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Employee Benefits Corner

Relief from the One Bad Apple Rule Is Coming (But Not Without a Price)

By Elizabeth Thomas Dold and David N. Levine

Multiple employer plans (MEPs) have long struggled with the historic rule that provides that if a single plan sponsor in a MEP fails the plan qualification rules under the Internal Revenue Code ("Code"), then the entire plan for all the plan sponsors would be disqualified. This is called the "unified plan" rule, or, more commonly called, the "one bad apple" rule. Although providers of MEPs had lived with this rule for a very long time without incidents, when the SECURE Act created the popular "Pooled Employer Plan" (PEP), the statute expressly provided for relief from this rule. As a result of the legislative change, the Internal Revenue Service (IRS) withdrew proposed regulations that were issued in 2019 that were designed to provide relief from the rule for MEPs, and issued new proposed regulations.

The rather complex (and onerous) process of obtaining relief from the "one bad apple" rule in the revised proposed regulations is set forth below, which picks up the numerous notice requirements that were in the initial proposed regulations and adds more complications with a participant election and required plan amendments.

I. The Failure

A participating employer in a MEP/PEP either (1) fails a plan qualification rule (*e.g.*, coverage, ADP/ACP testing, general Code Sec. 401(a)(4) testing, benefit, right or feature testing, minimum participation, eligibility, vesting, top heavy, no distributable event, missed contributions, *etc.*), or (2) does not provide the Code Sec. 413(e) (PEP) plan administrator with adequate data to ascertain if a plan qualification rule was violated. This failure to provide information or failure to take action is called a participating employer failure, which raises the one bad apple rule.

II. Notice Requirements

The PEP plan administrator must take the following steps after a reasonable time has been given for the participating employer to provide the requested data or initiate corrective action, and no action has been taken (or no data is provided).

- *First Notice*: The Notice to the participating employer must describe (1) the failure(s), (2) the corrective action that is required, or if no correction is made, the option to initiate a spinoff of the plan to a single employer plan maintained by the employer, and (3) the consequences if no action is taken under (2) above, which includes no further contributions to the plan, and adverse tax consequences for the individuals responsible for the failure.

  For a data request failure, the deadline for sending the First Notice is 12 months following the end of the plan year for which the information is necessary to determine whether the Code Sec. 413(e) plan is in compliance with a requirement under Code Sec. 401(a) (or Code Sec. 408 for individual retirement accounts (IRAs)). For a failure to take action, the deadline is 24 months following the end of the plan year in which the failure to satisfy a requirement of Code Sec. 401(a) (or Code Sec. 408 for IRAs) occurs.
- *Second Notice*: Within 30 days of the end of the 60-day period following the date the First Notice was provided, a Second Notice must be provided if corrective actions or spinoff has not occurred. The Second Notice to the participating employer must (1) describe the information within the First Notice (described above), and (2) expressly state that if, within 60 days following the date of the Second Notice is provided, the participant employer neither takes appropriate remedial action with respect to the failure nor initiates a spinoff, then a final notice describing the failure(s) and the consequences of not correcting the failure will be provided to participants who are employees of the employer (and their beneficiaries) and to the Department of Labor (DOL).
- *Third Notice*: Within 30 days of the end of the 60-day period following the date the Second Notice was provided, a Third and final notice must be provided if corrective actions or spinoff has not occurred. The Third Notice to the participant employer (along with copies to the participants/beneficiaries/alternate payees and DOL) must (1) describe the information within the First Notice (described above), (2) specify the final deadline to take action, which is 60 days after the final notice is provided, and (3) state that the notice is being provided to participants who are current or former employees of the unresponsive participating employer (and their beneficiaries/alternate payees) and the DOL.

Notably, if the failure is due to the lack of data being provided, then after the data is provided and the plan administrator then determines that the data results in a plan qualification failure—*e.g.*, violates nondiscrimination testing—the same process must be repeated for the failure to take corrective action in a reasonable period of time. However, there are special procedures that permit combining the First and Second Notice (if already did a First and Second Notice of the data request failure). This combined notice must be provided not later than 24 months following the end of the plan year in which the failure to satisfy a requirement of Code Sec. 401(a) (or Code Sec. 408 or IRAs) occurs.

