Guest Article

DOL Audits of 401k Deposits

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Subject to the exception for certain types of assets under ERISA 403(b), The Employee Retirement Income Security Act of 1974 ("ERISA") requires that plan assets be held in trust. Once assets constitute plan assets, the failure to timely transmit them to trust will violate ERISA's trust requirement and thus, constitute a breach of fiduciary duty. In addition, the failure will be deemed to constitute a prohibited transaction.

Department of Labor ("DOL") regulations govern when participant before-tax contributions to an Internal Revenue Code (the "Code") section 401k plan constitute plan assets. Under regulations issued in 1988, such amounts were deemed to become plan assets as of the earliest date on which such contributions could reasonably be segregated from the employer's general assets (the "general rule"), but in no event later than 90 days from the date on which such amounts are received by the employer or would otherwise have been payable to the participant, in the case of amounts withheld from the employee's wages (the "maximum period").

Concerned that plan sponsors were violating the regulation, in 1995 DOL began a project to investigate the misuse of employee contributions in

general, and before-tax contributions to 401k plans in particular. As a result of its investigation, DOL concluded that the regulations needed to be revised.

In revising its regulations, DOL noted that many employers were then misinterpreting the rule as permitting all employers to delay the transmission of 401k before-tax contributions until 90 days after they were withheld. That is, many employers misinterpreted the maximum period as constituting a safe harbor. Notwithstanding this observation, when DOL revised its regulations, it decided not to make any changes in that portion of the regulation that was obviously most misunderstood, that is, the general rule. Rather, the only change was to shorten the fixed period under the maximum period portion of the regulations.

With the revised regulations in hand, several regional offices of DOL have begun actively investigating 401k plans and plan sponsors for compliance with these requirements as part of DOL's National Enforcement Project.

Current Governing Regulations

Current DOL regulations provide that employee contributions to a 401k plan become plan assets as of the earliest date on which such contributions could reasonably be segregated from the employer's general assets (the "general rule"), but in no event later than the 15th business day of the month following the month in which the contributions are received by the employer or, in the case of amounts withheld from wages, would otherwise have been payable to the participant (the "maximum period"). The regulations contain a process by which a plan sponsor may be able to obtain an extension of the maximum period subject to, among other requirements, a participant notification requirement.

While the regulations, and in particular, the examples contained therein, can be interpreted as containing the expectation that a small employer with a single payroll system should be able to segregate 401k deposits from its general assets much quicker than a larger employer with several payroll centers, the regulations provide virtually no meaningful guidance as to how an employer is in fact to determine its compliance date under the general rule. As a result, an employer, particularly a small employer, may be unprepared for DOL's interpretation of the rules as they apply to the employer's plan in the event of a DOL investigation.

The general rule—the earliest date on which the contributions can reasonably be segregated.

DOL Audit Position

Small employers will, except in the rarest of circumstances, invariably be deemed by DOL to fall within the general rule. There may be a few rare exceptions where, for example, a small employer maintains multiple payroll systems. This is the case notwithstanding the fact that many small employers believe that they are in compliance with the plan asset rules because 401k contributions are being transferred to the financial institution where the assets are maintained not later than the 15th business day of the month following the month for which they were withheld. However, these small employers are not in compliance because, under the general rule, a small employer with a single payroll system will instead be determined to be able to segregate those assets much sooner.

In fact, DOL investigators, during the course of plan investigations (essentially, plan audits), have indicated that DOL has internally adopted a presumption that 401k contributions, when being made with respect to a plan maintained by a small employer, should be contributed to trust within seven days of the payroll date. Where a small employer has been waiting until the 15th business day of the next month to deposit the elective deferrals, DOL will view this as both a breach of fiduciary duty and a prohibited transaction. Correcting this breach, according to DOL, requires that the employer reimburse all participants, both current and former, for the earnings that were lost as a result of the delay. Moreover, since DOL takes the view that these delays in depositing contributions to trust constitute a breach of fiduciary duty, DOL may seek to apply this correction for all earlier years that remain open under the statute of limitations applicable to fiduciary breaches under ERISA. Thus, under ERISA 413 , correction may be required for up to six plan years.

