

Playing by the Rules With DC Plan Forfeitures

by | **Martha Mohs**

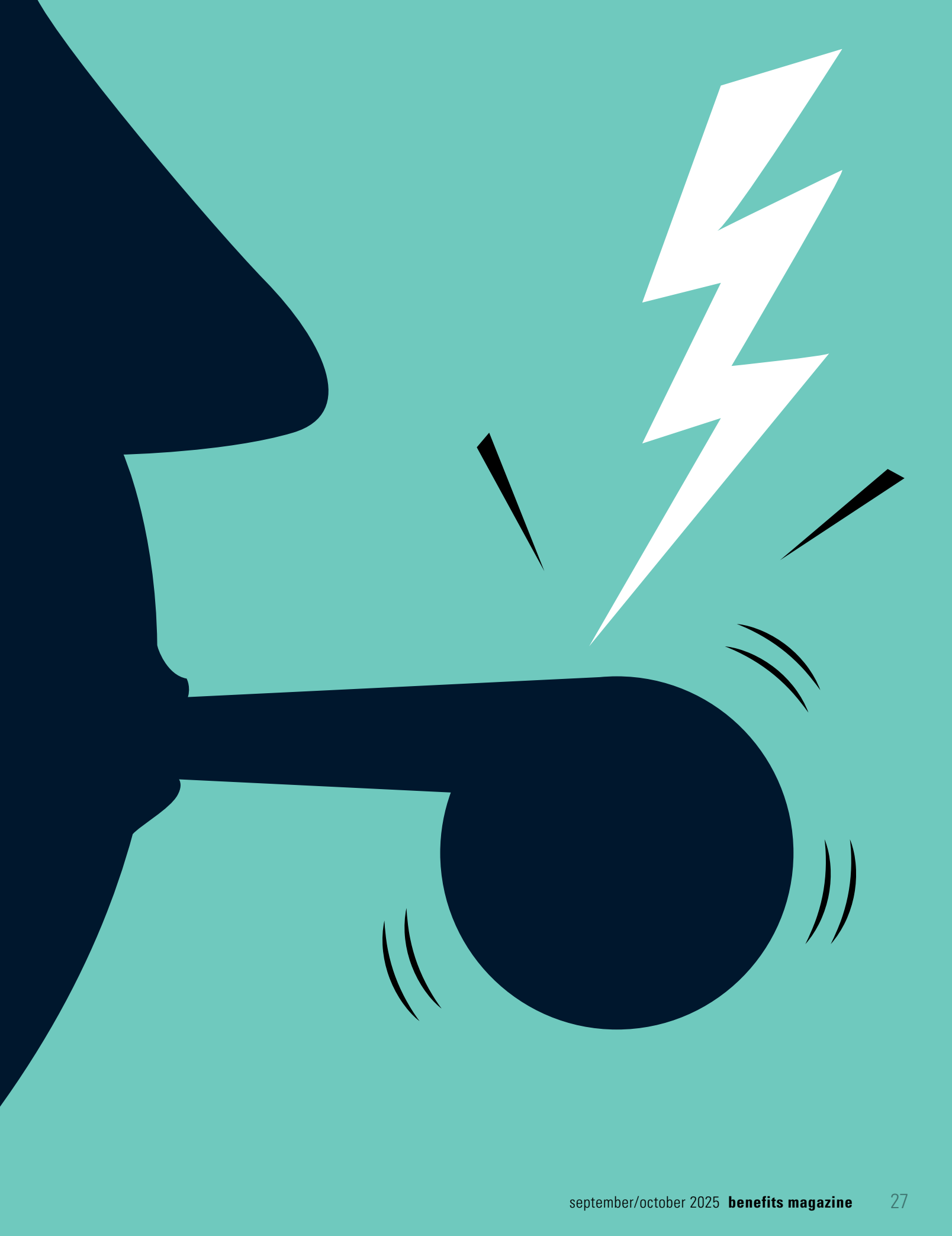
Amid new regulations and a rash of fiduciary breach litigation, defined contribution plan sponsors should pay close attention to how plan forfeitures are allocated. The author offers considerations for ongoing compliance and strategies for minimizing fiduciary risk.

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When a retirement plan participant leaves employment before they are vested in employer contributions to the plan, employers and plan sponsors are left with the decision of what to do with the money left behind, typically referred to as a *plan forfeiture*.

