

## Part I

### Section 4975.--Tax On Prohibited Transactions

26 CFR 141.4975-13: Definition of “amount involved” and “correction”.

Rev. Rul. 2006-38

#### **ISSUE**

What is the amount involved, for purposes of calculating the prohibited transaction excise tax under § 4975 of the Internal Revenue Code, if an employer does not timely pay elective deferrals to a qualified plan?

#### **FACTS**

Employer X sponsors a calendar year profit-sharing plan that is qualified under § 401(a) of the Internal Revenue Code and contains a qualified cash or deferred arrangement described in § 401(k). Employees of Employer X are paid on a payment date following the close of each payroll period. Pursuant to the terms of the plan, during a specific payroll period, a portion of the pay of each employee was withheld from his or her pay in accordance with a cash or deferred election made by the employee. The aggregate amount withheld for all employees for that payroll period totaled \$100,000. Although Employer X could

reasonably segregate this amount from its general assets and transmit it to the plan on December 8, 2004, Employer X failed to do so, and did not correct the failure until December 30, 2005.

The interest rate for underpayments under § 6621(a)(2) was 5 percent on December 8, 2004, and on January 1, 2005.

## **LAW AND ANALYSIS**

Section 4975(a) imposes a 15% excise tax (the first tier excise tax) on a prohibited transaction. In addition, § 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 tax applies to any disqualified person who participates in the prohibited transaction (other than a fiduciary acting only as such). Under § 4975, the applicable excise tax is applied to the amount involved in the prohibited transaction.<sup>1</sup>

Section 4975(c)(1)(D)<sup>2</sup> defines a prohibited transaction to include any direct or indirect transfer to, or use by or for the benefit of, a disqualified person of the income or assets of a plan. In addition, § 4975(c)(1)(E) defines a prohibited transaction to include any act by a disqualified person who is a fiduciary whereby the fiduciary deals with the income or assets of a plan for his or her own interest or for his or her own account. Section 4975(e)(2) includes in its definition of a disqualified person an employer any of whose employees are covered by the plan.

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<sup>1</sup> Section 102(a) of Reorganization Plan No. 4 of 1978 (43 F.R. 47713, October 17, 1978, 1979-1 C.B. 480) generally provides that the Secretary of Labor has the authority to issue regulations interpreting § 4975(c)(1). However, the Secretary of the Treasury retains the authority to issue rulings, etc., to the extent necessary for the continued enforcement of § 4975(a) and (b) and § 4975(f)(4).

<sup>2</sup> The Department of Labor has advised the Service that the failure to remit employee contributions to an employee benefit plan may constitute a crime under 18 U.S.C. 664 which provides, in relevant part, that anyone who unlawfully and willfully converts to his or her own use or to the use of another, any of the moneys or funds, or other assets of any employee benefit plan shall be subject to the fines and/or imprisonment as provided for under the provisions of title 18. This revenue ruling does not express any opinion concerning the application of title 18 to the facts set forth in it.

Section 4975(f)(4) defines the term “amount involved,” generally, as the greater of (1) the amount of money and the fair market value of the other property given or (2) the amount of money and the fair market value of the other property received in such transaction. For purposes of the first tier excise tax, the fair market value is determined as of the date on which the prohibited transaction occurs, whereas, for purposes of the second tier excise tax, the fair market value is the highest fair market value during the taxable period described in § 4975(f)(2).

Section 4975(f)(2) defines the term “taxable period” as the period beginning with the date on which the prohibited transaction occurs and ending on the earliest of (1) the date of the mailing of a statutory notice of deficiency, (2) the date on which the first tier excise tax is assessed, or (3) the date on which correction of the prohibited transaction is completed.

Section 4975(f)(5) defines a correction as undoing the transaction to the extent possible, but in any case placing the plan in a financial position not worse than that in which it would be if the disqualified person were acting under the highest fiduciary standards.

Section 141.4975-13 of the Temporary Pension Excise Tax Regulations provides that, under paragraphs (4) and (5) of § 4975(f), § 53.4941(e)-1 of the Foundation Excise Tax Regulations is controlling to the extent those regulations describe terms appearing both in § 4941(e) and § 4975(f). The term “amount involved” appears in both § 4941(e) and § 4975(f).

