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Delinquent 401(K) Deposits: Tough Enforcement by the Department of Labor

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An individual who browses through the Department of Labor's (DOL's) Media Releases cannot help but notice the number of actions brought by the DOL's enforcement agency to recover damages and interest for delinquent deposits to a 401(k) plan.

On the surface, these actions generally appear to be taken against unscrupulous employers who deliberately retain amounts withheld from an employee's payroll that should be placed in participants' 401(k) plan accounts and use these funds instead to prop up a beleaguered company or meet the company owner's cash flow needs. For example, the DOL announced recoveries of $19,680.59 against a food service company in Maryland and of $70,477 against a New Jersey bakery and its chief executive for failure to forward employee contributions to the plan. In the latter case, the judgment ordered that the bakery's chief executive's personal 401(k) plan account be offset to pay the amounts owed to the plan.[1]

Many conscientious plan sponsors reading these accounts may not realize that they too might be considered "delinquent" in their 401(k) deposits under DOL standards, and that they could face possible sanctions for making delinquent contributions. Such sponsors see that the deposits appear on the employees' 401(k) statements and assume that the payroll department is therefore properly depositing employee contributions into the company's 401(k) plan. What these employers may not realize is that the DOL has a much broader definition of "delinquent" than might be expected. According to the DOL, as discussed in more detail below, deposits made within a few days of their deduction from the employee's paycheck can be considered delinquent in some circumstances. And if payments are delinquent, the DOL takes the position that the employer/plan sponsor has misused plan assets, committed a pro-

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hibited transaction under the Employee Retirement Income Security Act (ERISA), and owes the plan participants any foregone earnings on these assets. As a result, being late or tolerating a less than efficient accounting system might result in significant consequences to the employer.

It is clear from the experience of this author and others that the DOL takes this position very seriously and is strictly enforcing the "timely deposit" rule. This article discusses the background for this rule, the DOL's current enforcement activities, and the means of correcting for any violations of the rule.

Background: Payroll Withholding and Plan Assets

When a participant makes a contribution of his or her own money to a 401(k) account, those contributions become plan assets and must be used solely for the benefit of the participant. Once any plan contributions become plan assets, they are entitled to the full panoply of the protections of ERISA—they must be placed in trust, used solely for the benefit of the participants, and are not reachable by the participants' or any other creditors. Any misuse of these assets can violate ERISA's fiduciary rules and be classified as a prohibited transaction subject to excise taxes.

Employers generally understand and accept the need to treat plan assets with the deference required by ERISA. It is not always clear, however, when amounts contributed by an employee or deferred by an employee under a payroll system become "plan assets." Some employers took the position that such contributions should not be treated as plan assets until they were actually deposited in the 401(k) trust. That position had the advantage of certainty, but it provided no protection for the 401(k) participant, who, after all, had given up his salary or handed over contributions for the opportunity to participate in the 401(k) plan. It caused serious difficulties if an employer went bankrupt before depositing participant contributions into a 401(k) plan. These contributions, which should have been protected from the employer's creditors (because qualified plan assets are shielded from those creditors under bankruptcy law), were not so protected.

Regulations issued in 1988 attempted to provide some guidance as to when contributions become plan assets required to be deposited in a trust. The regulations stated that all participant contributions became plan assets as of the earliest date on which they could reasonably be segregated from the general assets of the employer (the "general rule"), but no later than 90 days after the contribution was received by the employer or would otherwise have been payable to the participant in cash (the "maximum period"). Responding to a number of reported incidents

involving employee contributions that were withheld from 401(k) plans and either never deposited or deposited in a haphazard or untimely manner, the DOL again proposed these regulations in December of 1995. According to the DOL, the reproposed regulations were intended to emphasize the need for deposit as soon as such contributions could be segregated from other assets (the "general rule") and to make it clear that the "maximum period" (90 days under the 1988 regulations) was an outside date for depositing, and not a safe harbor.

