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# IRS Proposed Rule Offers Relief to The Multiple Employer Plan One Bad Apple Rule

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## BACKGROUND

For years, many members of the retirement community have been in favor of an expansion of the availability of multiple employer plans (MEPs) as a way to encourage more small employers to sponsor a retirement plan. The two issues most commonly cited as challenges in expanding the use of MEPs have been (1) the Employee Retirement Income Security Act's commonality requirement and (2) the IRC §413(c) requirements for multiple employer plans – most notably concerns that issues with one employer could lead to the disqualification of an entire MEP, which is commonly known as the ''one bad apple'' rule.[1] MEPs allow two or more employers who do not belong to the same group of controlled corporations to combine their resources in order to sponsor a tax-qualified retirement plan, with a centralized governance structure for plan administration. This article focuses on the one bad apple rule.

As background, according to the U.S. Bureau of Labor Statistics, just over half of workers employed by companies with fewer than 100 employees had access to retirement benefits as of March 2018, compared with 85% of workers employed by companies with 100 or more employees. Small employers often cite high administrative costs and a lack of organizational resources as reasons for not sponsoring retirement plans for their employees.[2]

## ONE BAD APPLE RULE

The one bad apple rule provides that a qualification failure by one employer that participates in a MEP will cause the entire MEP to be disqualified.[3] For example, if one of ten employers that participate in a MEP fails to provide necessary information to the MEP's plan administrator, which leads to a qualification failure, then all ten of the participating employers are placed at risk of incurring significant tax consequences if the MEP is disqualified. This risk creates a powerful disincentive for small employers who otherwise may be interested in joining a MEP and for entities that would other consider offering a MEP.

On August 31, 2018, the White House issued an Executive Order instructing the Department of Labor (DOL) and the Treasury Department (Treasury) to issue guidance expanding the availability of MEPs, among other directives.[4] In response to the Executive Order, the DOL published a proposed rule on October 23, 2018, that is intended to broaden the types of organizations that may jointly sponsor a MEP.[5] The DOL finalized its rule on July 31, 2019.[6] However, expanding MEP eligibility may have a limited impact if eligible employers continue to be concerned with the risk that their plan could become disqualified

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[1] All section references are to the Internal Revenue Code, as amended (Code), or the Treasury regulations thereunder, unless otherwise indicated.

[2] The Pew Charitable Trusts, Small Business Views on Retirement Savings Plans (January 2017).

[3] Reg. §1.413-2(a)(3)(iv).

[4] E.O. 12857 (Aug. 31, 2018).

[5] 83 Fed. Reg. 53,534 (Oct. 23, 2018).

[6] 84 Fed. Reg. 37,508 (Jul. 31, 2019).



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(through no fault of their own) under the one bad apple rule. To address this concern, Treasury and the Internal Revenue Service (IRS) published a proposed rule on July 3, 2019, that would provide an exception to the one bad apple rule, as further described below.[7]

## SUMMARY OF IRS PROPOSED RULE

The IRS's proposed regulations establish, for the first time, a clear process for a defined contribution MEP to preserve its tax-qualified status despite a qualification failure by a participating employer (or a participating employer failing to provide information to the MEP plan administrator necessary to determine if a qualification failure exists). Under the proposed regulations, the following general requirements must be met in order for a MEP to qualify for the exception:

- The plan administrator for the MEP must have established practices and procedures that are reasonably designed to promote and facilitate overall compliance with applicable Code requirements, including procedures for obtaining information from participating employers.[8]
- The MEP plan document must include language that describes the procedures that the plan will follow to address qualification failures by participating employers.[9]
- The MEP cannot be under examination by the IRS's Employee Plans division or Criminal Investigation division.[10] A MEP is considered to be under examination for purposes of this requirement if it has received verbal or written notification of an impending examination by the Employee Plans division, or if an IRS agent reviewing a MEP's determination letter application informs the MEP of possible qualification failures.[11]

If the above requirements are satisfied, the proposed regulations permit a MEP to avoid application of the one bad apple rule (thus preserving the tax-qualified status of the MEP) by taking the following actions with respect to the participating employer that is causing the qualification failure:

- **First Notice.** The MEP plan administrator must send a notice to the participating employer describing the qualification failure, the remedial actions that the participating employer would need to take in order to remedy the failure, and the employer's ability to instead initiate a spinoff of plan assets and account balances attributable to MEP participants who are employees of that employer. The first notice must also describe the consequences if the participating employer fails to take remedial action or initiate a spinoff, including the possibility that plan assets and account balances attributable to MEP participants who are employees of that employer could be spun off to a new plan, followed by a termination of that plan.[12]
- **Second Notice.** If the participating employer does not take appropriate remedial action or initiate a spinoff within 90 days of the date that the first notice is provided, then a second notice must be provided within 30 days of the expiration of such 90-day period. The second notice must include the same information that was required to be included in the first notice, and must further explain that if the participating employer fails to take remedial action or initiate a spinoff within 90 days of receiving the second notice, a notice describing the failure and the consequences of not correcting the failure will be provided to all MEP participants who are employees of the participating employer, and also to the DOL.[13]
- **Third Notice.** If the participating employer has still not taken remedial action or initiated a spinoff within 90 days of the date that the second notice is provided, then a third notice must be provided within 30 days of the expiration of such 90-day period. In addition to the participating employer, the third notice must be provided to (and must state that it is being provided to) all participants who are employees of that employer, and the Office of Enforcement of the DOL's Employee Benefits Security Administration. The third notice must include the same information that was required to be included in the first notice, the deadline for the participating employer to take action, and an explanation of any adverse consequences to participants in the event that a spinoff-termination occurs.[14]
- The final deadline for a participating employer to take remedial action or initiate a spinoff is 90 days following the date the third notice is provided.[15] If this deadline is not met, then the MEP plan ad-

[7] 84 Fed. Reg. 31,777 (Jul. 3, 2019).

[8] Prop. Reg. §1.413-2(g)(3)(i)(A).

[9] Prop. Reg. §1.413-2(g)(3)(i)(B).

[10] Prop. Reg. §1.413-2(g)(3)(i)(C), Prop. Reg. §1.413-2(g)(3)(ii).

[11] Prop. Reg. §1.413-2(g)(3)(iii). A determination letter applicant that self-identifies a qualification failure before an IRS agent recognizes the existence of the failure would not be treated as violating this condition.

[12] Prop. Reg. §1.413-2(g)(4)(i).

[13] Prop. Reg. §1.413-2(g)(4)(ii).

[14] Prop. Reg. §1.413-2(g)(4)(iii).

[15] Prop. Reg. §1.413-2(g)(5)(i).



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ministrator must take action to initiate a spinoff of plan assets and account balances attributable to participants who are employees of the participating employer, followed by a termination of the spun-off plan.[16]

To avoid punishing participants for the inaction of their employer, the proposed regulations provide that distributions from terminated spun-off plans under the above circumstances would not lose their tax-favored treatment solely because of the qualification failure that led to the spinoff and termination.[17] However, the IRS reserves the right to take action against any party responsible for the failure, including in the party's capacity as a participant. For example, the IRS could deem that a distribution from the terminated spun-off plan to a specific participant is not eligible for tax-favored treatment if the participant was determined to be responsible for the qualification failure.[18]

[16] Prop. Reg. §1.413-2(g)(7).

[17] Prop. Reg. §1.413-2(g)(8)(ii)(B).

[18] Prop. Reg. §1.413-2(g)(8)(ii)(C).

## WHAT COULD HAPPEN NEXT

As noted above, the one bad apple rule is only one part of the MEP puzzle. ERISA's commonality requirement remains a challenge for bringing together small employers who do not have an affiliation with each other. The DOL's final association retirement plan guidance is intended to further mitigate this challenge.[19] However, providing relief for the one bad apple rule is another step on the road toward facilitating the broader adoption of MEPs by small employers. In addition, the most likely game changer will be the SECURE Act,[20] when and if it passes, which provides enhanced relief from both the ERISA and one bad apple challenges to MEPs. Although the current timeline for this legislation is uncertain, the trend toward MEPs – whether a slow or fast trend – is likely to continue.

[19] For example, the DOL's Association Retirement Plan regulations provide that if an employer participating in a MEP ceases to meet ERISA's commonality requirement, it may be considered to have established its own separate employee benefit plan and the MEP sponsor may be considered to be acting as a service provider to the separate plan of the former participating employer. Reg. §2510.3–55, 84 Fed. Reg. 37,508 (Jul. 31, 2019).

[20] H.R. 1994, 116th Cong. (2019).



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