

Benefit Insights

Pinnacle
Financial Services, Inc.

A 401(k) Third Party Administrator of
Exceptional Caliber & Experience

A non-technical review of qualified retirement plan legislative and administrative issues

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Timely Deposit of Plan Contributions

The Department of Labor (DOL) has finally provided much anticipated guidance for the timely deposit of elective deferrals in qualified 401(k) plans. The proposed regulation keeps the same basic framework for determining if contributions are timely deposited but adds a safe harbor rule that many plans can utilize.

This newsletter will discuss the new rules, as well as the timing requirements for other types of plan contributions.

401(k) Salary Deferrals

A large percentage of retirement plans today are funded by employees' own contributions. In a 401(k) plan, participants can elect to defer a portion of their salary which is withheld from each paycheck. Deferrals can also be made from bonuses or other special compensation awards, if the plan allows.

The question arises as to how quickly the employer must transmit such deferrals to the plan once they have been withheld.

Existing Deferral Deposit Rules

Until now, DOL regulations provided only that salary deferrals must be deposited as soon as they become plan assets and that occurs as of the earliest date such contributions can reasonably be segregated from the employer's general assets. The DOL did not provide any more specific instructions on how this date could be determined.

The regulations also state that in no event shall the segregation date be later than the 15th business day of the month following the month the contribution was withheld. But the DOL has stated emphatically that this was not to be relied on as a safe harbor date and that most employers should be able to segregate the funds much sooner than the outside limit.

Upon audit, many employers were penalized for late deposits based on the enforcement of these regulations in a highly subjective manner. That's because the rules did not adequately provide objective standards that could be fairly applied to every situation. For many years there has been no definitive standard for determining if deferrals were being deposited on a timely basis in the opinion of the DOL.

When deferrals are not deposited on a timely basis, the employer is considered to be commingling plan funds with its own funds. The employer becomes liable for the payment of lost earnings to participants' accounts as well as prohibited transaction penalties. Trustees may also be liable for fiduciary breach penalties.

New Safe Harbor for Small Plans

On February 29, 2008 the DOL issued proposed regulations providing additional guidance on this issue. The existing standard of making deposits as soon as the money can be segregated from the employer's general assets remains in force. But a clear safe harbor time frame is established for small plans with fewer than 100 participants at the beginning of the plan year. The safe harbor deadline is the 7th business day after the day on which such amounts would have been payable to the participant in cash (in other words, withheld from paychecks).

The 100 participant cut-off for small plan status under the safe harbor deposit rule is not the same as small plan filing status of Form 5500. That is, a plan with a participant count between 100 and 120 may be able to file Form 5500 as a small plan but cannot utilize the 7-day safe harbor deposit rule. Plans with 100 or more participants at the beginning of the plan year are subject to the existing deposit rules.

Loan Repayments

Loans to plan participants, secured by their vested benefits, are common in 401(k) plans. Repayments are often deducted from the employee's wages, similar to salary deferrals. The same 7-day safe harbor deposit rules apply to loan repayments.

Effective Date

The new safe harbor rule will become effective on the date of publication of final regulations in the Federal Register. But the DOL has clearly

stated that employers can rely on the proposed safe harbor deadline until final regulations are issued. This provides immediate relief for many employers who now have at least 7 business days to make timely deposits without the uncertainty that previously existed.

Small employers who feel that they can't reasonably segregate withheld deferrals from their general assets within the 7-day period may want to rely on the existing deposit rules and ignore the safe harbor. But that may be a risky position to take now that a safe harbor has been established.

Matching Contributions

In order to encourage employees to participate in their 401(k) plans, employers will often provide a matching contribution. It is usually based on the employee's elective deferrals or a portion of such deferrals. Matching contributions are often deposited throughout the year along with deferral contributions.

The actual deadline for making matching contributions that are to be allocated for a particular year and included in the nondiscrimination test is the last day of the following plan year. But in order to be deducted on the employer's tax return for the year allocated, the contribution must be deposited by the tax return due date, including extensions. Different deduction rules apply where the employer's fiscal year is different than the plan year.

