VALOROUS ADVISORS

Forfeiture Accounts

The total plan assets include all dollars in the retirement plan, but as the plan sponsor, do you have a good handle on all those dollars? Sometimes plan sponsors forget about the small dollar accounts such as the revenue credit account and forfeiture account, which might be smaller dollars but may also come with big consequences.

Here's What You Really Need to Know:

1. The plan's forfeiture account in a retirement plan refers to non-vested employer contributions that are held when an employee leaves the company before becoming fully vested in those contributions.

2. The plan document should identify how forfeiture accounts may be spent, and plan fiduciaries should be thoughtful about spending forfeiture dollars within the specified method and time requirements.

3. Historically, the decision for how to spend forfeitures has been a settlor decision and not a fiduciary decision. Recent litigation may call this notion into question and should continue to be monitored.

Let's Dive In...

Forfeiture Basics

People are generally most familiar with the plan's designated investment alternatives (DIAs), or rather, those investment options that are part of the plan's core line-up. However, there are other plan assets for which plan sponsors have a fiduciary responsibility; these accounts include the revenue credit account and forfeiture account, among other holding accounts that the plan may have. The names of these accounts may vary across different recordkeeping platforms.

A forfeiture account in a retirement plan refers to an account where non-vested employer contributions are held when an employee leaves the company before becoming fully vested in those contributions. This primarily applies when the plan has a vesting schedule.

Employee contributions are always 100% vested (meaning they belong to the employee when they leave). However, employer contributions may be subject to a specified schedule in the plan document which determines when an employee gains ownership of any employer contributions. If an employee leaves the company before fully vesting based on the specified schedule, the non-vested portion is forfeited and goes back into the "forfeiture account" in the plan.

Employers have the choice of how they want to use these funds. It is important to make sure that the plan document as well as any other plan documentation specifies how the funds can be used. It is also critically important to ensure that any plan documents align with what is actually happening. Common uses include:

1. **Plan Expenses**: Covering administrative costs associated with managing the plan.

2. **Employer Contributions**: Reducing future employer contributions that the company needs to make to the plan.

3. **Reallocation to Participants**: In some cases, the forfeited amounts can be reallocated among the remaining plan participants in a nondiscriminatory manner.

Settlor v. Fiduciary Decisions

Historically, the decision as to who decides how to spend forfeitures has been a settlor decision. As a reminder, settlor decisions are considered business decisions made by the employer. They are not subject to fiduciary standards – or liability – under the Employee Retirement Income Security Act (ERISA). Examples of these decisions include the establishment, design, and amendment of the retirement plan, as well as anything – as a general rule of thumb – that can cost or save the company money. The opposite of a settlor decision is a fiduciary decision, which relates to the management, operation and administration of the plan. Those decisions must be made in the best interest of plan participants and beneficiaries and when there is a problem with fiduciary decisions, fiduciary liability (which is personal in nature) attaches.

Litigation Landscape

Despite what seems like clear guidance as to settlor versus fiduciary decisions for determining how to spend forfeiture dollars, there have been a series of cases filed in federal court in California challenging as a fiduciary breach the use of forfeitures to offset employer contributions. While clearly permissible, and in at least several cases, specifically detailed as permissible in the plan document, the argument has been that doing so is not in the "best interests" of participants. In the case of *Perez-Cruet v. Qualcomm Inc.*, a federal judge has now ruled that a "plausible" case has been made to sufficiently reject the motion to dismiss by the plan sponsor defendants. This means that the suit remains alive and that it is arguable that what was always considered settled guidance discussed above is called into question.

On the other hand, another case involving the use of forfeitures by HP, Inc. was recently dismissed by a federal judge, who found those allegations "implausible because it relies on a false premise that HP receives a windfall from forfeited amounts, and it would require that plan expenses are always paid before reducing employer contributions." However, the judge in that case gave the plaintiffs 30 days to remedy the shortfalls in their arguments and refile their case. Neither case represents a final judgment on the matter but makes clear this is an evolving issue and could impact what was considered a clear settlor decision.

Proposed Regulation and Timing

As a practical matter, most plans try to spend the revenue credit account and forfeiture account within the plan year in which the funds were generated or, at the latest, by the end of the following plan year. This was formalized in 2023 when the Internal Revenue Service (IRS) proposed a regulation for defined contribution plans to require that forfeitures must be used no later than twelve months after the close of the plan year in which the forfeiture is incurred. While this remains a proposed rule, the timing guidelines should be followed.

Action Items for Plan Sponsors

For plan sponsors, now is not the time to be reactionary to the splits between the two cases noted within this update and change policies related to spending forfeitures. However, for all plan sponsors, there are clear action steps to keep in mind:

1. Understand where all the plan assets are even if those funds are not in the core investment line-up; this extends to holding accounts including the revenue credit account and forfeiture account.

2. Determine how the forfeiture account can be spent as identified in the plan document or other governing documents and policies for the plan.

3. Ensure that the plan's operation aligns with the plan documentation, including as it relates to how to spend forfeiture dollars.

4. Determine a procedure to ensure that forfeiture dollars are spent within the plan year in which the funds were generated or, at the latest, by the end of the following plan year.

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