Any plan asset that is not held in a participant's account is also considered a forfeiture. Rules governing how these forfeitures may be allocated have been in place for decades, although there was some ambiguity regarding the scope of these rules.

Recent proposed Treasury regulations from the Internal Revenue Service (IRS) provide some clarity on the issue, but questions remain about how the regulations apply. Complicating this issue further, plan sponsors are suddenly faced with a rash of litigation surrounding allocation of forfeitures and challenging the use of allocation methods explicitly permitted by the proposed regulations.

This article will review a sample of the types of unallocated accounts subject to the proposed regulations as well as outline strategies and considerations for plan sponsors to review when determining how to allocate the amounts held in these accounts. With the deadline to allocate grand-

fathered forfeitures quickly approaching (for calendar year plans), plan sponsors should carefully review plan accounts to identify accounts that are subject to the proposed regulations and determine the proper method to allocate these amounts under the plan.

Background

In 2023, the IRS issued proposed Treasury regulations addressing the timing and permitted uses of forfeiture amounts held in both defined contribution (DC) retirement plans and defined benefit (DB) pension plans. While final regulations could still be issued, the proposed regulations became effective January 1, 2024.

The proposed regulations provided necessary clarity regarding the impact of forfeited benefits on funding valuations for pension plans. Given the IRS's long-standing position regarding the manner and timing of forfeiture allocations, the proposed regulations initially seemed like old hat for DC plan sponsors. However, in informal conversations with IRS compliance directors since the proposed regulations were issued, the IRS has advised that, in addition to traditional forfeiture accounts, the proposed regulations apply to any plan assets held in a DC plan that are not allocated to a participant's individual account.¹ This expanded application of the regulations has further complicated compliance efforts for DC plan sponsors and recordkeepers who now must ensure that all unallocated accounts are timely allocated.

takeaways

- Retirement plan forfeitures include unvested employer contributions left behind when a defined contribution plan participation leaves employment. In addition, any plan asset that is not held in a participant's account is also considered a forfeiture.
- Under proposed Internal Revenue Service (IRS) regulations, plan sponsors may use forfeitures for the payment of plan administrative expenses to reduce employer contributions required and to provide additional benefits to plan participants.
- Even though offsetting employer contributions is permitted under IRS guidance, several fiduciary breach lawsuits have been filed against plan sponsors for this practice.
- To maintain ongoing compliance, plan sponsors should regularly review sources of unallocated funds. Some are temporarily forfeited benefits or uncashed checks and should be returned to the intended participant or beneficiary when possible.
- Plan sponsors that use forfeitures for administrative expenses should ensure that they are included among expenses allowed by DOL guidance.
- To minimize fiduciary risk, plan sponsors could consider removing discretion from the plan document for the allocation of forfeitures. If the plan document allows discretion for the allocation of forfeitures, plan sponsors should document circumstances surrounding a forfeiture allocation decision.

IRS Position on Use of Forfeitures in DC Plans

The IRS has long taken the position that forfeitures in a qualified retirement plan must be used for a permissible purpose as soon as possible.

Historical Guidance

In 1963, the IRS issued Treasury Regulation Section 1.401-7(a), providing that forfeitures in a qualified retirement plan “must be used as soon as possible to reduce the employer's contributions under the plan.” Revenue Ruling 84-156 subsequently clarified that forfeitures may also be used to pay plan expenses and provide increased benefits to participants, while also reiterating that the forfeitures must be used as soon as possible.

In 2010, the IRS clarified its position about the timing of allocation of forfeitures, noting that “[f]orfeitures must be used or allocated in the plan year incurred” and that plan

documents must include language detailing how and when forfeitures would be used.² Further, the accumulation of forfeitures over multiple years should be corrected under the Employee Plans Compliance Resolution System (EPCRS).³ The IRS subsequently extended the deadline for allocation of forfeitures to the close of the year in which the amount was incurred but advised that further delays in the allocation of forfeitures is impermissible.^{4,5}

Proposed Treasury Regulations

On February 27, 2023, the IRS published proposed regulations to be effective January 1, 2024, consolidating its prior guidance for the timing and permitted methods of forfeiture allocation. The proposed regulations provide that a plan document must detail one or more of the following permissible uses for forfeitures:

- Payment of plan administrative expenses
- Reduction of employer contributions required under the plan
- Provision of additional benefits to participants in the plan.

