

# THE ASPPA Journal

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## Correcting Late Employee Contributions An Ounce of Prevention is Worth a Pound of Cure

by Karl E. Breice, QKA

On February 29, 2008, the Department of Labor (DOL) issued proposed regulations regarding the timing of employee contributions (*i.e.*, deferrals and loan repayments). The proposed regulations provide a seven business day safe harbor for deposit of employee contributions to the trust for small plans (*i.e.*, plans with fewer than 100 participants). In short, employee contributions are deposited on time when deposited to the trust within seven business days after the payroll period.

**T**hird party administrators (TPAs) have been clamoring for this kind of bright line rule for years. Getting a bright line rule, however, may turn into a case of “be careful what you ask for” as this issue will now be harder to ignore. Because the issue gives rise to serious consequences (discussed below), internal practices and procedures regarding deposit timing of employee contributions should be reviewed. Where possible, initiate transfers from payroll to the trust on the same day as payroll; ACH/electronic transfer represents the best practice. Then validate that the transactions were posted correctly within 24 to 48 hours after initiating the transfers. Some recordkeepers will debit the corporate account so that plan sponsors don't have to think about these transactions while on vacation.

### Identifying the Error

When the DOL audits a plan, they ask for all summary pages of payroll registers showing the total amount of employee contributions and loan repayments withheld for each pay date. The DOL then asks for and compares the payroll report to all bank accounts and investment statements showing the dates of deposit of each employee's



contributions and loan repayments. With these two items, the DOL (and the IRS) can identify the error rather handily. For TPAs, the error can be identified from the trust statements that show the dates that employee contributions were deposited. Once you suspect timing problems, the error can be verified by requesting the applicable summary payroll registers.

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### Consequences of the Error

Form 5500 requires reporting late employee contributions (line 4a of the Schedule H or I). This reporting alerts the government that prohibited transactions under ERISA §§ 406(a)(1)(D), 406(b)(1) and (2), as well as fiduciary violations under ERISA §§ 403(c)(1), 404(a)(1)(A) and (B), have occurred. This alert can trigger a DOL inquiry, or at a minimum, an invitation to use the DOL's voluntary correction program. In addition, because 5500s are public documents, participants can use this information in legal actions against the fiduciaries of the plan. Not reporting these violations on the annual return can lead to criminal penalties as the Form 5500 is signed under penalty of perjury. Moreover, the Form 5500 will continue to show late employee contributions year after year until corrected.

### Correcting the Error

If you have corrected this type of error, you know that it can cost a great deal to fix a small error. Attention to timing is definitely a case where an ounce of prevention is worth a pound of cure.

The big picture in correcting the error is to make participants whole (*i.e.*, calculating, contributing and allocating lost interest) and then addressing the excise tax. Unfortunately, while the amounts involved are often quite small, there is no applicable *de minimis* rule for correcting lost interest. Thus, plan sponsors have to report and correct this error. Generally, there are two correction options: (1) self-correction; or (2) submitting under the DOL's Voluntary Fiduciary Compliance Program (VFCP).

#### Self-correction

The tricky part here is determining lost interest without spending a small fortune in the process. Keeping in mind that the goal is to make participants whole, the DOL would prefer the use of actual rates of return experienced by participants to determine lost interest. This practice can get expensive, however, especially when correcting years long since closed. To avoid this expense, many practitioners use the DOL's online calculator to determine lost interest. While this practice is widespread, the DOL has repeatedly indicated that the online calculator to determine lost interest alone would not be appropriate and would not be respected upon audit. When late employee contributions are discovered on audit, the DOL has calculated lost interest by applying the *greater* of the DOL's online calculator or an average rate of

return realized by the plan during the year of the error. In my experience, the DOL has looked to the Form 5500 for the year in question and taken the difference between the end of the year trust value and the beginning of the year trust value, minus contributions for the year, to calculate an average rate of return.

Getting the lost interest calculation correct is important as the DOL can impose penalties under ERISA §502(l) if they do not agree with your correction methodology. In addition, having to rework a calculation adds to the cost of correction and does not look good in the eyes of your client.

