EMPLOYEE BENEFITS LAW

Lawsuits and Proposed IRS Regulations Conflict on the Use of Forfeitures in Defined Contribution Plans

For decades IRS regulations and guidance have allowed employers with qualified 401(k) plans wide discretion to decide how to use plan account forfeitures[1]—including paying plan expenses, reducing an employer's future contributions, or re-allocating to other participants, in accordance with the plan terms.[2] Now, however, a new type of lawsuit has been filed against fiduciaries of several California-based 401(k) plans, alleging that when a plan gives an employer discretion to apply forfeitures to pay plan expenses borne by plan participants or reduce employer contributions, the employer commits an ERISA fiduciary breach if it chooses to reduce employer contributions with these forfeitures rather than pay plan expenses.[3] The central allegation of the lawsuits is that the employers violated ERISA when they chose to benefit themselves by reducing contributions they otherwise owe to the plan, rather than using the forfeited funds to benefit plan participants by paying plan expenses.

These lawsuits contrast with proposed IRS regulations issued in February 2023 that, if finalized, may re-affirm employer discretion to use plan forfeitures to reduce employer contributions. The newly-proposed regulations specifically permit a plan to state forfeitures may be used to "pay plan administrative expenses," "reduce employer contributions," or "increase benefits in other participants' accounts."[4] The only significant restriction in the proposed regulations on this discretionary use of forfeitures is that forfeitures incurred in a plan year must be used within 12 months following the end of that plan year.[5] The long history of discretionary use of plan forfeitures, as well as new IRS regulations, may yet cement the long-standing discretion afforded to employers in deciding how to use forfeitures. But there remains a possibility that if the lawsuits are successful (or if the DOL issues guidance supporting the lawsuits' allegations), use of forfeitures—to either reduce plan expenses or employer contributions—will need to be prioritized or dictated in plan terms rather than be discretionary.

From all of us here at MMPL, your employee benefits law firm.

Not intended as legal advice.

[1] Forfeitures may include, for example, non-vested employer contributions in a former employee's 401(k) account which the employee forfeited after a termination of employment.

[2] For example, the House Conference Report regarding the Tax Reform Act of 1986 stated that "forfeitures arising in any defined contribution plan . . . can be either (1) reallocated to the accounts of other participants in a nondiscriminatory fashion, or (2) used to reduce future employer contributions or administrative costs." H.R. Rep. No. 99–841, pt. 2 at 442 (1986).

[3] *Hutchins v. HP Inc., et al.*, No. 5:23-cv-05875 (N.D. Cal. Nov. 14, 2023); *McManus v. The Clorox Company, et al.*, No. 4:23-cv-05325 (N.D. Cal. Oct. 18, 2023); *Perez-Cruet v. Qualcomm Inc. et al.*, No. 3:23-cv-01890 (S.D. Cal. Oct. 16, 2023); *Rodriguez v. Intuit, Inc., et al.,* No. 5:23-cv-05053 (N.D. Cal. Oct. 2, 2023); *Dimou v. Thermo Fisher Scientific, Inc., et al.*, No. 3:23-cv-01732 (S.D. Cal. Sept. 19, 2023). The cases are in the very early stages of litigation, with no court rulings to date on their merits.

[4] Prop. Treas. Reg. § 1.401-7(b)(1).

[5] Prop. Treas. Reg. § 1.401-7(b)(2).

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