The proposed regulations also require forfeitures to be used no later than 12 months after the close of the plan year in which they were incurred.⁶

Plan Amendment May Be Required for Compliance

The proposed regulations provide that the plan document must clearly state both how forfeitures will be used and the timing of the allocation. Plan sponsors should review the plan document to confirm whether it includes the appropriate level of detail regarding allocation of forfeitures and amend the language as necessary.

Transitional Relief for Allocation of Forfeitures

Acknowledging that many plans may not have followed these timing rules previously, the regulations offer a transitional rule to provide relief. Plans may treat any forfeitures incurred during any plan year prior to the plan year that begins on or after January 1, 2024 as being incurred during the first plan year that begins on or after January 1, 2024 (grandfathered forfeitures).⁷ For a calendar year plan, this relief means that using grandfathered forfeitures for a permissible purpose prior to December 31, 2025 will eliminate the need to correct the plan under EPCRS. If prior forfeitures are not timely allocated, the plan should

utilize applicable correction methods available under EPCRS.

Litigation Further Complicates Allocation Decisions

Despite explicit IRS guidance permitting the use of forfeitures to offset employer contributions, DC plan sponsors across the country have begun facing fiduciary breach litigation suits for this practice. The complaints in these lawsuits generally argue that the targeted plan sponsors breached their fiduciary duties by utilizing forfeitures to offset employer contributions rather than using the forfeitures to either reduce plan expenses or provide additional contributions.

In many of these cases, the plan document authorized the plan sponsor or administrator to use discretion in determining how to allocate forfeited amounts.⁸ District courts have declined to dismiss many of these cases, noting that there is a plausible claim that using forfeitures to offset employer contributions violates the best interest standard under ERISA. However, some courts have sided with plan sponsors, instead holding that using forfeitures in this manner can be a reasonable application of forfeited amounts depending upon the applicable facts and circumstances.

The DOL recently filed an amicus brief in a lawsuit filed against HP, Inc., about its use of forfeitures, firmly defending plan sponsors that elect to offset employer contributions with plan forfeitures.⁹ The agency noted that this practice is not a violation of ERISA and has been the “established understanding” in the industry for decades. However, it is unclear how persuasive the DOL’s position will be on the outcome of these cases.

Considerations for Ongoing Compliance

To comply with the proposed regulations, any unallocated amount held in a calendar year DC plan must be allocated by December 31, 2025.¹⁰ Correction under EPCRS remains available for any amounts that are not timely allocated. Plan sponsors should take the following steps to ensure that they remain in compliance.

Regularly Review Sources of Unallocated Funds

Plan sponsors should review the source of any unallocated amounts to determine whether a participant or beneficiary could be reunited with a benefit amount rather than the amount being allocated as a forfeiture.

For example, accounts holding benefits temporarily forfeited on behalf of missing participants and uncashed benefit checks could be returned to the intended participant or beneficiary rather than being allocated for plan purposes. To comply with the timing requirements under the proposed regulations, plan sponsors could consider or implement any of the following methods for reunification of these temporary forfeitures.¹¹

- **Reissue payment to participants or beneficiaries.** The plan sponsor could perform a missing participant search and either notify participants and beneficiaries of the existence of the benefit or reissue uncashed checks to participants if an updated address or telephone number is found.
- **Roll over the benefit to an individual retirement account (IRA) selected by the plan sponsor.** Any benefit that does not exceed \$7,000 may be rolled over to an external IRA selected by the plan sponsor. Before using this method, plan sponsors should confirm the minimum dollar amount that the IRA provider is willing to accept and ensure that the fee charged by the IRA provider is reasonable and in line with industry standards. Of course, before rolling any benefit over to an external IRA, plan sponsors must notify participants of their right to request a lump-sum distribution or direct the rollover of the benefit. Providing the notification to the last known address of a missing participant or beneficiary satisfies this obligation.¹²
- **Transfer the benefit to a state unclaimed property fund.** In January 2025, the DOL issued enforcement relief for plan sponsors that transfer benefits of \$1,000 or less to a state unclaimed property fund if the plan sponsor has adopted robust missing participant procedures, the plan sponsor finds that the transfer is prudent and the state unclaimed property

fund is an eligible state fund as defined under the guidance.¹³

- **Restore the amount to an individual account for the participant or beneficiary.** The proposed regulations apply only to accounts that are not held in a participant's name. Accordingly, plan sponsors could direct the plan's recordkeeper to reopen individual participant accounts and transfer any uncashed check or temporarily forfeited benefit to the individual account. Before taking such action, plan sponsors should consult with the recordkeeper regarding any applicable fees that will be charged to these participant accounts.