The reproposed regulations contained the general rule, but defined the period equal to the same number of days that an employer is required to deposit any income and employment taxes withheld on behalf of an employee as the maximum period by which all plan contributions had to be deposited. Under this rule, a period of time of as little as one banking day could have been required for certain large employers because they must withhold income and employment taxes within that time. (Under these Internal Revenue Service (IRS) rules, the time period for employers to make deposits varies due to their size or certain other characteristics set forth in the IRS withholding regulations.)

There was much resistance to this proposal, with employers emphasizing that the transmission of participant contributions to 401(k) plans is much more labor-intensive and time-consuming than the effort required to deposit payroll taxes. It was noted that for 401(k) deposits, eligibility must be confirmed, amounts allocated to the appropriate accounts and investment choices, and individual accounts reconciled to the general account. Moreover, coordinating payroll systems from various locations when contributions were being sent to one recordkeeper or trustee could be time-consuming. Employer representatives also argued that a single rule should apply to all employers, regardless of size.

In 1996 the DOL responded to such criticisms with final regulations containing the current rule, which defines a 15-day "maximum period" for depositing employee contributions to pension plans (including 401(k) plans) but retains the 90-day period for welfare plans.[2] As a result, the plan asset regulations now state that employee contributions to a 401(k) plan become plan assets as of (1) the earliest date on which such contributions may reasonably be segregated from the employer's general assets (the so-called "general rule"), but (2) in no event later than the 15th business day of the month following the month in which contributions were received by the employer, or, in the case of amounts withheld from wages, would otherwise have been payable to the participant (the so-called "maximum period"). See 29 C.F.R. Section 2510.3-102.3

The final regulations recognized that in unusual situations, an employ-

er might not be able to segregate employer contributions even within the 15 business-day maximum period. The regulations therefore provide a procedure for extending that maximum period for up to an additional 10 days, but it is quite cumbersome. It only applies to contributions received or withheld by an employer in a single month. The employer must obtain an irrevocable letter of credit or performance bond before the beginning of the extension period. Also, within five business days after the end of the extension, the employer must notify employees of the extension and explain why the extension was needed and provide the date that contributions were transmitted. This notice must be provided to the Secretary of Labor along with a certification from the employer that the notice was distributed and bond or letter of credit obtained. This extension cannot be used more than twice in a plan year, unless the employer pays interest to the plan in the amount equal to the greater of (1) the amount the participant contributions would otherwise have earned or (2) the underpayment rate defined in Section 6621(a)(2) of the Code.[4]

In late 1995 the DOL announced its 401(k) Employee Contribution Enforcement Project in conjunction with its revision of the plan asset regulation. The purpose of this project was to hold employers accountable for failing to deposit promptly employee contributions into the employees' 401(k) accounts and to enforce sanctions against employers who used the funds for other purposes, such as payment of current salaries or other business expenses. Since then, the DOL has conducted over 200 criminal investigations involving delinquent employee contributions, and obtained 132 indictments of individuals involving over 100 guilty pleas and settlements. The DOL found that these problems generally arose when the employer was having financial difficulties.[5]

Interpretation of the Plan Asset Rule

Despite the DOL's attempts to persuade them otherwise, a number of employers and recordkeepers continue to believe that they will not suffer any adverse consequences as long as they make deposits within what they consider the 15-day safe harbor. The DOL has consistently maintained that employee contributions had to be treated as plan assets and placed in trust as soon as the contributions could be reasonably segregated, even if that was before the end of the 15-day maximum period. It enforces this belief with investigations and sanctions. Representatives of the DOL have made its position clear in speeches and most recently in a series of frequently asked questions and answers published by the DOL.[6]

The DOL believes that an employer should determine when it is reasonable to be able to segregate its assets by reviewing the employer's payroll process in general and the history of employer deposits. This is a facts

and circumstances test. The DOL has informally stated, in a series of questions and answers, that one would look to the plan sponsor's withholding and remittance history and processes.[7] If employers can segregate payroll monies for other purposes (e.g., insurance payments, reimbursements) in a few days, then employee contributions destined for the 401(k) plan should be considered "plan assets" once that period is complete and need to be treated as such and placed in trust. Informal discussions with the DOL indicate that they believe that such deposits can and should be segregated in a matter of days, not weeks, although the number of days may depend in part on the size of the employer, the plan, and the employer's own accounting processes.

