MERGERS & ACQUISITIONS

Would Someone Decide What to Do with This Stuff, Already?

Clear guidance is needed, or at least acknowledgement that plan sponsors have the flexibility, to safely select among alternatives.

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If this column had sound effects, you would hear the "Theme From 2001: A Space Odyssey" (also known as Also Sprach Zarathustra by Strauss to you classical music enthusiasts) as you read this first paragraph. With the completion of the GUST remedial amendment period, those of us in the retirement plan industry look forward to the dawn of a new age, when plan documents actually match plan administration . . . well, except for that EGTRRA thing, but we at least have good faith amendments by year end for those changes. So, with this new era, administration of retirement plans should be an easy thing, right? Well, not so fast! (Insert sound effect here: a phonograph needle scratching across the record.)

The fact is: there are several open questions with regard to mergers and acquisitions (M&A) that have been left undecided for years, with little or no government guidance. That may be a good thing—it likely gives plan sponsors and administrators a reasonable amount of flexibility in handling these issues. Nonetheless, there is always that niggling feeling at the back of one's neck that warns that later guidance could prohibit a practice (with some attendant cost at that time), notwithstanding how reasonable it appears now. This is exacerbated because the reason why these issues have been left unclear is generally that they are truly complex, and no one in private practice or government has been able to come up with solutions that are fully satisfying.

So, without being able to give a definitive answer to the questions we are raising, here are some of the open questions for M&A situations.

Who Is an HCE After an Acquisition?

Highly compensated employees (HCEs) are defined as those individuals who meet one of two criteria. First, a person is an HCE if, during the current or prior year, he or she owns or owned more than 5 percent of the company (the "stock threshold"). Second, a person is an HCE if he or she earned compensation during the prior year in excess of a threshold amount ($90,000 for 2003) (the "compensation threshold"). [I.R.C. § 414(q)(1)] Companies may elect to limit the number of individuals who are classified as HCEs because of the compensation threshold to the top paid 20 percent of the employees. [I.R.C. § 414(q)(3)]

Code Section 414(q) and the regulations thereunder clearly anticipate that a company will have one set of HCEs, regardless of how many different plans there are and which employee groups those plans cover. Nonetheless, when there is a company acquisition, one can't help but wonder if there should be two sets of HCEs—one for the buyer's company and one for any plans of the acquired company.

Asset Acquisitions

Let's look first at an asset acquisition. In that case, the employees have actually stopped working for the seller and have begun working for a new employer—the buyer. It is clear, then, that such individuals have not possibly earned any compensation in the prior year for the new employer, so that they cannot be HCEs as a result of the compensation threshold. Furthermore, unless an employee is given stock in the buyer company as part of the transaction, he or she will not be an HCE because of the stock threshold because any stock ownership before the acquisition was with a totally different company. Therefore, none of the acquired employees (except those who are given stock in the buyer) should ever be an HCE in the year of acquisition.

But, wait! What if the asset buyer decides to assume the plan of the seller as a successor employer?

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Does it make sense for the people who were HCEs in that plan before the acquisition to suddenly cease to be HCEs after the acquisition because the sponsor has changed? Maybe so; there is no rule on the books requiring that someone who is an HCE at one time remain an HCE forever, and people whose compensation hovers near the threshold commonly float in and out of HCE status on a year-by-year basis. On the other hand, should there be two sets of HCEs in this setting—one for the plans of the buyer and one for the plans acquired in the acquisition?

Stock Acquisitions and Mergers

In a stock acquisition, the stock threshold is easier to answer. Upon the acquisition, the target corporation becomes a subsidiary of the buyer. Under the stock rules of the regulations, someone who owned more than 5 percent of a subsidiary anytime during the year (including before the acquisition) is treated as a 5 percent owner and, therefore, an HCE. [Treas. Reg. § 1.414(q)-1, Q&A-8] Furthermore, we can determine safely how much everyone earned in the prior year, and then apply the compensation threshold.

In a merger, it would appear that someone would be a 5 percent owner if he or she owned more than 5 percent of either of the two combining companies or the surviving merged company. With enough owners (for example, in a law firm situation), it is likely that someone who owned more than 5 percent of one of the pre-merged companies would own less than 5-percent of the survivor—and cease to be an HCE in a following year.