Keep in mind that even if corrected before the due date of the Form 5500, late employee contributions must still be reported on the annual return. Also, excise tax on the lost interest must be timely paid to the IRS using Form 5330. If the DOL sends your client the invitation letter as a result of reporting late employee contributions on the Form 5500, it is a best practice to acknowledge receipt of the invitation letter by responding with we knew, we corrected and we reported the excise tax. In off-the-record conversations with the DOL, they like to see evidence of the correction as the DOL can still open an investigation if the correction was not adequate, especially if the corresponding Form 5500 indicates that assets performed well and your lost interest calculation indicates that participants are not enjoying the benefit of the well performing investments.

#### Correction under the DOL's Voluntary Fiduciary Compliance Program (VFCP)

The tricky part here is cost effectively completing the detailed VFCP application. In return for applying under VFCP to correct late employee contributions, the DOL will issue a "no action" letter that states in part: "EBSA will not recommend that the Solicitor of Labor initiate legal action against you, and EBSA will not impose the penalties in section 502(l) or section 502(i) of ERISA on the amount you have repaid to the Plan." If the application process can be streamlined, receiving a "no action" letter can bring closure to this issue and, with the right facts, can make the most sense for correction.

In addition to a "no action" letter, under VFCP you can use the online calculator to quickly determine lost interest. This calculator economically and effectively removes all the guess work out of calculating lost interest. Using VFCP generally also gives you three options for dealing with the excise tax: 1) fill out IRS Form 5330

and file with the IRS to pay the excise tax on the prohibited transaction (usually a very small amount); 2) if the excise tax totals \$100 or less, no VFCP application has been made within the last three years and the employee contributions were no more than 180 days late, you can pay the excise tax to the trust and allocate it to participants just as you allocated lost interest; or 3) if you give notice to participants that late employee contributions have occurred, you do not have to pay the excise tax. The last option may be attractive when correcting years long since ended because of the pyramiding effect of calculating the excise tax taken by the IRS on Form 5330.

A final advantage to using VFCP to correct late employee contributions relates to abating the penalty for late filing of the excise tax. Generally, Form 5330 is due by the seventh month after the end of the tax year of the employer. When the correction of late employee contributions takes place after the due date for the Form 5330, penalties and interest can be assessed. Applying the penalty, however, arguably undermines the policy of VFCP. VFCP was designed by the government to encourage plan sponsors to review prior year's administration, voluntarily make participants whole, proactively correct policies and procedures and seek amnesty under VFCP. Thus, abating the penalty for late filing makes sense from a tax policy perspective.


### Allocating Lost Interest

Regardless of the approach used to correct the error, the lost interest has to be allocated. This allocation can get expensive, especially in the case of participants who no longer have an account balance in the plan but who did during the period being corrected. A pro-rata allocation of the lost interest based on account balances remaining in the plan at the time of correction has been respected by the DOL in applications I have filed.

### Other Considerations

A review of the plan document regarding the timing of employee contributions may reveal that the plan document has incorporated the timing rules regarding employee contributions. If that language has not been followed, you may have an operational error on your hands as well.

### Conclusion

The consequences for failing to make timely remittances of employee contributions are serious, including prohibited transactions, excise taxes, exposure to participant lawsuits and liability for lost earnings on these contributions. The first step in addressing this issue involves reviewing current practices and procedures for getting employee contributions into the plan as soon as possible but in no event later than seven business days after the end of the payroll period. Correcting the prohibited transaction promptly and completely ensures that your exposure to sanctions and participant lawsuits are minimized. 



*Karl E. Breice, QKA, JD, is an ERISA compliance manager at Primark Benefits located in Burlingame, CA. Primark Benefits is a full service third party administration firm. With more than 20 years of experience, Karl conducts compliance reviews, oversees corrections under EPCRS, VFCP and DFVCP as well as manages IRS/DOL audits. Karl has been a member of ASPPA since 2004. ([kbreice@primarkbenefits.com](mailto:kbreice@primarkbenefits.com))*

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