

# VCP—THE BEST IRS CORRECTION PROGRAM YOU MAY NOT BE USING

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## I. Introduction

I will often consult with other practitioners regarding the best means to correct qualification failures discovered with respect to client plans. After hearing a description of the failures and their client's goals in correcting, I often find, and suggest, that they consider correcting under the IRS's Voluntary Correction Program ("VCP"). On more occasions than not, I immediately hear or sense resistance to filing under VCP. Having used the program on several occasions, I am surprised at this hesitation and wish to explain why VCP may in fact be the best IRS correction program that your clients may not be using.

## II. Background on IRS Correction Programs

The IRS actually maintains a trio of programs designed to allow sponsors of qualified plans to correct various qualification failures and thus avoid the sanction of plan disqualification. These programs, consisting of the Self Correction Program, Audit CAP and the Voluntary Correction Program or VCP, together comprise the IRS' Employee Plans Compliance Resolution System (EPCRS).

Not surprisingly, both the failures and methods of correction available under the Self Correction Program are much more limited than those failures and methods of correction available under either VCP or Audit CAP. Moreover, since Audit CAP is effectively forced on a plan wishing to avoid disqualification where failures are discovered on audit and is therefore, essentially the last line of defense to disqualification on audit and requires the payment of a significant fine, Audit CAP is never a desired option.

VCP, on the other hand, has the breadth of options available under Audit CAP but it is a program that can only be availed voluntarily and therefore, only when the plan is not under audit. Moreover, it does not require the payment of a monetary sanction.

## III. Benefits of VCP

### A. Available to Correct All Qualification Failures

There are generally four types of recognized failures that can cause a plan to cease to be tax-qualified:

1. Plan Document Failure: a plan provision, or the absence of a plan

provision, that, on its face, violates the Internal Revenue Code's (the "Code's") qualification requirements. [Rev. Proc. 2008-50, Part III, Section 5.01(2)(a)]

2. Operational Failure: a failure, other than an Employer Eligibility Failure defined below, that arises solely from the failure to follow plan provisions. [Rev. Proc. 2008-50, Part III, Section 5.01(2)(b)]
3. Demographic Failure: essentially a failure to satisfy one of the basic demographic requirements that apply to the plan--this means either the failure to satisfy the nondiscrimination requirements of Section 401(a)(4), the minimum participation requirements applicable to defined benefit plans of Section 401(a)(26) or the minimum coverage requirements of Section 410(b). [Rev. Proc. 2008-50, Part III, Section 5.01(2)(c)], and
4. Employer Eligibility Failure: the adoption of a Section 401(k) plan by a governmental entity after a date when governmental employers cease to be eligible to maintain, that is, by an ineligible employer. [Rev. Proc. 2008-50, Part III, Section 5.01(2)(d)]

Plan Document Failures usually arise in two basic situations: (1) where a new law is enacted or regulations are issued and the plan fails to be timely amended to reflect the new qualification requirement, or (2) where the plan has not been timely or properly amended during the applicable period for adopting good faith or interim amendments as required by the IRS.

An Operational Failure is perhaps the most common type of failure. Essentially, it is any sort of disconnect between what the plan says should happen, and the plan's actual operation. An Operational Failure can arise even where the term of the plan that was not properly followed is itself not a condition of tax qualification.

While the ability to correct virtually any type of qualification failure under VCP, (with the exception of certain failures deemed to have arisen from abusive situations or involving the misuse of plan assets), the flexibility available with respect to the method of correction is in fact what makes VCP such an appealing choice—even sometimes more appealing than self correcting where the Self Correction Program is also available.

#### B. Flexibility in Correction Methods

Often, the reason given for shunning VCP in favor of SCP is the stated goal to avoid IRS involvement. However, while IRS involvement has an obvious drawback, it has benefits as well. Given that where the only failures are Operational Failures both Self Correction and VCP may be available, some comparison between the two programs at this point is appropriate.

First, when considering Self Correction as an alternative to VCP, it must be remembered that

Self Correction is much more limited in scope. Only those failures that fall within the definition of Operational Failures can be Self Corrected. This means, for example, that if the Plan's failure involves a Plan Document failure (i.e., the failure to be timely amended) or any other failure that does not constitute an Operational Failure, Self Correction is not an available option.

While Self Correction has the benefit of not requiring the payment of any monetary fee or sanction, one attribute viewed as its primary benefit by many is the fact that Self Correction does not require any IRS involvement.

If the plan's advisors are sure that the method of correction chosen to Self Correct an Operational Failure will be fully acceptable to the IRS in the event of an audit and if the client can afford the method of correction required under Self Correction, use of the Self Correction Program may well be appropriate. However, if the plan has failures that either cannot be corrected using Self Correction or which can, but for which the plan sponsor wants the certainty that comes with IRS involvement and approval or wants the flexibility to propose a correction method other than one sanctioned under the rules governing Self Correction, the VCP may be much more appropriate.

Subject to a few specific types of failures identified in the governing guidance, generally, correction under Self Correction requires reforming the plan's actual operation to the terms of the plan. Because there is no IRS involvement under Self Correction, and therefore, no IRS approval, the plan sponsor must tread carefully to ensure that, where sample correction methods are provided in the guidance for a specific Operational Failure, it adheres strictly to only those methods of correction allowed under Self Correction. Where the plan's advisors are dealing with an Operational Failure eligible for correction under Self Correction, but for which the guidance does not provide sample correction methods, the plan and its sponsors are left without the certainty that IRS approval under VCP would bring. This means that the plan may only know with any certainty whether the method of correction is acceptable to the IRS in the event of an audit.