Review Plan Administrative Expenses

Because forfeitures are plan assets, they may be used only to cover certain expenses related to the operation of the plan.¹⁴ In general, plan assets may be used to pay for plan expenses related to qualification of the plan but not for tasks that are deemed to be "settlor functions."¹⁵ Determining whether a particular expense may be paid from plan assets is generally a fiduciary decision.¹⁶ However, the DOL has opined that the following expenses (among others) are explicitly permitted to be paid from plan assets.¹⁷

- Expenses for plan recordkeeping services
- Expenses for plan accounting services
- Legal fees for services relating to plan qualification issues
- Legal fees for determining whether a domestic relations order is qualified
- Expenses for periodic or annual compliance testing
- Expenses relating to the preparation of legally required reporting, such as the Form 5500
- Expenses relating to claims processing
- Expenses for the preparation of participant communications
- Expenses for telephone voice response systems
- Investment management fees

While plan sponsors may not regularly use forfeitures or other unallocated accounts to pay these fees, they could consider temporarily suspending their regular practice to pay these additional plan administrative expenses and spend down any grandfathered forfeitures held in unallocated accounts by the allocation deadline.

In addition, plan sponsors should regularly review administrative expenses and participant fees to ensure that they are reasonable and prudent. This process is a core tenet of

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a plan sponsor's fiduciary duties under ERISA.¹⁸ If significant amounts are held in a plan's administrative expense account and carried forward year to year, the plan sponsor should consider whether a reduction in administrative fees is warranted to bring participant fees in line with the actual cost of administration.

Offset Employer Contributions

Plan sponsors may use forfeitures to offset any employer contribution required under the plan, including non-elective contributions and matching contributions.¹⁹ A plan sponsor could also use forfeitures to make any employer contribution required under the Uniformed Services Employment and Reemployment Rights Act (USERRA) on behalf of participants returning from a qualified military leave.

However, in light of the ongoing forfeiture litigation, offsetting employer contributions with plan forfeitures is not without risk. Opportunities to mitigate this risk are highlighted later in the article.

Review Accounting of Temporary Forfeitures and Uncashed Checks

If a participant's benefit is temporarily forfeited or a benefit payment is uncashed, some recordkeepers will transfer these benefits to an unallocated account holding these amounts. This practice may prevent a plan from complying with the proposed regulations. Accordingly, plan sponsors should consider whether to direct the plan's recordkeeper to maintain independent accounts for the participant to hold uncashed checks or temporarily forfeited benefits. These accounts could include a notation that the account balance is tem-

porarily forfeited. Alternatively, the plan sponsor should consider whether it is appropriate to continue the practice of temporarily forfeiting benefits.

Allocate Remaining Amounts to Eligible Participants

Finally, plan sponsors may provide an additional contribution to participants to allocate any remaining forfeiture amount. When determining the method of allocation, plan sponsors should consider the source of the forfeitures. For example, if the plan sponsor is allocating excess amounts held in an administrative expense account and expenses are charged against participant accounts on a per capita basis, the allocation of this amount should also likely be made on a per capita basis.

Strategies for Minimizing Fiduciary Risk

Given the ongoing litigation related to allocation of forfeitures, DC plan sponsors should consider the following when determining which forfeiture allocation strategy to utilize.