Section 53.4941(e)-1(b)(2)(ii) provides that, where the transaction involves the use of money or other property, the amount involved is the greater of the amount paid for such use or the fair market value of such use for the period for which the money or other property is used and the amount involved is determined for the entire period that the money or other property is used. In

addition, § 53.4941(e)-1(e)(1) provides that, in the instance of a prohibited transaction that is a loan, an additional prohibited transaction is deemed to occur on the first day of each taxable year in the taxable period after the taxable year in which the use occurred. Example (2) of § 53.4941(e)-1(b)(4) illustrates this where principal and interest already have been repaid by stating that, in that context, the amount involved is the principal times the percentage that constitutes the fair market value of the use of money on the date of the transaction for each year or partial year in the taxable period.

Rev. Rul. 2002-43, 2002-2 C.B. 85, addresses a prohibited transaction that spans multiple taxable years in a taxable period where the first tier excise tax rate changes and illustrates that where interest is not repaid in a given year, that interest is added to the principal amount in the subsequent year.

Section 2510.3-102 of the Department of Labor regulations provides that, for purposes of § 4975, amounts withheld from a participant's wages for contributions to a plan become plan assets as of the earliest date on which such contributions can reasonably be segregated from the employer's general assets. However, in the case of a plan, such as a section 401(k) plan, in no event does the date on which such contributions become plan assets occur later than the 15<sup>th</sup> business day of the month immediately following the month in which the participant contributions are received by the employer (in the case of amounts that a participant or beneficiary pays to an employer) or the 15<sup>th</sup> 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 by an employer from a participant's wages).

In the facts above, the failure to transmit the contribution until December 30, 2005, constitutes a prohibited transaction for 2004 and a prohibited transaction for 2005 under § 4975(c)(1). Accordingly, (1) the amount involved for the 2004 prohibited transaction is interest on \$100,000 from December 8, 2004,

to December 31, 2004, and (2) the amount involved for the 2005 prohibited transaction is interest on the new balance owed to the plan after increasing the principal as a result of there not being a correction of the 2004 prohibited transaction and is calculated from January 1, 2005, to December 30, 2005. The taxable period for the 2004 prohibited transaction begins on December 8, 2004 and ends on December 30, 2005 (the date of the correction), and the taxable period for the 2005 prohibited transaction begins on January 1, 2005 and ends on December 30, 2005 (the date of the correction).

For purposes of calculating the § 4975 excise tax on a timely filed Form 5330 for a failure to transmit participant contributions or amounts that would have otherwise been payable to the participant in cash, under the authority of § 7805, the interest rate for underpayments described in § 6621(a)(2) on the date of the prohibited transaction is an appropriate rate used to calculate the amount involved. The following illustrates the application of this rate to the facts above (and taking into account only the first tier excise tax):

Calculation of the amount involved

	<u>Date</u>	<u>Principal</u>	<u>Interest Rate</u>	<u>Time</u>	<u>Amount involved</u>
1.	12/8/2004	\$100,000	.05	.0628415	\$314
2.	1/1/2005	\$100,314	.05	.9972602	\$5,002

Calculation of the first tier excise tax under § 4975

<u>Act #</u>	<u>Date of Prohibited Transaction</u>	<u>Taxable Period</u>	<u>2004 Taxable Year</u>	<u>2005 Taxable Year</u>
1	12/8/2004	12/8/04 to 12/30/05	\$314	\$314
2	1/1/2005	1/1/05 to 12/30/05	-----	\$5,002
			\$314	\$5,316
			x .15	x .15
			\$47	\$797

Accordingly, the § 4975(a) first tier excise tax totals \$844 (\$47 plus \$797).

This revenue ruling only applies for purposes of determining the amount involved under § 4975 where there is a failure to transmit participant

contributions or amounts that would have otherwise been payable to the participant in cash, and does not apply for self-dealing violations under § 4941.

**HOLDING**

Solely for purposes of calculating the prohibited transaction excise tax under § 4975, the amount involved if an employer does not timely pay the participant deferrals or contributions to a qualified plan is based on interest on those elective deferrals.

**Drafting Information**

The principal author of this revenue ruling is Michael Rubin of the Employee Plans, Tax Exempt and Government Entities Division. For further information regarding this revenue ruling, please contact the Employee Plans' taxpayer assistance telephone service at 877-829-5500 (a toll-free number), between the hours of 8:30 a.m. and 4:30 p.m. Eastern Time, Monday through Friday. Mr. Rubin can be reached at 202-283-9888 (not a toll-free number).