IRS Stresses Requirement for Timely Forfeitures

Forfeitures occur in a plan when terminated participants are not fully vested in employer contribution accounts. There are two timing aspects of forfeitures which should be addressed in the plan document: when forfeitures occur and when they must be disposed of.

When forfeitures occur
There are two primary approaches to the timing of forfeitures:

- **Five-year break-in-service rule** – The non-vested benefit is forfeited after the participant incurs five consecutive one-year breaks in service. (This rule can be applied to DC plans and fully insured DB.) Note that this rule does not allow immediate use of forfeitures when participants take a distribution upon termination of employment.

  A break in service is a vesting computation period (usually the plan year) in which the participant is not credited with at least 501 hours of service. (Different application of this rule is involved when plans use the elapsed time method to count vesting service.)
- **Cash-out rule** – The non-vested benefit is forfeited when a terminated participant receives a cash-out distribution (voluntary or involuntary) of his or her entire vested benefit. Under the cash-out rule, a participant who is re-employed prior to incurring five consecutive breaks in service must be allowed to repay the distribution ("buy back") the forfeited benefit.

Many plans define the forfeiture to occur on the earlier of the five-year break in service or cash-out.

When forfeitures must be disposed of
There are two primary methods to dispose of forfeitures:

- **Reduce future company contributions (other than employee contributions)** – This is the most common approach used by 401(k) and profit sharing plans. In some cases, forfeitures due to specific contribution sources are used only to offset contributions for that source. For example, matching forfeitures will be used only to reduce matching contributions, and forfeitures due to profit sharing contributions will be used only to reduce future profit sharing contributions.
- **Reallocate forfeitures to remaining participants in the plan** – Reallocated forfeitures are considered annual additions under IRC §415.

(Plans that use the cash-out rule for forfeitures will generally use forfeitures first to reinstate accounts of rehired participants who buy back their non-vested benefits.)

In the Spring 2010 issue of the Internal Revenue Service (IRS) Retirement News for Employers (Volume 7), the IRS emphasizes the need to dispose of forfeitures on a timely basis and usually within the plan year in which they arise. Holding forfeitures indefinitely in a suspense account is not an acceptable practice in a DC plan, due to the fact all funds must be allocated under a definite formula. This generally precludes carrying over forfeitures from year to year.

If sponsors follow the rules outlined in the plan document and adhere to this compliance issue for handling forfeitures, it may help avoid problems later on.