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Proposed "One-Bad-Apple" Rules – IRS Takes Another Cut

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On March 25, the IRS issued a set of proposed regulations under Internal Revenue ("Code") section 413(c) and 413(e) addressing multiple employer plans, or "MEPs," and pooled employer plans, or "PEPs." 87 Fed. Reg. 17225. We provide some background on these rules, and summarize key provisions, below.

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Background

Section 413(c) of the Internal Revenue Code has long contained rules governing the operation of tax-qualified plans covering multiple, unrelated employers. The plans, commonly referred to as "MEPs," have been widely used by trade associations and similar organizations. When the SECURE Act was enacted at the end of 2019, a new type of defined contribution MEP was created – the pooled employer plan or "PEP" – and additional rules for MEPs and PEPs were added in Code section 413(e). Retirement plan providers identified PEPs as an attractive way to offer centrally managed plans to unrelated employers outside the traditional context.

MEPs have long been subject to a rule, commonly called the "unified plan rule," under which a MEP is generally subject to applicable Code requirements on a plan-wide basis even though there are multiple unaffiliated employers participating in a plan. This rule was commonly referred to as the "one-bad-apple" rule. Under this rule, the failure by one employer maintaining the plan to satisfy an applicable qualification requirement would have resulted in the disqualification of the multiple employer plan for all employers maintaining the plan. This rule provided a disincentive for some employers to adopt a MEP.

In 2019, prior to the enactment of the SECURE Act, the IRS issued proposed regulations that would have created an exception to the unified plan rule providing relief for situations where a single employer takes an action (or fails to take an action) that creates a failure that would cause a MEP to fail

to satisfy IRS requirements. The initial proposed regulations were a step in the right direction for relief from this rule – they provided 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). But they did impose a host of burdensome requirements to qualify for relief.

In response to comments, and the addition of PEPs in the SECURE Act, the 2019 proposed rules were withdrawn in their entirety and re-proposed on March 25. These re-proposed rules have two key components – an updated version of the "one bad apple" rule and new guidance for PEPs. While the regulators clearly listened to stakeholders' input and made helpful changes in a couple of areas, MEP/PEP providers of defined contribution plans still face an onerous path for relief from this rather harsh rule. And it is unclear what relief from the unified plan rule is available for defined benefit plan MEPs.

Summary of IRS Proposal

A. "One Bad Apple" Revisited

The SECURE Act added Code section 413(e), which provides statutory "one bad apple" relief for both PEPs and "related employer" MEPs, and directed the IRS to issue guidance addressing "one bad apple" relief.

Under the proposed regulations, the plan document must contain language that describes the procedures that would be followed to address a failure caused by a participating employer – commonly called a "participating employer failure". These procedures include a description of the notices and associated deadlines to be provided to the participating employer, the actions the plan administrator will take if the employer does not remedy the failure or initiate a spinoff of its portion of the plan, and a statement that participants will become fully vested in their benefits if the unresponsive employer does not take remedial action or initiate a spinoff.

The proposed regulations 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. Each notice must generally 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. For a failure to provide information, the first notice must be sent no later than 12 months following the end of the plan year for which information was required for continued plan qualification; for a failure to take action, the deadline is 24 months following the end of the plan year in which the qualification failure occurred. The second and third notices are required only if the participating employer does not take appropriate action within defined time periods (no later than 60 days following the date the prior notices were provided) – and the third notice (if applicable) must also be provided to participating employees (and beneficiaries) and to the Department of Labor.

While shortened under the re-proposed regulations, the final deadline for the participating employer to take corrective action is still lengthy, and could be as long as eight months after the first notice is provided. Further, while the MEP plan administrator has 180 days from the date on which the

participating employer initiates a spinoff to implement and complete such spinoff, such process could extend an additional six months before the matter is finally resolved.

If the participating employer does not take appropriate action to correct the failure or initiate a spinoff, the MEP plan administrator must stop accepting contributions from the employer and its employees, provide notice to participants (and their beneficiaries) that contributions have ceased and that they have become fully vested in their benefits, and provide participants with an election with respect to their benefits. The participants may elect to roll over their benefits to an eligible retirement plan, or leave the benefits in the plan – in which case the amounts must remain in the plan until a distribution is permitted under the terms of the plan. If a participant fails to make an affirmative election, the amounts will generally remain in the plan. Importantly, the previous proposed rule that required the MEP itself to 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, was eliminated.

