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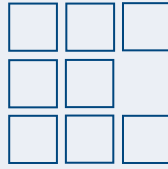

Compensation Strategies Group, Ltd.

Retirement and Welfare Benefit Plan Consultants and Administrators

800-780-7669
713-652-9099 (Houston)
409-898-0061 (Beaumont)
www.csgbenefits.com

A non-technical review of qualified retirement plan legislative and administrative issues **June 2016**

Fun with Forfeitures

Sooner or later, almost all 401(k) plans will face the "fun" of dealing with forfeitures. Just like every other plan-related operational item, there are specific rules that provide guidance on the "who, what, why, when and where" of using forfeitures.

What is a forfeiture?

Putting it simply, a forfeiture is the non-vested portion of a participant's account that he or she gives up in certain instances. The most common trigger is when a partially vested participant terminates employment and takes a distribution. That participant receives the vested portion and forfeits the non-vested portion.

Certain discrimination testing failures can also generate forfeitures by highly compensated employees (HCEs). For example, if a plan fails the average contribution percentage (ACP) test, amounts that are outside the limits are often distributed from the plan to the affected HCEs. However, if a particular HCE is not fully vested, he or she receives only the vested portion of the excess amount with the remainder treated as a forfeiture.

What isn't a forfeiture?

This is probably a good place to touch on amounts that may appear similar but are not actually forfeitures. Here are several:

- Revenue sharing held in an ERISA spending account;
- Pre-funded company contributions that have not yet been allocated to participant accounts;
- Removal of company contributions allocated to a participant by mistake;
- Settlement proceeds from mutual fund litigation; and
- Amounts that exceed other plan or regulatory limits.

Although these might look and feel like forfeitures, there are different sets of rules that determine when and how these amounts can/must be used. That means properly identifying and tracking them is critical to ensuring operational compliance.

When do forfeitures occur?

Now that we've addressed the "what," it's time to talk about the "when." The answer to this question can be found in the plan document, and it is

usually a function of how long a participant has been gone and when he or she takes a distribution. This is important because knowing when forfeitures occur is critical to determining when they can/must be used.

One of the more common plan document provisions is that a forfeiture occurs on the earlier of the date the participant:

- Receives a complete distribution of his or her vested account balance, or
- Incurs five consecutive one-year breaks in service.

Let's look at both in turn.

When is a distribution "complete"?

A complete distribution is pretty straightforward, but there is one nuance to check. Many plans include a provision that says if a participant terminates without any vested balance, he or she is treated as if a complete distribution has occurred.

When applying this rule, keep in mind that it doesn't just refer to amounts that are subject to a vesting schedule, like matching or profit sharing contributions. It also includes fully vested accounts like 401(k) deferrals and rollovers. In other words, the participant in question must be 0% vested and not have any deferrals in his or her account.

This rule often dovetails nicely with mandatory distribution provisions included in many plans, which require distributions to former employees when they have vested account balances of less than $5,000.

What is a one-year break in service?

Turning our attention to the second of the conditions, a one-year break in service (also referred to simply as a break in service) occurs on the last day of a plan year in which the former employee works fewer than 501 hours. This may be more easily explained with an example.

> Emmett works 750 hours during 2016 before terminating employment in May of that year. Emmett's first break in service will not occur until December 31, 2017. Assuming Emmett is not rehired, his fifth consecutive break in service will not occur until December 31, 2021.

These rules are fairly common, but be sure you confirm your specific plan's provisions. Some plans say that forfeitures occur on the later of these two conditions (rather than the earlier of… big difference). Other plans use a single break in service rather than five of them. Still other plans use a number less than 501 hours to define a break in service.

How are forfeitures used?

So, you have this pot of stray money that needs to be used. What can you do with it? It might seem reasonable to think you can pull it out of the plan and use it for something unrelated, but that is a big "NO-NO." You generally have three options. You can use forfeitures to:

- Pay allowable plan expenses;
- Reduce employer contributions (other than safe harbor contributions, Qualified Nonelective Contributions (QNECs) or Qualified Matching Contributions (QMACs)); and/or
- Add to employer contributions.