But wait! What if the buyer's plan uses the 20 percent rule to limit those who are classified as HCEs for purposes of the compensation threshold? How are the number of employees and the employee group to be determined for this purpose? Is it by the total of the subsidiary employees and the parent employees for the lookback year (that is, the year before the transaction), when they were not a controlled group at all? Can the transaction really convert individuals who were HCEs in the buyer's plan (or, for that matter, the target's plan) immediately before the transaction to non-HCEs because they have fallen out of the "top 20 percent" group when the two employee groups are aggregated?

What Service Counts After the Acquisition ?

Many buyers do not believe their plans are required to credit service with the target company for the period prior to the acquisition, and many do not want to do so. The justification for this is the fact that any service worked by the acquired employees prior to the purchase was with a company that was not part of the buyer's controlled group. Therefore, the service was not performed for the "employer" and does not count for vesting or eligibility purposes in the buyer's plan.

Again, this argument is more easily made in an asset acquisition, where the employees cease working for one company and join another upon the purchase. However, in a stock acquisition, where the employees continue to work for the same company, it is hard to distinguish how this is not the same "employer" from their points of view. Perhaps that is because this analysis does not occur from the employee's point of view, but the company's—and the company's ownership composition certainly has changed.

Nonetheless, if we examine this issue from another direction, it is even less clear cut. Suppose that, at the time of the acquisition, neither the new parent nor the acquired subsidiary sponsored a plan. After the acquisition, the subsidiary starts a brand new plan for its employees. In that situation, what service could be disregarded for eligibility purposes? Under the Code and ERISA, a plan may not exclude service prior to its effective date for eligibility purposes. [I.R.C. § 410(a)(3), ERISA § 202(b)(a)] All of the subsidiary's employees have always worked for the subsidiary. Therefore, no service (including that before the subsidiary was acquired by the parent) can be disregarded in the new plan for eligibility purposes (although the plan is permitted to exclude service prior to its effective date for vesting purposes [I.R.C. § 411(a)(4)(C)]).

If this is so, does it make sense that one plan of the "employer"—an existing parent plan—can exclude service that another plan of the "employer"—a new plan adopted by the subsidiary—cannot? The Code and ERISA do not appear to contemplate that the crediting of service depends on the plan, itself but simply on the service that is completed by the employee.

If we return to the asset acquisition and re-examine it again in light of the above stock-purchase analysis, there are similar facets that do not fit quite as well as we would have thought at first blush. In particular, what happens if a buyer that sponsors no plan adopts the seller's plan as part of the acquisition as a successor sponsor? May the buyer exclude service prior to the acquisition for vesting purposes in that plan for its own employees on the basis that the buyer never maintained a plan before, even though the plan includes service for the acquired employees who were previously covered?

Mid-Year Mergers and Nondiscrimination

When two plans merge mid-year, havoc is wreaked on any nondiscrimination testing or safe harbor structure.

Let's look first at 401(k) nondiscrimination testing. Suppose two calendar-year plans (say, Plan A and Plan B) merge on June 30, 2003. Plan A is the surviving plan. How is nondiscrimination tested for the year of merger?

Again, this is a question that the IRS has not yet answered. There appears to be three possibilities:

Possibility 1. Test Plan A for the period January 1, 2003, through June 30, 2003; test Plan B for the period January 1, 2003 through June 30, 2003; and test the merged plan for the period July 1, 2003, through December 31, 2003.

This solution recognizes that there are three plan structures during the year, and treats each differently. This testing method raises several concerns. First, it is the most expensive alternative, calling for three full ADP/ACP tests for the year. Second, if the test is failed as of June 30, 2003, the refunds and distributions and forfeitures will happen in the merged plan—and midyear, no less—which is disruptive to that plan (and, unless the merger agreement documents this situation, possibly without support in the plan document). Third, it forces nondiscrimination testing for a short period, despite the fact that the participants are actually participating for the full year.

Possibility 2. Test Plan A and Plan B on a combined basis for the entire 2003 calendar year.

This solution has support both in the recognition that ADP/ACP testing is done at year-end and also in the concept that merged plan succeeds to everything from the component merging plans. Therefore, to the extent that a participant had an amount in the numerator or denominator of the ADP or ACP at the time of the merger, the surviving plan should get "credit" for those amounts when it does its year-end test.

Nonetheless, there may be something a little intellectually dishonest about a test that includes deferrals that occurred when the plans were separated. Furthermore, what do we do if the plans have different year-ends?

