

Merger and Acquisitions: Coming Together for Retirement



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Many Types of Transactions

- Type of buyer
 - Individual
 - Partnership
 - Includes entities taxed as partnership
 - Corporation
 - S Corporation
 - C Corporation
- Type of seller
- What is acquired
 - Asset purchase
 - Stock purchase
 - Target survives
 - Target is merged into buyer
- Who's the employer rules
 - Controlled group/ASG status before and after

Many Issues Involved

- What to do with seller's plan
- Predecessor employer status
- Distributable event
- HCE determination
- Top-heavy status
- Service crediting
 - Eligibility
 - Vesting
- Partial termination
- 415



Sample Transaction: Individual Buys Stock From Another Individual

- Steve owns 100% of Steve, Inc.
- Sells stock to Betty
 - Renames corporation as Betty, Inc.
- Neither Steve nor Betty owns another business
- Employees haven't changed employment
 - No distributable event
 - Service carries over

Sample Transaction

Tweak 1: Steve Owns Another Business

- Steve also owns SSS, Inc.
 - Steve, Inc. and SSS, Inc. are in controlled group
 - SSS sponsors plan in which Steve, Inc. EEs participate
 - But not after Betty buys Steve, Inc.
 - No transfer from SSS plan to Betty's plan
- Treated as severance from employment
 - Distributable event

Sample Transaction

Tweak 2: Business Is Unincorporated

- Asset purchase
- Employees were working for Steve; now working for Betty
 - Severance of employment
 - Totally new employer
 - But depending on circumstances she may (or must) credit predecessor service

Sample Transaction

Tweak 3: Buyer Is a Corporation

- BigCo buys 100% of Steve, Inc. from Steve
 - No severance from employment
 - No distributable event
 - BigCo and Steve, Inc. are controlled group
- BigCo merges Steve, Inc. into BigCo
 - No severance from employment

IRS Guidance on Mergers and Acquisitions Is Sparse

- §1.401(k)-5 special rules for mergers, acquisitions, and similar events
 - [*Reserved*]
- 401(k) prior year plan coverage change rules
- 401(k) distribution rules
- 410(b)(6)(C) coverage transition rule
- Controlled group rules
- Predecessor employer rules

Predecessor Employer Rules

Predecessor Employer Guidance Spread Throughout Code

414(a)	Mandatory service crediting
401(a)(4)	Nondiscriminatory service crediting
415 final regulations	Limits, compensation

414(a)(1) Mandatory Crediting

- “In any case in which the employer maintains a plan of a predecessor employer, service for such predecessor shall be treated as service for the employer”
 - Plan merger
 - Transfer of assets
 - Buyer adopts seller’s plan

414(a)(2) Regulatory Crediting

- “In any case in which the employer maintains a plan which is not the plan maintained by a predecessor employer, service for such predecessor shall, to the extent provided in regulations prescribed by the Secretary, be treated as service for the employer”
 - No regulations before 415
 - So no requirement outside of 415

Treas. Reg. §1.401(a)(4)-11(d)(3)(iii)

Nondiscriminatory Service Crediting

- If prior service credits available to any HCE, they must be available to similarly situated NHCEs
- There must be a legitimate business reason for recognizing prior service
 - Such as merger or acquisition
- Provision can't discriminate in operation or design

415 Regulations:

Definition of Predecessor Employer

- Two ways to be a predecessor employer:
 - Plan sponsor maintains plan of predecessor
 - Like 414(a)
 - “Employer constitutes a continuation of all or a portion of the trade or business” of former entity
 - Facts and circumstances
 - Example: “Formation of the employer constitutes a mere formal or technical change in the employment relationship and continuity otherwise exists in the substance and administration of the business operations of the former entity and the employer”

Lear Eye Clinic: Example of Continuation of Business

- Dr. Pallin starts sole proprietorship in 1975
- In 1979, he incorporates the clinic
 - Pallin 51%
 - Wallman 49% (previously employee of sole prop)
- Clinic adopts DB plan
- Dr. Pallin wanted to count sole prop service in computing maximum 415 DB benefit

Lear Eye Clinic: Example of Continuation of Business

(continued)

- The Tax Court agreed:
 - The corporation was merely a formal change, but the substance of the business operations did not change
 - Did not discuss controlled groups, ASGs, etc.

