Employee Benefits Law Action Memo

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Electronic Dispatch

Go to BS&K Employee Benefits Home Page

RECENT IRS GUIDANCE HIGHLIGHTS THE IMPORTANCE OF MAKING TIMELY PLAN CONTRIBUTIONS OF EMPLOYEE ELECTIVE DEFERRAL AMOUNTS

The Internal Revenue Service ("IRS") recently issued Revenue Ruling 2006-38 which addresses the calculation of excise taxes that apply when an employer fails to make timely contributions of participant elective deferrals to a qualified retirement plan (e.g., an Internal Revenue Code Section 401(k) plan). The failure to make timely contributions of elective deferrals to a qualified retirement plan is a "prohibited transaction" for which an excise tax is owed on the "amount involved" in the transaction. In the Revenue Ruling, the IRS held that the "amount involved" for such failures is based on the interest that is calculated on the elective deferrals during the time period that contributions of such amounts are delinquent. The Revenue Ruling is the first guidance issued by the IRS that specifically addresses how to calculate the excise tax with respect to late contributions of participant elective deferral amounts.

Plan sponsors should be aware that recent United States Department of Labor ("DOL") audits have focused on the timing of contributions of participant elective deferral amounts by employers. Violations of the timely contribution requirement that are discovered by the DOL on audit are referred to the IRS for consideration regarding excise taxes due as a result of the violation. Such violations can be costly for employers, as the amount of excise taxes imposed upon an employer can quickly escalate if contributions are not paid on a timely basis. As discussed below, an employer should take steps to minimize the potential for such violations and, if a violation is discovered, take appropriate action as soon as possible in order to reduce the potential excise tax liability.

Background

DOL regulations provide that employee elective deferral amounts are considered "plan assets" that must be paid to the plan's trust (or to the insurance company for the plan) as of the earliest date on which such contributions can reasonably be segregated from the employer's general assets. In the case of amounts that are withheld by an employer from a participant's wages, the latest date that such amounts may be contributed to the trust by an employer is the 15th business day of the month following the month in which such amounts would otherwise have been payable to the participants in cash. Some employers have mistakenly believed that the maximum period allowed by the DOL regulations serves as a "safe harbor" time period in which to make the contributions. However, in the DOL's view, an employer who makes contributions of participant elective deferral amounts at or near the maximum period permitted under the regulations will rarely, if ever, be considered in compliance with such regulations. Our experience has been that the DOL will examine all of the relevant facts and circumstances to determine when "the earliest date upon which the contributions can reasonably be segregated from the employer's assets" occurs.

Both the Internal Revenue Code ("Code") and the Employee Retirement Income Security Act ("ERISA") prohibit loans between a plan and a "disqualified person" (e.g., an employer), unless an exemption applies. Late contributions of participant elective deferral amounts are considered to be a prohibited loan between the plan and the employer because the employer has the use of such funds during a time when they should be held in the plan's trust for the benefit of participants. Accordingly, an employer's failure to timely remit participant elective deferrals to the plan's trust constitutes a prohibited transaction for which excise taxes are due. Code Section 4975 imposes a 15% excise tax on the amount involved in the prohibited transaction. The excise tax can increase to 100% of the amount involved, if the prohibited transaction is not timely corrected.

Revenue Ruling 2006-38

In Revenue Ruling 2006-38, the IRS addressed the excise taxes due by the plan sponsor of a 401(k) plan that failed to remit participant elective deferral contributions to the plan's trust within the time required by the DOL's plan asset regulation. Pursuant to the terms of the plan, during each payroll period, a portion of the pay of each employee was withheld from the employee's pay in accordance with the employee's deferral election. The aggregate amount withheld from all employees during the pay period in question totaled $100,000. Under the facts in the Revenue Ruling, the date that the employer could reasonably segregate the $100,000 from its general assets and transmit it to the plan's trust was December 8, 2004. The employer failed to deposit such amounts until December 30, 2005.

The IRS ruled that the failure to transmit the contribution until December 30, 2005 constituted a prohibited transaction for both the 2004 and 2005 tax years. The amount involved for the 2004 prohibited transaction is the interest on the $100,000 from December 8, 2004 to December 31, 2004 (calculated using the interest rate for underpayments set forth in Section 6621 of the Code). The 2004 interest amount totaled $314. Because the prohibited transaction was not corrected in 2004, the amount involved for the 2005 prohibited transaction is the interest on the new balance owed after increasing the principal by the 2004 interest amount owed (i.e., $314) calculated from January 1, 2005 to December 30, 2005. The total interest owed for 2005 was $5,316. Applying the 15% excise tax to these amounts, the IRS ruled that a $47 excise tax was owed for the 2004 taxable year ($314 x .15 = $47) and a $797 excise tax was owed for the 2005 taxable year ($5,316 x .15 = $797).

Payment of Excise Taxes

Employers who owe excise taxes must submit a Form 5330 with payment of the applicable excise tax to the IRS for each taxable year in which a prohibited transaction takes place. A single failure to make timely contributions of participant elective deferrals can result in prohibited transactions in multiple years if the failure is not corrected in the tax year in which it occurred, resulting in the requirement to file a Form 5330 for each affected tax year. The Form 5330 generally is required to be filed by the end of the seventh month following the end of the taxable year in which the violation occurred. The IRS may impose additional penalties and interest amounts for tax years for which a timely Form 5330 is not filed.

Recommended Action for Plan Sponsors

Employer failures to make timely contributions of participant elective deferral amounts are not uncommon. Common reasons for such failures include: (1) the employer lacks sufficient administrative procedures to ensure that participant elective deferrals are contributed to the plan's trust as soon as reasonably possible; (2) the employer is unaware of the applicable timing requirements with respect to depositing such amounts; and (3) a malfunction in either the employer's or a third-party payroll provider's payroll administration system occurs that results in the inadvertent failure to deduct deferral amounts from participant paychecks. Steps that may be taken by plan sponsors to help minimize the occurrence of such violations include: (a) evaluating current administrative procedures to ensure that participant elective deferrals are remitted to the plan's trust as soon as they can reasonably be segregated from the employer's general assets; (b) periodically coordinating with third-party payroll providers to ensure that elective deferrals have been appropriately withheld from the paychecks of participants; and (c) establishing internal controls and audit procedures to ensure that violations are discovered as quickly as possible.

If a violation is discovered, plan sponsors should restore the elective deferral amounts to the plan's trust (including lost earnings on such amounts) as soon as reasonably possible and file a Form 5330 with the IRS to pay the applicable excise taxes. A quick response to such violations is desirable in order to avoid increased excise tax penalties as well as penalties and interest that may be imposed by the IRS for failing to file a Form 5330. Plan sponsors also should be aware that the DOL may assess penalties for fiduciary violations that result from the failure to make timely contributions of participant elective deferral amounts. Depending upon the nature of the violation, plan sponsors may want to consider whether participation in the DOL's Voluntary Fiduciary Correction Program ("VFCP") may be appropriate for correcting such a fiduciary violation. For more information regarding the VFCP, please refer to our June 2006 Employee Benefits Law Information Memo entitled "The Voluntary Fiduciary Correction Program Is Expanded and Simplified."[1]

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