Final Paychecks and Your 401(k)
Employers Should Examine Their Payroll Procedures

It is common for a Plan Sponsor to feel comfortable with an internal payroll system they have used for a long time or to rely on a system that is highly automated. However, employers should ensure that their payroll system properly addresses an employee's final paycheck with regards to their 401(k) contributions.

**Your employee terminates and you are processing their final paycheck, do you withhold for their 401k?**

**THE RULE:**

- Once an employee terminates, severance pay *not earned prior* to termination *cannot* be contributed to the 401(k) plan.
- The employee *can* make a contribution from their check when they are being paid for sick, vacation and other leave as well as regular pay, commissions, overtime, shift differential pay, and bonuses *earned prior* to their termination.
- The employee must have a salary deferral agreement in place in the month prior to receiving the last paycheck.
- The contribution must be sent to a plan within 2 ½ months after the employee's separation from employment.

**CORRECTING ERRORS:**

One of the biggest problems occurs where a plan document restricts participation to *current employees*. Many automated payroll systems treat the employee's final paycheck the same as prior paychecks and withhold accordingly, but a plan doesn't permit terminated employees to contribute. There are two ways to fix:

- If the contribution has not been deposited into a plan yet, it must be reversed and paid to the employee as wages.
- If the contribution has already made it to a plan, the employer may either follow complex IRS corrective procedures for excess allocations or move the contribution.
into a plan's suspense account and pay the employee for the amount of the error.

**SUMMARY:**

On an individual basis, the administrative burden of curing a mistake may not be too cumbersome, but for a reduction in force or a significant company-wide layoff, the failure to follow the rules could be costly. Take the time to ensure your payroll system can properly handle the final paycheck's 401(k) contribution.