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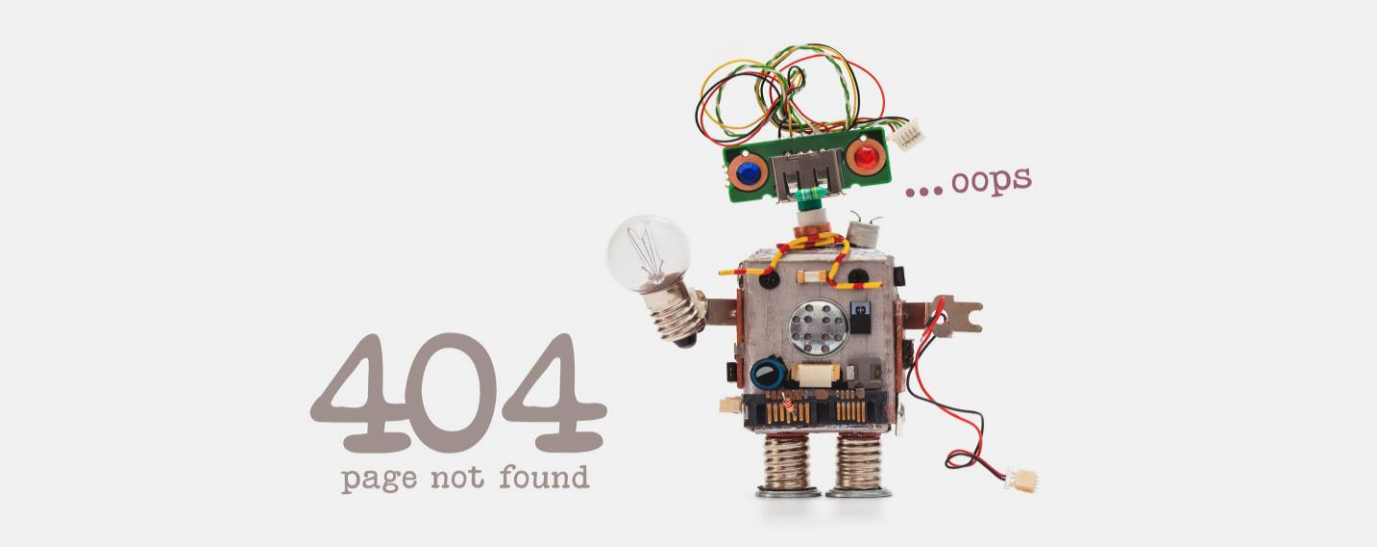

What Happens When You Deposit Employee Deferrals Late?

Richard Fellows, ERISA Specialist and Senior Plan Advisor

In our research, late deposit of contributions is a frequent error made by plan sponsors and is a key priority of the Department of Labor (DOL). In every plan audit conducted by the DOL, the investigator looks to see if contributions have been deposited in a timely manner.

A number of years ago, the DOL revised the instructions to Form 5500 requiring plan auditors to review and confirm that contributions are made in a timely manner. For this reason, it is unlikely that late deposit of contributions will go undetected in the case of plans subject to the audit requirement.

The essence of the requirement to deposit deferrals quickly is that once these amounts are withheld from employee paychecks, they become plan assets and therefore must be held in trust. It is a prohibited transaction for a sponsor to continue to hold these amounts after they have become plan assets.

Deadlines for Depositing Contributions

ERISA requires plan sponsors to deposit these amounts in the plan trust as of the earliest date they can "reasonably be segregated" from the sponsor's general assets. Although this timeframe is somewhat subjective, there is an outer limit which is the 15th day of the following month.

This period is sometimes interpreted as a safe harbor, in the sense that the rule has been complied with so long as the deposits are made by the 15th day of the following month. However, the DOL has made clear on many occasions that this is not the case. There is rarely a situation where a sponsor can wait this long to make deposits.

