Employee benefits consideration in corporate mergers and acquisitions

Vanguard commentary

December 2016

Employers that sponsor a retirement plan face a host of potential issues to consider both before and after a corporate merger or acquisition. These include the impact of the type of corporate transaction on the employee benefit plans sponsored by the buyer and the seller and the integration of the employee benefit programs following a corporate merger or acquisition. These topics can be complex and often require appropriate analysis and planning prior to an acquisition in order to meet the goals of all parties and the needs of the affected employees.

We will limit this discussion to a consideration of the issues affecting tax-qualified retirement plans and the alternatives available to the acquiring entity (the buyer).

Type of transaction

The type of transaction generally determines the options available to the acquiring entity. For purposes of this discussion, the types of transactions we will consider will be limited to those associated with an acquisition of the assets of another organization (an "asset acquisition") and the acquisition of all or a majority of the ownership interests of another organization (a "stock acquisition").

Asset acquisition

If the transaction involves the acquisition of all or a portion of the assets of another entity, the acquiring entity (the buyer) will typically not have any responsibility for the retirement plans of the entity from which the assets were acquired (the seller). This is due to the fact that the seller remains a "going concern" because all that has occurred is an exchange of one type of asset for another—e.g., operating assets exchanged for cash or other valuable consideration. The seller remains in existence and continues to sponsor the retirement plan in the same manner as before the transaction. If employees of the seller now work for the buyer, they will simply be considered terminated employees of the seller, with the same distribution rights under the retirement plan of the seller as any other terminated employee.

Thus, in the case of an asset acquisition, the retirement plans of the seller remain with the seller. The buyer does not automatically assume any responsibility or liability for the retirement plans of the seller. This is a particularly important consideration when the seller sponsors a substantially underfunded defined benefit pension plan. In an asset deal, the buyer does not assume responsibility for the seller's pension plan. The underfunded plan, and any associated liabilities, generally remain with the seller. (However, because the pension plan is underfunded, the Pension Benefit Guaranty Corporation (PBGC) will have a keen interest in the transaction and will exercise jurisdiction over the disposition of the cash proceeds of the sale, applying those proceeds to reduce or eliminate the underfunded condition of the pension plan).[1]

Plan spin-off

If the buyer is acquiring a portion of the business of the seller, such as a division or a business unit, there may be a desire on the part of the buyer to retain the retirement plan of the seller after the closing date of the sale for the employees who are hired by the buyer. For example, this sometimes occurs when a foreign parent company, with no operations in the United States, acquires all or a portion of the assets of a U.S. business. Because the foreign parent does not sponsor U.S. retirement plans, it may be willing to continue to sponsor all or a portion of the retirement plan of the selling company. In such a situation, a plan spin-off can serve to meet the needs of the buyer and the seller.

In a plan spin-off, all or a portion of a U.S. tax-qualified retirement plan is deemed to be sponsored by the acquiring company at the moment of the transaction. In other words, the seller is deemed to sponsor the retirement plan prior to the moment of sale, and the buyer sponsors the plan upon the completion of the sales transaction. If the buyer is acquiring only a portion of the business, only the portion of the plan that covers the plan participants who are employed with the buyer will be "spun off" from the seller's plan. The remainder of the plan will remain with the seller. A Form 5310 may be required to be filed in a plan spin-off.

Stock acquisition

If the buyer acquires all or a majority of the stock or other ownership interest in the seller, upon the completion of the transaction, the buyer will be considered to be a direct or indirect sponsor of the retirement plans of the seller.

The sponsorship of the seller's retirement plans has significant implications for the buyer because the compliance of those plans with federal laws and regulations prior to the date of sale becomes the responsibility of the buyer upon the completion of the transaction. Thus, it is in the buyer's interest to determine the compliance of the seller's retirement plans with all reporting, disclosure, nondiscrimination and coverage testing, and a host of other requirements prior to the completion of the sale, if possible, but certainly before the merger of the seller's plan with that of the buyer if such due diligence cannot be exercised earlier.

1 ERISA section 4062.

What are the alternatives available to the buyer in this scenario? Let's consider several of the most common.

