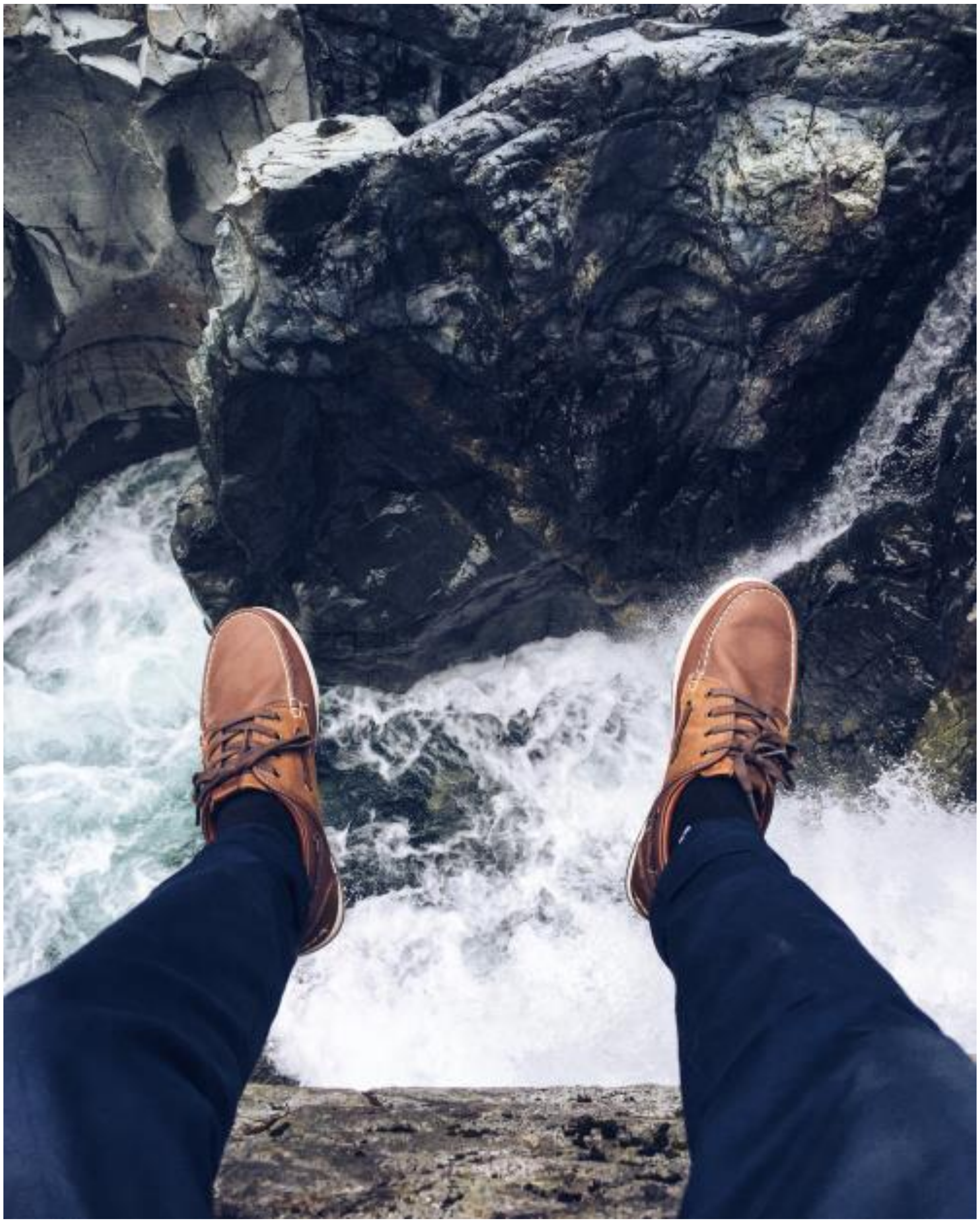
[Using Forfeitures for Corrective Contributions: Look Before You Leap]

January 22, 2017



When a 401(k) plan fails nondiscrimination testing that applies to employee salary deferrals, one way to correct the failure is for the plan sponsor to make qualified nonelective contributions (QNECs) on behalf of non-highly compensated employees. The same approach may apply to matching contribution failures, but in that instance the corrective contributions are called qualified matching contributions or QMACs. QNECs and QMACs must satisfy the same vesting and distribution restrictions that apply to employee salary deferrals – they must always be 100% vested and must not be allowed to be distributed prior to death, disability, severance from employment, attainment of age 59.5, or plan termination (i.e., they may not be used for hardship distributions).

Existing Treasury Regulations provide that QNEC and QMAC contributions must be 100% vested at when they are contributed to the plan, not just when they are allocated to an account.

Forfeitures are unvested employer contributions when originally contributed to the plan, and for this reason the IRS has taken the position that a plan sponsor may not use forfeitures to fund QNECs or QMACs. And in fact, the prohibition on using forfeitures to make QNECs or QMACs is reflected in the Internal Revenue Manual, and the IRS Employee Plans Compliance Resolution System (EPCRS) which outlines voluntary correction methods for plan sponsors.

On January 18, 2017, the IRS changed course by publishing a proposed regulation requiring that QNECs and QMACs be 100% vested only when they are allocated to an account, and need not be 100% vested when originally contributed to a plan. This means that forfeitures may be used to make QNECs and QMACs if the underlying plan document permits. It would logically follow that other employer contributions that are not fully vested when made may be re-designated as QNECs to satisfy ADP testing for a plan year.

The proposed regulation is applicable for plan years beginning on or after January 18, 2017 (January 1, 2018 for calendar year plans) but may be relied upon prior to that date.

Caution is advised, however, for plan sponsors wanting to make immediate use of forfeiture accounts for QNECs and QMACs. First, they must confirm that their plan document does not prohibit use of forfeitures for this purpose. In the author's experience, master and prototype and volume submitter basic plan documents may expressly prohibit use of forfeitures for QNECs and QMACs. The language below was taken from a master and prototype basic plan document:

7) Limitation on forfeiture uses. Effective for plan years beginning after the adoption of the 2010 Cumulative List (Notice 2010-90) restatement, forfeitures cannot be used as QNECs, QMACs, Elective Deferrals, or Safe Harbor Contributions (Code §401(k)(12)) other than QACA Safe Harbor Contributions (Code §401(k)(13)). However, forfeitures can be used to reduce Fixed Additional Matching Contributions which satisfy the ACP test safe harbor or as Discretionary Additional Matching Contributions.

Plan sponsors that locate a similar prohibition in their plan document should contact the prototype plan sponsor to determine whether they will be amending their plan document to permit use of forfeitures for QNECs and QMACs and when such an amendment will take effect.

In instances where there is no express plan prohibition, plan sponsors that are making use of EPCRS to correct plan failures should try to ascertain from the IRS whether or not they may use forfeitures to fund QNECs or QMACs as part of a self-correction or VCP application, as the most recently updated EPCRS Revenue Procedure (Revenue Procedure 2016-51, 2016-41 I.R.B. 465), expressly disallows this at Section §6.02(4)(c) and Appendix A §.03. Hopefully, the IRS will issue some guidance on this point without too much delay.

https://www.irs.gov/irm/part4/irm-04-072-002-html-d0e1555

https://www.gpo.gov/fdsys/pkg/FR-2017-01-18/pdf/2017-00876.pdf

https://www.irs.gov/pub/irs-drop/rp-16-51.pdf