

## Everything Old is New Again: Changing Employee Status Issues in an Acquisition

It is somewhat axiomatic that – for retirement plan purposes – an individual who changes employers in an asset acquisition is a “new” employee after the transaction is complete, whereas one who continues to work for the target company after a stock acquisition has no change in his or her employment status. However, a closer examination of the employment-related issues in company transactions reflects that it might not be so simple. In particular, the controlled group rules, as well as service crediting principles, may make a “new” employee not so new and an “old” employee not so old.

### Asset Acquisitions

#### *The General Rule Survives.*

In an asset acquisition, the seller retains control over the corporation, and the buyer simply buys the “stuff” that the corporation used to own. Therefore, employees who go to work for the buyer are considered to be new hires for most employment and benefit purposes. If the buyer sponsors a qualified plan, it is free to require the newly acquired employees to complete the plan’s service requirements before entering, and for the acquired employees’ vesting to begin anew in the buyer’s plan. In fact, these rules must apply if the buyer’s plan is to operate according to its terms. If the buyer wants to be more generous to these acquired individuals, it must amend its plan to either reduce the service requirement for eligibility or vesting or to credit prior service with the selling entity for either or both of these purposes.

If the buyer is in the process of acquiring several companies and wants to grant past service to all the employees of all acquired entities, it can amend its plan to automatically credit past service with acquired companies. This may be done across the board, granting past service to all acquisitions, or can be limited so that past service is granted only if the acquisition is of a given size or composition. It is important to remember that what is once given cannot be taken away. If the employer with an “automatic grant” of past service is buying a company for which it does not intend to provide this service credit, the plan must be amended before the acquisition is finalized to curtail the broad grant of past service credit.

Naturally, if the buyer is related to the seller, so that they were both members of the same controlled or affiliated service group even before the acquisition, the “new” employee is not new at all, but continues to be a member of the big, more global “employer” under Code section 414(b), (c), or (m). In that case, although the acquired individuals may have converted from an ineligible class of employee to a newly eligible class, the plan may not exclude their past service for eligibility or vesting purposes.

#### *Who is a Highly Compensated Employee?*

Individuals are highly compensated employees (HCEs) if they either own a sufficient portion of the employer (i.e., more than 5% of the stock) or earn compensation in excess of a certain amount (\$85,000 in 2001). However, keep in mind that the HCE compensation determination contains a 1-year lookback rule: one must have earned in excess of \$85,000 in the prior year in order to be highly compensated. (Whereas the compensation determination is based only on the lookback year, whether someone is a 5 percent owner is determined for both the lookback year and the current year. As a result,

someone who acquires a more than 5 percent ownership interest in the company during the current year will be a highly compensated employee for that year.)

Because the acquired employees in an asset acquisition accumulated no compensation with (and provided no services for) the buyer during the year before the acquisition, they cannot be highly compensated in the year of the transaction (unless they are owners). As a result, the newly acquired non-owner executives will be nonHCEs in the year of acquisition, regardless of their rate of income during that entire year.

If the acquisition takes place close to the plan's year end, it is possible that the nonHCE status of the executives could continue through the following plan year. For example, suppose that Bigco purchases Target's assets in late November of 2001, and Bigco and the plan it sponsors both operate on a calendar year. In that case, unless compensation for the former Target executives exceeds \$85,000 for the time in 2001 that they spend as Bigco employees, the lookback rule will prevent executives from being considered to be HCEs in the Bigco plan in the 2002 year (regardless of their rate of pay in 2002).

This situation can provide significant opportunities for the plan to operate as a special compensation tool in both the acquisition year and the following year. Suppose that Target sponsored a qualified money purchase pension plan that guaranteed participants a 10% of pay contribution annually. Bigco, on the other hand, sponsors a 401(k) profit sharing plan that provides a matching contribution. These matching contributions are not as generous as the Target money purchase plan was, distressing the former Target employees. In order to help the Target's former employees' transition to the new company, Bigco agrees to give them a one-time contribution equal to 10% of

their compensation in 2002. Because none of the acquired Target employees is highly compensated in 2002, this special one-time contribution is not discriminatory, even though it is not provided to any of the Bigco employees. (Note, however, that Bigco will likely have to amend its plan to provide this special contribution.)