Termination of seller's plan

Because the seller's plan may bring with it the potential for significant non-compliance with federal law and regulatory requirements, one approach might be to simply terminate the acquired plan. The primary advantage to the buyer is the elimination of ongoing penalties for the operational non-compliance of the acquired plan. There also is the matter of filing a timely claim against the transaction escrow account if a government agency levies fines or penalties upon a review of the terminating plan's satisfaction of regulatory requirements. Such claims must generally be made within a short period of time following the completion of the acquisition transaction.

There are several downsides to the termination of the retirement plans of the seller. Upon termination, the accounts of plan participants become immediately distributable. This could result in some plan participants squandering their retirement benefits on nonretirement purchases, such as a boat, car, etc.

If the terminated plan is a 401(k) plan, and the assets are distributed to plan participants, those participants cannot participate in another defined contribution plan of the employer for a period of twelve months following the date of the distribution. This restriction is imposed even if the participant chooses to roll over his or her account from the terminated plan to the new employer's plan. A one-year suspension of contributions by participants of the terminated plan would have significant negative consequences to the retirement security of those participants.[2]

Finally, the termination of a retirement plan can have unforeseen consequences on the buyer as plan sponsor. For example, while a defined benefit pension plan may be fully funded on an ongoing basis, the pension plan may be significantly underfunded on a termination basis. This is a result of the different factors used when measuring funding of a terminated versus an ongoing plan.

In conclusion, the termination of an acquired company's retirement plan may not be the panacea that it first appears.

Maintain two separate plans

Another alternative is for the buyer to continue to maintain the plans of the seller, separate from the retirement plans of the buyer. These separate plans can be active or "frozen." An active plan would continue to cover the acquired employees just as it had when they were employed with the seller, providing contributions based on the previous formula or an entirely new formula. A frozen plan would cease contributions for employees who are participants in the plan but would continue to maintain the account balances of the plan participants and satisfy all reporting and disclosure requirements.

The advantage to maintaining the seller's retirement plans as separate plans is the ability to offer a retirement plan to the acquired employees without any impact to the buyer's retirement plans. This is especially important if it is evident that the acquired company's retirement plans were not operated in a manner that was compliant with all applicable federal laws and regulations. A noncompliant retirement plan could "taint" the retirement plan of the buyer if the plan was merged with that of the buyer, potentially jeopardizing the tax-qualified status of both plans.

The primary disadvantage to maintaining separate retirement plans for the employees of the selling company is the added cost of maintaining multiple plans, including the costs associated with plan reporting (such as Form 5500), plan audits, separate coverage and nondiscrimination testing, maintenance of separate plan documents, and summary plan descriptions. If the buyer is an active acquirer of other businesses, it may find itself with multiple retirement plans, the compliance and administration of which would quickly become unwieldy.

2 One way to avoid this result is for the seller to terminate the plan. Since the one-year restriction on participation is imposed on the employees of the employer (here, the seller) terminating the plan, the plan participants would not be prohibited from participating in the 401(k) plan of the buyer, resulting in no interruption in participation.

Merger of retirement plans

The most logical approach to the disposition of an acquired retirement plan may be to merge the acquired plan into the plan of the acquiring entity. The resulting plan would provide contributions and benefits to the employees of the buyer as well as to the newly acquired employees. A plan merger eliminates the duplication and expenses associated with maintaining two plans. When the plans merge, there will be one plan document, one summary plan description (SPD), one plan audit, one Form 5500, etc.

The downside to a plan merger is the potential that the acquired company's plan may taint the surviving plan of the buyer if the seller's plan did not comply with the myriad of procedural and operational compliance requirements in the years preceding the plan merger. As a result, it is imperative that, before undertaking a plan merger, the acquiring company perform an exhaustive review of the procedural and operational compliance of the seller's plan for the years prior to the acquisition. Because government agencies generally are restricted to a three-year statute of limitations[3] in the audit of a retirement plan, a review of the procedural and operational compliance of the retirement plan for the four preceding years should be sufficient.

Keep in mind that if there are any material errors or noncompliance issues identified during the review, the acquired company's plan should not be merged with the plan of the buyer until the identified issues can be resolved through the Internal Revenue Service (IRS) Employee Plans Compliance Resolution System (EPCRS) program.

There are no formal requirements for a plan merger, apart from a board resolution, amendment, or other document authorizing the merger. A Form 5310 may be required if the allocation of the assets of the plans, post-merger, will be different than the allocation of the assets of the plans prior to the merger.

