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Welcome to the Family...Assimilating Benefits for New Employees in an Asset Acquisition

In this time of nonstop mergers, acquisitions, and buyouts, frequently one of the "forgotten sons" is the employee benefits plans. Rife with pitfalls, thorny issues, and complications, these programs are often left unattended until the transaction is complete. With the short time frames required by law for transitioning employees and their benefits plans, it pays to plan ahead.

When one company acquires another through an asset acquisition, some or all of the seller's employees may leave to join the buyer's ranks. While those employees will often find their working environment to be substantially the same after the transaction as it was the day before, their employment status will have changed significantly. One of the most important areas of change will be the benefits programs and structure that apply to these employees in the new company.

While some purchasers will let the benefit chips fall where they may, leaving the newly acquired employees to become eligible for the benefit plans in the normal course of their employment, many buyers want the new workforce to be integrated with its more senior staff as quickly and as easily as possible. This integration raises some special issues, for which advance consideration and planning may be helpful.

EMPLOYMENT STATUS OF ACQUIRED EMPLOYEES

When one company acquires the assets of the other, the employees who remain with the acquired business assets actually experience a termination of employment from the selling company and a rehire by the buyer. They will often receive two [Forms W-2](#) for that year—one from each company, although [Revenue Procedure 96-60](#) [1996-2 CB 399] offers a reporting alternative under which the buyer may do a consolidated [Form W-2](#) for the acquired employees. In addition, the buyer has no legal obligation to grant any seniority to these acquired employees, other than that to which the buyer agreed in the acquisition contract with the seller. Some sellers may take action to protect their soon-to-be-former employees in the contract, eliciting promises from the buyer as to seniority and service credit; other sellers do not.

The fact that there is a termination of employment and rehire makes the acquired employees very vulnerable to a cessation of certain benefits, either temporarily or permanently. It also means that the seller's plans may have obligations to the employees that should be explored.

WITHHOLDING ISSUES

Since the affected employees now work for a new company, withholding for FICA generally begins anew. The seller may have ceased to withhold the old age and survivor taxes from the paycheck of an employee who had earned compensation in excess of the Social Security taxable wage base prior to the acquisition date. If the buyer re-starts FICA withholding, that employee will experience an immediate decrease in take-home pay. To the extent that the withholding by the two companies results in the overpayment of FICA taxes by the employee, the employee will be able to obtain a refund on his or her federal tax return for the year. That may be of little solace to the employee whose paycheck just decreased by 6.2 percent. It would be better for both the employee and the new employer if FICA could be coordinated between the seller and the buyer, avoiding the duplication of tax withholding. The law permits this in asset acquisitions. [[IRC §3121\(a\)\(1\)](#)]; see also [Rev Rul 62-60](#), 1962-1 CB 186]

BENEFIT PROGRAM ELIGIBILITY

Since the acquired employees are new to the buyer, they are subject to all waiting periods embodied in the buyer's benefit programs. If the health program has a waiting period, these employees may find themselves without employer-provided health insurance during the waiting period (although they will be eligible for

continuation of health care through COBRA from their old employer—at their own expense, of course. Similarly, if the buyer's retirement plan requires completion of a service period, such as six months or a year, the newly acquired employees will have a period of time during which they may not be eligible to participate in the plan.

Many buyers want to integrate the acquired employees immediately into their existing plans, notwithstanding the waiting periods. This is permissible, so long as the plans so provide. Generally, a plan amendment will be needed to the health and retirement plans to eliminate the waiting period for the new workers. In addition, if the buyer wants the employees to enter on the acquisition date, it is likely that the amendment will also need to provide for a special entry date for these employees (unless, of course, the acquisition is coincidentally consummated on a normal plan entry date). Often, buyers allow acquired employees to enter benefit plans early without taking action to amend the plans on the theory that being more generous with employees is a good thing, not necessitating formal action. That theory is incorrect, particularly with regard to qualified retirement plans, for which a failure to follow plan terms can lead to disqualification causing a loss of the significant tax benefits enjoyed by these plans.

Companies that acquire other businesses on a regular basis may have a policy that they allow the employees to enter the plans immediately after the acquisition. If that policy is *always* followed, the benefit plans may be amended to provide that all employees of companies acquired through a stock or asset acquisition will enter the plan on the day on which the acquisition is finalized. Other buyers have a policy of entering newly acquired employees immediately only if the purchased company is of a given size, such as 50 employees. In that situation, the plan amendment may be written to limit the automatic entry to companies that meet those criteria.

