

Actuarial Systems Corporation

Mergers and Acquisitions

October 22, 2020

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Agenda

- Introduction to Mergers and Acquisitions
- Asset vs. Stock sales
- Due Diligence/Compliance Reviews
- Specific Merger and Acquisition Issues
- Merger/Acquisition Checklist



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Mergers and Acquisitions

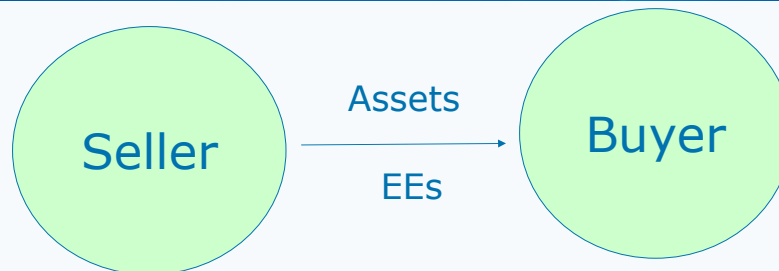
- Among most complex areas of plan administration and compliance
 - Many questions, few answers
 - Waiting for IRS guidance (for a long time!)
- Difficult transition and testing issues can arise during mergers and acquisitions
- Company transactions
 - Change in controlled group members
 - Asset sale
 - Stock sale

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Asset Sale

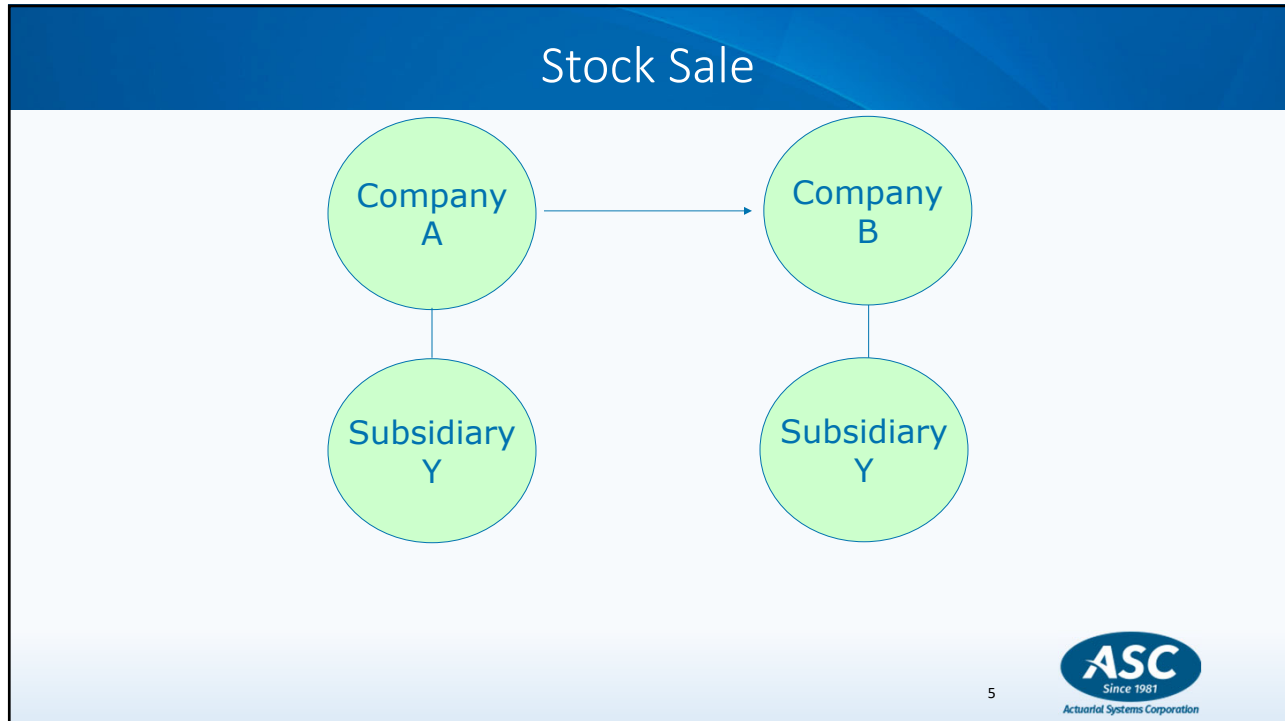


- After sale
 - Seller may continue to maintain plan or terminate plan
 - Plan may be transferred to Buyer as part of sale
- Many times the plan is not considered in sales agreement

