

# Client Alert

A report  
for clients  
and friends  
of the firm     August 2006

## IRS Issues Guidance on Calculating Penalty for Failure to Timely Pay Elective Deferrals to a Qualified Plan

The IRS has issued guidance in Revenue Ruling 2006-38 (the "Revenue Ruling") on the manner in which the excise tax under Section 4975 of the Internal Revenue Code (the "Code") should be calculated if an employer does not timely pay participant contributions or deferrals to a qualified plan. **Issuance of this Revenue Ruling is a reminder to plan sponsors that the Department of Labor imposes strict guidelines on the timing of remitting elective contributions to a qualified pension plan.**

### Background

Section 2510.3-102 of the Department of Labor regulations provides that amounts withheld from a participant's wages for contributions to a qualified plan become plan assets as of the *earliest date on which such contributions can reasonably be segregated* from the employer's general assets. In no event, however, may this date be later than the 15th business day of the month immediately following the month in which the participant contributions are received by the employer (in the case of amounts paid to an employer) or the 15th business day of the month following the month in which such amounts would otherwise have been payable to the participant in cash (in the case of amounts withheld from wages by an employer). The Department of Labor has emphasized that employers should not rely on the 15 business day deadline as a safe harbor and has consistently taken the position that the **deadline for remittance of contributions should be viewed as the earliest date on which such contributions reasonably can be segregated.**

Failure to remit contributions within the prescribed time frame results in a prohibited transaction subject to excise tax under Code Section 4975. In addition, failure to timely remit elective contributions may give rise to civil penalties under the Employee Retirement Income Security Act (ERISA) and, if the failure is willful, may give rise to criminal penalties under ERISA. In fact, according to testimony given by a Department of Labor representative in September of 2002, at that time, the Department of Labor had conducted over 200 criminal investigations involving delinquent contributions under its 401(k) Employee Contribution Enforcement Project and had obtained over 132 indictments of individuals.

### Correction

[The Department of Labor's Voluntary Fiduciary Correction Program \(VFCP\)](#) allows employers to voluntarily correct late deposits of employee deferrals. If an employer complies with all of the requirements of the VFCP in connection with the correction of late deposits of employee deferrals and satisfies all of the conditions for exemption set forth in Prohibited Transaction Class Exemption 2002-51 (as amended), the employer will be exempt from the payment of the excise tax otherwise imposed under Code Section 4975. If, however, an employer does not comply with the requirements of the VFCP and the conditions for exemption under Prohibited Transaction Class Exemption 2002-51 (as amended), the excise tax must be paid to the IRS along with a Form 5330 filing.

Code Section 4975(a) imposes a 15% excise tax on a prohibited transaction. In addition, Code Section 4975(b) imposes a 100% excise tax (the second tier excise tax) on a prohibited transaction if that prohibited transaction is not corrected during the taxable period. The excise tax is applied to the "amount involved" in the prohibited transaction. Generally, the "amount involved" means the greater of the amount of money and the fair market value of other property given or the amount of money and fair market value of other property received in such transaction.

The Revenue Ruling provides that solely for purposes of calculating the prohibited transaction excise tax, the "amount involved" if an employer does not timely pay the participant contributions or deferrals to a qualified pension plan is based on interest on those elective deferrals. Accordingly, the interest rate for underpayments described in Code Section 6621(a)(2) on the date of the prohibited transaction is the rate that should be used to calculate the "amount involved." The Revenue Ruling provides an example where contributions could have reasonably been segregated and transmitted to a qualified pension plan on December 8, 2004, the employer failed to do so, and did not correct the failure until December 30, 2005. The interest rate for underpayments under Code Section 6621(a)(2) was 5% on December 8, 2004, and was 5% on January 1, 2005. Therefore, in this example, 5% was used to calculate the "amount involved" for the entire period.

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Proskauer's Employee Benefits and Executive Compensation Law Practice Group includes over 50 attorneys with significant and diverse tax, executive compensation, and employee benefits law experience. The following individuals serve as contact persons with respect to this Client Alert and would welcome any questions you might have:

**Ira G. Bogner**

212.969.3947 – [ibogner@proskauer.com](mailto:ibogner@proskauer.com)

**Jacob I. Friedman**

212.969.3805 – [jfriedman@proskauer.com](mailto:jfriedman@proskauer.com)

**Robert M. Projansky**

212.969.3367 – [rprojansky@proskauer.com](mailto:rprojansky@proskauer.com)

**Michael S. Sirkin**

212.969.3840 – [msirkin@proskauer.com](mailto:msirkin@proskauer.com)

**Lisa B. Herrnson**

212.969.3146 – [lherrnson@proskauer.com](mailto:lherrnson@proskauer.com)

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