Common Problems in M&A: The 410(b)(6) Transition Period

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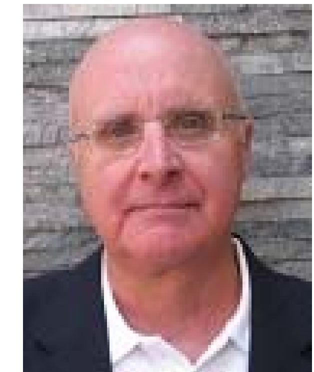

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COMMON PROBLEMS IN M&A: The 410(b)(6) Transition Period

- Facilitator:

  Maureen Pesek

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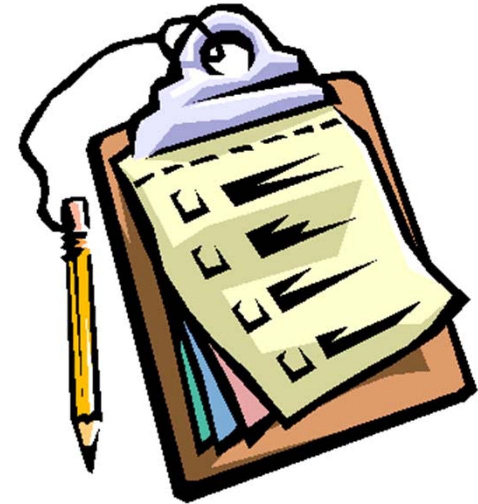
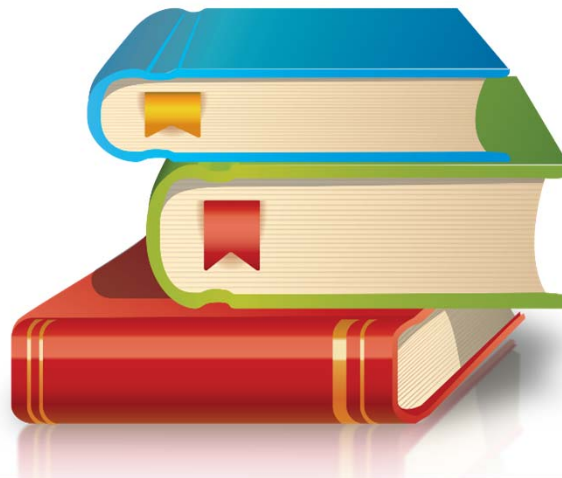
Agenda



- Quick IRC §410(b) Primer
- M&A and Employees
- Service Crediting Rules in M&A … Such as They Are
- With Basics Covered … Let's See What Happens Next
- Transition Rule Fine Points

Quick IRC §410(b) Primer



Let's Talk First About IRC §410(b)

- IRC §410(b) deals with plan coverage – that is, does the plan cover a fair cross-section of NHCE employees?
  - This does not generally judge the *amount* of benefit, only whether the person is in a position to earn a benefit

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Let’s Talk First About IRC §410(b)

- Ways to meet §410(b) rules:
  - Ratio percentage test (RPT)
  - Average benefits test (ABT)
  - Qualified separate lines of business (QSLOB) (must meet one of the other two tests, but can do so with reference to only a specific group of employees)

Let’s Talk First About IRC §410(b)

- The rule: enough employees must be *benefiting* to meet the RPT or the ABT

Let's Talk First About IRC §410(b)

- Who is "benefiting"?
  - DB plan: accruing a benefit
  - MP/PS plan: getting an allocation of contribution or forfeitures
  - 401(k) deferral plan: able to defer if s/he wants to, whether s/he does or not
  - Match: would get a match if s/he deferred, whether s/he does or not

Let’s Talk First About IRC §410(b)

- RPT: Procedure
  - Start with all employees of the “employer”
    - Includes all controlled/affiliated companies
  - Ignore the “excluded employees”:
    - Do not meet minimum age/service requirements
    - Are collectively bargained

Let's Talk First About IRC §410(b)

- RPT: Procedure
  - Ignore the "excluded employees" (cont'd)
    - Nonresident aliens with no US source income (if the plan does not cover nonresident aliens)
    - Terminated employees who:
      - Do not benefit under the plan for the year;
      - Are otherwise eligible to participate;
      - Do not meet the plan's minimum service requirement for allocations or the plan's last day rule (and that is why they do not benefit)
      - Have 500 or fewer hours in the plan year

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Let's Talk First About IRC §410(b)

- RPT: Procedure
  - Divide the nonexcluded employees into two groups: HCE and NHCE
  - Create a fraction for each of the groups

$$\frac{\text{Employees in the Group Who Benefit}}{\text{Total Nonexcluded Employees in the Group}}$$