Most plan documents include language authorizing any of these uses; however, some limit use to only one or two of these options.

IRS and DOL rules limit the types of expenses that are allowed to be paid using plan assets. Since forfeitures are still assets that belong to the

plan, they can only be used to cover expenses the plan is otherwise allowed to pay.

The other two options, reducing or adding to company contributions, seem fairly similar, and are better explained with an example.

> The ABC Company 401(k) Plan has a forfeiture account balance of $2,000. ABC decides to make a profit sharing contribution of 5% of compensation for the year, which equals $20,000. In this case, ABC could remit $18,000 and use the $2,000 in forfeitures to bring the total to $20,000. This is an example of using forfeitures to reduce the contribution.
>
> Alternatively, assume ABC wishes to deduct a contribution of $20,000 on its corporate tax return, so it remits $20,000 to the plan and adds the $2,000 in forfeitures for a total allocation to employees of $22,000. Since the forfeited amounts were deducted when they were originally contributed (before they were eventually forfeited), they are not deducted a second time when allocated from the forfeiture account. This is an example of adding forfeitures to the contribution.

It is important to remember that IRS regulations limit the types of contributions that can be funded with forfeitures. Those rules require safe harbor matching and nonelective contributions to be fully vested when they are contributed to the plan. Since forfeitures arise from non-vested account balances, they could not have been fully vested at the time of initial contribution, so they cannot be used to fund these types of contributions. The same is true for other types of QNECs and QMACs.

Can forfeitures be reinstated?

There is one other option available for using forfeitures even though it does not arise all that often. It's not all that uncommon for a former employee to be rehired, but it is quite uncommon for that rehired person to pay back a distribution he or she took from the plan when he or she terminated the first time.

If you experience this rare occurrence, the employee in question may be entitled to have any previously forfeited amounts reinstated to his or her account, and money in the forfeiture account can be used to fund that reinstatement.

When must forfeitures be used?

Contrary to popular belief, forfeitures cannot sit there and accumulate over time. Rather, IRS rules and plan document provisions dictate when they must be used. Typically, that timing is either by:

- The end of the plan year in which they occur, or
- The end of the plan year following the year in which they occur.

Some plans are written more broadly to say forfeitures must be used no later than the end of the year after the year of occurrence, which effectively offers flexibility over two plan years. However, since we're talking about when they must be used rather than when they can be used, it is important that you know exactly what your plan requires.

Let's return to our friends at ABC Company for a few examples to clarify things.

> Assume the forfeitures were generated in 2015. The plan requires that they be used in the year of occurrence. If ABC doesn't have any remaining expenses to pay for 2015, the forfeitures must be used toward company contributions for 2015. They cannot be carried forward and applied to 2016. If ABC doesn't normally make profit sharing contributions, it could declare

Compensation
Strategies Group, Ltd.
2920 Toccoa Road
Beaumont, TX 77703

a $2,000 match so that it is allocated only to participants who otherwise have an account balance in the plan.

Assume, instead, ABC's plan requires forfeitures to be used in the year following occurrence, and there are unpaid fees for 2015. The $2,000 could not be used to pay those expenses but would need to be held and used for 2016 expenses or contributions.

If the plan uses the more flexible "no later than" language, the $2,000 could be used for either 2015 or 2016.

What can I do to get this right?

Proper treatment of forfeitures is something that is on the IRS's radar, and some proactive planning can go a long way. For starters, make sure you know what your plan says and then monitor your forfeiture account on an ongoing basis. This allows you the greatest time frame to use those forfeitures in a way that works well for the plan and the participants.

It's also a good idea to review your plan design to see if you can build in features that give you more flexibility. For example, if you have a safe harbor 401(k) plan, make sure it also allows for an additional discretionary matching contribution. Since allocation of forfeitures to key employees (generally owners and officers) can trigger required "top heavy" contributions, perhaps writing the plan to place each participant in a separate profit sharing allocation group would allow you to make sure contributions only go to non-key employees.

Despite the title of this article, dealing with forfeitures is never really fun, but working with experienced professionals can help ensure smooth sailing.

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