Plan transition

The decision to merge the plan of the acquired company into the plan of the buyer is the first of several decisions the plan sponsor will have to make before effectively merging the plans. For example, the plan sponsor must consider how merging the plans will impact the design of the acquiring plan. This next section identifies common issues encountered when merging defined contribution plans and presents considerations for making those decisions. It assumes the surviving plan will remain with the buyer's trustee and recordkeeper.

To effectively prepare for a successful merger, planning often begins more than a year ahead of the planned merger date. Plans with less complexity may be merged with as little as four-to-six months' preparation. No legal or regulatory deadline exists for merging plans once the employer-level transaction occurs, although the limited period of transitional relief for which the employer may qualify, as outlined later in this paper, can impose a deadline. Employer interest in offering a consistent benefit package to all employees and simplifying administration of the plans generally drives the timeline.

3 Generally speaking, the IRS statute of limitations is measured from the date Form 5500 is filed for a given year.

Review contracts

An important yet often overlooked aspect of preparing for a plan merger involves reviewing existing contracts with service providers, including the recordkeeper, the trustee, and the issuer of a stable value fund (SVF) or guaranteed investment contract (GIC) offered as an investment within the acquired plan.

In reviewing contracts, the plan sponsor should identify any advance notice requirements when terminating these relationships. Lead times generally range from 30 to 90 days, although certain investment contracts may impose longer transition periods. The contracts also will disclose fees that may be incurred relative to the plan merger, such as termination fees. The recordkeeper may assess conversion fees associated with the transfer of participant records. The plan sponsor will also want to be aware of whether short-term redemption fees will be imposed at the time of the transfer if any mutual funds that will be liquidated charge such fees.

If the plan merger involves the removal of a GIC or SVF from the investment lineup, special attention must be paid to these contracts to identify potential liquidity issues. While these funds generally offer full liquidity for participant-directed transactions, most contracts don't extend the right to immediate withdrawals at book value when full liquidation occurs as a result of merger activity. Upon receiving a request for a plan-initiated liquidation, the providers of these investments often have the right to exercise a "put provision," which is typically a 12-month advance notice period intended to protect issuers and remaining investors. Alternatively, the contract may permit earlier liquidation with a market-value adjustment, which could result in a loss to participants holding the investment. However, depending on market conditions, the provider may shorten or even waive the put option.

If a GIC or SVF provider exercises the put, or the plan sponsor does not want participants to incur a market-value adjustment, the plan sponsor may have the option to discontinue new investments to the contract and maintain the existing investment until the put expires, at which time it is transferred to investments in the surviving plan. All other plan assets are transferred to the funds in the surviving plan as of the merger date. Generally, individual participants can withdraw their own investment in the GIC or SVF at book value, during the period in which the put is in effect, in the case of a distributable event or even through a participant-initiated exchange.

If the acquired company is a party to one or more collective bargaining agreements, these agreements should be reviewed to determine whether their terms require the employer to provide benefit or contribution increases that are not reflected in plan documents. For example, if a union negotiates increasing levels of matching contributions over the term of the agreement, the acquiring company should be aware of this when planning the future cost of the employee benefit programs.

Fund lineup and transfer of plan assets

The merging plans most likely offer different investment options. The fund lineup of the acquiring plan is frequently maintained. The plan fiduciary has responsibility for the selection and monitoring of the investments offered in the plan while adhering to the plan's investment policy statement. This may be an appropriate time to review the investment lineup of the acquiring plan to identify gaps and consider whether funds should be added or substituted.

Once the future lineup is finalized, the plan sponsor must determine how to establish investment elections and invest participants' accounts from the acquired plan into the investment options of the surviving plan. The two options available are fund mapping or a reenrollment.

Fund mapping versus reenrollment

A fund mapping approach involves identifying an investment in the ongoing fund lineup that is similar in investment objective, risk, and return to each of the funds offered in the acquired plan's lineup. Participants' investment elections and existing account balances as of the date of the merger are then established in the surviving plan according to this mapping strategy. Mapping to similar funds preserves the investment mix the participants selected or were defaulted into in the past.

Fiduciaries may be afforded some protection from liability for such mapping to like investment options, provided certain conditions are met. The Pension Protection Act of 2006 (PPA) extends ERISA §404(c) fiduciary relief for participant-directed accounts to the mapping of a participant's assets from one fund to another when the mapped investments are "reasonably similar" to the prior investments in terms of risk and return. The participants must also receive proper notification of the mapping and have opportunity to make changes prior to the mapping.