  - The fraction for the NHCEs must be at least 70% of the fraction for the HCEs

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Let’s Talk First About IRC §410(b)

- ABT:
  - Much more complex
  - Two parts, and both must be passed:
    - Part 1: Nondiscriminatory classification test
      - The plan covers a “reasonable classification” of employees – based on type of job, type of compensation, geographic location, or other similar bona fide business criteria (but not by name or classifications having “substantially the same effect”)
      - Classification is deemed correct if the RPT is passed using the “unsafe harbor percentage” (between 20-40%, rather than 70%)

Let's Talk First About IRC §410(b)

- ABT:
  - Two parts, and both must be passed (cont'd):
    - Part 2: Average benefits percentage test
      - Generally determines the average benefits earned by the employee groups (HCE vs. NHCE) in all plans of the employer, and makes sure they are within a proper range of each other

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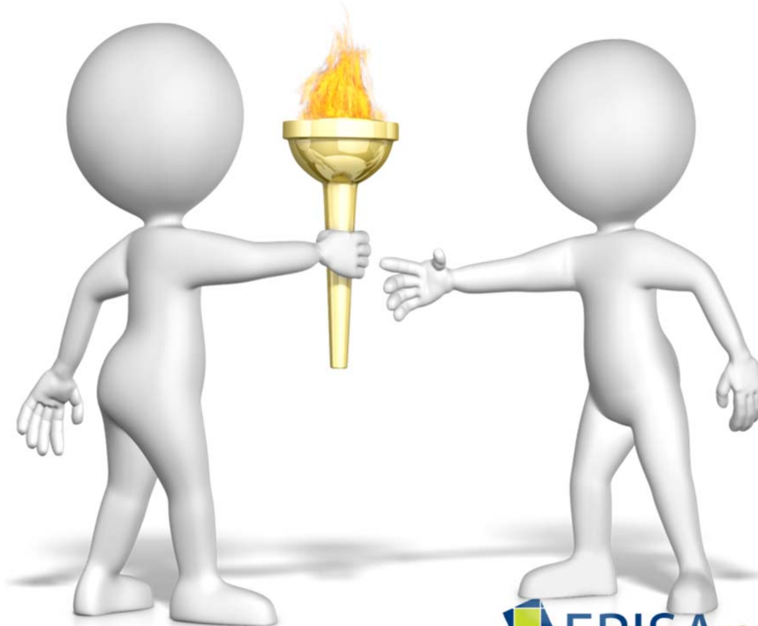
Let’s Talk First About IRC §410(b)

- If all nonexcluded employees benefit, the RPT is 100% - If this is the case, IRC §410(b) is **automatically met**
- The RPT is passed so long as the percentage of nonexcluded NHCEs is 30% or less (i.e., RP for NHCEs is at least 70%)



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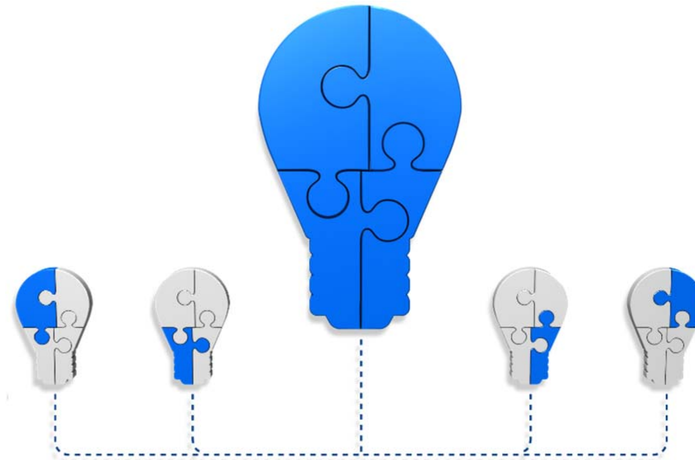
Let’s Talk First About IRC §410(b)

- If any HCEs do not benefit, the minimum coverage RP for the NHCEs goes down
  - For example, suppose one of four HCEs is not benefiting
    - RP = 3/4 = 75%
    - Minimum RP for NHCEs = 70% of 75%, or 52.5% - nearly half of the otherwise nonexcludable employees can fail to benefit and the plan will still meet coverage



M&A and Employees

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M&A Transactions and Employees

- Asset Acquisition
  - Buyer just buys "stuff" from the Seller
  - Employees cease to be Seller employees; become new employees of the Buyer
  - Seller's plan stays with the Seller unless Buyer adopts as successor employer