EXAMPLE: ABC Company's fiscal and 401(k) plan year are both the calendar year. The company always deposits the entire matching contribution after the plan year end. For 2007, ABC filed for an extension (to September 15, 2008) to file its federal tax return. The matching contribution is made September 12, 2008. Since it was contributed before the federal tax return due date (including extension), it is deductible on the 2007 return.

QNECs and QMACs

Each year a separate nondiscrimination test must be performed for salary deferrals (ADP test) and matching and/or voluntary after-tax contributions (ACP test) under a 401(k) plan. One method of passing an otherwise failed test is for the employer to make a qualified nonelective contribution (QNEC) or a qualified matching contribution (QMAC) to some or all of the non-highly compensated employees.

In order to be utilized in the test for a particular plan year, these contributions must be made by the last day of the following plan year. The timing issues that apply to the deduction of matching contributions also apply to QNEC and QMAC contributions.

Safe Harbor 401(k) Contributions

A 401(k) plan will be treated as automatically passing the ADP test for any year that it satisfies the safe harbor contribution requirement and the notice requirement. The contribution requirement can be met by either a specified matching contribution rate or an employer nonelective contribution of 3% of eligible employees' compensation.

Generally, the safe harbor contribution must be made by the last day of the following plan year. The timing issues that apply to the deduction of matching contributions also apply to safe harbor contributions.

Where the safe harbor matching contribution is being made on a per payroll basis instead of an annual compensation basis, the match must be deposited by the last day of the following plan quarter.

Profit Sharing Plans

Employer nonelective contributions to a profit sharing plan are generally credited in the year

they are deposited. However, contributions made after the end of the employer's fiscal year but before the due date for filing its federal tax return (including extensions) may be considered to have been paid as of the last day of the fiscal year. If the employer's fiscal year is different than the plan year, other factors may have to be considered.

EXAMPLE: The XYZ Corporation's fiscal year is the calendar year. XYZ's profit sharing plan also has a calendar plan year. For 2007, the due date of XYZ's federal tax return was extended to September 15, 2008. Any employer nonelective contributions deposited by that date can be considered deposited on December 31, 2007 and allocated under the plan as of that date. They would be deductible to the corporation for 2007.

Money Purchase Pension Plans

Unlike profit sharing plans, in which employer contributions are often discretionary, money purchase pension plans require a specific contribution formula. Failure to deposit the required contribution is a violation of the minimum funding standards. The contribution deadline for minimum funding purposes is 8½ months after the end of the plan year. If the deadline is not met, the employer is subject to a late funding penalty.

Where the employer's fiscal year is the same as the plan year, this date matches the day a corporation could extend the due date of its tax return. This allows the employer to deduct the payments necessary to fully fund the plan within the allowable funding period. However, the 8½-month funding period exists regardless of whether or not the corporation files for an extension.

Non-corporate entities such as partnerships and sole proprietors have different tax filing due dates which must be taken into consideration for deduction purposes.

Top Heavy Contributions

If a plan is considered to be top heavy (i.e., at least 60% of the benefits belong to key employees), it must provide minimum contributions, usually 3% of compensation, to non-key employees. Though there is no clear deadline for top heavy contributions, it is advisable to make such contributions by the employer's deduction deadline.

Defined Benefit Pension Plans

The funding requirements for defined benefit pension plans are based on actuarial calculations which spread out payments over the years to provide for specific benefits as they become due.

As with money purchase plans, defined benefit plans are also subject to the minimum funding rules which allow required contributions to be made up to 8½ months after the end of the plan year. Plans that do not contribute enough money to fully fund the current benefit liabilities must

make deposits on a quarterly basis or else notify employees that quarterly deposits will not be made.

The timing issues that apply to the deduction of money purchase plan contributions also apply to defined benefit plan contributions.

Conclusion

Earlier this year the DOL provided long-awaited relief from the vague and confusing salary deferral deposit rules for small employers. The new 7-day safe harbor is a reasonable deadline that most small companies should be able to meet. If not, the existing guidelines are still available. Failure to make timely deposits could subject the plan to lost interest payments and penalties.

It is important that both employee and employer contributions be deposited by the required due dates to keep the plan properly funded and in compliance with qualification requirements.

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