Retirement Plan Correction Solution
Forfeitures: The Final Frontier

By Alison J. Cohen, Esq., APR

This is the dilemma of the company, Enterprise, Inc. Enterprise engaged Galactic Payroll Services to administer its 401(k) plan for six years. Once Enterprise had grown larger into a small empire, its CEO, Jean-Luc Picard, decided he needed to improve the plan to attract and retain top talent. On the advice of his financial advisor, Picard moved the Enterprise 401(k) plan to a new third party administrator, the Borg. During the conversion to the Borg, as they were being assimilated, the new plan consultant, William Riker, noticed the very large forfeiture balance in the plan. After probing Galactic Payroll for further details, Riker learned that the total forfeitures actually represented amounts from plan years going back to 2015. Picard was completely unaware of the situation and thought Galactic Payroll had properly administered the plan. Riker offered to solve the problem and so Picard said, “make it so and you’ll be my Number One administrator.”

How Forfeitures Should be Handled

Forfeitures occur when a non-vested participant either takes a distribution or incurs a five-year break in service. Once the funds are moved from the participant’s account after one of these triggering events, they stay in the forfeiture account waiting to be used on an annual basis in accordance with the terms of the plan document. A plan may provide that forfeitures can be used to reduce employer contributions, be allocated to eligible employees, and/or be used to reduce eligible plan fees. At the end of the plan year, as part of the annual administration, forfeitures should be examined and addressed in some way. The key point is that the forfeitures must be used. They can’t be hoarded year after year.

What Are the First Steps Riker Should Take?

Riker starts with the plan document, which is always the first place to start, and reviews the forfeiture provision that was in effect during the period in question. The Enterprise plan provides that forfeitures are used to reduce employer contributions. In many cases, if the employer doesn’t make contributions, a common misconception is that the forfeitures can remain unallocated. The proper way of handling this situation would be to consider the year’s forfeiture amount to be the employer contribution, and allocate it accordingly. For example, if there are $3,000 in forfeitures and the plan provides for either a discretionary matching or profit sharing contribution, assuming that the plan document allows the sponsor to use the forfeitures for either contribution type, it likely would make sense to use the $3,000 as a matching contribution. To use this amount for a profit sharing contribution could create small accounts for non-participating individuals, which could prove to be expensive.

As a good plan consultant, Riker keeps his copy of EPCRS (currently Rev. Proc. 2019-19) handy at his desk. Riker searches through the procedure and discovers that there are specific corrections for fixing this problem. EPCRS section 6.02(4)(a) provides general principles for correcting allocations, which require that the Plan Sponsor correct the situation by allocating the forfeitures according to the plan's terms, as if the allocations had been done correctly at the time. Riker then sighs: he needs (D)ata! (Trekkies will get that Data joke.)

Riker's next step is to gather more information from Galactic Payroll regarding the forfeiture amounts that are attributable to each plan year from 2015 forward. Given that the proper way to have handled the forfeitures would have been to allocate the amounts for each plan year, Riker needs to know how much should have been so used each plan year. Some service providers keep separate forfeiture accounts for each year, but others keep everything all in one bucket. The single bucket approach makes calculations more difficult, since it is harder to keep track of each year's amount, and earnings attributable to each year will need to be approximated.

Best Alternative for Correction

If Galactic Payroll can give enough data to Riker for each year's forfeitures, then Riker needs to collect the historical census data from Enterprise. That can sometimes be the most difficult part of the correction. Many TPAs know how challenging it can be to get current year census data, let alone census data from six years ago. Assuming that the data can be obtained, Riker and his team will need to calculate the appropriate allocations for each plan year.

Once the calculating is done, the amounts being given to the participants should be evaluated to determine if anyone that no longer has an account balance in the plan is receiving $75 or less. EPCRS section 6.02(5)(b) allows such a resulting corrective distribution to be avoided. However, the amount must then be reallocated to the other eligible employees. For example, D. Troi would receive $15 for the 2015 – 2016 plan years. Ms. Troy took distribution of what was thought to be her full account in 2017 after her termination of employment. Since the $15 is less than the $75 de minimis requirement, the $15 would go back into the pot and get reallocated to the other 2015 and 2016 eligible participants. This process, while tedious, may require several iterations of the calculations to be done.

Other Possibilities

What if we have only $40 total in forfeitures for 2015? And there are 90 employees. Do we need to allocate $.02 per person? Technically, yes. However, one could argue that it is reasonable to take the risk of not following the procedure to the letter and push the $40 into the following plan year to be allocated. If the employees of 2015 are also the same employees of 2016, it bolsters the position that we can combine the two years for allocation.

If the bucket of forfeitures is unable to be distinguished by plan year, other reasonable approaches should be considered, based on the specific circumstances. For example, if the vast majority of the impacted participants remain in the plan year after year, there might be a solid argument for allocating the forfeitures as of the most recent plan year. In contrast, if there was consistent turnover, but a steady number of eligible participants, it might be possible to divide the forfeitures equally across the plan years. Again, our goal is to be reasonable – which is one of the general principles for EPCRS. The total amount of the forfeiture bucket should also be taken into account. The cost for the allocation process versus the total amount of the forfeitures is a valid concern. The plan sponsor should not have to spend $2,000 in fees to allocate $1,000 in forfeitures! If you find the situation is getting murkier than a glass of Romulan Ale, advising the plan sponsor to seek advice of legal counsel might be the best course of action. And, of course, if the amount of money is significant and you are forced to go light years past the borders of the EPCRS guidance to find a solution that works, you may want to submit the issue to the IRS for review under the Voluntary Compliance Program (VCP) (which may be required in any event if the number of years at issue is more than two and the problem is not considered insignificant).

Ending the Voyage and Bringing It All Home

It should be part of a best practice for all plan sponsors (and TPAs) to make sure that forfeitures are examined on an annual basis and dealt with appropriately and timely. As part of any 'assimilation' process, a thorough check should be made for any unallocated forfeitures (or ERISA Budget Account/PERA Account) that have gone unattended. A smart plan design will help Enterprise reach for the stars! And remember, if you have questions or issues, call us. We are your ERISA solution!

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