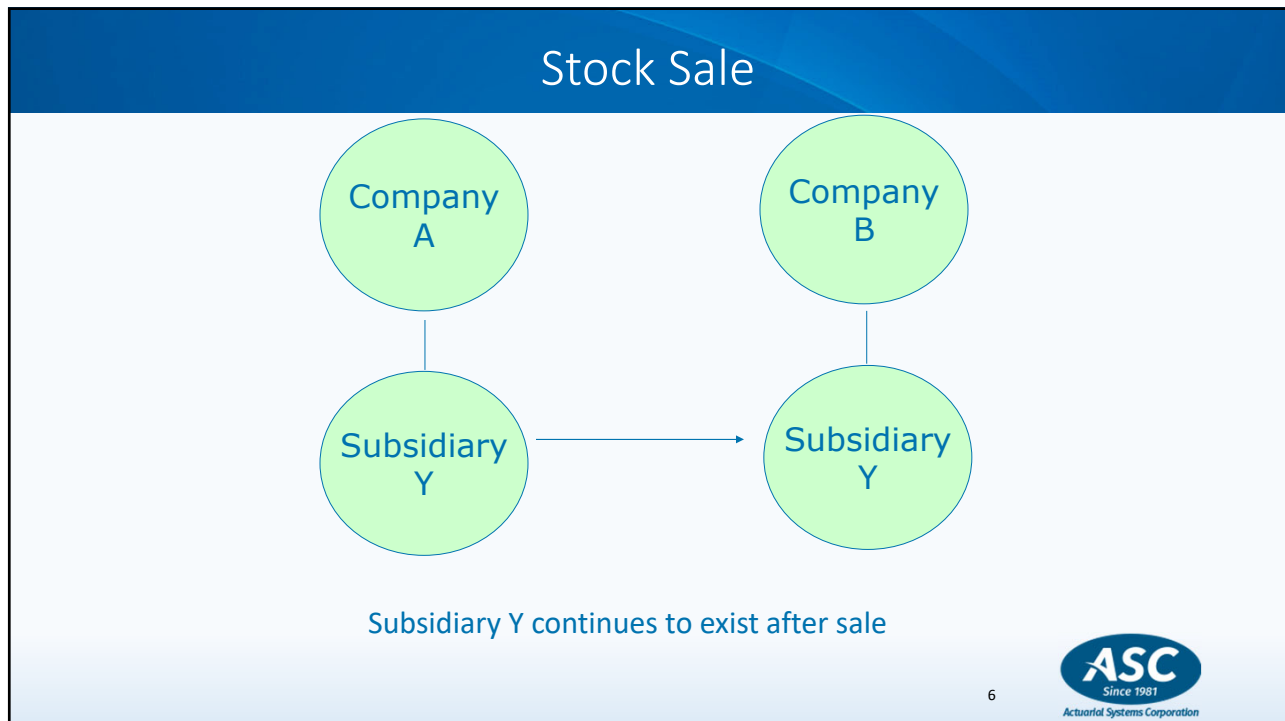
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Due Diligence/Compliance Review

- Merger/acquisition transaction documents
- Acquisition warranty and representations documents
 - Compliance with ERISA
 - Fiduciary breaches
 - Contribution responsibility
 - Litigation
 - Complete employee data
- Qualified plan document(s)
 - Adoption agreements/basic plan documents/interim amendments
 - Individually designed plans
- Qualified plan trust or custodial agreement
- IRS Approval letters – Opinion, Advisory and Determination Letters