In determining whether contributions have been made in a timely fashion, investigators look at how long it usually takes the sponsor to make deposits as the standard. For example, if contributions are generally deposited within two to three days after being withheld from employee paychecks, two to three days is seen as the standard. If a deposit for another pay period is delayed for a month, it would be considered late.

Small plans (less than 100 participants), although not subject to plan audit requirement, must still comply with the timeframe for depositing deferrals. However, the ERISA regulations allow a seven-day safe harbor period for small plans. As such, deposits made by small plans will be deemed timely if made within seven business days following the date withheld from employee paychecks.

What Steps are Required When Deposits are Late?

When it is detected that deferrals have not been deposited in a timely manner, the sponsor must follow four steps of action:

1. Deposit these amounts as quickly as possible;
2. Calculate and deposit the lost earnings on these contributions to compensate participants for loss of investment opportunity due to the delay;
3. Report the late contributions on Form 5500 for the year in question; and
4. Pay the excise tax on the prohibited transaction.

There are two approaches to correcting late contributions – filing under the DOL's Voluntary Fiduciary Compliance Program (VFCP) or self-correction. Most sponsors elect self-correction, rather than undertake the expense and effort involved in completing a filing under the VFCP.

When a sponsor elects self-correction, lost earnings can be calculated using the interest rate imposed by the Internal Revenue Service on the underpayment of taxes, essentially the same rate as the DOL's online calculator. However, the plan's actual investment return must be used if this is greater. The interest on underpayment of taxes can be in the range of 4 to 6 percent.

The excise tax on the prohibited transaction must be paid. The return used to pay this tax is Form 5330. Although this form is six pages in length, it is relatively simple to complete. The tax is 15 percent. This tax is assessed only on the lost earnings and not the late contributions themselves, so the amount of the tax is generally not significant - often less than $100.

If a sponsor elects to do a filing under the VFCP, it must still complete the first three steps above. The main disadvantage of this approach is that the application is time-consuming and cumbersome. It must describe in detail why deposits were not made within the required timeframe and the method of correction, and they will have to do so under penalty of perjury.

However, there are three distinct advantages to filing under the VFCP. First, the DOL will not recommend a plan for audit where the late contributions are revealed through a VFCP filing.

The second is that the online calculator may be used to calculate lost earnings regardless of the plan's actual investment return. As mentioned above, the rate for the online calculator is in the range of 4 to 6 percent, far below typical investment returns in recent years.

The third advantage is excise tax relief. This relief is available if three conditions are met:

1. Late deposits were made to the plan within 180 calendar days of the date these amounts were withheld from employee paycheck;
2. The applicant has not filed under VFCP in the three years prior to the submission date; and
3. If the amount of the excise tax exceeds $100.00, a notice of the filing is provided to plan participants affected by the delinquent deposits within 60 days of the date of the submission.

Summary

Don't get into a bind with the DOL by depositing employee deferrals late. If deferrals are late, be sure to follow the action steps to rectify the situation.

About the Author, Richard Fellows

Richard is an attorney and investment advisor with almost 30 years of experience working with plan sponsors and plan participants. He has a unique perspective derived from serving as an advisor to plan sponsors and holding senior positions with several financial services firms. He understands how the financial service industry constructs, positions and prices investment products. Before joining RPAG, Richard was vice president and secretary for Loomis Sayles Distributors and prior to that he was a vice president with Fidelity Investments. Before entering financial services, Richard was a principal with William M. Mercer where he advised plan sponsors regarding plan design and investments. Richard began his career as a trial attorney with the U.S. Department of Labor in Washington, DC and as an associate with the Wall Street law firm of Cadwalader, Wickersham & Taft.

Is it Time for a Plan Refresh?

The duty to provide participants with sufficient information to make consistently informed retirement investment decisions is a basic fiduciary responsibility under ERISA Section 404(a). However, there could be some plan committees who feel their participants are not consistently making prudent decisions.