Even if the aggregate dollar amounts are determined by the plan to be relatively small, the administrative cost associated with notifying and perhaps finding former participants (some of whom may not have terminated on the best of terms), of any error may not only prove costly, but may lead current and—particularly—former participants to wonder whether there are other errors that also require correction.

Refuting the Seven-day Presumption

Part of the employer's strategy, if it is to successfully refute or at least reduce the amount of interest earnings to be assessed against it, will be to attempt to push the time line forward as much as possible. That is, the employer must be able to refute that the seven-day period is in fact a reasonable period of time in which it could have segregated the assets. While DOL has apparently adopted this presumption of seven days in the case of small plans, it must be remembered that the regulations

intentionally do not contain a fixed period of time under the general rule. Moreover, it can be argued that the adoption of this presumption is itself counter to the basic structure of the general rule. That is, the general rule necessarily contemplates that each employer, whether large or small, must be taken on its own. That is, each employer must treat withheld deferrals as plan assets as of the earliest time that the individual employer, given its own circumstances and systems, could segregate the contributions from its general assets. Thus, to the extent that the employer can legitimately show that, under its procedures, seven days was or is not a reasonable period, the employer should be able to move the applicable time period forward, and thus, the point at which DOL will begin to assess for loss earnings.

Given the fact that the correction period where a fiduciary breach is found is statutory, and that the basis of determining the interest loss is consistent with the approach taken by DOL under its Voluntary Fiduciary Correction Program, attacking the compliance date under the general rule may indeed be the most fruitful avenue for an employer. This is particularly the case since the regulations themselves do not contain any hard and fast guidance on this point. As such, the employer may wish to lay out a time line documenting both the actual steps that it takes to transmit 401k contributions, as well as the time required for each step. This time line must be based upon the employer's actual process and must be documented. However, it might include:

1. The time required to actually calculate the 401k deferrals to be transmitted for each payroll.

The time required will likely differ for each employer based on such factors as who makes this calculation, whether it is derived solely in-house, or whether an outside payroll vendor is involved. If no outside payroll vendor is involved and the plan sponsor maintains a relatively antiquated payroll or software system, the time required may be extensive. If an outside vendor is used, different vendors and packages purchased provide summaries of the 401k contributions, by participants, later than others. For example, even though the plan sponsor may have weekly payrolls, and therefore, weekly 401k deferrals, some vendor packages will only provide a summary of the elective deferrals by participants on a monthly basis with the final payroll for the month. If the employer must manually determine the 401k deferrals for each participant from the often voluminous total weekly payroll information provided by the payroll vendor, this will obviously take some additional time to accomplish than it would under a fully automated system. Moreover, manually determining 401k deferrals has a greater potential for errors; a fact that should be pointed out to the DOL investigator. Moreover, the person at the plan sponsor who is responsible for transmitting the 401k contributions may also affect how long it takes the company to complete the process.

For example, at some small companies, all payroll responsibilities are left to an individual at a relatively high position to ensure confidentiality of payroll information. However, the higher the position of the individual responsible for this process, the more other responsibilities this person is likely to have. Thus, it will likely take this individual more time to process the information than might otherwise be required if left to an individual with fewer responsibilities given the fact that the higher-ranking person will be unable to devote 100% of his or her time to the process.

If the plan uses a decentralized payroll system, the time required to process payroll information from different locations should also be detailed.

2. If there are participant loans outstanding that are being repaid by payroll deduction, the company may also be responsible for manually processing the loans for each payroll period and ensuring that each payment is properly divided between principal and interest.

3. The time required to check and verify any of the above calculations.

If the employer, as part of its reconciliation process, transmits the participant contribution data to an outside administrative firm, which subsequently must transmit the information back to the plan sponsor, the time required in this part of the process should be detailed to DOL.