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Due Diligence/Compliance Review

- Summary Plan Description(s) (SPDs) and Summary of Material Modifications (SMMs)
- Board resolutions
- Plan practices and procedures manual
- Participant notices and disclosures
- Forms 5500, including audit reports
- Trust accounting reports
- Employee census
- Employee deferral election forms

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Due Diligence/Compliance Review

- Participating employer documentation – related employers, Multiple Employer Plans
- Nondiscrimination testing reports
- Coverage testing reports
- Evidence of timely correction of failed testing
- EPCRS filings/self-corrections

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Due Diligence/Compliance Review

- Plan fiduciary information
 - Fiduciary bonding
 - Liability insurance
- Vesting reports
- Distribution reports and forms
- Investment policy statements
- Investment management agreements

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Due Diligence/Compliance Review

- Insurance contracts
- Collective bargaining agreements, if applicable
- Beneficiary designations, spousal consents, if required
- Participant loan policy, loan agreements, etc.
- Any other relevant documents!

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Specific Merger and Acquisition Issues

- Severance of employment
- Crediting of service for eligibility/vesting
- Coverage/nondiscrimination testing
- Determining Highly Compensated Employees
- Plan contributions
- Plan distributions/successor plan
- Protected benefits
- Plan loans
- Plan termination
- Partial plan termination
- Form 5310-A

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Severance of Employment

- Many issues can be answered based on whether employees have severance of employment
 - Determination is based on whether employees are still working for company maintaining plan
 - If have severance of employment, treated as new employee
- Different analysis applies depending on whether sale is asset sale or stock sale
- Need to know what will happen to plan after acquisition

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Severance of Employment - Asset Sale

- What will happen to plan after acquisition?
 - Seller retains plan or Seller has no plan
 - Buyer maintains Seller's plan
 - May want to include in purchase agreement that Seller remains liable for any qualification failures
 - Purchase agreement should cover division of responsibilities regarding contributions and reporting requirements
 - Plan merger
 - Merged plan would take on any taint from prior plan
 - Plan termination
 - May want to terminate 401(k) plan prior to acquisition to allow for distribution of deferrals

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Severance of Employment - Asset Sale

Sale

- If Seller retains plan after sale or has no plan, there is a severance of employment
 - Buyer is treated as new employer and employees who go to work for Buyer are treated as new employees
- If Buyer takes over sponsorship of plan or merges Seller's plan into Buyer's plan, there is not a severance of employment for employees who go to work for the Buyer
 - Buyer is treated as same employer with respect to Seller's employees who are employed by Buyer

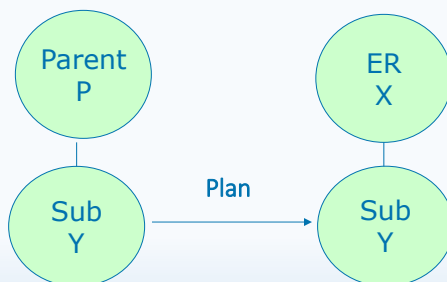
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Severance of Employment - Stock Sale

- Since employees continue to work for same employer after sale (only change in controlled group), there is no severance of employment
 - Generally, plan will continue to be maintained by sold company since it continues after sale
 - Exception applies if purchase subsidiary of parent and parent maintains plan before and after sale



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Crediting of Service

- Does Buyer have to credit service with Seller for purposes of eligibility/vesting in Buyer's plan?
- Will new employees participate immediately in Buyer's plan?
 - Is plan amendment needed to cover or exclude new employees immediately?
- Will plan(s) pass coverage after sale?
 - How does Code §410(b)(6)(C) transition rule affect coverage testing?