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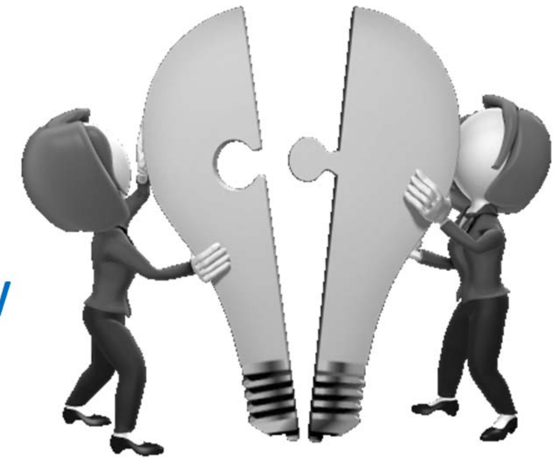
M&A Transactions and Employees

- Stock Acquisition
  - Purchased company becomes subsidiary of Buyer
  - Subsidiary is part of controlled group
  - If no change, the employees keep working for the Buyer, but they are now employees of the greater “Employer” group

M&A Transactions and Employees

- Merger
  - Buyer and acquired company "smoosh" together to form surviving entity by operation of law
  - General rule: anything owned and owed by either company is now owned and owed by the Survivor
  - All employees become employees of the Survivor



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M&A Transactions and Employees

- Merger (cont'd)
  - Any plan sponsored by either the Buyer or the purchased company is now sponsored automatically by the Survivor
  - All employees work for the same company, the Survivor

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Service Crediting Rules in M&A … Such as They Are

When Do the Acquired Employees Meet the Eligibility Requirements?

- Asset acquisition: unless the plan provides otherwise, all employees are new to the buyer, and no prior service counts
  - Acquired employees must start from scratch to meet eligibility requirements in the Buyer's Plan

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When Do the Acquired Employees Meet the Eligibility Requirements?

- Stock Acquisition: Not clear
  - Nothing specific in Code or regulations
  - If Company B adopts the Company A plan, the rules for eligibility service under IRC §410(a) kick in:
    - There is no provision under which service prior to the adoption of the plan may be excluded for eligibility purposes (it can for vesting)

When Do the Acquired Employees Meet the Eligibility Requirements?

- Stock Acquisition: Not clear (cont'd)
  - But, what if Company B does not adopt the Company A plan:
    - Either, the plan simply provides for coverage of all employees of the controlled group; or
    - All the employees are terminated from Company B and become Company A employees
    - Argument: "service" for Company A plan purposes means service with that Employer, i.e., not pre-controlled group service

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When Do the Acquired Employees Meet the Eligibility Requirements?

- Merger: Even less clear
  - Nothing specific in Code or regulations
  - Everyone works for the survivor; isn't prior service something "owned and owed" by the merging companies?
    - It seems intellectually dishonest to say that prior service isn't counted
    - But, people make that argument

When Do the Acquired Employees Meet the Eligibility Requirements?

- Merger: Even less clear (cont'd)
  - Is there any way to exclude prior service for former Company B employees if the only plan to survive the merger is the Company A plan?

With Basics Covered … Let's See What Happens Next

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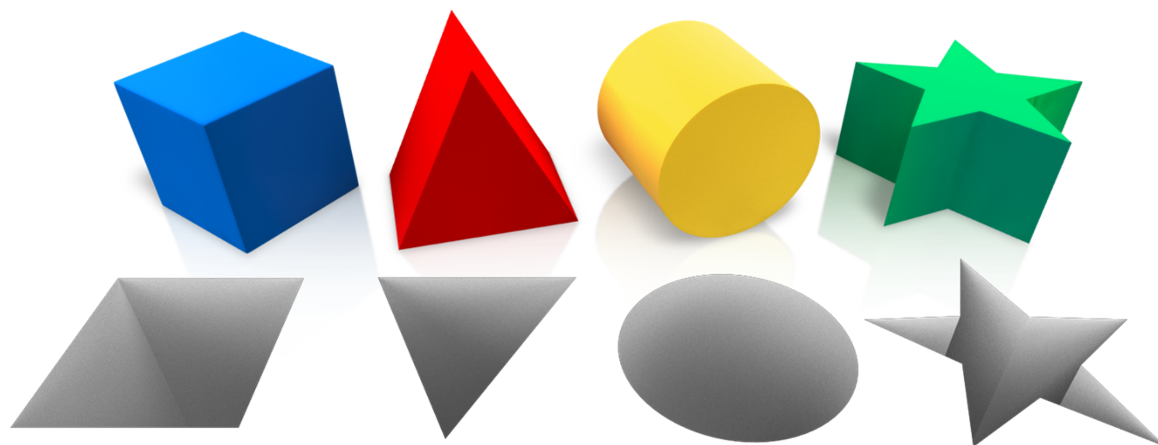
Asset Acquisitions