Possibility 3. Test Plan B (the disappearing plan) for the period January 1, 2003 through June 30, 2003, and test Plan A for the entire year, showing the deferrals from the former Plan B participants as of the date they joined Plan A (that is, July 1, 2003).

This option is a nice compromise—testing the disappearing plan almost as if it terminated at the merger date, while recognizing that the surviving plan truly existed all year long. However, this solution raises the same objection as the first in regard to mid-year corrections for Plan B, and still costs more than the second alternative.

What happens when two safe harbor 401(k) plans merge mid-year? If both plans use the same safe harbor formula, the merged plans would be able to continue without interruption with little problem. However, it is possible that the two plans are using different types of safe harbor contributions. For example, one plan could be using the three percent nonelective contribution option, while the other is using the safe harbor matching contribution to meet the safe harbor requirements. Alternatively, one plan could be matching employee deferrals at the rate of 100 percent of the first four percent of compensation deferred, while the other is using the more common "basic" formula under which 100 percent of the first three percent of compensation deferred is matched, and then 50 percent of the next two percent is matched. In light of the fact that both plans were required to give their employees notice before the beginning of the year of the safe harbor contribution formula to be applied, which formula survives the plan merger? Does the merger of the safe harbor plans taint the safe harbor for that year, requiring actual ADP/ACP testing?

401(k) Plans of Parents and Employees of Sold Subsidiaries

Prior to EGTRRA, the same desk rule guarded participants' access to 401(k) deferrals and QNECs very closely. If an employee went to work for another company in connection with an acquisition, doing essentially the same job for the buyer, special rules were needed to permit distributions to that employee. EGTRRA got rid of all that, eliminating the same desk rule and permitting any employee who terminated employment with the seller to get paid out.

Unfortunately, Congress threw out the baby with the bath water. When it amended Code Section 401(k)(10) to eliminate the no-longer-needed exceptions to the same desk rule, it failed to notice that one situation was not resolved by the change to the payout rules. In particular, if a subsidiary's employees participate in a parent's 401(k) plan, and the parent sells the subsidiary, the employees do not experience any kind of termination of employment. Therefore, there is no distributable event. Prior to EGTRRA, the "disposition of subsidiary" exception would have permitted the parent's 401(k) plan to pay out the subsidiary's

employees. After EGTRRA, that exception vanished.

The IRS was quick on its white steed to save the day. Besides an old General Counsel Memorandum [GCM 39824], which permitted most distributions to subsidiary employees in this circumstance, the IRS issued Notice 2002-4 [2002-2 IRB 298], which clarified that distributions were permissible in this situation. However, both the GCM and the Notice require that the distributing plan be maintained by the original sponsor and not by the subsidiary after the transaction.

Here's the problem: what if there is some lag time between the sale of the subsidiary and the subsidiary's withdrawal as a participating sponsor in the prior parent's plan? This time lag may occur purposely, because the buyer and seller would like time to make the necessary transition after the transaction is complete. Alternatively, it may happen inadvertently, as the parties don't always tell the attorneys to fix the plan until several months later.

Neither GCM 39824 nor Notice 2002-4 defines whether there is any permissible lag time and, if there is, how long it may last. In addition, neither piece of guidance indicates that distributions become permissible at whatever time the subsidiary ceases to participate in the former parent's plan. Therefore, one is left with the knowledge that, at some point, continued participation in the former parent's plan precludes distributions when the participation ends . . . but with no understanding of when that point occurs.

There is a solution to this problem when it is recognized prospectively, which is to make sure that the subsidiary adopts documents terminating its participation in the parent's plan concurrent with the sale transaction. However, that solution is not available months later when the companies belatedly go to their benefits advisors for the first time with the news that the acquisition or disposition has occurred.

So, What's a Client to Do?

As discussed earlier, when there is no clear guidance, all a plan sponsor can do is to act reasonably and in a fashion that is unlikely to look like an unfair skewing of the facts or the rules. This may cause many employers to be more generous to employees than the rules will ultimately require. Nonetheless, when all is said and done, someone may need to keep a straight face with the IRS, the Department of Labor, or the courts to explain why the client chose one of the options we have discussed. Therefore, the safest course of action is to select the option that is most mainstream, with the most reasonable outcome.

None of this is very satisfying. Clear guidance is needed, or at least acknowledgement that plan sponsors have the flexibility, to safely select among the alternatives discussed above (or other options that can be devised). In the meantime, we all just need to live with that niggling feeling at the back of our necks and hope for the best.