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Crediting of Service - Asset Sale

- Crediting service with prior employer is mandatory if maintaining plan of predecessor employer (i.e., there is no severance of employment)
 - Plan should be drafted to automatically count service
- Crediting service with prior employer is voluntary if not maintaining plan of predecessor employer (i.e., there is a severance of employment)
 - Plan amendment may be required for employees to begin participating in Buyer's plan

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Example – Asset Sale

- Buyer maintains 401(k) plan. Buyer takes over plan of Seller following an asset sale. Buyer intends to maintain a separate plan for Seller’s employees during “transition period.” Do Buyer/Seller plans need to be amended?
 - Service with Seller counts for plans maintained by Buyer
 - Buyer and Seller plans should be amended to exclude employees not covered in each plan
 - Should amend plans before sale occurs

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Example – Asset Sale

- Suppose Seller retains plan or does not maintain plan
 - Service with Seller does not count under Buyer's plan since there is a severance of employment
 - Buyer needs to make decision whether it wants to cover Seller’s employees
 - If Buyer wants to exclude Seller’s employees completely, Buyer may need to amend plan
 - Some plans provide for exclusion of employees in Code §410(b)(6)(C) transaction, which may require plan amendment if Buyer wants to cover those employees
 - If Buyer wants to cover Seller employees immediately (i.e., give credit for service with Seller), Buyer should amend plan before transaction to allow employees to begin deferring immediately in Buyer’s plan

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Crediting of Service - Stock Sale

- Generally, employees will continue to work for company maintaining plan so no severance of employment
- Crediting of service for eligibility and vesting is mandatory, since employees do not have severance of employment

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Example – Stock Sale

- Suppose Buyer purchases Seller in a stock sale. Buyer's plan requires 1 YOS/age 21 for eligibility purposes. Seller does not maintain a plan.
 - Since no severance of employment (because working for same company), service with Seller counts under Buyer's plan
- Do Seller's employees participate in Buyer's plan?
 - Depends on plan design and terms
 - Plan should be drafted to require controlled group members to adopt plan
 - Some plans cover all employees of controlled group - participation would be automatic for employees who satisfy 1 YOS (including service with Seller)

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Example – Stock Sale

- Would answer change if Seller maintains 401(k) plan?
 - Same answer – depends on plan design and terms
 - Need to make decision how plans will be maintained after sale
 - If separate plans for each entity, then make sure no duplicate coverage
 - If going to terminate Seller's plan, then should do so before sale occurs

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Code §410(b)(6)(C) Transition Rule

- Code §410(b)(6)(C) transition rule applies when there is a change in related group due to an acquisition or disposition
 - If plan satisfies coverage at the time of acquisition or disposition, then plan is deemed to pass coverage during the transition period
 - Optional application
- Transition period begins on the date of transaction and ends on the last day of the next plan year
- Cannot be substantial change in plan coverage (other than *direct* result of merger/acquisition)

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Example - Code §410(b)(6)(C) Transition Rule

- Buyer buys stock of Seller in July of 2020. Buyer maintains Safe Harbor 401(k) plan and Seller maintains traditional 401(k) plan.
 - Must Buyer cover employees of Seller in Buyer's plan?
 - If Buyer's plan does not cover employees of Seller, how does acquisition effect coverage/nondiscrimination test?
 - Transition rule allows plan to be tested separately for coverage and for nondiscrimination for 2020 and 2021
 - Would answer change if Buyer merges Seller's plan into Buyer's plan?

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Example - Code §410(b)(6)(C) Transition Rule

X Company
4 HCEs, 30 NHCEs
3% contribution

Y Company
6 HCEs, 20 NHCEs
6% contribution

- X and Y are part of controlled group. Do X and Y plans satisfy coverage?
 - For 2020 and 2021, plans are deemed to pass coverage (transition period)
 - Does *not* apply for nondiscrimination testing
 - Still must run nondiscrimination test but can run separate test for each plan
 - In this case, assuming contribution is based on nondiscriminatory definition of compensation, each plan satisfies uniform allocation safe harbor

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Example - Code §410(b)(6)(C) Transition Rule