*What if the Buyer Acquires the Seller's Plan?*

The ease with which the above analysis was performed turns murky if any action is taken by the buyer to adopt the seller's plan. Let's look at an example.

Say that Smallco sponsors a 401(k) plan for its 10 employees. Bigco buys Smallco's assets, and the Smallco employees become Bigco workers. Bigco has been thinking of adopting a 401(k) plan and this purchase transaction causes it to examine the Smallco plan in some detail. It looks like a nice, solid plan with good provisions, so Bigco negotiates with Smallco to adopt the Smallco plan as a successor employer at the same time as the asset sale is finalized.

Let's look first at the service issues. In this case, the Smallco plan previously included service with Smallco. What service must the plan now include for Bigco employees? Because Bigco is an adopting employer, it is not possible for any of the Bigco employees' service to be excluded for eligibility purposes. As a result, the Bigco employees will enter the plan on the first entry date following their completion of the plan's eligibility requirements, using all of the Bigco employees' service. If Bigco wants, it may amend the plan to provide for an entry date on the effective date of the acquisition, so that its employees who have already met the eligibility requirements can enter right away.

What about vesting? If this is Bigco's first foray into the qualified plan realm, it would appear that it could exclude service performed by the Bigco employees prior to Bigco's adoption of the plan. [IRC §411(a)(4)(C)] Alternatively, the plan may include all Bigco service for all years. Again, even though this is an asset acquisition, all service with Smallco must be counted, because the plan always included service with Smallco.

Who are the HCEs under the plan? The Code, regulations, and Treasury releases provide us with no guidance. If Bigco was adopting a brand new plan that had never been operated previously, it is clear that the lookback year for compensation would prevent the former Smallco executives from being highly compensated employees in the Bigco plan. However, this plan has historically included service with Smallco, and the compensation earned by the employees with Smallco is included for plan allocation purposes. As a result, an argument can be made that all compensation earned in the current and prior years for either Smallco or Bigco would be used to determine who is highly compensated. (Note that, if this approach is used and the plan has adopted the "20% rule" -- under which only the top 20 percent of the employees are considered to be highly compensated on the basis of pay -- some Smallco employees that were HCEs prior to the acquisition may be converted to nonHCEs after the transaction.

On the other hand, the argument may be made that the determination of who is highly compensated is performed by looking at the employees of the employer and not to the terms of the Plan. If a company has multiple plans with different year ends, it still has one determination of who is highly compensated. That determination looks at the compensation and ownership history of the employer, which is Bigco, not Smallco. If that is the case, it makes sense that the determination of who is highly compensated does

not change just because the buyer adopted the plan of the seller. Under this analysis only compensation and ownership with Bigco is relevant in determining who is highly compensated once Bigco adopts the plan as its successor employer. This could convert all the Smallco HCEs to nonHCEs upon the acquisition – a very odd result, particularly if they become HCEs in the following year when their Bigco compensation in the lookback year is back above \$85,000.

### Stock Acquisitions

Believe it or not, the guidance on service and HCE issues is even vaguer in a stock acquisition. While most buyers think of the newly acquired employees as new hires, it is possible that retirement plan rules treat them like long lost family.

#### *Service crediting rules*

Let's first examine what service needs to be credited when the newly acquired employees are to be part of the eligible pool for the buyer's existing plan. Again, buyers generally anticipate that the acquired employees' date of hire for purposes of participation in its plan will be the date of acquisition. However, the law is not clear about whether or not this is supportable, particularly in the eligibility arena. The affected employees have not changed employers as part of the acquisition (i.e., they still work for the corporation whose stock was purchased by the buyer), but the company for which they work is now part of a greater "employer" because of the controlled group rules.