- Because the acquired employees in an asset acquisition are considered to be new hires, there is no IRC §410(b) issue unless the plan excludes them (or other employees) as a class



Stock Acquisitions Are the More Difficult Situations

- Suppose Company A buys the stock of Company B
  - Company B becomes a wholly owned subsidiary and is part of Company A's controlled group
  - When Company A does its §410(b) testing, Company B employees must be included unless they are Excludible Employees (i.e., age/service, union, nonresident alien, terminated with 500 or fewer hours)

Stock Acquisitions Are the More Difficult Situations

- If Company A's plan covers the Company B employees, the RPT is still 100%
- But, if it doesn't, we can have a coverage failure

Scenario #1: Stock Acquisition, Buyer's Plan Covers Acquired Employees

- Suppose that the Company A plan provides that there are no eligibility requirements and the plan covers any employee in the controlled or affiliated service group with Company A
- Result: immediately upon the acquisition, all the Company B employees are eligible to participate in Company A's plan

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Scenario #2: Buyer's Plan Excludes Acquired Employees

- Suppose instead that Company A's plan provides: only employees of those affiliates who adopt the plan as a participating employer are eligible to participate (Company B does not adopt)
- Suppose further that Company A's plan has no eligibility requirements, so long as you are in the covered class of employees

Scenario #2: Buyer's Plan Excludes Acquired Employees

- Immediately upon the acquisition, the Company B employees become a nonbenefiting group for coverage purposes
- You may fail coverage …

Turning on a Dime …

- Is it possible that the Company A plan immediately fails coverage at the time of the acquisition?
- It would be … but for IRC Section 410(b)(6)

IRC §410(b)(6): Giving Breathing Room

- Section §410(b)(6) and the relevant regulations provide:
  - There is a transaction that causes a company to become or cease to be an affiliate in a group
    - Broadly interpreted in regulations: asset acquisition, stock acquisition, merger, or disposition
  - The plan at issue met coverage prior to the transaction

IRC §410(b)(6): Giving Breathing Room

- Section §410(b)(6) and the relevant regulations provide (cont'd):
  - There is "no significant change in the plan or the coverage of the plan other than the acquisition or disposition"
  - Then, the plan is ***treated as satisfying*** coverage rules during a transition period

IRC §410(b)(6)(C) Transition Period

- The plan is treated as if it satisfies coverage during the period:
  - That begins with the transaction date; and
  - Ends at the end of the plan year following the year in which the transaction occurred

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IRC §410(b)(6)(C) Transition Period

- E.g., calendar year plan year; acquisition takes place July 15, 2017
  - Transition period begins 7/15/17
  - Transition period ends 12/31/18
  - This has been interpreted to mean that the plan must actually meet coverage rules on 1/1/19

Length of the Transition Period

- The length of the transition period depends on when during the plan year the transaction occurs
  - Example 1: Transaction happens 1/5/17 for a calendar year plan
    - Transition period is 1/5/17 through 12/31/18 – nearly two years
  - Example 2: Transaction happens 12/15/17 for a calendar year plan
    - Transition period is 12/15/17 through 12/31/18 – a little over one year

Things to Note About the Transition Period

- It applies to each plan separately
  - A violation of the transition period rules in one plan does not affect the other plan if it remains compliant
  - E.g., if the buyer had two plans, one of which failed coverage on the eve of the transaction, the compliant plan can take advantage of the transition period

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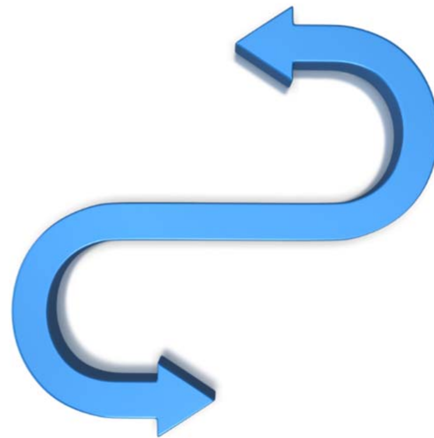
Things to Note About the Transition Period

- It applies to each plan separately (cont'd)
  - E.g., if the buyer had one plan that was a calendar year plan, and the other was a June 30 year end, the two plans will have different transition periods



