



MERGERS AND ACQUISITIONS

Revenue Ruling 2004-11: The IRS Starts

Climbing the M&A Mountain

It is encouraging to see the IRS and the Treasury attempting to tackle some of the complex issues raised by company acquisitions and dispositions. Practitioners have had to deal with these questions for years in an uncertain environment. Probably the most positive development is that the government is seeking practitioner input on these issues.

Nonetheless, we recognize that the Section 410(b) transition period rules are just the tip of the M&A iceberg.

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Practitioners whose clients are the instigators or subjects of company acquisitions and dispositions know well how much of the related benefits law remains unresolved. The list of M&A benefits issues continues to lengthen and neither legislation nor regulations have addressed the unanswered queries. EGTRRA brought some welcome relief to 401(k) plans when the same desk rule was repealed. However, this is a relative drop in the bucket of concerns.

The IRS has taken a step forward with the recent Revenue Ruling 2004-11 [2004-7 IRB 480], addressing concerns surrounding the M&A transaction rules of Code Section 410(b)(6). Under these rules, a company qualified plan gets a “bye” from testing compliance under the Code’s coverage rules during a transition period following a company transaction. This transition period runs from the date of an “acquisition, disposition or similar transaction” to the last day of the plan year following the year in which the transaction occurred.

The transition period does not apply or ends abruptly if the plan experiences a significant change in its terms or coverage during the period (except as a result of the transaction itself). Actually, the Code’s language terminates the transition period only if there is a significant change in coverage. The scope of the Code’s change prohibition was expanded in the regulations (perhaps beyond what is legally permitted), which terminates the period if there is a significant change in either coverage or “the plan.” The apparent philosophy behind this rule is that the government is

happy to give a plan sponsor time to evaluate the impact on a plan of a change in covered employees, but if the sponsor endeavors to modify the plan before the transition period is over, the sponsor should address the coverage issues at that time, as well.

The transition period rules have raised additional questions in the minds of many practitioners:

1. What constitutes a “significant change” in the plan that might lead to an early termination of the transition period?
2. Does the transition period also result in a “bye” for nondiscrimination testing in the affected plan?

Plan Changes and the Early Demise of the Transition Period

The Ruling addresses these two questions, at least in part. The short answers the Ruling gives to the questions appear to be “anything” and “no.” In particular, the Ruling states that any substantial modification of the plan’s terms in relation to the affected participants will terminate the transition period.

The Ruling provides an example, under which a parent sells a subsidiary and then immediately amends its defined benefit plan benefit formula. Under this example, the IRS ruled that the change in the benefit formula constituted a “significant change in the plan.” As a result, the transition period with regard to the defined benefit plan terminated when the amendment was adopted.

The Ruling did not provide criteria for assessing whether a plan change is “significant,” but simply states as a given in the example that the benefit formula change was, *per se*, significant. Nonetheless, the example does confirm that the significant change does not have to be related to coverage in order to affect the Section 410(b) transition period. Under the Ruling, *any* type of significant change can bring an early end to the transition period.

In this atmosphere of uncertainty as to what does and does not constitute a significant change, the conservative position would be to avoid amending the plan during the transition period at all, unless the plan as amended can meet the coverage rules as of the date of change—that is, to assume that any amendment will result in the termination of the transition period. While it is likely that practitioners will ask the IRS for some type of bright line test of “significance,” this is an area where facts and circumstances—and the attendant uncertainty—may continue to control.

It is important to note that the transition period is plan specific. This is clarified by the Ruling, which notes that if a sponsor has two plans and amends one, the transition period remains in place for the unamended plan, even though it is cut short for the amended plan.

The Effect (or Lack Thereof) of the Transition Period on Nondiscrimination Testing

The second issue addressed by the Ruling is the impact of the transition period on nondiscrimination testing. Because of the close relationship between the coverage rules of Code Section 410(b) and the nondiscrimination requirements of 401(a)(4) (and, by association, Sections 401(k)(3) and 401(m)(2)(A)), many practitioners believed that the Section 410(b)(6) transition period also provided post-transaction relief from nondiscrimination testing. The Ruling confirms what a close reading of the Code and regulations indicated by omission—that is, the transition period does not apply for nondiscrimination testing purposes.