4. The time required to communicate the total aggregate contribution to the company's payables department.

Some companies have a general operating position that they will only write checks on certain days. If this is in fact part of the company's normal operations, this should also be factored into the equation.

5. If payment is made to the brokerage house or other financial institution by actual check, the general time required for the check to be both received by the financial institution and processed as a contribution.

6. If applicable, the time required for the company to actually provide the investment firm with detailed instructions as to how the funds reflected in the check are to be allocated among the applicable participants.

DOL generally seems unmoved by arguments pointing out that the plan sponsor has in fact done more than would otherwise be required and taken steps that have more of an affect on the participants' overall earnings than depositing the 401k contributions a few days earlier. For example, arguments that the employer has either paid all administrative

expenses of the plan consistently or made its matching contributions much earlier than required appear to fall on deaf ears.

DOL investigators, as well as some practitioners, have sometimes suggested that, because the regulations do not require that the contributions actually be invested as of the earliest time they can be segregated from the employer's general assets, but that they merely be segregated , the solution is to set up a separate interest bearing account to which the contributions are first contributed. Later, the amounts can be transferred to the general investments under the plan. However, unless the earnings will then be used to defray reasonable administrative costs of the plan, such an approach raises concerns of its own.

First, from an administrative standpoint, by using a separate, interest bearing account the plan would have the added administrative burden of constantly tracking the earnings on contributions and then transferring the contributions and earnings to the plan's general investment alternatives. Moreover, this practice raises questions as to whether the employer will actually gain the benefit of ERISA 404c status since it will be depriving participants of control over the investment of their accounts for some period of time. While this may not be of great concern currently, when the markets are generally down, when there is again a month or months when the market increases, participants will have the benefit of saying what the additional gain could have been for a month, or whatever period they are denied control over their additions to their account, had the monies been deposited in their accounts sooner. Further, use of a separate account may be inconsistent with the provisions of the plan document.

Calculating the Lost Earnings

DOL's position is that where it determines that the deposits have not been made in accordance with its regulations, correction requires that the loss earnings be replaced by the plan sponsor. DOL has, on audit, required that the determination as to the amount of interest to be contributed is to be made using the Code Sec. 6621(a)(2) rate. This is the rate applied to tax underpayments and is the sum of the federal short-term rate plus three percentage points. This means, for example, for late deposits that occurred in fourth quarter of 2001, the applicable rate would be 7%. The rate changes quarterly. As such, a single late deposit could be subjected to various interest rates throughout the period that it was not timely deposited. Presumably, however, had actual earnings under the plan been greater than the applicable Code Sec. 6621(a)(2) rate, this would form the basis for the calculation of lost earnings as under DOL's Voluntary Fiduciary Correction Program.

Avoiding the 20% Penalty

Where there is a fiduciary breach, ERISA 502(l) provides that DOL shall assess a penalty of 20% of the amount recovered as a result of a settlement or litigation. The Secretary of Labor is, however, authorized to reduce the penalty where she determines that the fiduciary acted reasonably and in good faith, or the Secretary determines that the fiduciary will not be able to make restoration to the plan without severe financial hardship unless the penalty is waived or reduced.

As is the case under its Voluntary Fiduciary Correction Program, DOL is permitting correction on audit without assessing this penalty. That is, if the employer agrees to pay to the plan the amount of lost earnings for the periods involved, the payment is treated as having been made voluntarily and not as part of a settlement with DOL.

Summary

DOL is once again investigating 401k plans for compliance with its plan asset regulations. Unfortunately, many small employers may be operating under the mistaken belief that compliance only requires that deposits be made by the 15th business day following the month for which 401k deposits were withheld. Employers may wish to review their procedures prior to a DOL investigation and, should they determine that they are not in compliance, consider reimbursing participants for the lost earnings in accordance with DOL's internal position as well as its Voluntary Fiduciary Corrections Program.

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