The interpretation of the regulation has not been definitively litigated. In most cases, the DOL reaches a settlement with the plan sponsor or the plan sponsor uses the DOL's Voluntary Fiduciary Correction Program (see discussion below). Judicial guidance with respect to the regulation is sparse and has only clouded the issue. In *Golden v. wwwrrr, Inc.*, 2002 U.S. Dist. Lexis 3053, 27 EBC 2063 (D.Mn. 2002), the plaintiffs sued a failed internet company that had insufficient funds to make payments during the employees' last eight days of employment. In addition to suing for wages not paid with respect to those eight days, the plaintiffs alleged that the employee contributions to the 401(k) plan withheld from November 1999 through December 2000, which were deposited by the 15th of the month following the two bi-weekly pay periods of each month, had not been made in a timely manner. The plaintiffs claimed breach of fiduciary duty, and requested payment of the amounts "gained" by the company with respect to the use and benefit of approximately $17,000 of employee contributions made each pay period.

The court stated that the issue was when such contributions became plan assets. It recited the regulation and said that the maximum period was the deadline by which the plan contributions had to be made to avoid a statutory violation. The court ruled that the payments in all but one instance were made within 15 days of the end of the month following the applicable payroll period and "[a]s such, no violation for delay in contributions occurred … " In so ruling, the court rejected plaintiffs' argument that the payments of plan contributions in the past had normally been made within seven days, and therefore that this is the time period during which assets could be reasonably segregated. The court disagreed, saying that merely because in some cases a seven-day deposit period was met, such a standard was not required forever, particularly for a struggling company.

It is difficult to give too much deference to this case. The court's language can be read to support a "safe harbor" interpretation allowing

deposits up to the maximum period, although certainly one could have wished that the court's analysis were more precise. Supporters of the DOL's interpretation can point to the fact that the court seemed to believe that the employee contributions might not be able to be segregated from employer's assets until the end of the maximum period in any event, so it could be seen to be applying the "general test," although perhaps in a more lenient manner than the DOL would prefer.

Other cases illustrate confusion on this issue. In *Wilson v. International Investigative Services 401(k) Savings Plan*, U.S. Dist. LEXIS 22259 (E.D. Pa 2002), the parties assumed that contributions were not deposited in a timely manner because they were made later than 15 days after the close of the month in which payroll withholding occurred, but the parties here did not really litigate the issue. By contrast, in *McConnell v. Costigan*, 2002 U.S. Dist. Lexis 3279, n19 (SDNY 2002), the District Court found the defendants guilty of late deposits of employee and matching contributions and stated that the length of the overdue period was to be calculated from two days after the employee's wages were paid. In so doing, the Court rejected the defendant's argument that a delayed remittance was appropriate.

Application of the Timely Deposit Rule to Loan Repayments

The DOL has applied a similar but not identical analysis to the timely deposit rule when dealing with loan repayments. In DOL Advisory Opinion 2002-02A (May 17, 2002), the DOL acknowledged that it had stated in the preamble to the plan asset regulations that participant loan repayments were beyond the scope of those regulations. Nonetheless, the DOL takes the position that even in the absence of a regulation, plan loan repayments are sufficiently similar to employee contributions so that the same analysis applies, and that under ERISA, such loan repayments become "plan assets" subject to ERISA protections as of the earliest date on which they can reasonably be segregated from the employer's assets. In its opinion, the DOL states that under the plan asset regulations, there exists a maximum period of 15 business days after the end of the month after employee contributions are received by the employer (or would otherwise be paid to the participant). While the DOL acknowledges that these maximum periods do not specifically appear to plan loan repayments, it goes on to say that holding such repayments beyond that period "would raise serious questions as to whether the employer forwarded the repayment to the plan as soon as they were reasonably segregated from its general assets."