Influx of New Employees Through an Acquisition

This result may not be problematic in a properly managed acquisition. For example, suppose Company P maintains a 401(k) plan. On June 1, 2004, P acquires all the stock of Company S. Prior to the acquisition, P amended its 401(k) plan to exclude employees of all employers (including affiliated employers) that have not affirmatively adopted the plan.

Because the amendment was adopted prior to the transaction, there is no effect on the transition period. Only amendments during the transition period are problematic, and the transition period begins with the transaction itself. When the 2004 administration is performed for P's plan, there is no required Section 410(b) coverage testing. However, nondiscrimination testing is required. The employee group used for the ADP testing includes only those employees of P who participate in the plan. The S employees are not part of the testing

group, because they are not in the plan. Therefore, the nondiscrimination testing is the same as it would have been had no acquisition occurred, and it is presumably passed if it was passed in prior years.

What happens in an acquisition, however, if the plan *includes* the Company S employees in the year of the transaction? This occurs in situations in which the buyer wants to integrate the acquired employees as soon as possible. There is still no coverage testing if the plan was not amended to include the S employees—that is, if the plan included them by its terms at the time the acquisition occurred. Amendments prior to the acquisition do not affect the transition period, even if they are inclusive of employees.

The infusion of the S nonhighly compensated employees (NHCEs) will also have no impact on the nondiscrimination testing if prior year testing is used. The influx of the Company S highly compensated employees (HCEs), however, and the NHCEs if current year testing is used, will affect the nondiscrimination testing in the year of the acquisition. If the S employees defer at a lower rate than the parent company employees, failed ADP/ACP testing can result.

Departure of Employees in a Disposition

Contrast the above results with what happens in a disposition situation. Suppose instead that Company P owns 100 percent of the stock of Company S and the Company S employees participate in P's 401(k) plan. P then sells the stock of S, on June 1, 2004, and the S employees cease to participate in the 401(k) plan. For 2004, the coverage testing is waived. The ADP testing reflects the participation of the S employees for the period during which they were in the plan before the sale. Because the S employees' compensation and deferrals ceased at the same time with their termination of employment in the controlled group, their deferral ratios should be substantially the same as they would have been had no disposition occurred. (This is likely true whether current year or prior year testing is used.) Therefore, the 2004 testing results are similar if not identical to what they would have been had no transaction occurred, and the testing is passed if it would have been passed in the absence of the transaction.

In 2005, however, the result is quite different (assuming that current year testing is performed). The S employees do not participate in that year at all. If the S employees deferred compensation into the plan at a higher rate than the P employees, the nondiscrimination testing is harder to pass than it was when they

were participants. Notwithstanding the fact that this impact on the testing is the result of the disposition, P receives no relief from the nondiscrimination testing during this second year of the transition period. P must make whatever deferral refunds or qualified non-elective contributions as are needed to meet the nondiscrimination testing requirements.

Pretransaction Coverage Failures

The transition period is provided only if the plan met coverage requirements prior to the transaction. One question that this raises is whether a correction to a failed test preserves the transition period.

Suppose, for example, that an initial coverage test is performed for the 2004 calendar plan year for Company P's profit sharing plan. The test is failed. On or before October 15, 2005, Company P amends its plan pursuant to Treasury Regulations Section 1.401(a)(4)-11(g)(3) to permit three additional employees to receive a contribution for 2004. This corrects the coverage failure on a timely basis. If an acquisition occurred during 2005, would this correction preserve the transition period?

While this is not addressed in the law, the regulations, or the new Revenue Ruling, one would believe that a timely correction of a failed test would be considered to as meeting the coverage rules. It is less clear, however, when a failed test is corrected after the 9-1/2 month period permitted by Treasury Regulations Section 1.401(a)(4)-11(g)(3) through use of the Employee Plans Compliance Resolution System (EPCRS) under Revenue Procedure 2003-44. In that circumstance, does the correction of the failed testing re-establish the transition period? No one knows.

