Can We Require Employees to be Employed at Year-End to Receive a Safe Harbor Contribution?

Facts

Our company sponsors a safe harbor 401(k) plan. Each participant receives a safe harbor nonelective contribution equal to 3% of his or her annual pay. Our TPA calculates the safe harbor contribution for us after the close of each year, and we deposit it sometime before we file our company tax return for that year. Each year, we have a couple of participants who terminated employment before year end, and we end up making contributions for them even though they are long gone by the time we make the deposit.

Question

Is there a way to limit the safe harbor contribution to only those who remain employed on the last day of the year? What do we do if the terminated employees have already taken a distribution of their full account balance by the time the safe harbor nonelective is to be deposited?

Answer

Your first question is one of the very few that has a concise, definitive answer. Unfortunately, that answer is "No." Generally speaking, it is possible to require participants to be employed on the last day of the year in order to share in non-safe-harbor contributions such as profit sharing or non-safe harbor match. However, one of the requirements for safe harbor plans is that the contributions used to satisfy the safe harbor (the 3% nonelective in this case) cannot be subject to a last day rule.

With the easier, or at least more objective, question out of the way, let's tackle the second one. When a participant submits a distribution request, that paperwork remains valid for 180 days before it goes "stale." That means the handling of a safe harbor contribution made for a terminated participant who has already taken a full distribution depends on timing.

The first order of business is to get the contribution for the former employee deposited just like you would for anyone else. The plan's recordkeeper will need to reinstate the former participant's account to accept the contribution. There are some differences of opinion as to whether the contribution should be invested according to the former participant's investment election (if one was in place) or in the plan's default investment. In situations where there are solid arguments to support both positions, it is always recommended that you document your decision (along with your reasoning) and follow it consistently.

If the deposit is made within 180 days of the participant's previous distribution request, the additional amount can be distributed using those same instructions. If the previous transaction was a direct rollover to an IRA, the plan can rollover this subsequent amount to the same IRA. If it was paid in cash, the additional deposit can also be paid out in cash with the requisite tax withholding. You get the idea.

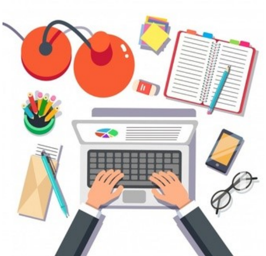
But what if it has been more than 180 days? In that case, the participant is treated the same as any other former participant with a balance. If the balance is below the plan's mandatory cash-out limit, you can provide the participant with the necessary paperwork and force the residual distribution if you do not get a response within the appropriate timeframe. If the balance is above the cash-out limit, then the participant can keep the new balance in the plan for as long as he or she wants. Obviously, if s/he took out the previous balance, s/he will probably want to withdraw this newly deposited amount also. But the point is that it must be the participant's choice rather than you forcing the issue. As long as the balance remains in the plan, the participant must receive all of the regular notices (summary annual report, fee disclosure, etc.) that other former employees with balances receive.

We know that all sound like a colossal pain in the neck. There is one option you can consider if you want to avoid the whole residual deposit/distribution problem altogether. Even though you do not usually deposit the safe harbor contribution until sometime between the end of the year and the due date of the company tax return, you could make the deposit for any terminating participant(s) immediately after they receive their final paycheck. Since the safe harbor contribution is mandatory and the formula is fixed at 3% of pay, there isn't really any discretion or subjectivity as to the amount to be contributed. The only thing to watch out for is to make sure you don't accidentally deposit the contribution again when your TPA calculates the amount due for the rest of the participants after the end of the year.

Of course, if you're not sure how to proceed in a specific situation, give us a call. We are glad to work through it with you and point you in the right direction.

Related Resources

- Archives: Safe Harbor 401(k) Plans



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