At first blush, it would appear that the buyer's plan could exclude service worked while the acquired company was not part of its controlled group. After all, that was service for a different "employer" – i.e., while the acquired company was a stand-alone company or while it was part of a different controlled group. If so, this produces an

anomalous result. Consider this: if the subsidiary adopted its own plan (separate and apart from the parent company), it would not be permitted to exclude service prior to the acquisition date, but would need to include all service for eligibility purposes. May the subsidiary avoid the service crediting rules by simply adopting its parent's plan? Is there a different result if the subsidiary does not affirmatively adopt the parent's plan, but if the plan automatically covers all employees of all members of the controlled group?

Determining applicable service for vesting purposes is similarly problematic, although a newly adopted plan of the subsidiary is permitted to exclude pre-adoption service for vesting (assuming that the subsidiary never sponsored a prior plan). Therefore, the exclusion of pre-acquisition service for vesting purposes does not create quite the same intellectual conundrum, as does eligibility service. Nonetheless, if the subsidiary previously sponsored its own retirement plan, or if it participated in a plan of its pre-acquisition parent, the exclusion of the old service again makes one squeamish.

What happens in real life? A large number of buyers exclude pre-acquisition service for all purposes, or grant only partial service for the pre-acquisition period. And, there is nothing in black and white that says this may not be done, only the above interpolation of the service crediting rules. This is an area in which the IRS has not spoken clearly, and it needs to do so.

As with the asset acquisition, if the buyer adopts the new subsidiary's existing plan, the exclusion of pre-acquisition service for the subsidiary is out of the question. Similarly, since the new parent is affirmatively adopting a plan, it would be required to comply with the same service crediting rules that would apply if it adopted a brand new plan. However, if the subsidiary's plan automatically covers the parent's employees

through a broad “all service with all members of the controlled group” provision, the ability to exclude pre-acquisition service for plan purposes seems more difficult to support.

#### *HCE Determination*

The underlying issue when one is trying to decipher who is an HCE in an acquisition situation is the same as it was for service crediting rules: the employees have not changed employers, so they have a compensation history that was absent in the asset acquisition scenario. On the other hand, that compensation history was earned while the employing company was not a member of the current controlled group. So, was that compensation earned while the company was another “employer” for plan purposes?

The analysis is essentially the same as what was discussed above for an asset acquisition. It is unclear whether the service performed and compensation earned by the Target employees prior to the time that their employer was made part of the controlled group with the Buyer counts for HCE purposes. Some practitioners are of the opinion that, once the Target becomes part of the controlled group, its compensation and service history are credited for purposes of the controlled group. Others believe that service prior to the acquisition was for a different “employer,” and should be disregarded. Again, the guidance from the government is silent on this point.

The more conservative outlook is likely to be one that includes the service and compensation earned prior to the acquisition.

#### What Does the Plan Say ... And What Should it Say?

All of the previous discussion assumes that there is nothing in the plan document that makes this murky issue more clear. However, the plan language must control unless

it acts to limit service crediting in a manner that violates the Code and ERISA. As a result, explicit plan language that grants service credit in excess of that which is required by law (whatever that is!) must be followed religiously.

Should a plan be drafted to be explicit in this manner? There are two advantages to having plan language that is clear about what service is to be granted or excluded from consideration under the plan. First, it permits the Plan Administrator to operate the plan without ambiguity, and prevents lawsuits if parties dispute what the plan language means. Second, if the plan sponsor obtains a favorable determination letter on a plan that includes specific language, the IRS is estopped from later claiming that the service crediting rules violated the Code's requirements, particularly if the application for the determination letter specifically identified the service crediting issue as a matter for review.

On the other hand (there's always another hand, isn't there!), explicit language precludes the Plan Administrator from taking a more restrictive position on service crediting issues if the IRS should come out with guidance permitting it to do so. If the explicit language is more permissive than it is required to be, the employer is stuck with those rules.