The Government Seeks Practitioner Input

Probably the most encouraging portion of the Ruling gives no current guidance at all. At the end of the Ruling, the government notes that it is giving due consideration to the plan issues that arise as a result of company transactions. The IRS and Treasury then request that the public submit comments on where guidance is needed and a suggested resolution of the raised issues. The Ruling specifically notes the following areas that are ripe for comment:

1. The requirement that plans meet Section 410(b) coverage immediately before the company transaction;
2. The requirement that coverage under the plan not be significantly changed during the transition period; and
3. Whether there are appropriate cases where a plan

that is required to calculate the employee allocation or accrual rates or benefit percentages for Section 401(a)(4) or Section 410(b) purposes should be treated as satisfying both those sections during the transition period.

The Ruling specifically notes that the suggestions under this section should not create a potential for abuse. The Ruling also raises several scenarios for practitioners to consider.

Scenario 1

Facts: P sponsors Plan A, which covers the employees of P and its wholly owned subsidiary S. P sells the stock of S to unrelated Buyer Y. After the sale, Plan A is split into two parts: Plan A-1, which continues to cover the P employees, and Plan A-2, which is spun off to S and maintained by S to cover the employees after the sale to Y.

The Ruling questions: If Plan A-1 would have failed coverage testing under Section 410(b) had it existed before the sale of S (unless it was aggregated with Plan A-2), how should it be treated for transition period purposes?

Although the Ruling does not outline the issues this scenario raises, one must consider the following:

1. Is Plan A-1 considered to have met coverage testing before the transaction so that the transition period rules apply? Is Plan A-2?
2. Is the spinoff of Plan A-2 considered to be a change in coverage, when the S employees would have ceased being participants in Plan A-1 anyway (*i.e.*, the S employees no longer work for Plan A-1's sponsor after the transaction)?
3. As noted above, should the rules be changed so that Plan A-1 is treated as passing nondiscrimination testing during the transition period? Would that rule encourage the HCEs in the plan, knowing that the nondiscrimination testing will not be performed in the transition period, to defer significantly more than they did during tested years and to receive proportionately larger matches? Does that constitute an abuse?

The Ruling also asks if the practitioner's conclusions would change if there is no spin-off. In that case, it would seem obvious that Plan A would get the benefit of the transition period; it clearly met the Section 410(b) requirements before the transaction and experienced no change in the plan other than the transaction itself.

Is it appropriate that the application of the transition period is dependent on whether the S employers are denied the continuity of benefits that a spin-off provides? Is it good public policy for the rules to discourage spin-offs in this manner?

Scenario 2

Facts: Corporation P sells the assets and liabilities of S division to unrelated Buyer Y. P sponsors a defined benefit plan, Plan A. Y maintains Plan B, which is a defined benefit plan with a unit credit formula based on service. Y assumes Plan A from Corporation P (that is, adopts the Plan as the successor sponsor), and Plan A covers only the employees acquired from P (and not the other employees of Y, who are covered by Plan B). The S employees are excluded from Plan B. (No amendment—other than the assumption of Plan A by Y—is needed, because the two plans' terms provide for this coverage prior to the transaction.)

It is noteworthy that the Ruling does not discuss what happens to the employees of Corporation P who participate in Plan A before it is assumed by Buyer Y. It is possible that the portion of Plan A that covers the sold division is spun-off into its own plan, which is adopted by Y. It is further possible that Buyer Y adopts the entire plan, and then treats the employees it did not acquire as terminated for plan purposes. For purposes of the analysis below, we are assuming that there are no participants in the plan that were not acquired by Y.

Again, the Ruling asks no specific questions, but the following come to mind:

1. Is the adoption of Plan A by Y a change in coverage that terminates the transition period? While the covered participant group does not change, the employees' status is vastly different, as they are now employed by an entirely different company. For that matter, would a GUST or EGTRRA amendment—which clearly substantially change a plan—terminate the transition period?
2. At such time that the transition period ends, if the S employees are then covered by Plan B, what service must be included for eligibility, vesting, and benefit accrual? Is the answer different if Plan A is not assumed by Y?

