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Retirement Plan Correction Solution
The Acquisition Apocalypse

Ilene H. Ferenczy, Esq.

Grace has long looked to expand her cosmetics business (Say Grace, Inc. or "SGI"), and finally decides to acquire a similar company. She is introduced to Frankie, whose small, five-employee company (You're Creamed, Inc. or "YCI") manufactures natural beauty creams and balms from fruits and vegetables. The two women hit it off like gangbusters, and, before they know it, their new company, Grace and Frankie Beauty Corporation, was formed in 2021.

When reporting the census information to their third-party administrator, Bud, in mid-2022, Grace's office manager notes in the transmittal communication that they added new employees in the prior year due to the purchase of the new business. This was news to Bud, who immediately wondered what new business purchase occurred and what effect this transaction had on the SGI 401(k) plan.

Company acquisitions are all too common these days, and it is also common that the lawyers, accountants and business owners who are involved in the transaction have no idea the havoc that can be wreaked upon the retirement plan of either, or both, companies. The effects on a plan can be enormous, and it is much harder to resolve these problems after the fact than it is to strategize in advance to get the desired result. Unfortunately, as is the case with Grace and Frankie Beauty, none of the M&A people tell the retirement plan professionals about the transaction until after it is completed, when it is often too late to have the best options.

Bud calls Grace to talk about the transaction, but finds that Grace is nearly as confused as he is. No, she doesn't know if it was a stock or asset purchase or a merger. No, she doesn't know if Frankie's company had a plan. She gives Bud the resources to ask: her corporate attorney, her accountant, and Frankie.

The First Issue: What Kind of Transaction Was It?

Whether the plans sponsored by the pre-transaction employers must now cover the employees of the newly related other company depends in large part on the legal structure of the purchase transaction. If the stock of YCI was acquired by SGI, YCI is now a wholly owned subsidiary of SGI and the two companies are considered to be one "employer" for retirement plan purposes. On the other hand, if the acquisition is related only to assets – SGI just bought YCI's "stuff" (such as, client lists, desks, computers, patents, formulas), any YCI employees that work for SGI after the acquisition have actually terminated employment with YCI and become SGI employees as of the date of the transaction. That means that the former YCI employees must complete eligibility requirements to enter the SGI plan, like all new hires, unless someone preemptively amends the plan to provide service credit for YCI work. Company mergers are generally treated similarly to stock acquisitions.

After much digging and data collecting, Bud finds out that:

1. SGI acquired the stock of YCI, which is now a wholly owned subsidiary.
2. SGI's name was changed to the new company name, Grace and Frankie Beauty Corporation, although the company (and its taxpayer ID number) stayed the same.
3. YCI sponsors a Simplified Employer Plan ("SEP-IRA") for her employees. Contributions were made to the SEP-IRA for the YCI employees for the 2021 plan year.
4. None of the employees of YCI have been enrolled in the SGI 401(k) plan to date.

The Second Issue: What Do the Plans Say?

Bud's next job is to see what the SGI 401(k) Plan says about subsidiaries and whether they are included in the Plan. Plan documents (including most preapproved plans) commonly contain specific provisions about people who become employees of the plan sponsor (or a related company) in connection with a business purchase. These employees are often referred to as "410(b)(6) employees," after an Internal Revenue Code section that discusses meeting plan coverage requirements after a business transaction.

SGI's plan specifically excludes 410(b)(6) employees until the last day of the plan year following the plan year in which the transaction occurred. This exclusion period (usually called the "transition period") is permitted by the Code under certain circumstances, to give companies a chance to adjust their plans after business transactions occur. As SGI's plan operates on a calendar year and the transaction happened in late 2021, the YCI employees will be excluded from the SGI plan through the end of 2022. Bud takes a deep breath: there's been no violation of the plan due to failure to enroll the YCI employees for 2022.

The YCI SEP-IRA, on the other hand, may be a problem. A SEP-IRA must cover all employees of the controlled or affiliated service group, which includes parents of wholly owned subsidiaries. Bud knows that a SEP-IRA can require that eligible employees work for the employer during at least three of the past five years before entering the plan … but worked for whom? Does the service performed by SGI employees prior to the time when YCI and SGI became related employers count for this purpose? Bud makes a note to find out. (Spoiler alert: The answer to this question is not clear from the law or IRS regulations. Therefore, SGI and YCI should discuss this with legal counsel.)