According to a recent JP Morgan survey[1] nearly 75 percent of participants say they are not confident with selecting investments. It is no surprise they found that 80 percent of participants surveyed have portfolios that do not match their stated risk tolerance. Also, according to an Investment Company Institute (ICI) research report[2], only six percent of participants changed their asset allocation in 2016. This percentage has been similar since 2007 including during the 2008 market crash. No rebalancing after violent market movement? This does not look like "consistently informed investment decisions" as per ERISA.

Plan refresh is a process by which participants are notified that all existing assets and future contributions will be invested in the plan's target date fund (TDF) (Qualified Default Investment Alternative (QDIA)) based on each participant's date of birth, unless the participant notifies the plan otherwise. This is the same process as for other QDIA default actions.

The primary motivation for a plan refresh should be to improve participant investing. Assuming an appropriate TDF is offered as QDIA, why not affirm to participants that this is typically where they should invest, as opposed to giving them an array of mutual funds and anticipating that they will choose prudently? Surveys show that employees look to their employers for messaging which they assume to be in their interest.[3] For many employers it seems this messaging may not be working and often results in participant confusion and imprudent investment selection, thereby diluting retirement readiness. A plan refresh could help solve this problem and also can have significant fiduciary liability mitigation benefits.

Benefits of investment refresh:

For participants this can help: 1) Improve asset allocation*; 2) solve for use of any imprudent investments that may be in menu; 3) solve for legacy assets (prior default no longer appropriate); 4) solve for employees who asked HR what may be a suitable investment option; 5) solve for inertia; and 6) solve for rebalancing investments.

We find that refresh is frequently used at the point of a recordkeeper change or menu reconstruction. Assuming that doing a refresh makes sense and yields the type of results you want to see, why wait for a recordkeeper change?

Unfortunately, there is a pervasive misperception that participants may push back, as was anticipated when auto enrollment was first introduced. Let's look at the data:

1. According to JP Morgan Plan Participant Research in 2016, one in two participants would rather push the easy button
2. 75 percent of participants are not confident they know how to best allocate contributions
3. 82 percent of participants support employers conducting a re-enrollment

Often, many re-enrolled participants stick with the default investment long term. With good communication, pushback can be often non-existent, as with original auto enrollment.

Another misperception is that participants will opt out. Vanguard noted that the percentage of participants who fully opt out of refresh remains low. In fact, after one year, QDIA was held by 92 percent of participants and captured 81 percent of plan assets. A small group, 7 percent of participants, held what Vanguard described as "extreme" positions, a group that it said was comprised predominantly of participants who fully opted out of the target date default fund and constructed their own portfolios. This is exactly how refresh is supposed to work.[4]

We've covered the symptoms, diagnosis, prognosis, prescription and implementation. Can you recall a business decision that appears so clearly beneficial for plans, their participants and fiduciaries? Ask yourself if you were faced with making a decision that impacted the productivity or profitability of your company that is so clearly documented and supported… would you not act on it or wait?

**Asset allocation does not protect against loss of principal due to market fluctuations. It is a method used to help manage investment risk.*

[1]J.P. Morgan Plan Participant Research 2016. https://am.jpmorgan.com/gi/getdoc/1383355101755

[2]ICI report. https://www.ici.org/pdf/ppr_16_rec_survey_q4.pdf

[3]NYU Law Review. "The Behavior of Defined Contribution Plan Participants." 2002. www.nyulawreview.org

[4]Vanguard. Reenrollment: One year later. 2017. https://institutional.vanguard.com/iam/pdf/REEROLL.pdf?cbdForceDomain=false

Hey Joel! – *Answers from a recovering former practicing ERISA attorney*

Do you have a question for an ERISA attorney burning in your heart? Well, you're not the only one! Welcome to our new *Retirement Times* feature, *Hey Joel*! We're featuring plan sponsor questions from all over the country and answers from our in-house former practicing ERISA attorney.