Effect of 415 Regulations on Predecessor Employer

- Must aggregate benefits from plan of predecessor employer
- Credit service from predecessor employer to apply 415(b) limits
- Does not require counting service for other purposes

Predecessor Employer and Acquisitions

- If the money follows the participants (414(a)(1)), then the buyer must count service with the seller for all purposes
 - If you don't like that result, don't:
 - Take a plan to plan transfer (spin-off)
 - Do a plan merger
 - Take over the seller's plan
 - You can allow participants to roll over
- If buyer and seller are in a controlled group, you will count the prior service
- Otherwise, buyer can count service with seller on nondiscriminatory basis

Related Employers and Acquisitions

Ways to Have Related Employers

- Controlled group
 - Parent-subsubsidiary
 - Brother-sister
 - Combined
- Common control
 - Special tax-exempt rules
- Traditional affiliated service groups
 - A-Org
 - B-Org
- Management function groups

Consequences of Related Employer Status

- All employees of all related employers are deemed to be employed by a single employer for most retirement plan purposes
 - Exclusive benefit rule
 - Crediting service for eligibility, vesting, and benefit accrual
 - Coverage
 - Nondiscrimination
 - 415 limits
 - Top-heavy

Typical Related Employer Question

- Scenario:
 - A and B are in a controlled group
 - A sponsors a plan
 - Does the plan need to cover the employees of B?
- The related employer rules don't answer that question
 - Instead, they tell you all employees of A and B are deemed to have a single employer
- So what's the answer?
 - SEPs, SIMPLEs, standardized plans: cover them
 - Other plans: you don't have to cover B if you can pass coverage and nondiscrimination (and minimum participation for defined benefit)

How Do I Count Hours and Compensation of Employees Who Work at Both Companies?

- Pretend it's a single company with two divisions
- You must count hours from both companies
 - Including service before the acquisition
- 415 compensation includes compensation from both companies
 - You can consider only compensation of sponsor in making allocations, but that may be discriminatory

Controlled Group Service Examples

1. BigCo buys 100% of SmallCo stock
 - BigCo and SmallCo are controlled group
 - Jane has five YOS with SmallCo
 - BigCo must count Jane's five YOS
2. Same facts except BigCo buys SmallCo assets
 - Jane becomes BigCo employee
 - Jane starts over on service
 - Unless BigCo counts predecessor service

Compensation Example

- Parent owns 100% of Sub
- Sub has a plan covering its employees
- Ed works for both Parent and Sub
 - \$60,000 comp from each
- Ed's comp is \$120,000 for HCE, 415, TH
- Ed's allocation is based on \$120,000 unless plan limits comp to comp from Sub

Coverage Testing

410(b)(6)(c) Coverage Transition Rule to the Rescue

- Sometimes called “free pass”
- Applies to ownership transactions:
 - Formation of controlled group/ASG, etc.
 - Change in controlled group/ASG, etc.
 - Asset or stock acquisition
 - Merger
- Plan must be in existence prior to transaction
 - Must satisfy 410(b) and 401(a)(26) immediately prior to transaction

Result of Free Pass

- If free pass applies, then plan passes 410(b) and 401(a)(26) throughout coverage transition period
 - Transition period:
 - Begins on date of transaction
 - Ends at earlier of:
 - End of following plan year
 - Change in coverage or benefits

Other Plans

- SIMPLE IRA and 401(k)
 - Free pass lasts one year longer
- SEPs
 - No free pass!!!
- 403(b)
 - Should be able to use free pass for 410(b) testing
 - Doesn't need free pass for deferrals

What Happens After the Free Pass?

- Plan must count all employees of all group members in testing coverage

EE count	Buyer	Seller	Total	Coverage	Buyer	Seller
NHCE	500	5	505	NHCE	99.01%	0.99%
HCE	20	5	25	HCE	80.00%	20.00%
				Ratio %	123.76%	4.95%

- Seller's DB plan must cover at least 50 employees to pass 401(a)(26)

Ways of Dealing With Coverage Failure

- Terminate seller's plan
 - Merge into buyer's plan
 - Terminate and transfer
 - Terminate and rollover
 - Not for 401(k) unless done before transaction
- Bring more people into seller's plan
- Combine plans for coverage and nondiscrimination
 - Won't help 401(a)(26)

HCE Status

Types of HCEs

- More than 5% owners
 - Any day in current plan year, or
 - Any day in prior 12 months
- HCEs by virtue of compensation
 - Based on last year's compensation
 - Option to limit to top 20%
 - Based on entire group



Ownership

- Attribution rules of Code §318 apply
- A 5% owner of any group member is a 5% owner for the entire group
- Example:
 - Parent owns 90% of Sub
 - Oscar (Sub's president) owns 10% of Sub
 - Oscar is an HCE
 - For a plan Sub sponsors
 - Or a plan Parent sponsors

HCE by Compensation

- HCE by compensation made more than the threshold in the prior 12 months
- Example:
 - Natasha started work 1/2/2013
 - Natasha makes \$117,000/year
 - Not HCE for 2013; \$0 comp in 2012
 - Is HCE for 2014 and 2015 but not thereafter

Year	Threshold
2001	\$85,000
2002-4	\$90,000
2005	\$95,000
2006-7	\$100,000
2008	\$105,000
2009-11	\$110,000
2012-14	\$115,000
2015-16	\$120,000

