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Legislative Guidance Alert

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

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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.

**Fiduciary Risk Management: Compliance Services
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