THE NORTH PIER*spective*

Fiduciary Commentary

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Focus on Vesting and Forfeitures

IRS regulations provide a great deal of flexibility on the use of forfeited plan assets in defined contribution plans. Forfeitures are created when a participant terminates their employment before obtaining full vesting in their employer contributions. The administration of plan forfeitures is a challenge and often a potential compliance risk. Effective internal procedures to ensure compliance and understanding of current regulations can alleviate these plan hazards.

Forfeiture Basics

Forfeitures are assets from participants that terminated their employment and had not yet earned the right to the full allocation of employer contributions according to the terms of the plan. A plan's vesting schedule defines the rate that a plan participant will become vested based on the length of service with their employer. Individual participant's salary deferrals, rollovers into the plan and qualified nonelective and matching contributions (QNECs and QMACs) are always 100% vested and non-forfeitable.

Vesting of Employer Contributions

There are two types of vesting schedules:

- **Graded -** Graded vesting schedules are the most commonly used in defined contribution plans. With this arrangement, vesting increases with each year of service reaching 100% after no more than six years of service with the employer. Participants must become at least 20% vested after the completion of two years of service and the rate of vesting must increase by at least 20% after each additional year of services.
- **Cliff -** Cliff vesting provides for immediate 100% vesting of employer contributions when the participant completes the required years of services with their employer. Prior to the time when full vesting occurs, the employee has no vested interest in the employer benefits. Cliff vesting cannot require more than three years of service before 100% vesting is earned.

Sample Vesting Schedules		
Years of Service	Graded Vesting	Cliff Vesting
0	0	0
1	0	0
2	20	0
3	40	100
4	60	100
5	80	100
6	100	100

When a plan participant terminates service with their employer, the non-vested portion of their account becomes subject to forfeiture, as defined by the plan document. The forfeiture occurs upon termination or after the participant incurs five consecutive one-year breaks in service. If the employee is rehired after the five-year period from his last date of employment, his prior service would no longer count towards vesting. Due to the burdensome administration of this five-year rule, most plan provisions allow for accelerated forfeitures consistent with IRS rules.

Forfeiture Uses

Forfeitures must be used in ways identified by the plan document and in alignment with IRS regulations. Current guidance provides that forfeitures may be used to:

- **Pay plan expenses -** Forfeiture balances may be used to pay reasonable plan expenses including the plan administration and consulting fees. An example of an expense not permitted to be paid from forfeitures is the payment of a fee resulting from a fiduciary breach.
- **Off-set future employer contributions -** The most common use of forfeitures is to fund future employer matching or profit-sharing contributions, thereby relieving the employer's funding obligations of new money to the plan.
- **Allocate an additional plan contribution -** Forfeitures may be utilized as additional employer discretionary or non-

discretionary profit sharing or match contributions. These allocations would be aggregated with all other employer contributions in the plan's annual additions test.

- **Restore prior forfeited plan participants -** Lastly, forfeitures may be used to reinstate account balances of rehired employees who previously forfeited their non-vested amounts due to termination.

One of the largest compliance concerns with forfeitures has been disposing of them within the time frame specified by the regulations and their plan provisions. Frequently, when plan sponsors forfeit accounts the money is placed in a plan-level suspense account and not immediately used in one of the permissible methods identified above. Often, these accounts are not routinely monitored and the forfeiture balances lay idle within the plan without being allocated in a timely manner.

The regulations state that forfeitures are to be exhausted during the plan year in which they are incurred, or no later than the following plan year in certain circumstances. If these forfeiture accounts are not disposed of properly, corrections can be made under the IRS's Employee Plans Compliance Resolution System (EPCRS). The correction would require that a participant's account be made whole as if the error had not occurred. Depending on several factors, such as the number of affected employees, how far back the error occurred, locating any terminated participants the calculating a participant's forfeiture amounts and earnings, the correction could be especially complicated.

Conclusion

In recent years, forfeitures have been more heavily scrutinized in internal and IRS audits. Operational failures resulting from their untimely use and insufficient internal controls over their administration have drawn increased attention by regulators.

A review of plan documents to identify the plan's language governing forfeitures is the natural starting point to ensure a proper procedure is in place to ensure conformance to the regulations. Plan sponsors should also discuss whether the plan's use of forfeitures aids them in achieving their business objectives and if there are clear policies and procedures in place for using forfeitures that is in alignment with these objectives.

The Fiduciary Rule Is Now Law

As of June 9, 2017, the Fiduciary Rule is law. As discussed in previous commentaries, the rule defines investment advice more broadly than the original definition in the DOL's 1975 bill. This sweeping legislation will automatically hold all financial representatives who work with retirement plans and IRAs to a fiduciary standard. A fiduciary standard requires a financial representative to put their client's interest first. The DOL will continue to review the potential implications of the new law. A transitional period is in effect until January 1, 2018.

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