It is important to note, however, that a plan that provides for immediate entry cannot usually be amended retroactively to kick those new entrants out again if the plan sponsor changes its mind. Therefore, the buyer must be advised that, if the employees of a company that is being purchased are *not* supposed to be covered automatically by the plan, the amendment to exclude them from that automatic language must be adopted *prior* to the acquisition.

HEALTH INSURANCE ISSUES

On the health side, buyers may request that the seller continue to cover the employees on its plan until the buyer's plan has its next enrollment date. Usually, this request is accompanied by a promise to reimburse the seller for the cost of this extended coverage. This type of structure is particularly popular when an acquisition occurs in the last quarter of the year, within a few months of the customary January 1 enrollment date.

While this structure makes perfect sense from a business and logistical standpoint, this may produce significant additional legal complications for the seller. If the plan is fully insured, it is important that the seller elicit the approval of the insurer to cover employees of another company. Failure to do this could cause a significant claim to be denied. On the other hand, if the plan is partially or entirely self-funded (that is, all or a portion of the health benefits are paid by the company, itself, without an insurer), the coverage of employees from more than one unrelated company creates a multiple employer welfare association (MEWA). Under ERISA, a MEWA may be considered to be a type of insurance program, required to comply with various state insurance regulations. In most states, these regulations are sufficiently onerous and compliance sufficiently expensive that employers are advised to avoid MEWAs like the plague. Therefore, this proposed solution—so logical from a business perspective—is usually considered to be unworkable or untenable from a benefits standpoint.

Another option is for the new employer to increase employee compensation for the balance of the plan year, effectively financing the acquired employees' payment of COBRA premiums to the seller's health program. In this manner, the employees can continue to be covered by the seller's plan without MEWA ramifications, and the buyer has some time before integrating the employees into its own plan at the next new enrollment period (and often after negotiating a better deal with the insurer or service provider in light of the increased workforce). While this may give the buyer some extra time to reconnoiter, it may be a poor substitute for covering the employees in its plan. The premiums for the COBRA coverage are likely to be more expensive than covering the employees under the buyer's plan. This occurs for two reasons:

1. The seller is permitted to charge 102 percent of normal premium for COBRA coverage, ostensibly to cover its expenses in administering the health program.
2. Because the increased compensation is taxable to the employee, the employer must "gross up" the increased compensation so that the net amount available to the employee is equal to the COBRA premium payment.

Other problems associated with this approach include the following:

1. Individual employees may choose to pocket the increased pay and not buy the COBRA coverage, leaving themselves uninsured for the interim period. This may also cause the person to lose the HIPAA protection against preexisting conditions, since he or she will not have been continuously covered by health insurance prior to becoming eligible for the buyer's health program. (One would hope that someone with a condition at the time of the acquisition would elect COBRA coverage, but something could arise in the interim for someone who does not elect COBRA between the end of coverage under the seller's plan and the initiation of coverage under the buyer's program.)
2. When the employees are placed on the employer's insurance on the next enrollment date, the decrease in paycheck amount may be distressing to the employees, notwithstanding the concurrent decrease in their personal medical expenses.
3. If the seller is terminating its operations as a result of the acquisition, there may not be any remaining health plan to provide COBRA to the acquired employees. In that case, the buyer is required by Treasury regulations to provide COBRA benefits to the acquired employees. [[TreasReg § 54.4980B-9](#), Q&A-8(c)] As a result, the employees must be covered under the buyer's plan, which was the result that the COBRA option was intended to avoid.

CAFETERIA PLAN ISSUES

When an employee leaves a company with a positive balance in his or her medical expense reimbursement plan account, the employee generally has until the end of the plan year to submit claims against that account. However, unless the employee elects COBRA coverage under the cafeteria plan, expenses incurred after the termination of employment may not be reimbursed from the cafeteria plan. [[Treas Reg § 1.125-2](#), Q&A-7(b)(2), Example 2] Unused accounts are forfeited at year-end, as a result of the IRS-mandated "use it or lose it" rule. The result is that employees with significant accounts in the cafeteria plan in preparation for an intended procedure or expense may find that they are foreclosed from making a claim to collect these funds, and that their accounts are forfeited, unless they elect COBRA coverage. Needless to say, this produces considerable consternation for the acquired employees.