For an employer-initiated spinoff, the PEP plan administrator must implement and complete the spinoff as soon as reasonably practicable. The proposed regulations provide a safe harbor for this purpose, which is within 180 days of initiation (and ask for comments on any exceptions where any amounts should be retained). Notably, the spinoff plan is still treated as having failed to meet the Code Sec. 401(a) requirement that applies while it is part of the MEP/PEP.

These steps also apply to a participating employer who is under examination with the IRS or DOL. The proposed regulations explain that corrective action should be taken in accordance with the procedures set forth in the Employee Plans Compliance Resolution System (EPCRS, currently Rev. Proc. 2021-30).

III. Unresponsive Participating Employer

If following 60 days after the Third Notice is provided, the participating employer failed to timely take appropriate corrective action or otherwise initiate a plan spinoff, then the PEP plan administrator must (1) stop accepting contributions from the unresponsive participating employer and its employees, (2) provide notice to participants who are current and former employees of the unresponsive participating employer (and their beneficiaries/alternate payees), (3) 100% vest the participants in the participating employer's plan (as if the plan was in fact terminated pursuant to Code Sec. 411(d)(3)), and (4) provide participants a rollover election to an IRA (or another eligible retirement plan that will accept the assets). Failure to make an election results in the retention of the plan assets within the MEP/PEP. To the extent that the impacted account balances are not otherwise eligible for rollover treatment (*e.g.*, minimum required distributions), these amounts must be paid directly to the participant, but there is not otherwise a right to take a cash or an in-kind distribution from the plan.

Notably, the PEP plan administrator must distribute the benefits as soon as administratively feasible following the election (generally, within one year of termination is viewed as a safe harbor). If amounts are retained in the MEP/PEP, then the PEP plan administrator can rely on the participants' later representations that they had a severance from employment, unless the plan administrator has actual knowledge to the contrary. Moreover, retention in the plan is not available if the plan has a mandatory cashout provision that would otherwise apply (with the impacted participant treated as having a severance from employment). Comments are being requested as to whether special cashout rules and missing participant rules should apply herein.

If a participant's account balance includes amounts that are attributable to current employment with an unresponsive participating employer and to previous employment with other participant employers, the entire account balance is subject to these rules. Conversely, if the current employment is attributable to a responsive participating employer, and it is the previous employer that is unresponsive, none of the account balance is subject to these rules. For this purpose, the most recent employment with a participant employer in the MEP/PEP will be treated as the participant's current employment.

Importantly, the proposed regulations make it clear that the IRS reserves the right to pursue appropriate remedies under the Code against a party (such as the owner of the participant employer) who is responsible for the Code Sec. 401(a) failure, even in the party's capacity as a participant or beneficiary (such as threatening that a plan distribution under these rules that are made with respect to the owner will not be eligible for rollover treatment).

IV. Plan Document Requirement

Details of the steps required to address the one bad apple must be set forth in the MEP/PEP plan document. The proposed regulations indicate that the IRS is working on a model plan language for this purpose. By placing these procedures into the plan document, the IRS can also raise an operational failure—*i.e.*, plan qualification concerns—if the plan administrator fails to follow these procedures. And the preamble to the proposed regulations appears to indicate that missteps in complying with these procedures result in a significant operational failure under EPCRS.

V. Pooled Plan Provider Guidance

The proposed regulations provide, without explanation, that the PEP is subject to the same plan qualification rules as MEPs set forth in Code Sec. 413(c). This has been an area of confusion, and one that hopefully will be given additional consideration, and ample good faith relief, pending the final guidance being issued.

The proposed regulations also provide some guidance on how a PEP is structured and the duties of a pooled plan provider (PPP). For example, the proposed regulations reiterate the PPP requirements outlined in Code Sec. 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 Sec. 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 that 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 PPP. 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;
- Meeting applicable Code and ERISA reporting and notice requirements; and
- Updating the plan document for changes in the law, if delegated to do so.

VI. Next Steps

Although relief from the one bad apple rule was surely needed, the devil is clearly in the details, which are numerous and complex here. Thankfully, pending final regulations, the statute provides for reasonable, good faith compliance with PEP rules, including these new bad apple rules. The proposed regulations expressly provide that compliance with these proposed rules is deemed to satisfy the statute's good faith compliance standard, and the industry is hopeful that pending final guidance, additional flexibility will be granted in this area. So, stay tuned for the final regulations in this area, and be prepared to see new procedures and plan amendments, and lots of notices regarding Code compliance issues that will be important for the PEP plan administrators to issue and for plan sponsors to comply with.