Compensation Definition



- Always total compensation
 - Includes elective deferrals
 - Regardless of
 - Plan participation
 - Plan definition for allocation purposes
- Includes all group members
- I think it includes 414(a) predecessor service

HCEs in Mergers

- BigCo buys 100% of SmallCo stock 1/1/2017
 - Peter's 2016 SmallCo salary was \$125,000
 - Peter is HCE of BigCo/SmallCo for 2017
 - Top 20% rule could modify
- BigCo buys SmallCo assets 1/1/2017
 - Peter becomes BigCo employee
 - Peter's 2016 SmallCo salary was \$125,000
 - Peter is not HCE of BigCo except through predecessor service

415 Issues

Midyear Transaction for 415 Defined Contribution

- Applies if:
 - Related employer formation midyear, or 415 predecessor plan exists
 - Both buyer and seller have plans covering same person
- Starting with final regulations, one plan with one limit on transaction date
 - If individual already over limit, freeze accruals for balance of year

DC 415 Example

- Buyer buys 50% of assets of Seller 10/1/2016
 - Many Seller employees become Buyer employees
 - Seller transfers their plan accounts to Buyer's plan
 - With regard to those employees, Seller is predecessor employer to Buyer
 - Buyer must count contributions to Seller's plan
 - Edna worked at Buyer and Seller before deal
 - Edna has \$53,000 total 415 limit for 2016 between Buyer and Seller plans
 - If she's already over, freeze Edna's benefits for rest of 2016

Midyear Merger for 415 Defined Benefit

- No problem for year of transaction
 - So long as no amendment increasing benefits
- Thereafter, must pass 415 on combined basis
 - If already over, then freeze accruals

Distribution Issues; Other 401(k) Issues

Is There a Severance From Employment?

- Generally, if you haven't changed employer, then you haven't severed
 - Example: Buyer buys 100% of Seller's stock
 - Employees haven't severed employment
- Generally, if you have changed employer, then you have severed
 - Example: Buyer buys 100% of Seller's assets
 - Seller's employees become buyer's employees
 - They have severed employment

Follow the Money

- Exceptions:
 1. If the money follows the participants (414(a)), they haven't severed
 - So if Buyer wants to prevent distributable event, take a transfer
 2. Parent sponsors plan in which Sub EEs participate
 - Parent sells Sub to Buyer
 - Money does not follow EEs
 - Severance from employment

Plan Termination as 401(k) Distributable Event

- No distributable event if employer maintains alternative DC plan
 - Employer determined on date of termination
 - So if you want to terminate as distributable event, do so before transaction
 - Alternative DC plan doesn't include ESOP, SEP, SIMPLE IRA, 403(b), 457(b)
- Lump sum distributions required

401(k) Testing Method Issues

- Free switch from current year testing to prior year testing to conform to group testing
 - Must be during coverage transition period
- Acquisition may alter prior year testing
 - Need to use weighted average of plans
 - Detailed rules at Treas. Reg. §1.401(k)-2(c)(4)

Vesting Issues

Transaction Can Affect Vesting

- Merger/Spin-off: No vesting change
 - Employees continue to vest after transaction
- Termination: Full vesting for all
- Partial termination: Full vesting for affected participants

Consequences of Partial Termination From Turnover

- “If a partial termination occurs on account of turnover during an applicable period, all participating employees who had a severance from employment during the period must be fully vested in their accrued benefits, to the extent funded on that date, or in the amounts credited to their accounts”
 - All terminated employees?

Transferred Assets

Special Rules Apply to Transferred Assets

- Plan assets acquired:
 - In merger, acquisition, or similar transaction
 - In 414(l) transfer from employer that wasn't previously in controlled group

Transferred Assets Rules

- Self-correction of significant failures available for at least one year after transfer
 - Can establish practices and procedures during year
 - Gives time to find the problems
 - Also applies to plan assumed in acquisition
 - Normal 2-year self-correction period also available
- May be able to limit:
 - VCP compliance fee
 - Audit CAP sanction

Requirements for DC Transfer/Spin-off

- Suppose Plan A is spinning off assets into Plan B
 - Total assets in A + Total assets in B before transaction = Total assets in A + Total assets in B after transaction
 - Assets in A after transaction = Account balances in A after transaction
 - Assets in B after transaction = Account balances in B after transaction
 - No participant's total account balance (A + B) is reduced as a result of the transaction
 - 411(d)(6) protected benefits and distribution options are still protected in B
 - B enforces distribution restrictions from A

Do You Really Want That Used Car? You Don't Know Where It's Been

- Many buyers leery of accepting transfer of assets
 - Potentially could taint entire plan
- Alternative: Distribute and roll from old plan
 - Then if old plan bad, simply return rollovers
 - Of course, that means full vesting if complete or partial termination

Questions?