X Company
4 HCEs, 30 NHCEs
3% contribution

Y Company
6 HCEs, 20 NHCEs
6% contribution

- X and Y are part of controlled group. Do X and Y plans satisfy coverage?
 - For 2022 - outside of transition rule
 - Each plan must satisfy coverage taking into account all employees in controlled group
 - If cannot pass using ratio test, can use average benefits test to pass coverage
 - Be careful if plan uses fail-safe coverage provisions

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Coverage / Nondiscrimination Tests

- If employer maintains more than one plan, may test each plan separately for coverage and nondiscrimination
 - If satisfy coverage separately, must run separate 401(a)(4) tests
- May permissively aggregate plans
 - If aggregate for coverage must aggregate for nondiscrimination
 - May only permissively aggregate if plans are using same plan year
 - Can only permissively aggregate qualified plans
 - Cannot aggregate qualified plan with 403(b) or SEP

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Example - Coverage / Nondiscrimination Tests

X Company
4 HCEs, 30 NHCEs
3% contribution

Y Company
6 HCEs, 20 NHCEs
6% contribution

- If both plans satisfy coverage, can test plans separately for nondiscrimination
- Why is that important?
 - Both plans satisfy a safe harbor contribution formula (equal percentage of compensation)
 - Do not have to worry about different benefits, rights and features
 - If one plan was a 401(k) plan, could run a separate ADP test for that group without bringing in other employees

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Merger of Plans

- If employer decides to merge plans, special issues can occur, especially if merger occurs mid-year
 - Timing of deferrals - when will Seller's employees begin participating in Buyer's plan?
 - How will Buyer enroll Seller's employees in Buyer's plan?
 - What will happen if cannot enroll Seller's employees right away?
- If merge plans, lose transition rule
- Special rules apply for running ADP test where plan is using prior year testing

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Example – Merger of Plans

- Buyer buys the assets of Seller on October 1, 2020. Buyer takes over Seller’s plan and continues to maintain plans as separate plans until they are merged effective January 1, 2022. How should the plans be tested for coverage and nondiscrimination for 2020 and 2021?
 - If the Buyer and Seller plans satisfied coverage prior to the sale, they are deemed to satisfy coverage during Code §410(b)(6)(C) transition period and may be tested separately for nondiscrimination

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Example – Merger of Plans

- Would answer change if plans are merged effective October 1, 2020?
 - The transition rule may not apply since there is a “change in coverage”
 - How should employer test plan for coverage and nondiscrimination in year of merger?
 - How should employer run the ADP/ACP tests?
 - May run three separate ADP/ACP tests
 - May run two ADP/ACP tests
 - May run single ADP/ACP test for the merged plans using full year data

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Example – Merger of Plans

- Assume Buyer merges plans effective January 1, 2020 and runs ADP test using prior year testing. How is ADP test performed?
 - Coverage change which results in more than one prior year subgroup - must use weighted average of NHCE ADP for prior year

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ADP Test - Weighted Average

- Applies when using prior year testing and have coverage change during year resulting in more than one “prior year subgroup”
- NHCE ADP = Sum of adjusted NHCE ADPs
- Adjusted NHCE ADPs = NHCE ADP x $\frac{\text{NHCEs in prior year subgroup}}{\text{total NHCEs in all prior year subgroups}}$
- Gives greater weight to ADP of plan with more NHCEs

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ADP Test - Weighted Average

- Seller's plan covered 100 employees. The ADP of the NHCEs for the prior year was 3.3%.
- Buyer's plan covered 200 employees. The ADP of the NHCEs for the prior year was 2.7%.
- The adjusted NHCE ADP for Seller's plan is $3.3\% \times 100/300 = 1.1\%$
- The adjusted NHCE ADP for Buyer's plan is $2.7\% \times 200/300 = 1.8\%$
- The weighted average for the merged plan is $1.1\% + 1.8\% = 2.9\%$

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Determination of Highly Compensated Employees

