IRS Proposes 401(k) Forfeiture Rules

Mar 21, 2023

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On February 27, the Internal Revenue Service (IRS) issued proposed regulations on when and how forfeitures must be used or allocated in a defined contribution plan, such as a 401(k) plan. The new rules build on previous IRS informal guidance while also providing additional clarification. The new forfeiture regulations are proposed to be effective for plan years **beginning on or after January 1, 2024, but plans may rely on these proposed rules immediately.**

The new proposed regulations outline the only appropriate uses of forfeitures and the date by which they must be used. They also provide a helpful transition rule for forfeitures from prior plan years.

Use of Forfeitures

The proposed regulations provide that defined contribution plans must use forfeitures, as specified in the plan document, in one or more of the following ways:

- To pay plan administrative expenses;
- To reduce employer plan contributions; or
- To increase benefits in other participant accounts in accordance with plan terms.

Deadline for the use of Forfeitures

The proposed regulations clarify that forfeitures must be used by 12 months following the close of the plan year in which the forfeitures occurred under plan terms.

- **Transition Rule:** All forfeitures which occurred during plan years beginning before January 1, 2024, will be treated as having been incurred in the first plan year that begins on or after January 1, 2024, for purposes of the above deadline. This rule will be especially beneficial for any plan sponsors who have allowed their forfeiture accounts to accumulate over several years, a common compliance concern.

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Plan Documentation

Plan documents should be drafted to allow forfeitures to be used in any of the permitted ways listed above and to provide how they will be allocated if not used for expenses to avoid unused forfeiture amounts remaining after the deadline. For example, if the current plan document only allows for forfeitures to be used to pay plan administrative expenses, then for any year in which forfeitures exceed plan administrative expenses, the unused forfeiture amount will cause the plan to incur an operational qualification failure. This situation could easily be avoided by permitting forfeitures to be used for more than one purpose.

Next Steps

Plan sponsors should review their plans to determine what they say regarding how forfeitures may be used and whether a plan amendment is in order.

Additionally, plan sponsors with large forfeiture accounts should take action immediately to decide how best to use the forfeitures in a timely manner. Even with this new rule, a plan's terms in place in prior years must be followed. If a forfeiture balance has built up over several years or longer, legal counsel should be consulted on how the forfeitures can be allocated while remaining in compliance with both IRS and Department of Labor rules.

For more information regarding the IRS' proposed forfeiture rules and their potential impact on 401(k) plans, please contact the authors of this article or any member of Frost Brown Todd's Employee Benefits & ERISA practice.

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