A solution to this problem is for the buyer to adopt the cafeteria plan of the seller, at least through the end of the year of the acquisition. The plan can be terminated or merged with the buyer's plan as soon as the year is completed. By adopting the cafeteria plan, the buyer enables the employees to continue to make claims against their plan accounts for procedures performed and expenses incurred through the balance of the year, avoiding the undesired forfeiture. However, the buyer must be very careful to ensure through proper due diligence that its adoption of the cafeteria plan is not the opening of a Pandora's box of problems due to administrative errors and/or failure to perform proper reporting and disclosure in prior years. It may also be impossible to adopt the seller's plan if the buyer has purchased only a portion of the seller's company and the plan is to be continued for the benefit of the seller's remaining employees.

It appears to be possible to "spin off" the portion of the seller's cafeteria plan to be adopted by the buyer as a successor. This would enable the continuation of the benefit elections and the reimbursements for funds already removed. A spin-off requires significant cooperation between the buyer and the seller, however, which may not be forthcoming. It also involves more expense to create the new plan document and the adopting resolutions. Nonetheless, a willing buyer may be able to resolve the employees' reimbursement concerns by taking this tack.

ENROLLMENT PROCEDURES

Even if the buyer wants to cover the acquired employees as soon as possible in its benefit plans, logistics may throw a monkey wrench into the works. If a large number of individuals come to the buyer's company as

part of the transaction, or if the acquired employees are geographically dispersed, the process of enrolling everyone in the various benefit programs may be daunting. It may not be possible to do so during the period between the acquisition date and the first payroll date following the purchase.

While it may appear that the reasonable solution to this problem is to pre-enroll the employees prior to the closing of the acquisition, this is often impractical. First, company acquisitions are very volatile transactions, and the buyer and seller are often not entirely sure that the purchase will take place up until the final moment at which the papers are signed. As a result, neither is interested in disrupting the employee workforce before everything is consummated. At times, the transaction remains a well-kept (or even not-so-well-kept) secret until on or near the closing date. This also interferes with the buyer's ability to begin enrollment of the employees it intends to retain until after the transaction is complete.

Even when the transaction is made public prior to its effective date and the "deal" looks like it is struck, other considerations often derail the transaction before closing. Delays in closing are common, extending from a few days to several weeks, depending on the cause. Therefore, even if there is no doubt as to *whether* the transaction will occur, the parties may not be sure until right before closing exactly *when* the transaction will take place.

A final reason why pre-enrollment may not be practical has to do with the transaction process. Usually, a large part of the buyer's and seller's executive groups will be busy through closing performing tasks relating to the acquisition, and their preoccupation with making the transaction happen will forestall advance planning for the assimilation of benefits.

Nonetheless, planning by the buyer can reduce the rush-to-the-finish-line benefits panic once the transaction has occurred. If secrecy is not a significant consideration, enrollment meetings may be scheduled on a tentative basis for several days after the expected closing date, with the proviso that rescheduling may be required if the transaction is not finalized when planned. In some cases, providing enrollment packages to employees on the closing date, with the promise that educational meetings will follow in the next several weeks will permit the employees to make initial elections without further involvement by the buyer and its enrollment staff or provider. This may work better for 401(k) enrollments than for health and welfare plans, since changes in elections are usually permitted for the former, while the latter generally allow modification of elections only at future enrollment dates. Indeed, decisions made at initial employment sometimes forestall options in the future. For example, supplemental insurance programs often provide that insurance elected at initial employment will be guaranteed issue, while the employee will need to submit to health evaluations and underwriting if the insurance is to be issued or increased at a later time.

PARTICIPANT LOANS IN SELLER'S RETIREMENT PLAN

Qualified plans, particularly 401(k) plans often permit participants to borrow against their vested interests in the plan. These loans are commonly repaid through payroll deduction. When the employees no longer work for the seller due to an asset acquisition, they no longer have payroll from which loan payments may be removed and paid to the seller's plan. Furthermore, many qualified plans specifically provide that loans are considered to be in default immediately upon a participant's termination of employment, causing the borrowing employee to recognize taxable income equal to the outstanding loan balance at that time. Other plans permit the employee to repay the loan within a certain time period before the loan is considered to be in default. Still other plans—very rare plans indeed—permit participants to continue to make loan payments by check after they terminate employment with the plan sponsor.