B. Pooled Plan Provider Requirements

While the core focus of the proposed regulations is on one-bad-apple relief, the proposed regulations also provide some initial IRS guidance on PEP-specific requirements.

As an initial matter, the proposed regulations reiterate the PPP requirements outlined in Code section 413(e). A PPP must: register as a PPP, be designated by the plan as a named fiduciary, as the plan administrator, and as the person required to perform the administrative duties, acknowledge its designations, and ensure that persons handling plan assets or who are fiduciaries are bonded. In addition, as required by Code section 413(e), the proposed regulations identify the administrative duties and other actions required to be performed by a PPP and describe the procedures to be taken with respect to a plan which fails to meet the qualification or disclosure requirements.

The proposed regulations provide that a PPP must perform all of the administrative duties that are required of the pooled plan provider. These duties include, but are not limited to:

- Monitoring compliance with the terms of the plan, the Code and ERISA;
- Maintaining accurate plan data, including participant and beneficiary information;
- Performing coverage, top-heavy, and discrimination testing;
- Processing all employee transactions, such as investment changes, loans and distributions;
- Satisfying applicable Code and ERISA reporting and disclosure requirements; and
- Keeping the plan updated for changes in the law, if delegated to do so.

Should a participating employer fail to meet any applicable Code or ERISA requirements or fail to provide any disclosures or other information required to maintain plan qualification, pursuant to the one bad apple relief described above, the PPP must provide the notices to the participating employer and implement a spinoff if initiated by a participating employer. If an "unresponsive" participating employer neither takes appropriate remedial action nor initiates a spinoff, the PPP must:

- Stop accepting contributions from the employer and employees;
- Provide notice (in written or electronic form) to participants stating that no further contributions will be made, that full vesting shall apply to amounts that are attributable to

employment with the unresponsive participating employer, and that additional information will be provided regarding the disposition of their account;
- Provide participants and their beneficiaries with an election to have eligible rollover distributions (other than with respect to amounts subject to mandatory distribution) directly rolled over to an eligible retirement plan (including an IRA), or remain in the plan; and
- Deem a failure to make an election as an election to remain in the plan.

Individuals that elect to have their benefits remain in the plan continue to be subject to the terms of the plan, and may only take a distribution as permitted by the plan. Significantly, the plan administrator may rely on the participant's representation that the participant has experienced a severance from employment unless the plan administrator has actual knowledge otherwise. Amounts subject to mandatory distribution may not remain in the plan and, if subject to the automatic rollover rules, must be directly rolled over to an eligible retirement plan. Amounts not eligible for rollover must be paid to the individual.

Observations/Next Steps

The latest IRS proposal provides a detailed framework to alleviate the potential impact of the "unified plan" rule and the IRS compliance requirements for PEPs. Helpfully, the IRS eliminated the mandate to spin off to a new plan when an employer remains unresponsive. Nevertheless, these rules remain complex and rather onerous, and questions and issues remain. These include:

- Whether or not the PPP may delegate any of its administrative duties or engage recordkeepers; read literally, a PPP's ability to delegate responsibility to other vendors would appear to be severely limited, which is inconsistent with industry practice.
- The preamble to the proposed regulations treats a PEP the same as a MEP for Code purposes – therefore, it is a "single plan" for purposes of several key qualification issues, such as participation, vesting, and distribution on severance from employment, 415 annual limits, catch-up contributions, and elective deferrals under Code section 402(g). As a result of their expansive approach, costly and complex plan qualification issues involving these provisions may arise, for example, where an employee participates in more than one unrelated participating employer's plan under a PEP.

Ideally, sample IRS plan amendments will be issued to help plans comply with these rules.

We hope that these and other issues will be addressed in public comments, which should be submitted by May 27. A public hearing on the proposed rule has been scheduled for June 22. IRS has requested comments in several areas, including:

- The rules for mandatory distributions for employees of an unresponsive participating employer;
- Whether there are any circumstances in which it would be appropriate for any of the amounts attributable to the employees of the unresponsive participating employer to remain in the MEP after the employer has specifically directed there to be a spinoff; and
- What (if any) guidance would be helpful regarding when/whether employers have a "common interest" other than having adopted a common plan.

Notably, the proposed rules only apply to defined contribution plans; the request for comments in the initial proposed rules on whether or not the rules should apply to defined benefit plans was not included in the re-proposed regulations.

Although not effective until finalized, the regulations provide that compliance with these re-proposed regulations will be considered to be good-faith, reasonable interpretation of the rules. Fortunately, reasonable interpretations of the statute are also permitted in the interim.

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