may be deemed as having repaid their plan distributions and would have their previously forfeited benefits restored to their account balance.

## How can forfeitures be used?

Plan sponsors must understand the proper use of forfeitures in the plan. The IRC and relevant IRS guidance provide that forfeitures may be used in four ways:

- Reduce future employer contributions.
- Pay reasonable plan expenses.
- Allocate among participants as additional contributions.
- Restore previously forfeited participant accounts.

The plan document must clearly define how the plan will use forfeitures. For administrative flexibility, a plan may include more than one of these methods. Further detail about each of the four methods follows.

### **Reduce future employer contributions.**

Plans most commonly use forfeitures to reduce future employer contributions. Under this method, forfeitures satisfy some or all of the employer contribution funding rather than the plan sponsor funding the entire contribution with new monies to the plan.

A plan sponsor may not use forfeitures to fund elective deferral contributions. Since forfeitures are already plan assets, the IRS considers using forfeitures to fund a contribution of elective deferrals to be impermissible prefunding.

**Pay plan expenses.** Plan forfeitures may be applied to pay any reasonable expenses incurred in the operation of the plan. After the plan fiduciaries determine the reasonableness of a fee and its eligibility to be paid with plan assets, they may use forfeitures to pay part or all of this expense. For additional considerations related to paying plan expenses, please refer to Vanguard's *Determining Reasonableness of Retirement Plan Fees*, [vanguard.com/fees](http://vanguard.com/fees).

**Allocate to participants.** Plan sponsors may allocate forfeitures as an additional employer contribution. The plan document should clearly describe the method of allocation (e.g., pro rata to participants) and any allocation eligibility requirements (e.g., to be eligible, participants must be employed on the last day of the plan year).

But plan sponsors should also be aware that, under IRC rules, allocated forfeitures would be aggregated with other employer contributions in determining a participant's annual additions. Thus, the IRC annual addition limit could affect the amount of forfeitures allocated to a participant.

**Restore participant accounts.** As previously discussed, certain rehired participants who repay plan distributions may buy back any previously forfeited account balance. In this case, the plan sponsor may reinstate previously forfeited amounts using available forfeitures.

**Forfeitures from multiple sources.**

Some plans provide participants more than one employer contribution that is subject to a vesting schedule (e.g., employer match and employer profit sharing). A plan with multiple employer contribution sources may specify that the forfeitures attributable to each type of contribution will be applied in a distinct manner. However, for maximum flexibility, many plans permit forfeitures attributable to any type of employer contribution to be used for any plan-defined purpose. In any case, the plan sponsor should be familiar with the provisions of the plan to ensure consistency between the plan document and the operation of the plan.

**Fiduciary responsibility.** As noted above, a plan may permit forfeiture usage in several ways. The plan sponsor uses discretion in determining how to manage forfeitures. Under the Employee Retirement Income Security Act ("ERISA"), exercising discretion over the administration of a plan is a fiduciary duty and requires plan fiduciaries to follow the terms of the plan. When providing direction to the plan's recordkeeper, the fiduciary should be mindful of the plan's forfeiture rules and act in the best interests of participants and beneficiaries, which in turn will mitigate the risk of fiduciary breach claims.

**When are forfeitures used?**

Plan administrators must be prepared to use forfeitures within time frames established by the IRC.

**Annual usage.** All funds in a defined contribution plan should be allocated to participants on at least an annual basis. In the Spring 2010 edition of *Retirement News for Employers*, the IRS noted that audit experience illustrates some plans inappropriately allow forfeitures to accumulate for several years, when, in fact, forfeitures are to be exhausted during the plan year in which they are incurred, or no later than the following plan year in appropriate circumstances. To mitigate risk, plan sponsors should review the plan language and associated administrative procedures to ensure they use forfeitures within the specified time periods.

**Clear plan provisions.** If a plan document is silent or ambiguous as to when forfeitures must be used, the plan sponsor should determine how and when forfeitures will be utilized and amend the plan document to be clear.

## **Additional considerations**

In addition to the basics already outlined, forfeitures present plan sponsors with a few additional considerations.

**Corrections.** One of the guiding correction principles of the Employee Plans Compliance Resolution System (“EPCRS”) is to keep assets in the plan. Thus, forfeitures can sometimes result from correction activity (e.g., forfeiture of erroneous employee or employer contributions). Forfeitures that result from this type of activity may be used in the same way as any other forfeiture in the plan.

**Missing participants.** Participants who cannot be located can create plan forfeitures. Some plans may provide that a missing participant’s account may be forfeited after a diligent search. When this is done, the plan must restore the previously forfeited amounts if the participant or beneficiary later returns to make a claim for benefits. As noted with corrections above, forfeitures that result from this activity can be used in the same way as any other forfeiture in the plan.

**Plans with full vesting.** Confusion arises when a plan that provides full and immediate vesting and contains no forfeiture language experiences forfeitures from corrections or missing participants. The sponsor must then determine the best use of the forfeitures without any specific plan language. In such a case, the plan should be amended to authorize the use of forfeitures to reduce employer contributions or to pay plan expenses.

**Plan termination.** Plan terminations may also present some forfeiture challenges. First, a terminated plan must 100% vest all current participants, including terminated participants who have not yet incurred five consecutive one-year breaks in service. Next, if a plan terminates with unallocated amounts in the plan’s forfeiture account, the plan sponsor must decide how to use these forfeitures. This could occur, for example, when a plan provides that forfeitures are used to reduce future employer contributions, and no future contributions are anticipated due to the plan termination. Using the remaining forfeitures to pay final plan expenses or allocating these forfeitures to participants may be the most viable solution. The plan document may need to be amended to provide for use of the forfeitures under these circumstances. Strict adherence to the timing rules for the use of forfeitures as described above should help to minimize the amount of forfeitures remaining upon plan termination.

## Final thoughts

Plan sponsors have options with respect to plan forfeitures. The plan document should contain clear forfeiture provisions that align with the plan sponsor's intent.

As a first step, plan sponsors should understand when forfeitures will occur, how to use them, and when to use them. Lack of awareness could lead to compliance violations.

Considering the renewed audit initiatives by the IRS, sponsors should evaluate the intent and operation of the plan with respect to forfeitures. Plan sponsors who ensure that the plan document and administrative procedures agree will be better able to demonstrate compliance. Taking the time to complete such a review may also save the plan sponsor from an unexpected and costly plan correction. Should significant discrepancies be discovered, plan sponsors may rely on consultants, counsel, or the many compliance tools the IRS offers to assist in correcting plan failures, including EPCRS and the 401(k) Plan Fix-It Guide.

The best way to mitigate forfeiture compliance risk is for plan sponsors to know their plan and operate accordingly. Vanguard Strategic Retirement Consulting helps sponsors resolve challenges and manage their plan more effectively.

*Vanguard Strategic Retirement Consulting (SRC) is a valuable technical resource that can help both defined contribution and defined benefit plan sponsors optimize their plan design, develop fiduciary best practices, and achieve regulatory compliance. The strategies developed by SRC consultants are grounded in expert analysis of broad-based data and are informed by Vanguard's highly respected research teams, including the Vanguard Center for Investor Research.*





P.O. Box 2900  
Valley Forge, PA 19482-2900

**Connect with Vanguard®** > [vanguard.com](http://vanguard.com)

© 2017 The Vanguard Group, Inc.  
All rights reserved.

All investing is subject to risk, including the possible loss of the money you invest.

FRFTP 022017