Under current Treasury regulations, a loan is considered to be in default when a payment is missed, resulting in the entire remaining loan balance constituting taxable income to the employee. [[Treas Reg § 1.72\(p\)-1](#), Q&A 10] This is called a "deemed distribution" of the loan. If the borrowing participant is under age 59 1/2, an additional 10 percent tax will be payable on the deemed distribution. [[IRC § 72\(t\)](#); [Treas Reg § 1.72\(p\)-1](#), Q&A 11(b)] The regulations permit the plan to provide a "cure period" during which the employee may catch up on late payments, but that period may not extend beyond the end of the calendar quarter following the quarter in which a payment date is missed. [[TreasReg § 1.72\(p\)-1](#), Q&A 10] As a result, if loan payments do not continue in some fashion, all borrowing participants will have deemed distributions of their loan balances within three to six months of the acquisition. Needless to say, this creates a group of very disgruntled employees at a time when the buyer is trying to convince them that the acquisition was a *good*

thing. (It would be nice if the IRS's "leave of absence" rules would accommodate this situation, but they do not currently do so.)

There are several solutions to this problem, none of which is particularly satisfying. If the seller is willing, the employees may continue to make payments on the loans by check. This may be permitted even if the plan did not previously permit this for other borrowers, although an amendment to the plan or the plan's loan procedure may be required. Most sellers are not willing to use this solution. Often, the administrative costs of collecting the loan payments and transmitting them to the fundholder or trustee are too high, and the hassle is too large. This is particularly true if the seller has sold substantially all of the company to the buyer. In that circumstance, the seller may no longer have the infrastructure needed to administer this type of repayment process. In addition, if the "continued repayment" option was previously denied to terminated nonhighly compensated employees and the only participants who want to take advantage of this option after the acquisition are highly compensated, it is possible that the plan amendment will be discriminatory. [See [Treas Reg § 1.401\(a\)\(4\)-5](#)]

Alternatively, the buyer may permit employees to elect to have the loan payments removed from their new payroll, and then the buyer can transmit the loan payments (along with a schedule outlining who has paid what amount on their loans) either to the seller or directly to the fundholder. Again, this process requires the cooperation of the buyer and the seller, as well as the fundholder or trustee, and this is not always forthcoming.

A third solution is for the buyer to permit the acquired employees to make direct rollovers of their accounts from the seller's plan (with the loans intact) to its plan. This solution is often vetoed by the buyer, which either does not want to accept rollovers at all or does not want to accept the costs associated with administering the rolled-over participant loans. The latter consideration is particularly common when the buyer's plan does not permit loans to its employees, or when the recordkeeper of the buyer's plan is loathe to administer loans that did not originate within its system without a significant increase in fees.

If the seller's plan is being terminated as a result of the acquisition, many buyers want to await the receipt by the seller of an IRS favorable determination letter on the termination before accepting rollovers into their plans. If loan repayments to the seller's plan are suspended while the favorable determination letter process is ongoing, it is likely that the maximum grace period under the Treasury regulations will expire long before the IRS issues the determination letter, and the affected participants will be faced with deemed distributions.

A fourth solution—and the least likely to occur—is for the buyer to provide affected employees with loans from the *company*. These loans will enable the employees to repay the participant loan in the seller's plan and then can be repaid directly to the company through payroll deduction. Buyers disfavor this option for two reasons. First, it involves a cash outlay on behalf of employees that are new to the buyer (and to whom the buyer feels very little loyalty). Second, and more important, is the fact that the employee cannot pledge his or her account in the seller's plan as security for the loan from the buyer. [[IRC §401\(a\)\(13\)](#)] Therefore, the loan from the buyer is generally unsecured, leaving the buyer vulnerable to default by employees who cease working for the company prior to the time that the loan is completely repaid.

If none of these solutions works in a given situation, the employees will default on their loans and recognize taxable income (and possibly a 10 percent excise tax) in the year of the transaction. The buyer will likely have an unhappy group of employees to reckon with. On the other hand, the buyer often considers this a "cost of doing business"—and one that, in light of the alternatives, is the best option available.

CONCLUSION

Before an acquisition, the focus of the buyer's and seller's attention is usually on the transaction, itself. However, the time frame for assimilation of the employees into the buyer's workforce and setting up the benefits for those employees may be very short, and the process can be very intense. Addressing some of the issues that are anticipated to arise in advance of the transaction may permit a reasoned solution of the problems, or at least prepare the parties for what is yet to come.