The Ruling specifically asks whether the answer is different if the exclusion of the S employees from Plan B is a result of an amendment adopted “at the time of the sale of S to Y.” This is very perplexing. Under current rules, an amendment to coverage (which this

amendment to Plan B surely is) would terminate the transition period if adopted after the transaction closes. Similarly, such an amendment does not affect the transition period if it is adopted *before* the transaction occurs. The answer to the Ruling's question appears to depend on whether the phrase, “at the time of the sale of S to Y” means before or after the closing of the transaction.

Perhaps the Ruling is asking whether an amendment adopted *at* closing should affect the transition period. If so, it is reasonable to consider such amendment to be before the transaction, since a transaction usually does not close until all documents are signed.

Scenario 3

Facts: Corporation P sells the assets and liabilities of Division S to unrelated Buyer Y. Suppose that Y's plan, Plan B, does not exclude the S employees, so that the S employees start participating immediately in B.

In this situation, it would seem likely that Plan B gets a “bye” from Section 410(b) coverage testing, but must meet nondiscrimination testing for the year of the transaction and later years.

However, it is possible that the inclusion of the S employees will skew the nondiscrimination testing for the plan, assuming that the plan has historically used general testing for this purpose. If that is the case, it seems reasonable (and not abusive) that the IRS permit the plan to continue to operate with the same formula as it had in the pre-transition period year without having to engage in new nondiscrimination testing. The IRS may be concerned that a rule permitting a “bye” from nondiscrimination testing will encourage knowledgeable employers to amend their plans to offer for contributions or benefits that would be discriminatory if tested. If this potential abuse does provide cause for concern, the IRS could provide that an amendment within the plan year prior to the acquisition would negate the transition period for nondiscrimination testing purposes, and testing would be required for the year of the transaction and later years.

The problem with this bright-line “no amendment” recommendation is that it ignores whether the amendment was adopted in anticipation of the transaction and whether it would have been beneficial to the Y NHCES. For example, suppose Y adopts an amendment to Plan B in January to increase accrual rates for past service. This increases the benefits of all Y employees who are employed as of that date. Assume for purposes of this example that Plan B, as amended, would pass general nondiscrimination test-

ing. Ten months later, Y decides to buy S (a transaction that was not even under consideration when the January amendment was adopted). Under the “no amendment” rule proposed above, Plan B would get no relief from nondiscrimination testing during the transition period, and would be required to pass testing in the year of the transaction.

This hypothetical does not involve an intent by Y to abuse the transition period rules. Perhaps, therefore, the rule should permit an employer to demonstrate that an amendment adopted before the transaction would have passed nondiscrimination testing, and then get the benefit of the transition period. Alternatively, the proposed solution could be that the plan sponsor may request a ruling in a favorable determination letter application, and then have the opportunity to demonstrate its nonabusive intent in amending the plan. Unfortunately, both these resolutions of the abuse considerations distort the “bright line” that the proposal was intended to provide, and create uncertainty and more work (and fees) for the plan sponsor.

The Ruling further requests that we consider a situation under which Plan B excludes the S employees.

As a result, the S employees did not benefit under *any* plan after the sale. While this circumstance seems unfortunate from the S employees’ perspective, it also appears clearly covered by current rules. Assuming no change is made to Plan B, it will not be required to perform Section 410(b) coverage testing during the transition period. Furthermore, assuming that the Plan met nondiscrimination testing before the transaction, it would likely do so afterwards, excluding the acquired employee group.

So, Where Do We Stand?

It is encouraging to see the IRS and Treasury attempting to tackle some of the complex issues raised by company acquisitions and dispositions. Practitioners have had to deal with these questions for years in an uncertain environment. It is also a positive development that the government is seeking practitioner input on these issues.

Nonetheless, we recognize that the Section 410(b) transition period rules are just the tip of the M&A iceberg. We look forward to the government continuing to attack the various benefits issues that arise from company transactions, even if it is done one step at a time.