- **Remove discretion from the plan document.** Because the use of discretion in determining how to allocate forfeitures could create fiduciary risk, plan sponsors could consider amending the plan document to provide a specific, sequential ordering for how forfeitures will be allocated. This approach removes all discretion and instead would require plan sponsors and administrators to simply follow the plan document when determining how to allocate forfeitures.
- **Document circumstances impacting the forfeiture allocation decision.** If a plan sponsor de-

sires to retain the flexibility to allocate forfeitures in any permitted method depending upon the specific facts and circumstances present at the time of allocation, the allocation method utilized and the reasoning supporting the

Funding of USERRA Contributions for Multiemployer Plans

Many plan sponsors utilize either forfeiture accounts or specific contributions to fund any contributions required under the Uniformed Services Employment and Reemployment Rights Act (USERRA). Amounts allocated to a USERRA account may have historically been carried forward from year to year to ensure that sufficient amounts were available to fund any required contribution. However, under the proposed regulations, plan sponsors may no longer carry these amounts forward. In addition, the Department of Labor generally discourages plan sponsors from charging other participant accounts to fund these contributions.* Accordingly, multiemployer plan sponsors may need to consider alternative funding methods for required contributions under USERRA to ensure compliance with the proposed regulations.

*"While forfeitures and interest provide a source of funds that might be utilized to fund USERRA obligations, that source may not always be enough. The commenter submits that in some cases, the only way in which a multiemployer defined contribution plan can fund its obligations under USERRA might be to reduce the account balance of other participants in the plan. While the Department acknowledges this possibility, it nevertheless expects plans to comport with USERRA's intent that the funding of obligations required by USERRA should avoid a reduction in the account balances of other plan participants, and plans should develop reasonable procedures to achieve this result to the greatest extent possible." Preamble to 20 CFR 1002 (2005).

selected method should be documented contemporaneously.

- **Determine the risk tolerance for litigation.** Plan sponsors should weigh their tolerance for litigation risk and determine whether the practice of offsetting employer contributions provides sufficient value to continue this practice. 6

Endnotes

1. 88 Federal Register 12282.
2. Internal Revenue Service (IRS). See page 4 of the Spring 2010 Retirement News for Employers newsletter.
3. Ibid at page 5.
4. See Defined Contribution Qs and As from the 2010 American Society of Pension Professionals & Actuaries (ASPPA) Annual Conference.
5. See Answer 49 of the above cited question and answer document.
6. 88 FR 12282, 12284.
7. 88 FR 12282, 12285.
8. See e.g., *Rodriguez v. Intuit, Inc.*, N.D.Cal., No. 5:23-cv-05053 and *Perez-Cruet v. Qualcomm Inc.*, S.D.Cal., No. 3:23-cv-019890 (2024).
9. Brief for the Chamber of Commerce of the United States of America, The American Benefits Council, and the ERISA Industry Committee as Amici Curiae, *Hutchins v. HP Inc.*, No. 5:23-cv-05875-BLF (9th Cir., July 9, 2025).
10. This specific deadline applies only to calendar year plans. Non-calendar year plans must allocate any forfeitures accumulated prior to the first plan year that begins on or after January 1, 2024, by the close of the second plan year beginning on or after January 1, 2024. As an example, a plan that uses a July 1 plan year must allocate all forfeitures accumulated prior to July 1, 2024 by June 30, 2026.
11. If a participant or beneficiary is missing at the time the individual reaches their required beginning date for distribution of their retirement benefit, some plan sponsors will forfeit the individual's benefit. If the indi-

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vidual later comes forward to claim the benefit, the plan sponsor will reinstate the benefit and pay any benefit payments owed to comply with the required minimum distribution rules. These forfeitures are generally known as *temporary forfeitures*.

12. IRS Notice 2005-5, Q&A-15.
13. Department of Labor (DOL) *Field Assistance Bulletin No. 2025-01*. Note that the guidance details numerous requirements for a state's unclaimed property fund to become an eligible state fund.
14. See DOL Advisory Opinion 93-14A.
15. See Employee Retirement Income Security Act (ERISA) Opinion Letter No. 2001-01A.
16. See DOL Advisory Opinion 90-03A.
17. DOL *Field Assistance Bulletin 2003-3* and DOL booklet "A Look at 401(k) Plan Fees."
18. ERISA Section 404(a)(1)(A)(ii) provides that a fiduciary shall discharge their duties with respect to a plan solely in the interest of participants and beneficiaries and for the exclusive purpose of defraying reasonable expenses of administering the plan.
19. Employer contributions to a multiemployer plan are required under a collective bargaining agreement or other written agreement regardless of whether forfeitures are available to make the required contribution. Accordingly, this method is unlikely to be helpful in reducing the unallocated amounts held in a plan.