VCP Loan Corrections

The Internal Revenue Service on August 14 published Revenue Procedure 2008-50, updating its plan qualification correction program, the Employee Plans Compliance Resolution System. EPCRS allows plan sponsors to correct failures to satisfy plan qualification requirements, without suffering the severe consequences of plan disqualification. **Rev. Proc. 2008-50** retains the basic structure and operation of EPCRS, but adds several new correction methods for common plan qualification failures and makes numerous, mostly liberalizing, technical and procedural changes.

The following addresses the specific part of the Rev. Proc. as it relates to Loan corrections:

New Guidance on Participant Loan Corrections **– Rev. Proc. 2008-50**

Plan loans made to participants are included in taxable income unless they comply with restrictions in IRC § 72(p) regarding the amount of the loan, the period over which it is repaid, and level amortization of principal repayment. In addition, if the participant defaults on a loan, the unpaid balance will, at that time, be treated as a distribution and taxed. Under Rev. Proc. 2006-27, the IRS may postpone income recognition until the year of the correction or to waive it altogether if, and only if, the correction is made through VCP. If a default is self-corrected, the defaulted principal must be reported as taxable income in the year of the default; any subsequent repayments give the participant basis in the plan.

Rev. Proc. 2008-50 retains these rules and liberalizes the correction requirements for defaulted loans in one major and two minor respects. Rev. Proc. 2006-27 allowed a default to be corrected by a one-time payment of the overdue principal and interest, after which regularly scheduled payments would resume, by re-amortization of the remaining principal in level installments over the remainder of the original loan period, or in some circumstances, by a combination of the two methods. Regardless of the method chosen, the loan had to be repaid over a period not longer than its original term. Thus, for example, if the original term of the loan was 3 years, and the participant defaulted after one year, the unpaid portion of the loan could not be re-amortized over a period of longer than two years.

Rev. Proc. 2008-50 allows a defaulted loan that originally had a shorter term than the maximum permitted by IRC § 72(p) (five years except in the case of a loan whose proceeds are used to acquire a principal place of residence) to be re-amortized over the longest period for which it could have been taken out. Hence, in the case of the typical participant loan where the maximum term was 5 years, the loan may be re-amortized over any that ends no later than 5 years from the date of original issuance.

One of the minor changes is the elimination of the previous condition that correction was possible only if the plan provisions explicitly mandated compliance with IRC § 72(p). Under the new procedure, loans made by a plan without IRC § 72(p) language (or even without any provision for loans at all) may be brought into compliance with the tax rules, although, as the procedure observes, they may result in fiduciary violations or prohibited transactions that will have to be dealt with separately under the rules established by the Department of Labor. The new procedure also allows corrections when a loan is made by a plan that has no provision for loans.

The other minor change relates only to Audit CAP. Rev. Proc. 2008-50 states that the “maximum payment amount” (the basis for negotiating sanctions under Audit CAP) will now include the amount of income tax that would be due under IRC § 72(p) if a loan failure is discovered upon examination and corrected through the Audit CAP process. While not stated explicitly, because Audit CAP sanctions are paid exclusively by the employer, this presumably means that the participant will be excused from the income tax consequences normally associated with loan failures.

Accidentally Defaulted Loans

A common loan problem occurs when an employer either does not begin taking loan repayment deductions from a participant’s paycheck as scheduled or accidentally stops deducting those payments too soon. These situations may occur when the employer or the plan goes through a merger situation, payroll vendors are changed, an employee is moved from one payroll system to another payroll system, or even when a plan changes its recordkeeper. Where a loan is in default due to payments not being made as scheduled, the error may be corrected under VCP by:

• The participant making a lump sum payment equal to the amount of missed payments, plus accrued interest, and continuing with scheduled loan repayments going forward;

• Re-amortizing the outstanding loan balance, including accrued interest, over the remaining payment schedule of the original loan; or

• A combination of these two correction methods.

If the employer is partially at fault for not beginning or continuing repayment of the loan, the IRS may require the employer to pay the additional interest owed by the participant for failure to timely repay the loan.

This correction is not available if the maximum loan repayment period, taking into account any permissible suspension periods, has already expired.