Bud makes a note to talk about these issues with his client, and to confirm what legal changes must be made to the SEP-IRA documentation if the SGI employees need to participate. He also makes a note to evaluate whether to keep the SEP-IRA in place through 2022, or to terminate it immediately.

The Third Issue: What Do Grace and Frankie Want in the Short Run?

It is common that owners of newly related companies want to have one set of retirement plans for everyone. In that case, SGI would want to let the YCI employees into its plan right away. As the

SGI plan provisions say that the YCI employees are excluded for a period of time, the plan would need to be amended to accomplish this. Similarly, some companies want to keep plans separate for forever, particularly if the types of businesses are very different from each other or if the parent company encourages a decentralized management of each subsidiary. This might also take some design finesse.

This is where pre-planning is critically important. Prior to an acquisition, changes may be made to a plan to make sure employees will be excluded from or enter the plan after the transaction, as desired by the owners. If this is not examined before the purchase, it is possible that the plan provisions will create an unintended result.

Suppose, for example, that Grace and Frankie wanted the YCI employees to be in the SGI 401(k) plan as of January 1, 2022. Therefore, they enrolled all the YCI employees, got their salary deferral elections, and began making those deferral contributions to the plan as of the first 2022 payroll date. Because the SGI 401(k) plan excludes the YCI employees, this would mean that SGI let a whole bunch of people participate who were not eligible to do so. This is a violation of the plan's terms, and can cause a loss of tax-deferred status to the entire SGI plan unless fixed.

Similarly, if the terms of the SGI 401(k) plan *included* the YCI employees, but this was not the desired result, a failure to enroll the YCI employees after the acquisition would be a failure to follow the plan's terms. The correction for this error – which would involve Grace and Frankie Beauty Corporation having to make corrective contributions for the YCI employees – can become very expensive.

Finally, What Do Grace and Frankie Want in the Long Run?

Even though the law and the plan terms may permit the exclusion of an acquired company's employees during the transition period, the plan must meet all the coverage and nondiscrimination rules after that period ends. Changing plans and their design isn't necessarily an easy thing, so preplanning is required. Someone needs to work with the plan sponsors to make sure that their retirement program operates in the future in a way that will accomplish their goals.

Recommendations: Preparing Your Clients Before They Contemplate a Transaction

TPAs often tell us mournfully about clients who engaged in company purchases or sales without letting them know in advance, and then seek our assistance in handling the problems that arise as a result. You need that little voice in your client's head that reminds them of things they need to do (a la Jiminy Cricket) to speak up in time to get early advice. Here are some ideas to help you prime that pump:

1. **Put it in your service contract that the employer is obligated to tell you about company transactions and recommend that they do so before the transaction**. Service agreements that we prepare state, "The options for dealing with certain plan issues in the event you buy another company or the Company itself is purchased by another are much broader *before* the transaction occurs than after. Please advise us as early as possible of a pending company transaction so that we can do our best work for you in this context." This also protects you from liability when the client points its finger at you for the mess that results from not getting you involved sooner.
2. **Remind clients in your annual data request of their obligation to inform you of company transactions and that they should do so in advance of the transaction.**
3. **Mention this to your clients periodically in other conversations or correspondence**.

4. **Tell the client's other advisors about your need to know about transactions early**. The accountant and attorney for your client will likely be involved in the transaction and may be less emotional when this momentous event occurs for your mutual clients.

If worse comes to worst, it is our experience that a client (and, perhaps, its other advisors) who finds itself in a mess due to a lack of preplanning will remember the hard lesson the next time such a transaction takes place.

Conclusion

In this case, Grace and Frankie were lucky. They didn't take any actions after the transaction in violation of their plans' terms, and they still have time for proper planning before they need to cover the YCI employees in the SGI 401(k) plan. On the other hand, the YCI employees may be very unhappy if the SEP-IRA is terminated, because they will have no plan during the transition period. That may speed up the amendment and integration process in the SGI 401(k) Plan.

Have an M&A question that you need answered? Contact us. After all, we are your ERISA solution!

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BENEFITS LAW CENTER
We are your ^ solution™ ERISA

Ilene Ferenczy • ilene@ferenczylaw.com | Alison Cohen • acohen@ferenczylaw.com
Adrienne Moore • amoore@ferenczylaw.com | Adriana Starr • astarr@ferenczylaw.com
Tia Brown • tbrown@ferenczylaw.com | Leah Dean • ldean@ferenczylaw.com

2635 Century Parkway Suite 200, Atlanta, GA 30345
T 404.320.1100 | F 404.320.1105 | www.ferenczylaw.com