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Late Deposits – A Timely Topic

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Plan sponsors need to remain attentive about ensuring that elective deferrals are deposited into their 401(k) plans on a timely basis. Plans may be subject to a higher risk for audit where late deposits are concerned, especially in those cases where there has been a pattern of recurring delinquent deposits reported on the annual Form 5500s. Recently, the U.S. Department of Labor (the "DOL") has increased its focus on this issue by sending informational letters to plan sponsors who report such failures on their annual returns. In such situations, the DOL generally recommends filing an application under its Voluntary Fiduciary Correction Program ("VFCP") to correct the issue and minimize the plan's risk for audit.

DOL Deadline for Timely Deposits

As part of their fiduciary responsibilities, plan sponsors are required to ensure that participant contributions are deposited in a plan's trust on a timely basis. The DOL defines participant contributions to include any amounts withheld from wages by an employer for a participant or received by an employer from a participant, such as elective deferrals and voluntary after-tax contributions, as well as participant loan repayments.

Unlike employer contributions (which become plan assets when they are actually contributed), participant contributions are treated as plan assets as of the date they can reasonably be segregated from the employer's general assets. The DOL regulations state that participant contributions become plan assets on the earlier of:

1. The 15th business day of the month following the month in which the contribution is withheld by the employer from the employee's wages (or the amount is received by the employer);
2. The earliest date on which the contributions can reasonably be segregated from the employer's general assets.

**Note that the date in item 1 is not a safe harbor deadline; it is instead the maximum deadline which is applicable only if the date in item 2 is not earlier.*

7-Business Day Safe Harbor for Small Plans

For plans that have fewer than 100 participants at the beginning of the plan year, there is a safe harbor deadline in effect for depositing participant contributions. Such contributions are considered to have been timely deposited if the segregation from the employer's general assets occurs bor for any one payroll period will not prevent the plan sponsor from meeting the safe harbor for any other payroll period during the plan year.

The benefit of the safe harbor is that participant contributions are treated as being deposited into the plan by the 7-business day safe harbor deadline, even in those cases where the "earliest reasonable segregation" date might have otherwise occurred earlier under the regular DOL deadline. If, however, a plan sponsor of a small plan does not deposit participant contributions by the safe harbor deadline, the standard DOL deadline will be used to make corrections, not the 7-business day safe harbor deadline. As a result, if the employer could have segregated participant contributions earlier than the 7-business day safe harbor deadline, corrections will be determined based upon the earlier date.

"Earliest Reasonable Date" for Segregation

For large plans that cannot rely on the 7-business day safe harbor deadline, there is no definitive time frame used to determine the "earliest reasonable date" participant contributions can be segregated from an employer's general assets. It is essentially determined by the recurring pattern established in connection with the regular processing of an employer's payroll, based upon each employer's individual payroll processing system. There is no clear guidance in the DOL regulations on this point.

Some factors to consider when determining the reasonableness of an employer's payroll and deposit processing system are:

- How fast the segregation can reasonably occur;
- What the current processing costs are, as well as the additional expense that might be associated with expediting the process;
- Any additional assurance and comfort the plan sponsor might gain from using a faster system, and
- Any income plan participants might recognize by having their participant contributions transferred sooner into the plan's assets, weighing in any potential increase in cost for improved/expedited processing.

Another factor to recognize is that any plan documents or employer participation agreements (including collective bargaining agreements) which establish the timing for making participant contributions to the plan will also generally need to be taken into account. In most cases, where the procedures in those documents conflict with the general DOL deadline, it will be necessary to examine how reasonable the procedures are in actual practice. In such cases, it may also be necessary to examine whether an application under the Internal Revenue Service (the "IRS") Employee Plans Compliance Resolution System ("EPCRS") is desirable, if the terms of the plan have not been followed in this regard.

Correction for Delinquent Deposits

The correction for the late transmittal of participants contributions is to transfer the funds from the employer's general assets into the plan's trust as quickly as possible after the error has been detected. Lost earnings on the late deposits will also need to be allocated to the accounts of affected plan participants. This allocation is required because such participants are considered to have lost the opportunity to earn investment income on their participant contributions while those amounts were held as part of the employer's general assets. Lost earnings are provided on the late participant contributions from the "earliest reasonable date" those contributions could have been deposited into the plan's trust through the date they are actually deposited. If the deposit dates for both the participant contributions and lost earnings differ, earnings on the lost earnings will also need to be included. It is generally advisable to complete the correction before the annual Form 5500 is filed for the associated late deposits. That way, the annual report will reflect that the late deposits have been corrected and are not outstanding, thereby reducing the plan's risk for audit.

Prohibited Transaction and Excise Taxes

Delinquent deposits result in a prohibited transaction under Internal Revenue Code ("Code") §4975 for which applicable excise taxes are assessed. Because the employer is treated as a "disqualified person" under Code §4975, the DOL views the employer as using the amount of the plan assets represented by the participant contributions for its own business purposes: either (i) that the employer has effectively received a loan from the plan for the amount of the plan assets the employer failed to contribute on a timely basis, in violation of ERISA §406(a)(1)(B) and Code §4975(c)(1)(A), or (ii) that the employer is benefiting from the use of plan assets, in violation of ERISA §406(a)(1)(D) and Code §4975(c)(1)(D). The penalty on a prohibited transaction is at least 15% of the lost earnings associated with the late deposits, with possible additional penalties assessed at the DOL level. The excise tax penalties are paid to the IRS by submitting Form 5330. The DOL's VFCP allows for a waiver of the related excises taxes on delinquent deposits in certain circumstances.

