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MEP Update: The IRS Proposes Exception to Its "One Bad Apple" Rule

On July 3, 2019, the IRS proposed a regulation under which it would not apply its "one bad apple" rule—that a qualification failure of one employer in a multiple employer plan disqualifies the entire plan—if certain conditions are met. In this article we begin with a review of the current status of this issue and then briefly discuss the IRS's proposal.

Background

A multiple employer plan (MEP) is, generally, a plan for employees of two or more separate, unrelated employers (other than a plan maintained pursuant to a collective bargaining agreement, which is called a "multiemployer plan"). "Open MEPs" (in effect, provider-sponsored MEPs that may generally be adopted by any employer) are viewed by many as a way to make the qualified plan system generally and DC plans in particular "more accessible"—that is, cheaper and easier to administer—to smaller employers.

There are (at least) two major regulatory obstacles to using MEPs this way. First, current Department of Labor rules provide that MEPs may generally only be established where there is a "nexus" between employers (e.g., all the employers in the MEP are in the same industry).

Second, current Internal Revenue Code regulations apply a "one bad apple" rule (aka a "unified plan" rule) to MEPs: generally, a qualification violation that applies to only one employer may disqualify the entire plan. An example of this sort of qualification violation in a 401(k) MEP would be an individual employer's failure to pass the ADP (actual deferral percentage) test for a given year. Under IRS rules, in an MEP, the ADP test is applied separately to each employer, on an employer-by-employer basis. But if one employer failed the ADP test (with respect to its employee-participant population), under the one bad apple rule, the entire MEP would be subject to disqualification.

Disqualification is generally regarded as a catastrophic event—possibly resulting in the employer and all participants losing all the tax benefits provided to tax-qualified retirement plans. The possibility, in an MEP, that the actions of a single employer could trigger disqualification for all employers participating in the MEP is viewed by many as one of the principal reasons more employers do not adopt MEPs.

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On August 31, 2018, President Trump signed an Executive Order on Strengthening Retirement Security in America that, among other things, instructed the Secretary of Labor to "examine policies" that would eliminate ERISA regulatory obstacles to the creation of Open MEPs and instructed the Secretary of the Treasury to "consider proposing amendments to regulations" that would address the "one bad apple" issue.

On October 22, 2018, the Department of Labor released a proposed regulation that clarifies and (to some extent) relaxes its nexus rule. On July 3, 2019, the IRS proposed regulations under which it would not apply the "one bad apple" rule if certain requirements are met.

Summary of The IRS's Proposal

IRS's proposal would generally provide an exception to the "one bad apple" rule for "known" qualification failures and "potential" qualification failures in DC MEPs, where certain conditions are met.

A known qualification failure is defined as a failure to satisfy a qualification requirement identified by the MEP administrator that is attributable solely to an unresponsive participating employer. One obvious example would be the one noted above—the failure of a participating employer to pass the ADP test with respect to its own employee population.

A potential qualification failure is a qualification failure the MEP administrator believes might exist, with respect to which the participating employer has failed to provide necessary data, documents, or other information; e.g., where the participating employer has not provided data demonstrating passage of the ADP test.

Conditions that Must be Met

To qualify for the exception, five conditions must be met:

- The MEP must meet certain eligibility requirements (e.g., maintain practices and procedures promoting compliance and adopt certain plan language).
- The MEP administrator must comply with detailed notice provisions and provide the "failing" employer an opportunity to remedy the failure.
- At the time of the first required notice, the MEP may not be under examination.
- Where the "failing" employer does not remedy the failure, the MEP administrator must implement a spin-off of the failing employer's share of the plan. This spin-off may be initiated by the failing employer; where it is not, the MEP administrator must both spin off and terminate the plan.
- The MEP administrator must comply with information requests from the IRS and the representative of the spun-off plan.

Rank and File Employees Not Subject to Tax Penalties

Generally, the plan qualification failure that triggers any spin-off would continue to apply to the spun-off plan.

Where a qualification failure is not corrected, generally the assets of the MEP attributable to employee-participants of the failing employer will be distributed to them. An interesting innovation in the IRS's proposal is a change to current rules: the amounts so distributed "would not, solely because of the participating employer failure, fail to be eligible for favorable tax treatment accorded to distributions from qualified plans." The IRS, however, reserves the right to not apply this special treatment to a person (e.g., an owner-participant) that is responsible for the plan failure.

Both the House of Representative's SECURE Act and the Senate's RESA proposals include provisions broadly exempting defined contribution plan MEPs (including Open MEPs) from the "one bad apple" rule. These proposals are less detailed, less complicated, and in some respects less flexible than the IRS's proposed regulation.

We expect that there will be a significant number of comments on the IRS's proposal.

How this process will turn out—whether SECURE or RESA will pass before the IRS's proposal is finalized, or the IRS's proposal will be finalized first—is still very much up in the air.

We will continue to follow this issue.

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