In its quarterly newsletter, Retirement Plans for Employers (Spring 2010), the IRS highlighted a common error among defined contribution plans—not allocating forfeitures on a timely basis. While the IRS has not addressed the issue in many years, we often see plans that carry over suspense accounts from year to year instead of clearing the funds out at year-end. The IRS newsletter draws attention to this problem—and to the potential fixes.

**Background** – Many defined contribution plans have participants who terminate employment before becoming fully vested in employer contributions, resulting in forfeitures for the plan. These forfeitures typically sit in a suspense account and wait for the administrator to direct the recordkeeper or trustee on how the forfeitures should be applied, in accordance with the terms of the plan. Common uses of forfeitures include offsetting plan expenses and reducing employer contributions—sometimes they are even allocated to participants as an additional benefit. Frequently, this “clearing” process is overlooked—and the forfeitures roll over from year to year—even though the plan may say otherwise.

The IRS notes that, under longstanding guidance, failing to allocate forfeitures at least annually (and preferably as promptly as possible) raises a plan qualification issue. The issue can be corrected under the IRS’ voluntary correction system (“EPCRS”) by going back to past years and reallocating forfeiture amounts as it should have been done. Depending on plan terms, this process can become complicated and time consuming—especially where a number of participants have already taken distributions and small amounts may be involved.

**Recommended Steps** – To avoid potential issues, defined contribution plans should create a regular process to handle forfeited amounts. (While the IRS guidance in the area pertains to section 401(a) qualified plans, section 403(b) plan sponsors may want to follow the same approach.) The desired steps are as follows:

- First, check the plan to determine when forfeitures occur and how they can be used. If needed, amend the plan to allow forfeitures to pay plan expenses and/or reduce employer contributions.

- At a minimum, the forfeiture account should be reviewed near year-end to make sure it will be fully allocated before the end of the year. If a plan has a lot of forfeitures during the year, more frequent review of forfeitures may be desirable to ensure all of the forfeitures can be allocated within the year.

- Coordinate with the recordkeeper and trustee on use of the forfeitures. For example, when the plan sponsor receives an invoice for plan expenses that can be paid by the plan, or will make a match/profit-sharing contribution, it may apply the unallocated forfeiture amounts first. In some cases, to use up
remaining amounts, it may be possible to pre-pay expenses due early in the next plan year.

- If operational errors involving large amounts or an extended time frame are identified, consider an EPCRS filing to cleanse the plan of the potential defect (or possibly to bless a retroactive amendment that conforms to plan operations).

Of course, forfeiture accounts are plan assets. Accordingly, the plan expenses must be reasonable and appropriate in light of ERISA fiduciary standards (i.e., “non-settlor” type expenses) to be paid with forfeitures, and the plan must authorize any use of plan assets to reduce employer contributions.

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