

Publications

Long-Awaited Proposed IRS Rules Would Alleviate “One-Bad-Apple” Rule for Multiple Employer DC Plans

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For more than 40 years, the IRS rules for multiple employer plans (MEPs) have 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 draconian IRS position – often referred to as the “unified plan” or “one-bad-apple” rule – has received considerable attention over the years, and more recently in connection with the movement to allow 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). Recent Executive Order 13847 (Aug. 31, 2018) directed Treasury “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 October 2018, the Department of Labor issued proposed regulations to facilitate and expand the availability of open MEPs. Now, Treasury and IRS have released proposed rules in response to the Executive Order (84 Fed. Reg. 31777 (July 3, 2019)), which complement the Department of Labor’s proposed rule by providing an exception to the “unified plan” rule. Although not effective until finalized, the Treasury/IRS rule appears intended to further encourage the adoption of MEPs. As summarized below, the proposed regulations provide detailed rules to address longstanding issues raised by the “unified plan” rule – but would impose comprehensive administrative procedures and plan amendment requirements in the process.

A. Summary of IRS Proposal

The proposed regulations 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). As a threshold matter, the plan administrator must have established practices and procedures (formal or informal) that

are reasonably designed to promote and facilitate overall compliance with applicable 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. The proposed regulations then 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.) 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. 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) must also be provided to participating employees (and beneficiaries) and to the Department of Labor. 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.

All told, the final deadline for the participating employer to take corrective action could be close to a full year after the first notice is provided. 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 on 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 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”). Importantly, the proposed regulations provide that in the case of a spinoff-termination, distributions would generally 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. It is unclear how this would all work in practice.

B. Possible Concerns With the Proposal

The proposal provides a detailed framework to alleviate the potential impact of the “unified plan” rule. Nevertheless, there are many areas for possible improvement, including the following.

Are Such Elaborate Procedures Necessary? – Many established MEPs – such as trade association or professional employer organization (“PEO”) plans – already have reasonable procedures in place to address problems of this type. The proposal will add many more layers to those procedures (with accompanying administrative costs) – as well as requiring detailed plan amendments.

Limited to DC Plans – Like the pending legislation on “open MEPs,” the proposal is limited to defined contribution (DC) plans. IRS asks for comment on whether similar procedures should apply to defined benefit (DB) plans which may have “bad apples,” too.

Fiduciary Concerns – While this is a Treasury/IRS regulation, the preamble to the rule notes that the Department of Labor informed Treasury/IRS that a plan administrator that implements a spinoff-termination could have concerns about its fiduciary obligations to both the MEP and the spun-off plan, as well as prohibited transaction concerns. The rule encourages commenters to provide feedback on these concerns, as well as the need for additional interpretive guidance from the Department of Labor to facilitate the implementation of the rules.

Involuntary Spinoff and Termination May be Problematic – The proposal is quite specific as to the requirements to spin off the problem employer’s portion of the plan to a separate plan with the same administrator, trustee, etc., and then terminate the plan and make distributions to participants in a compliant manner. This process – which is also required more generally in the pending SECURE Act legislation – may well involve practical problems. For example, would the plan trustee have to segregate the assets for the affected employer’s portion of the plan in a separate sub-trust?

We would expect these and other issues will be addressed in public comments, which must be filed by October 1.

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