#### If I Were the King of the World . . .

What should be the rule? Well, (with apologies to Three Dog Night) if I were the king of the world (or at least the author of IRS regulations), I'll tell you what I'd do: I would recognize that when one company acquires another – by either asset or stock purchase – the people who work for the acquired company are new employees to the buyer. As a result, if the buyer's plan is to cover the acquired employees, it could

exclude service prior to the acquisition date for both eligibility and vesting purposes. Similarly, I would eliminate compensation earned by employees of the acquired entity from the lookback rule for HCE purposes. On the other hand, if the buyer should adopt the plan that was previously sponsored by the acquired company, all service with the acquired company should continue to be fully credited for all purposes.

Why would I take this position? First, if full service is credited with the acquired entity, it makes the buyer responsible for having good records for all prior employment years with the targeted company. That is not realistic. The buyer should be held responsible for employment records only during its own tenure as employer of these individuals. Second, this position reflects what I believe is the most common expectation of the buyer when it acquires a company. While there is relatively little cost in granting past service and vesting credit for a defined contribution plan, the cost of doing so for defined benefit purposes can be extraordinary. The employer should not be forced to bear that burden. Third, while I realize that employee rights are at stake, it's just an easier result to administer. At a time when the administration of retirement plans is getting more and more complex, it's time to just start picking our employee rights fights better. When your employer is acquired by another company, you work for someone new. Let's acknowledge the truth of that, and operate in that manner.

This solution still permits an employer to be more generous to the employees if it wants to do so. It may amend the plan to grant service with the acquired entity, either in full or in part, and may be forced to do so in its negotiations for the acquisition of the company or to retain the target's executives and employees. Furthermore, to the extent that the acquired employees were vested in the seller's plan, that vesting is not being

taken away (in fact, a partial plan termination caused by the loss of the seller's employees may fully vest individuals who were not vested prior to the acquisition).

EGTRRA Addendum: Say Goodbye to the Same Desk Rule

EGTRRA Section 646 finally eliminated the "same desk rule" from 401(k) plan distributions. This section, which modified the phrase, "separation from service" to "severance from employment" now permits employees who leave a company in connection with an asset sale to receive a distribution of their salary deferral accounts from the seller's plan.

There is one glitch in the legislative changes, however. While Congress was eliminating the same desk rule from the 401(k) lexicon, it got carried away with its eraser. It also eliminated Code section 401(k)(10)(A)(iii) – the Disposition of Subsidiary rule. Under that rule, if employees of a subsidiary participated in the parent's 401(k) plan and the stock of the subsidiary was sold to an unrelated buyer, the 401(k) accounts of the employees could be paid to them. This is important because the employees, who continue to work for the subsidiary both before and after the transaction, experience no separation of service or severance from employment at all. As a result, the new rules eliminate the ability of these individuals to be paid their interest from the parent's plan.

There is a General Counsel Memorandum on point, GCM 39824, that addresses this issue. Under the GCM, if the following three requirements are met, distributions are permitted to the subsidiary employees:

1. The plan "continues to be maintained" by the Seller/Parent and is "no longer" maintained by the original subsidiary in the hands of the new parent;

2. There is no transfer of assets and liabilities from the Parent's plan to a plan sponsored by the subsidiary; and
3. The subsidiary is no longer part of the controlled or affiliated service group with the Parent.

The second two requirements are easy to meet. It's the first requirement that gives one pause. If the sale occurs when the subsidiary is still a participating employer in the Parent's plan, the first requirement will fail. As a result, a literal reading of the GCM would require that the subsidiary resolve to terminate its participation in the parent's plan before the acquisition is final, so that it departs the controlled group as a nonparticipating employer in the Plan. In that way, the first requirement will be met, and the employees can be paid out.

It is likely that Congress did not intend to create one more situation in which an unwary company can deny its participants distribution of 401(k) funds through a corporate transaction that did not properly address distribution issues. As a result, we remain hopeful that a technical corrections bill will bring back the Disposition of Subsidiary Rule. In the meantime, beware of the remaining 'same desk' problem in subsidiary sales.

In addition, it is likely that the transfer of assets and liabilities referred to in the second requirement does not include the direct rollover of distributions at the participants' election.