Continued Enforcement of the Timely Deposit Rule

The DOL has conducted numerous investigations of and has sued employers who may meet the 15 day "maximum" rule but who nonetheless are found to be able to segregate assets earlier. A new emphasis on this position has occurred in connection with the 5500 Forms used to meet ERISA's annual reporting requirements. The DOL and IRS have recently revised these forms to make this position clearer and to provide more information about employer practices. Schedules H and I of the annual reporting Form 5500 previously asked if the plan sponsor deposited employee contributions within the maximum time period set forth in the regulations. The new 2002 forms (which will be completed by plan sponsors in 2003) have been revised to delete the word "maximum" from the question (see, for example, new Question 4a on the Schedule H) and the instructions now recite the general rule ("as soon as can be reasonably segregated") as the test to use in determining whether the employer can represent on the form that it has made timely deposits. Thus, if the employers could have deposited the employee contributions earlier than the maximum period but did not, the forms attempt to make it clear that they will be required to indicate that they have made untimely deposits and specify the amount of untimely contribution. The chances of a DOL audit will likely increase significantly for plan sponsors that indicate untimely deposits of employee contributions.

Correction of Untimely Deposits

The employer, plan sponsor, or fiduciary that is responsible for a delinquent contribution must consider how best to correct the error. The options available depend on the degree of delinquency and the cost of corrections and are described below.

Restoration of Contributions

The DOL's Voluntary Fiduciary Correction Program (VFC Program) provides a roadmap for correcting delinquent contributions. Under that Program, which can be used for a variety of errors involving potential fiduciary violations, the plan official or authorized representative must apply to the appropriate regional office of the DOL's Employee Benefit Security Administration, explain the error, and take corrective action.[8] In the case of delinquent contributions, the employer must make a contribution equal to the greatest of (1) the plan's rate of earnings, (2) the interest rate for underpayments under Internal Revenue Code (Code) Section 6621(a)(2), or (3) the restoration of profits on the deferrals. These amounts would be measured from the date the assets could have reasonably been segregated until the deposit date.

The plan's rate of earnings, which in essence represents "lost earnings," is defined as the amount that would otherwise have been earned under the plan provisions. The appropriate rate will depend on how investments are chosen. If the plan fiduciaries select the investments, the plan's rate of earnings is the overall rate of return for the plan calculated by (1) subtracting the amount of plan assets on the date contributions should have been deposited from the assets on the date contributions were made (excluding the delinquent contributions) and (2) dividing that numerator by the amount of assets on the date contributions should have been deposited. If there were distributions or expenses incurred during this period, the plan sponsor must demonstrate the actual average rate of return if it wants to take such costs into account. Alternatively, as a matter of convenience, the plan sponsor can calculate the fraction described above but add to the numerator distributions made and expenses incurred during the delinquency period. This alternative creates a larger rate of return, but avoids the need to document actual rate of return. For a plan that has participant directed accounts, "lost earnings" would be based on each participant's earnings, although as an alternative, the plan could use the highest rate of earnings for any of the participant accounts.[9]

The interest rate under Code Section 6621(a)(2) is the underpayment rate set forth by the IRS equal to the sum of the federal short-term interest rate plus three percentage points. For the June 2002 through June 2003 period, the 6621(a)(2) rate has been either 6 percent or 5 percent, a rate significantly higher in many cases than the amounts retirement plans earned during that period given the stock market returns and low bond rates. (Thus, in many cases participants who would actually have lost earnings in their 401(k) plan had they been timely deposited may get a windfall from the correction.) The DOL defines "restoration of profits" as the amount earned by the fiduciary or party in interest on the use of the monies that should have been forwarded to the plan for the period of delinquency. For purposes of the VFC Program, the DOL provides that if the purpose for which the monies were used is known and the earnings are ascertainable, those earnings should be used. If, however, the monies were commingled so that actual profits cannot be used, then the restoration of profits will equal interest at the Code Section 6621(a)(2) underpayment rate.[10]

The DOL's VFC Program does provide for a *de minimus* exception, under which a corrective payment to a specific participant is not required with respect to former participants if the amount they would receive is less than $20 and if the administrative cost of correction exceeds $20. This does not, however, absolve the employer of its obligation to pay. If

this *de minimus* payment is not paid to the former participant, it must be paid to the plan for general use.[11]