While VCP requires submission of the failures to the IRS and the proposal of a correction method, which, once approved results in certainty, it also lends itself to the proposal of more creative correction methods which might prove less costly to the plan sponsor.

This is in part because VCP provides a greater potential for use of reformation to correct failures. While Self Correction generally means reforming the plan's operation to match its terms, a plan sponsor may, subject to the approval of the IRS, use VCP to correct any of the four types of failures by instead amending the plan's terms to reflect its actual prior operation. Any such amendment must itself satisfy the various qualification requirements and in general, the proposed correction method must adhere to some basic overriding principles. [Rev. Proc. 2008-50, Part II, Section 4.05(1)] This option, however, could potentially result in significant savings to the plan sponsor in correcting plan failures.

Example: A money purchase pension plan of a not-for-profit entity that has been in effect

since the 1980s has always been operated with the assumption that the Executive Director would not participate in the money purchase plan but rather would participate solely in a separate nonqualified deferred compensation arrangement. Unfortunately, the prototype plan document does not reflect her exclusion.

This is the plan's sole failure and constitutes an Operational Failure stemming from the failure to follow the terms of the plan. Correction using Self Correction would require that the plan retroactively include the Executive Director and that the not-for-profit make up the missed contributions. This is because generally Self Correction requires reforming the plan's operations to conform to the plan's terms. The few instances allowed under Self Correction to use reformation (that is, to retroactively amend the plan to conform to its actual operation) do not cover this situation.

However, by submitting under VCP with its broader flexibility of both failures and correction methods, the plan proposes to instead reform the plan's terms to its actual operation. The plan submits documentation supporting the assertion that all parties understood and agreed that the plan would in fact exclude the Executive Director. The evidence includes an affidavit from the Executive Director and a copy of the nonqualified plan.

The IRS accepts the proposed correction and the plan is requalified without the payment of significant contributions to the plan from the not-for-profit that otherwise would have been required to be made if the plan had corrected using Self Correction.

It must be remembered that the method of correction of any failure under any of the three correction programs must adhere to certain basic overriding principles designed to ensure full correction and fairness to rank and file employees. These overriding principles include, for example, a requirement that any proposed correction method provide full and complete correction for all taxable years, without regard to whether the statute of limitations has run and for all affected participants, including former participants.

#### D. Certainty

Even where Self Correction is available, it may leave an air of uncertainty in that, if the failure to be corrected is not one for which specific guidance is contained in the IRS guidance as to acceptable correction methods, the plan will not be sure that it has made correction that will be acceptable to the IRS unless it is audited. Submission under VCP brings with it the review and approval by the IRS and thus, the certainty of the correction method chosen.

#### E. John Doe VCP

Sometimes clients are concerned about submitting under VCP and proposing a creative

correction method that the IRS may ultimately not approve. In such case, the concern is that the client and its plan failures have then be exposed to the IRS.

However, VCP allows for an anonymous of “John Doe” submission process pursuant to which no identifying information is disclosed until an agreement is reached on the method of correction.

One potential drawback to use of this procedure is the lack of protection in the event of an audit. Until the identifying information is released to the IRS, a submission under the John Doe procedure does not preclude or impede an examination by the IRS. Thus, a plan submitted under the John Doe procedure that comes under an examination prior to the date the plan and plan sponsor identifying materials are received by the IRS will no longer be eligible for either anonymous submission procedure or the VCP in general.

[Rev. Proc. 2008-50, Part V, Section 10.10]

F. Reasonable Cost

While submission under VCP does not require the payment of a sanction, it does require the payment of a user fee. This is to be contrasted with Self Correction where no sanction or fee is paid. However, because the general fee under VCP is based upon the number of participants in the plan, most plans will not find the user fee prohibitive. Specifically, the general user fee is determined in accordance with the following:

<u>Number of Participants</u>	<u>Fee</u>
20 or fewer	\$750
21 to 50	\$1,000
51 to 100	\$2,500
101 to 500	\$5,000
501 to 1000	\$8,000
1001 to 5,000	\$15,000
5001 to 10,000	\$20,000
Over 10,000	\$25,000

[Rev. Proc. 2008-50, Part V, Section 12.02]

While most plans will find the applicable fee reasonable, there are special situations that may result in an even lower fee. For example, if the only failure is a Plan Document failure and the failure is submitted within a year of the time it should have been adopted, the fee is cut in half. [Rev. Proc. 2008-50, Part V, Section 12.03] If the only failure is the failure to timely adopt an interim amendment or an amendment to implement an optional law change, the fee is \$375. [Rev. Proc. 2008-50, Part V, Section 12.03] Special reduced fees may also be available under VCP to correct certain required minimum distribution or loan failures.

#### F. Less Burdensome Submission Process

The submission process under VCP requires the submission of an application that describes the failures, how the failures occurred, the proposed method of correction as well as other information. Previously, preparing a letter describing the failures in detail and containing all of the information required to be included was always fairly time consuming. While still requiring time, the IRS has now streamlined the process by allowing some of the failures submitted most often to be submitted using pre-printed forms that require the insertion of certain plan-specific information

Once submitted to the IRS the process currently takes 6-9 months to complete. Once agreement is reached, the IRS issues the plan a Compliance Statement that essentially reflects the requalification of the plan.

Except in unusual circumstances, a plan that has been properly submitted under VCP will not be examined while the submission is pending. [Rev. Proc. 2008-50, Part V, Section 10.04]