ASC ALERT

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IRS Finally Relents on the Use of Forfeitures to Fund QNECs, QMACs and Safe Harbor Contributions

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In a welcome development, the Internal Revenue Service has finally changed its position on the use of forfeitures to fund qualified nonelective contributions (QNECs), qualified matching contributions (QMACs) and safe harbor 401(k) plan contributions. The new position recognizes the arguments of many practitioners over the years that regulatory restrictions on the use of forfeitures to fund QNECs, QMACs and safe harbor 401(k) plan contributions are not consistent with the law and present an unnecessary burden on plan sponsors.

While the new position, which the IRS announced through the issuance of proposed regulations, technically is not effective until the regulations are finalized, plan sponsors may rely on the proposed regulations immediately.

What Has Changed?

Under current IRS regulations, QNECS and QMACs are required to satisfy nonforfeitability (i.e., 100% vesting) and distribution restrictions "when they are contributed to the plan." The IRS interpretation of these regulations prevented a plan sponsor from using forfeitures to fund QNECs and QMACs because the forfeiture amounts, when originally contributed to the plan, were not 100% vested. This meant that plan sponsors could not use forfeitures to correct ADP or ACP test failures, as safe harbor 401(k) contributions or for other purposes. The IRS reiterated its position through document provision requirements for pre-approved plans, guidance to IRS agents in the Internal Revenue Manual and in its EPCRS procedures.

For years, practitioners have argued that the IRS position in interpreting its regulations was not supported by the law, which appeared to only require that QNECs and QMACs (and therefore safe harbor 401(k) plan contributions) be nonforfeitable and subject to the distribution restrictions at the time they are allocated to participant accounts. With the issuance of the new proposed regulations, which change the regulatory definitions of QNECs and QMACs, the IRS has expanded the use of forfeitures.

Effective Date

The proposed regulations are not officially effective until tax years beginning on or after the issuance of final regulations. However, the preamble provides the "Taxpayers … may rely on these proposed regulations for periods preceding (emphasis added) the proposed applicability date. If, and to the extent, the final regulations are more restrictive than the rules in these proposed regulations, those provisions of the final regulations will be applied without retroactive effect."

> ASC Insight: The preamble language relating to the proposed effective date, especially the use of the term "preceding," has raised questions as to how and when plan sponsors may utilize the new IRS position on the use of forfeitures. For example, may a plan sponsor use forfeitures to fund safe harbor 401(k) plan contributions due for a 2016 calendar plan year? Certainly, it is arguable that, although the IRS did not issue the proposed regulations until January 18, 2017, the term" preceding" would allow the use of forfeitures to fund safe harbor 401(k) plan contributions for the 2016 plan year. Some practitioners are taking a more conservative approach and suggesting a delay in the use of forfeitures until the 2017 plan year. ASC and other practitioners are seeking clarification of the term "preceding" from the IRS.

Course of Action for Plan Sponsors and Document Providers

Because plan sponsors may rely on the new IRS position immediately, they should review their plan documents'

terms applicable to the use of forfeitures. Since the IRS required many pre-approved plans to include provisions limiting the use of forfeitures, particularly for safe harbor 401(k) plan contributions, most plans likely will require an interim amendment reflecting the changed IRS position. As a discretionary amendment, a plan sponsor (perhaps through the pre-approved plan sponsor) must adopt the interim amendment by the end of the plan year for which it applies. Pending the adoption of the interim amendment, unless plan terms cause a possible violation of the anti-cutback rules of Code §411(d)(6), plan sponsors may operationally apply the new definitions of QNECs and QMACs. Plans that have a possible anti-cutback issue (e.g., under plan terms forfeitures are used to increase allocations to plan participants) will need to be amended before participants have satisfied the allocation conditions for receiving the allocation of forfeitures.

ASC Insight: ASC will provide an interim amendment for its pre-approved defined contribution plans later this year. Even though the ASC pre-approved plan included terms that anticipated the change in IRS position relating to the use of forfeitures, we believe that an interim amendment will clarify the acceptable uses of forfeitures to fund QNECs, QMACs and safe harbor 401(k) plan contributions. The interim amendment also will address the revised definition of QNECs and QMACs made under the proposed regulation. In the meantime, plans with no anti-cutback issues may immediately operate under the new IRS position. If the plan has an anti-cutback issue, the plan sponsor should amend the current adoption agreement to avoid violations.

The favorable change in IRS position presents plan sponsors with a significant cost savings opportunity. Plan sponsors now may decide to use forfeitures within the plan rather than making additional employer contributions to fund QNECs, QMACs and safe harbor 401(k) contributions.

Still, questions remain on the new IRS position. The IRS will accept comments on the proposed regulations and may modify its position in the final regulations. The IRS also will need to provide guidance on the impact of the new IRS position on the EPCRS program.

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