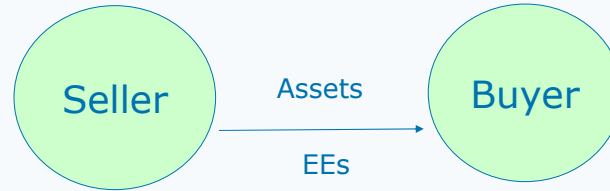
- Buyer buys the assets of Seller on 10/1/19. Bill, an employee of Seller, earned \$180,000 in 2018 and \$105,000 from 1/1/19 – 9/30/19. Bill earns \$40,000 with Buyer from 10/1/19 - 12/31/19. For 2019, is Bill an HCE of Buyer if:
 - Seller retains the plan after the sale
 - Buyer takes over the Seller's plan as a separate plan or merges the plans
- What about for 2020?
- What if Buyer buys the stock of Seller?

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Determination of HCEs



\$180,000 = 2018

\$105,000 = 2019

\$40,000 = 2019

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Plan Contributions

- Buyer buys the assets of Seller on 10/1/20. Jim deferred \$12,000 into the Seller 401(k) plan. The Seller 401(k) plan provides for employer contribution formula with last day of employment condition. Is Jim entitled to contribution under Seller's plan?
 - If Seller retains plan, Jim has no right to contribution because Jim has severance of employment before last day of plan year
 - Could Buyer make contribution for Seller employees in Buyer's plan?
 - If Buyer takes over plan, Jim is entitled to contribution unless Buyer amends plan to eliminate contribution before end of year

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Distribution Restrictions

- Distribution restrictions follow merged assets
 - Difference between merger and rollover
 - Be careful if have Money Purchase assets in Seller's plan
- Distribution of deferrals may not be made from terminated 401(k) plan if employer maintains a successor plan
 - Successor plan is any other defined contribution plan (except an ESOP) maintained by employer within 12 months of final distribution of plan assets
 - Successor plan does not include SEPs, SIMPLE-IRAs, 403(b) plans or 457(b) plans
 - Must terminate plan before sale to permit distribution

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Example - Distribution Restrictions

- Assume after an asset sale, Seller stays in business and continues to maintain the plan. May the employees now working for Buyer take a distribution from the Seller's plan and rollover to Buyer's plan?
 - Yes, employees have severance of employment
- Would answer change if Buyer took over maintenance of Seller's plan?
 - No severance of employment, but may take in-service distribution, if allowed

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Example - Distribution Restrictions

- Buyer purchases Seller in stock sale on 7/1/2020. Seller maintains 401(k) plan. Buyer does not want to merge plans due to concerns over possible qualification issues. May Buyer terminate Seller's plan on 7/2/2020 and distribute to participants?
 - No – Seller's plan is a "successor" plan
 - Buyer may not distribute deferrals upon plan termination since maintains another plan
 - Will have to continue Seller's plan, freeze Seller's plan or merge plans together
- What should Buyer and Seller have done?

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Termination of Seller's Plan

- If have stock sale and do not wish to merge plans, must terminate Seller's plan *before* transaction
 - Even though employees work for same company, IRS allows distribution since were in different control group at time of termination
 - Suppose Seller's plan was "terminated" on 6/25/2020, may distribution still be made on 9/1/2020, after sale has occurred?
- If do not terminate before sale, can maintain Seller's plan as frozen plan
 - Make sure plan is amended to freeze benefits
 - Amend Buyer's plan to cover employees of Seller

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Protected Benefits

- Plans generally cannot be amended to retroactively eliminate optional forms of benefit
 - Plans may be amended to prospectively eliminate benefits
 - Participants do not accrue right to benefits until have satisfied any allocation conditions on such benefits
- If merging plans, must protect optional forms of benefits under prior plan
- IRS regulations permit elimination of installments and annuity payments in non-pension plans

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Plan Loans

- Plan loans may become immediately due and payable if employees have severance of employment
- Employees may be allowed to transfer loans to Buyer's plan in direct rollover
- Employees may be able to use bridge loan

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Plan Termination

- Decision to terminate plan
- Establish date of termination
 - Board of directors or other formal resolution
 - As of termination date:
 - contribution obligations stop
 - 100% vesting applies
 - date on which the plan must be amended for all current laws and regulations
- Provide notice of termination to employees
 - Pension plans must provide an ERISA § 204(h)
 - Non-pension plans – Some type of notice that employer intends to terminate plan