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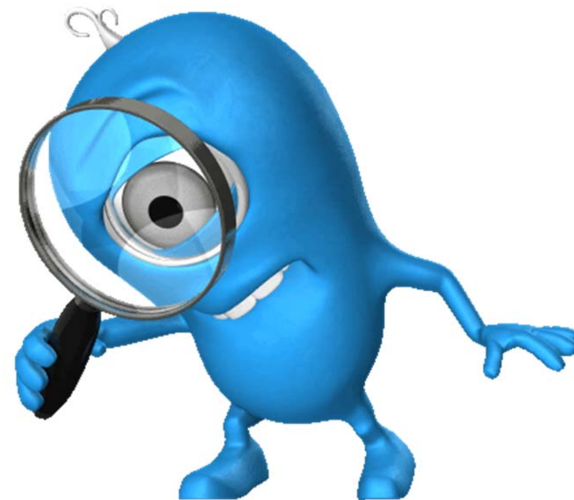
Transition Rule Fine Points



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"No Significant Change …"

- One of the requirements to take advantage of the transition period is: there is "no significant change in the plan or the coverage of the plan other than the acquisition or disposition"
- Effect of a change in the plan: terminates the transition period immediately and plan must meet coverage now

"No Significant Change …"

- What is a "significant change"?
  - There is no guidance on point
  - Clearly, a change in eligibility requirements that affects the covered group
  - Rev. Rul. 2004-11 provides that a significant amendment to a plan's benefit formula is a significant change
  - The Rev. Rul. indicates that, if the employer is changing the plan during the period, it must take into account the coverage issues and fix them as part of the change

"No Significant Change …"

- Does that answer the question?
  - No.
- General rule: be on the safe side and do not amend *anything*

"No Significant Change …"

- But, what if we need to restate during the transition period due to end of remedial amendment period?
  - IRS has said informally: keep all the active provisions the same, and just move the plan to a new document

“No Significant Change …”

- Does a change to one plan terminate the transition period with regard to another?
  - No, transition period is maintained on a plan-by-plan basis
  - The unchanged plan continues to be covered by transition period

So Consider This Scenario …

- Company A sponsors a plan that covers all employees of the controlled or affiliated service group
- The plan's eligibility requirement is three months of service
- Company A acquires the stock of Company B
- Prior to the time that the Company B employees will become eligible, Company A amends the plan to exclude the Company B employees

So Consider This Scenario …

- What is the effect?
- Transition period ends; plan must immediately meet coverage rules.

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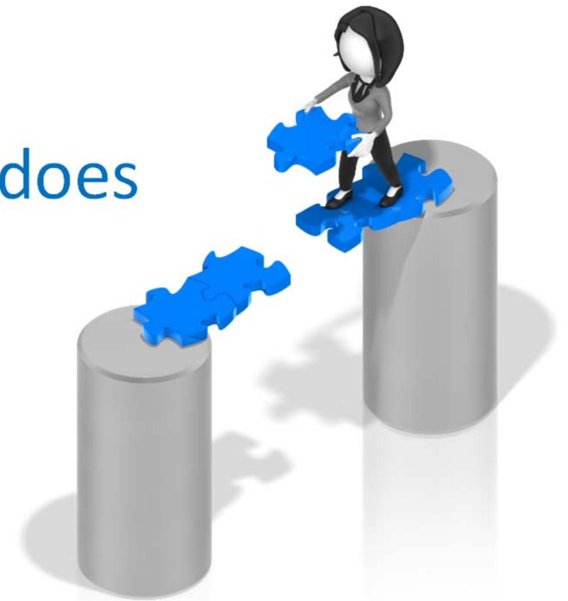
What's the Solution?

- The best global solution:
  - Review this issue before the acquisition
  - If the plan(s) does not do what you want, amend the plan *before* the acquisition date so the amendment does not take place during the transition period.



What's the Solution?

- Problem: this requires you to know in advance that this problem will arise
  - This, of course, requires the client to bring you into the loop
  - How do you make that happen?

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What’s the Solution?

- After the fact solutions:
  - Amend the plan during the transition period and figure out how to pass coverage
    - RPT
    - ABT
    - QSLOBs
    - Other …

What's the Solution?

- After the fact solutions:
  - Enter VCP and try to convince the IRS to permit you to amend retroactively and treat it like the transition period was not violated by the amendment
    - Not an easy thing to do except in extreme circumstances
  - Cover the employees like the plan says (and if you didn't enroll them in time, EPCRS the late enrollment)

Key Point

- This issue *must* be dealt with before the transaction to preserve the largest amount of flexibility
- Clients (and their M&A attorneys) tend to "find religion" after one mess-up

Questions?

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