Liability for Excise Tax

In addition to the corrective amounts that must be paid to the plan, unless the Prohibited Transaction Class Exemption 2002-51 described below applies, the employer will have to report a prohibited transaction on IRS Form 5330 and pay a 15 percent excise tax on the value of the use of the money to the employer. Class Exemption 2002-51 was adopted by the DOL in part to coordinate with, and to encourage the use of, the DOL's Voluntary Fiduciary Correction Program.[12] The Class Exemption provides relief from the excise tax sanctions of Code Section 4975(a) and (b) for certain "eligible transactions," if the requirements of the exemption are met and the plan sponsor or fiduciary uses the VFC Program to correct the error. One of the eligible transactions is the failure to transmit participant contributions or loan repayments to a pension plan within the time frames described in the plan asset regulation. To qualify for the exemption, the following conditions must be met:

1. Contributions or loan repayments must be made no more than 180 calendar days from the date the amounts were received by the employer (in the case of amounts that a participant or beneficiary pays to an employer) or the date the amounts otherwise would have been payable to the participant in cash (in the case of an amount withheld by an employer from a participant's wages).

2. The transaction must not be a part of any agreement, arrangement, or transaction designed to benefit a party in interest. The DOL made it clear that the purpose of this condition was to prevent some types of prearrangements; the fact that the employer may have benefited does not disqualify it.

3. The applicant must not have taken advantage of the relief provided by the VFC Program and Class Exemption 2002-51 for a similar type of transaction during the three-year period prior to the submission of the application.

4. Notice under the exemption must be given to interested persons within sixty days following the date of submission of the VFC Program application. The DOL makes it clear that plan assets cannot be used to pay for the cost of the notice.

If the Class Exemption cannot apply (because, for example, the deposits were made more than 180 days after they were withheld or paid to the employer), a Form 5330 must be filed with the IRS and a 15 percent excise tax would have to be paid on the value of the use of the delinquent deposits in addition to the corrective payments to the plan. The excise tax applies to the value of the use of the money to the fiduciary or parties in interest—this may be a different dollar amount than the lost earnings to the participant calculated under the VFC Program. (Although not entirely clear in all circumstances, presumably one could use the definition of "restoration of profits" set forth in the VFC Program as guidance for the amount of the value of the use of the money.) Interest and penalties are also due if the Form 5330 is filed late (more than seven months after the end of the plan year in which the prohibited transaction occurred).

Determining the Best Approach for Correction

Assuming that the employer's error in many cases is not the failure to actually make deposits but the failure to make such deposits in as prompt a manner as the DOL requires, the actual cost of the correction and excise tax may not be significant. If the error is a systemic one (e.g., the payroll system for a significant number of years did not operate as efficiently as the DOL believed possible and thus systematically was delinquent every two weeks), the cost of performing the calculation of the correction and making the required payments to participants could be quite high, however, and in fact exceed the actual amount of corrective payments.

Given these choices and issues involving the method of correction, it may be difficult to determine the one best method for plan sponsors to correct for untimely deposits. Employers that meet the requirements of the Class Exemption have the option of filing a VFC Program application, and can avoid the excise tax with the Class Exemption. Nonetheless, because the excise tax may be quite low, some employers may elect to make the correction, pay the excise tax, and not use the Class Exemption. Others will not qualify for the Class Exemption. If the Class Exemption is not or cannot be used, then employers might consider whether the VFC Program is worth the effort or whether they should merely self-correct and pay the excise tax. The VFC Program provides certainty that the DOL has blessed the correction and the method chosen by the employer to calculate the tax, allows for specific definitions of the amounts to be paid (for example, restoration of profits), and sets forth certain administrative shortcuts (for example, the *de minimus* rule). It also avoids any penalties if the DOL reviews a self-correction on audit and finds it inadequate. The VFC Program, however, does not appear to lower the cost of correction other than avoidance of the excise tax if Class Exemption

2002-51 (which requires use of the VFC Program) can be used. Employers pondering these options will have to weigh their tolerance for risk against the transaction costs of a VFC Program filing—preparation of the application and cost of dealing with the Labor Department.