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Plan Termination

- Amend the plan to:
 - Establish termination date
 - Update plan for all laws and regulations in effect on the date of termination
 - Cease plan contributions
 - Provide full vesting to all “affected employees” on the date of termination; and
 - Authorize plan to make distributions in accordance with plan terms as soon as administratively feasible after the termination date



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Plan Termination

- File for a determination letter (if desired) as to the qualification status as of termination – Form 5310
- Distribute plan assets
 - Calculate benefits
 - Provide proper notices to employees 30 – 180 days before date of distribution (Don't send too early!!)
 - Missing participants
 - Distribution restrictions
- Reversion of plan assets
- File final Form 5500



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Partial Plan Termination

- Upon a partial plan termination, all “affected” employees must be 100% vested
 - Whether a partial termination occurs is a factual question
 - Rev. Rul. 2007-43 provide guidance
- Partial termination - a significant reduction in plan participation caused by an EMPLOYER-INITIATED action
 - Sale of business (among other actions) is employer-initiated action



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Partial Plan Termination

- Revenue Ruling 2007-43
 - Employer ceases operations at one of four business locations, resulting in a 23% reduction in plan participation (excluding any severance from employment resulting from death, disability or retirement). The plan uses a 3-year “cliff” vesting schedule
 - The ruling concludes a partial termination has occurred under these facts



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Partial Plan Termination

- Presumption of partial plan termination if at least 20% reduction in participation
 - Number of participants experiencing employer-initiated severance divided by sum of participants at beginning of year plus new participants during the year
 - The determination takes into account both vested and nonvested participants.
 - Partial termination may extend beyond one year if series of “related” severances
- Employer-initiated severance occurs even if event is outside ER’s control, such as depressed economic conditions
- Employer may show severance was purely voluntary



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Partial Plan Termination

- Who is an affected employee?
 - IRS - An affected employee in a partial plan termination is generally anyone who left employment for any reason during the plan year in which the partial termination occurred and who still has an account balance under the plan
 - Other view – Affected employees in a partial termination are the participants eliminated from participation or the participants affected by the plan amendment that resulted in the partial termination. Other participants are not affected and continue to be subject to the vesting schedule with respect to their benefits



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Partial Plan Termination

- Use Form 5300 to request determination of partial plan termination
 - Why? – Determination not only impacts affected employees, but also other participants
 - Prevents potential disqualification or sanctions
 - Avoids costs if forfeitures awarded and distributed
- American Retirement Association and others are asking for relief from the partial plan termination rules during COVID-19 crisis



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Determination Letter for Merged Plans

- Revenue Procedure 2019-20 permits sponsors of individually-designed merged plans to apply for a determination letter
- For this purpose, a “merged plan” means a plan resulting from the merger or consolidation of two or more formerly separate plans into a single plan, which must have occurred in connection with a corporate merger, acquisition, or similar business transaction among unrelated entities
- To be eligible, a plan merger must be completed within the transition period under Code §410(b)(6)(C) and the determination letter application must be submitted by the last day of the first plan year (of the merged plan) that begins *after* the effective date of the plan merger



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Form 5310-A

- Form 5310-A – required notice in certain situations
 - A plan merger or consolidation that is the combining of two or more plans into a single plan
 - A plan spinoff that is the splitting of a single plan into two or more spinoff plans
 - A plan transfer of plan assets or liabilities to another plan that is the splitting off of a portion of the assets or liabilities of the transferor plan and the concurrent acquisition or assumption of these split-off assets or liabilities by the transferee plan
- Several exceptions are available



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Form 5310-A

- Merger/Acquisition Checklist
 - Designed to provide useful information in regard to the complex matter of mergers and acquisitions involving qualified retirement plans
 - Not a legal document or determination
 - Plan sponsors should always seek expert advice and consultation



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THANKS FOR ATTENDING!



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