DOL VFCP

Submitting under the DOL's VFCP essentially provides applicants with the assurance that the DOL will not recommend the plan for audit for the fiduciary breaches associated with the delinquent deposits reported as part of the VFCP. Under ERISA, the DOL is required to assess a civil penalty for fiduciary breaches equal to 20% of the amount recovered as part of a settlement or litigation. However, this penalty is waived since the applicant is voluntarily reporting and correcting the violations under VFCP.

To receive relief under VFCP from the fiduciary breach, the employer (or other responsible fiduciary) must correct the failure in the manner described above (*i.e.*, by transferring the delinquent deposits from the employer's general assets into the plan's trust and providing affected participants with lost earnings on their late deposits). Under VFCP, applicants have the benefit of relying on the DOL's online calculator to compute the lost earnings, which greatly simplifies the interest rate to use for this purpose.

In addition, excise tax relief on the prohibited transactions associated with the late deposits may be available under certain circumstances, provided (i) the delinquent deposits were made not more than 180 days after the payroll withholding date (determined using calendar days, rather than business days), (ii) the applicant has not taken advantage of VFCP and its related excise tax relief during the three (3) year period prior to the VFCP submission, and (iii) notice is provided to "interested parties" (and the appropriate regional office of the DOL's Employee Benefits Security Administration) within sixty (60) calendar days following the date of the VFCP submission. While not defined under the VFCP procedures, "interested parties" are generally all participants who were affected by the delinquent deposits, including beneficiaries of deceased participants, as well as alternate payees. Satisfaction of these conditions automatically grants excise tax relief, thereby eliminating the need to file Form 5330 and the related excise taxes with the IRS.

An exception to the notice requirement occurs where the amount of the excise tax that would otherwise apply is less than $100. To meet this exception, the applicant must agree to pay the excise tax to the plan and have it allocated to affected participants in the same manner as plan earnings. Proof of payment must also be included with the VFCP application, as well as either a completed copy of Form 5330 or written documentation containing the same information.

Self-Correction

Delinquent deposits are not required to be corrected through VFCP. However, employers who elect not to correct through VFCP won't be able to rely on the DOL online calculator for purposes of calculating lost earnings. In this case, the general practice is to use the greater of (i) the plan's actual rate of return (as otherwise required under EPCRS) or (ii) the IRS §6621 underpayment rate (*i.e.*, the rate used under VFCP, which is essentially the rate replicated by the DOL's online calculator). Note that there is no statutory requirement to contribute the rate of earnings required under the DOL's VFCP. Also note that the excise tax relief provided under VFCP will not be available when self-correcting. The excise tax penalties will need to be submitted to the IRS with Form 5330.

Preventive Measures

To help prevent late deposits, it is useful to examine some of the common reasons why they occur. Modifications in an employer's payroll processing system may result in deposit delays, causing them to occur past their "earliest reasonable segregation" deadline. Some common reasons are (i) knowledgeable people involved in the process are out of the office unexpectedly or on vacation, (ii) staff shortages, changes in personnel and/or training of new hires in the processing system, (iii) changes in payroll providers and/or modification of the payroll depositing system. It is advisable to institute protective measures in anticipation of such occurrences to avoid delays. Such measures might include training back-up personnel to assist when knowledgeable people are out and enforcing stricter observance of processing procedures during new hire training. It is also important to allow enough time to implement new procedures or changes in processing or the selection of new payroll vendors.

It is also advisable to document the payroll processing procedures. Such documentation might include establishing a written timeline showing the actual steps and time involved in the transmittal process. Such a timeline might include (i) the time required to calculate the participant contributions to be transmitted for each payroll (whether that is calculated manually in-house or determined by an outside payroll vendor, and even when multiple payroll locations are involved for larger companies), (ii) any manual processing of participant loan repayments made through payroll deduction that may be required, (iii) the time needed to verify and reconcile the steps in the transmittal process (including time needed to submit information back and forth for verification with an outside vendor), (iv) the time required to fund the total amount of participant contributions (including working with the accounting department to issue checks or wire funds to financial institutions, as well as the time involved for the institution to process the funds as contributions), and (v) any instructions to the financial institution on how such funds should be allocated to participants' accounts.

DOL's Heightened Interest

Delinquent deposits of participant contributions continue to be of heightened interest to the DOL, as seen by its monitoring of Forms 5500s and the issuance of its recent informational letters to those plan sponsors reporting late participant contributions on those Forms. Recently, the DOL has also begun issuing "public service announcements" alerting plan sponsors of their fiduciary duties involved in selecting and monitoring qualified plan auditors to review the financial statements to their Forms 5500. While the announcement is not an indication that the DOL intends to select a plan for audit, it does show that the DOL is taking an accelerated interest in employee benefit plans and how information is reported on the annual reports.

To minimize the risk of an audit, measures should be taken to help prevent late deposits from occurring. Documentation of the steps and time involved in your payroll transmittal process will help you develop and maintain such procedures. It will also help support your selection of your "earliest reasonable segregation" date in the event of an audit. Regular monitoring of your payroll procedures will also help prevent late deposits from occurring and assist in the early detection of any late deposits if they do occur. When late deposits are discovered, correction should be made as soon as possible and any changes made in your transmittal procedures to prevent similar errors from occurring should be documented to demonstrate fiduciary compliance.

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