Coping With the Timely Deposit Rule in the Current Environment

As can be seen from the discussion above, the DOL is vigorously enforcing the timely deposit rule and is not sympathetic to employer arguments as to hardship or inconvenience. The DOL can easily justify its attitude, pointing to the large number of bankruptcies that have occurred over recent years and its role as protector of employee rights. Employers would be wise to heed these trends and consider reviewing its 401(k) deposits with the following questions in mind:

- What is the average time between an employee's payroll deduction and its deposit in the 401(k) plan?
- Is this time period consistent with the employer's other payroll practices? If not, are there reasons for the discrepancies—such as the need to aggregate or reconcile accounts or recordkeeper requirements or other limitations? Are these time periods justified? If they are, the employer should document them.
- Has the employer discussed the timely deposit rule with its internal payroll staff and any recordkeeper, and documented the reason for any time lag with respect to deposits?
- Has the employer considered a procedure to review the timeliness of deposits?
- If the employer has plan loans, are loan repayments deposited in the same or similar manner? If not, the reasons for the discrepancy should be reviewed and justified.

Conclusion

The DOL is not going to retreat from its position that employee contributions must be deposited into the qualified plan as soon as they can be segregated from the employer's general assets, even if that period is before the maximum period set forth in the regulations. The DOL's Employee Contribution Enforcement Program is widely publicized and is often cited by the DOL in its public statements as a significant achievement that has assisted participants. Moreover, given the losses that some participants have suffered due to employers' bankruptcies, the

practical reasons for the DOL's strict enforcement policy are apparent even to a lay person, and are not merely technical interpretations of an arcane statutory provision. As a result, employers and plan sponsors should expect continued stringent enforcement and should be prepared to document and defend their payroll practices in this regard. Employers and plan sponsors should also be aware that the DOL's interpretation of what constitutes a reasonable period may not provide the employer or plan sponsor with as much flexibility as it would like to administer its payroll system.

Notes

1. *See* Department of Labor, Employee Benefits Security Administration, Media Releases dated April 23, 2003 (re *Chaco v. Canelos*, Civil Action No. 1:03-CV-1132) and October 30, 2002 (re *Chao v. Acerlo*, Civil Action No. 01-CV-1861), at http://www.dol.gov./ebsa/newsroom.

2. See a complete discussion of the history of this rule in the preamble to the final plan asset regulations, 61 Fed. Reg. 41220 (August 7, 1996).

3. The regulations provide a special 30-business day maximum period for SIMPLE plans that involve SIMPLE IRA accounts, as defined in Code Section 408(p). *See* 29 C.F.R. § 2510.3-102(b)(2). That rule is not specifically discussed further herein, but the same principles apply.

4. 29 C.F.R. § 2510.3-102(d).

5. Testimony of Ann L. Combs, Assistant Secretary of Labor, before the House Committee on Education and the Workforce, Subcommittee on Employer-Employee Relations, (September 10, 2002).

6. See the answer to the first question in *PWBA Voluntary Fiduciary Correction Program FAQs*, (August 6, 2002), published in *RIA Pension & Profit Sharing* ¶ 98, 157. These FAQs are also available at http://www.dol.gov./ebsa. The Voluntary Fiduciary Correction Program is discussed in more detail in the text of this article.

7. See the second question and answer set forth in *DOL Voluntary Fiduciary Correction Program FAQs*, cited in endnote 6.

8. The DOL's discussion of the application process can be found at 67 Fed. Reg. 15,062 (March 28, 2002) or at http://www.dol.gov./ebsa. For a description of this program, *see also* A. Moran and S. Terrill, "IRS and DOL Correction Procedures," in Schneider and Freedman, *ERISA: A Comprehensive Guide*, 2nd ed. (Aspen Publishers 2003), at § 4.15.

9. *See* DOL FAQs cited at endnote 6.

10. Section 5(b)(6) of the DOL's Voluntary Fiduciary Correction Program, set forth in 67 Fed. Reg. 15,062 (March 28, 2002); see endnote 8 above.

11. Section 5(e) of the DOL's Voluntary Fiduciary Correction Program, set forth in 67 Fed. Reg. 15,062 (March 28, 2002); see endnote 8 above.

12. The Class Exemption is set forth in 67 Fed. Reg. 70623-70628 (Nov. 25, 2002).