Do we need to adopt a loan policy?
- *Confused in Connecticut*

Dear Confused,

It is a plan/legal determination as to whether a separate loan policy is required. However, the following loan provisions should be documented:

1. The identity of the person authorized to administer the participant program;
2. The procedure for applying for loans;
3. The standards for approving or denying loans;
4. Any limitations on loan types or loan amounts;
5. The procedures used to determine a reasonable rate of interest;
6. The types of collateral that can be used to secure participant loans; and
7. The events constituting default and the steps necessary to preserve plan assets in the event of default.

This information may be contained either in the plan document itself or in a written document (such as a loan policy) forming part of the plan. [DOL Reg. § 2550.408b-1(d)]

Loan procedures are located at the end of the Summary Plan Description (SPD) and incorporated into the Basic Plan Document (BPD) by reference.

Always happy to *lend* a helping hand!

Joel Shapiro

About Joel Shapiro, JD, LLM
As a former practicing ERISA attorney Joel works to ensure that plan sponsors stay fully informed on all legislative and regulatory matters. Joel earned his Bachelor of Arts from Tufts University and his Juris Doctor from Washington College of Law at the American University.

If you have a question for Joel, please send it to your plan advisor. Maybe it will be featured in a future issue!

Participant Corner: Tax Savers Credit Reminder

This month's employee memo is a reminder that participants may be eligible for a valuable tax incentive. Download the memo from your Fiduciary Briefcase at fiduciarybriefcase.com.

You may be eligible for a valuable incentive, which could reduce your federal income tax liability, for contributing to your company's 401(k) or 403(b) plan. **If you qualify, you may receive a Tax Saver's Credit of up to $1,000 ($2,000 for married couples filing jointly) if you made eligible contributions to an employer sponsored retirement savings plan.** The deduction is claimed in the form of a non-refundable tax credit, ranging from 10% to 50% of your annual contribution.

Remember, when you contribute a portion of each paycheck into the plan on a pre-tax basis, you are reducing the amount of your income subject to federal taxation. And, those assets grow tax-deferred until you receive a distribution. If you qualify for the Tax Saver's Credit, you may even further reduce your taxes.

Your eligibility depends on your Adjusted Gross Income (AGI), your tax filing status, and your retirement contributions. To qualify for the credit, you must be age 18 or older and cannot be a full-time student or claimed as a dependent on someone else's tax return.

Use this chart to calculate your credit for the tax year 2018. First, determine your AGI – your total income minus all qualified deductions. Then refer to the chart below to see how much you can claim as a tax credit if you qualify.

Filing Status/Adjusted Gross Income for 2018			
Amount of Credit	Joint	Head of Household	Single/Others
50% of amount deferred	$0 to $38,000	$0 to $28,500	$0 to $19,000
20% of amount deferred	$38,001 to $41,000	$25,501 to $30,750	$19,001 to $20,500
10% of amount deferred	$40,001 to $63,000	$30,751 to $47,250	$20,501 to $31,500

Source: IRS Form 8880

For example:

- A single employee whose AGI is $17,000 defers $2,000 to their retirement plan will qualify for a tax credit equal to 50% of their total contribution. That's a tax savings of $1,000.
- A married couple, filing jointly, with a combined AGI of $39,000 each contributes $1,000 to their respective company plans, for a total contribution of $2,000. They will receive a 20% credit reducing their tax bill by $400.

With the Tax Saver's Credit, you may owe less in federal taxes the next time you file by contributing to your retirement plan today!

Distributions before the age of 59 ½ may be subject to an additional 10% early withdrawal penalty. This is for informational purposes only, we suggest that you speak with a tax professional about your individual situation.

The target date is the approximate date when investors plan to start withdrawing their money. Generally, the asset allocation of each fund will change on an annual basis with the asset allocation becoming more conservative as the fund nears the target retirement date.

Mutual funds are sold by prospectus only. Before investing, investors should carefully consider the investment objectives, risks, charges and expenses of a mutual fund. The fund prospectus provides this and other important information. Please contact your representative or the Company to obtain a prospectus. Please read the prospectus carefully before investing or sending money.

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