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LEGAL DEVELOPMENTS

IRS Takes a Bite Out of the "One-Bad-Apple" Rule

The Treasury/IRS have proposed rules that specify numerous steps that the defined contribution MEP provider and the impacted employer can take to avoid triggering the "one-bad-apple" rule and disqualifying the entire MEP. Unfortunately, these proposed rules create a number of administrative procedures that may prove to be costly and time-consuming.

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The Internal Revenue Service (IRS) rules for multiple employer plans (MEPs) have historically provided that "the failure by one employer maintaining the plan (or by the plan itself) to satisfy an applicable qualification requirement will result in the disqualification of the [Section 413(c)] plan for all employers maintaining the plan." [Treas. Reg. § 1.413-2(a)(3)(iv)] This rather harsh rule often is referred to as the "unified plan" or "one-bad-apple" rule, and for years has made employers

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and MEP providers anxious as to the implications of such a rule, especially in light of the very complex tax qualification rules that apply to MEPs. This is particularly true with the recent talk of so-called 'open MEPs,' under which unrelated employers may join in a common 401(k) plan, even though they have no connection to each other or the plan sponsor (other than the plan itself).

Last year, Executive Order 13847 (Aug. 31, 2018) directed the Treasury to reconsider this rule and other barriers to open MEPs—specifically, it provided direction

> to consider proposing amendments to regulations or other guidance, consistent with applicable law and the policy [to expand access to MEPs] set forth in . . . this order, regarding the circumstances under which a MEP may satisfy the tax qualification requirements . . ., including the consequences if one or more employers that sponsored or adopted the plan fails to take one or more actions necessary to meet those requirements.

In response to this Executive Order, the Treasury and the IRS released proposed rules [84 Fed. Reg. 31777 (July 3, 2019)]. Although the Treasury/IRS proposed rules cannot be relied on until they are issued in final form, the rules would set forth specific (and rather numerous) steps that the defined contribution MEP provider and the impacted employer can take to avoid triggering the "one-bad-apple" rule and disqualifying the entire MEP. The proposed rules are briefly summarized below. The rules address the one-bad-apple threat, but unfortunately involve comprehensive administrative procedures and plan amendment/spinoff/termination requirements in the process.

Summary of IRS Proposal

The proposed rules provide a detailed road map for a defined contribution MEP to avoid disqualification in the event of a participating employer's qualification failure (or failure to provide necessary information).

Step 1: Established Procedures and Plan Documents

The plan administrator must have established practices and procedures (formal or informal) that are reasonably designed to promote and facilitate overall compliance with applicable Internal Revenue Code (Code) requirements, including procedures for obtaining information from participating employers to identify and correct errors (*e.g.*, nondiscrimination testing, top-heavy contributions). In addition, the plan document must contain language that describes the procedures that would be followed to address participating employer failures.

Step 2: Plan Sponsor Notices

The proposed rules next provide for a series of successive notices to the participating employer with the goal of either correcting the failure or moving the employer out of the MEP. (To take advantage of the exception, the MEP cannot be "under examination" at the time the first notice is provided, that is, the plan cannot be the subject of an Employee Plans Form 5500 audit, but a Department of Labor audit is permissible.) Each notice generally must describe the failure, the actions the employer would need to take to remedy the failure, the employer's option to instead initiate a spinoff of its portion of the plan, and the consequences if the participating employer does not take corrective action or initiate a spinoff. The second and third notices are required only if the participating employer does not take appropriate action within defined time periods; the third notice (if applicable) also must be provided to participating employees (and beneficiaries) and to the Department of Labor (DOL). Additionally, the third notice must include the deadline for employer action, and an explanation of any adverse consequences to participants if a spinoff-termination (described below) occurs.

This process is complicated by the fact that there also is a notice process for instances where there is a potential qualification failure. All in, the final deadline for the participating employer to take corrective action could take over a year. Further, as the MEP plan administrator has 180 days from the date on which the participating employer initiates the spinoff to implement and complete such spinoff, such process could go an additional six months before the matter is finally resolved.

Step 3: Spinoff and Termination

If the participating employer does not take appropriate action to correct the failure or initiate a spinoff, the MEP plan administrator must then take action to initiate a spinoff of the plan assets and account balances of the employees of the unresponsive employer, followed by a termination of the spun-off plan (a spinoff-termination). This is a rather onerous process for the plan administrator as it involves:

1. Sending notice of the spinoff-termination to participants who are employees of the unresponsive participating employer (and their beneficiaries)

(which has its own list of requirements in the proposed regulations);

2. Ceasing acceptance of contributions from the unresponsive participating employer;
3. Implementing a spinoff, in accordance with the transfer requirements of Code Section 414(l) and the anti-cutback requirements of Code Section 411(d)(6), of the plan assets and account balances on behalf of employees of the unresponsive participating employer that are attributable to their employment by that employer to a separate single-employer plan and trust that has the same plan administrator, trustee, and substantive plan terms as the MEP; and
4. Terminating the new spun-off plan and distributing the assets (and notifying the IRS of the same) which includes:
   a. reasonably determining whether, and to what extent, the survivor annuity requirements of Code Sections 401(a)(11) and 417 apply to any plan benefit and taking reasonable steps to comply with these QJSA/QPSA rules;
   b. providing each participant and beneficiary with a nonforfeitable right to his or her accrued benefits as of the date of plan termination, subject to income, expenses, gains, and losses between that date and the date of distribution; and
   c. notifying participants and beneficiaries of their rights under Code Section 402(f) regarding rolling over the plan benefit to an IRA or another eligible employer plan.

Notably, the proposed regulations provide that, in the case of a spinoff-termination, distributions generally would not lose their tax-favored treatment solely because of the participating employer's failure that led to the distribution. However, the IRS does retain the right to seek remedies against any party responsible for the failure, including the right to treat a distribution to a responsible participant as a non-eligible rollover distribution.

Lastly, these steps of spin-off and plan termination raise not only tax considerations, but also fiduciary concerns that are not addressed in the proposed IRS regulations. For example, implementing a split of assets and liabilities and selecting an annuity provider for purchasing annuities on plan termination are fiduciary acts that require careful consideration and process.

Conclusion

The proposed rules address the hardship of the "one-bad-apple" rule, but unfortunately bring with the relief extensive administrative procedures that are both costly and time-consuming to correct the failure, and also create ERISA fiduciary concerns. Therefore, MEP fans should stay tuned to see what the final regulations will bring. ■

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