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FOR RETIREMENT STUDIES℠

TCRS 2006-04: IRS Revenue Ruling 2006-38 – Calculation of the Prohibited Transaction Excise Tax For Untimely Paid Employee Deferrals

Section 4975(a) of the Internal Revenue Code (Code) imposes a 15% excise tax (the first tier excise tax) on the amount involved in a prohibited transaction for each year during a taxable period. In addition, if the 15% excise tax is imposed and the transaction is not corrected within the taxable period, a second tier excise tax of 100% of the amount involved in the prohibited transaction is imposed.

A prohibited transaction generally includes any direct or indirect transfer to, or use by or for the benefit of, a disqualified person of the income or assets of an employee benefit plan. The tax is imposed on the disqualified person. A disqualified person includes any plan fiduciary, a person providing services to an employee benefit plan, and an employer any of whose employees are covered under the employee benefit plan.

The Department of Labor (DOL) regulations provide that amounts withheld from a participant's wages for contributions to an employee benefit plan become plan assets as of the earliest date such contributions can reasonably be segregated from the employer's general assets. In the case of employee deferrals under a 401(k) plan, in no event does the date on which such deferrals become plan assets occur later than the 15th business day of the month following the month the deferrals are withheld by the employer. The DOL has consistently taken the position that the 15th business day window is not a safe harbor. Rather, employee deferrals must be transmitted to the 401(k) plan as soon as such contributions can reasonably be segregated. Therefore, employers with weekly pay periods, for example, may have a difficult time persuading the DOL that the 15th business day window is a reasonable time for such contributions to become plan assets.

The IRS recently issued Revenue Ruling 2006-38 to provide guidance on determining the amount of the excise tax imposed when an employer fails to timely remit employee deferrals. According to the hypothetical example included in this Revenue Ruling, an employer's failure to remit until December 30, 2005, employee deferrals that could reasonably be segregated from the employer's general assets as of December 8, 2004, constituted a prohibited transaction for taxable years 2004 and 2005. Revenue Ruling 2006-38 makes clear that if an employer does not timely pay participant deferrals or contributions to an employee benefit plan, the excise tax is based on the interest on those elective deferrals or contributions. In addition, the Revenue Ruling states what interest rate to use in computing the excise tax and how the interest should be calculated.

The mere fact that the IRS provided the guidance in Revenue Ruling 2006-38 further illustrates the severity with which the IRS and DOL view untimely deposits of employee deferrals to employee benefit plans. Employers are encouraged to be more mindful of their administrative procedures in transmitting employee deferrals to their 401(k) plan.

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