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IRS OKs Use of Forfeitures as QNEC/QMAC/Safe Harbor Contributions

Proposed IRS changes to 401(k) regulations will allow employers to use forfeitures as qualified nonelective and qualified matching contributions to help pass nondiscrimination tests and as safe harbor contributions. The change is proposed to be effective after it is finalized, but can be relied on now – great news for employers who have long operated using this logical approach.

Background

Qualified Nonelective Contributions (QNECs) and Qualified Matching Contributions (QMACs) may be made to correct a 401(k) plan's failed ADP/ACP (nondiscrimination) test. The ADP/ACP tests limit the disparity in contributions between highly compensated employees (HCE) and non-highly compensated employees (NHCE) within a plan, by comparing the average deferral/contribution percentage of HCEs to the average deferral/contribution percentage of NHCEs. If the plan is found to have failed either of these tests, a correction must be made by either returning excess contributions to the HCEs, or making a QNEC and/or a QMAC to all eligible NHCEs to increase their average percentage deferrals or match in comparison to the HCEs. When QNECs or QMACs are used for nondiscrimination tests, the contributions must be nonforfeitable and must not be eligible for early distribution. The same rules apply to contributions (nonelective or matching) to a safe harbor plan. Constituents had always assumed that any plan forfeitures applied as contributions to a participant's account would be treated the same as new money deposited currently by the employer as long as the nonforfeitability requirement and distribution restrictions were met. That is, until updated IRS regulations redefined these money-types to require full vesting and restrictions at the time *contributed*.

Frankly, for years after the regulations were finalized, many read into that definition the ability to use forfeitures and apply full vesting at the time of *allocation*, comparable to treating forfeitures no differently than employer contributions under the Section 415 annual addition rules. To assume otherwise would mean that plans would have to use the forfeitures for other allocation purposes even though the basic structure of the plan did not contemplate such additional allocations. But in more recent years, news that IRS takes a literal spin on the language spread and comment letter writing ensued.

IRS Proposes Fix to Regulations

Proposed IRS regulatory changes would modify the required timing of the nonforfeitability requirement and distribution restriction to the date of allocation to participants' accounts and would no longer require that QNECs, QMACs, and safe harbor contributions be limited to new contribution deposits to the plan. Plan forfeitures are now explicitly fair game.

The proposed regulations would be effective for taxable years beginning on or after publication in final form. However, IRS states that taxpayers may rely on the proposed regulations for earlier periods. If the final regulations are more restrictive than the proposed changes, the final rule will be applied prospectively.

In Closing

Plan sponsors and their recordkeepers may wish to ensure that current document language supports current operations or, if forfeitures are not currently utilized, revise plans accordingly taking into account this "new" flexibility. Sponsors of safe harbor plans should be mindful of the rules for mid-year plan amendments (see our February 3, 2016 *For Your Information*).

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