Therefore, if participants of the acquired plan previously selected their investment mix or were properly defaulted into a qualified default investment alternative (QDIA), fiduciaries may benefit from section 404(c) protection for the fund mapping. The mapping approach offers other advantages in that participants do not have to select investments again from the new lineup and the assets remain invested in the market throughout the transition process.

Disadvantages of the fund mapping strategy also exist. For example, if there is no similar fund in the surviving plan's investment menu for one of the investment options, the fiduciary must select a fund that may not meet the PPA requirements, thereby limiting the relief afforded. Per the discussion above, the fiduciary may have opportunity to review and select an appropriate fund to address this gap. Another challenge presents itself when some participants did not direct their investments in the past and were defaulted into a fund that was not a QDIA. For example, participants may have been defaulted years earlier into a money market fund, which does not satisfy QDIA requirements and offers no fiduciary protection. Mapping those participants' accounts now to the money market option in the surviving plan provides no fiduciary relief. If this scenario exists and the surviving plan offers a QDIA, the reenrollment strategy that follows may be the better approach. Finally, in retaining the same investment mix for participants, fund mapping does nothing to address issues of poor portfolio diversification for individuals.

The reenrollment strategy provides the acquired employees an opportunity to choose new investment elections in the surviving plan ahead of the transfer of plan assets from the acquired plan. The transferring assets are then invested according to participants' current investment elections when the plans are merged. Account balances transferring for participants who do not select new investments in the surviving plan will be invested in the plan's default fund.

Assuming that the surviving plan has adopted a QDIA and the plan sponsor meets the timing and notice requirements provided in Department of Labor (DOL) regulations[4], the reenrollment approach limits fiduciary liability on the investment of the transferred assets and future contributions. If the plan fiduciary has not previously established a QDIA, one may be adopted as the plan's default investment at any time. Two-thirds of Vanguard plans have designated a QDIA under the DOL's regulations, 90% of which have selected target-date funds as their QDIA.[5]

In addition to the fiduciary protection that proper reenrollment can provide, this method may also dramatically improve diversification of the acquired participants' investment portfolios. Adequate diversification is a key driver of long-term investment success.[6] As a best practice, the plan sponsor who is concerned that participants in the surviving plan may not be adequately diversified may want to consider reenrolling a broader group than just those in the acquired plan. As long as the reenrollment complies with the DOL's QDIA regulations, fiduciary relief is available even if the investment lineup is not changing for some participants involved.[7]

The reenrollment approach will require active participants to select their investment mix anew and may also involve a few days during which plan assets are "out of the market" while participants' account records transfer. However, the plan sponsor may find that the long-term benefits of broadly improved diversification and the fiduciary relief provided by the reenrollment far outweigh the perceived short-term inconveniences of the mapping strategy.

Plan design considerations

When merging defined contribution plans, inevitably there will be many dissimilar provisions between the plans. Review of the provisions and features of each of the plans is imperative. While the plan sponsor may be legally obligated to preserve certain features pertaining to the accrued benefits from the acquired plan, the sponsor may want to consider new features or revise existing ones. Optimally, the plan design of the surviving plan will incorporate features from each of the predecessor plans that together promote the best participant outcomes.

Protected benefits

Prior to merging, the plans' provisions must be compared to ensure that the merger does not violate the "anti-cutback" rule of Internal Revenue Code (IRC or Code) §411(d)(6). This section of the Code provides that protected benefits that have already accrued cannot be reduced or eliminated by an amendment or transfer. Any differences between the merged plans may be required to be retained to preserve rights earned on accrued benefits. The following are common protected benefits:

- Accrued benefit, including the accrual of vesting
- Early retirement benefits
- In-service withdrawals, such as withdrawals at age 59½
- Optional forms of benefit
  - Payment schedule
  - Timing of payment
  - Commencement of benefit
  - Medium of distribution (e.g., in cash or in kind)

4 29 CFR Reg. §2550.404c-5.

5 *How America Saves 2016: A report on Vanguard 2015 defined contribution plan data.* Vanguard, 2016.

6 V*anguard's Principles for Investing Success.* Vanguard, 2014.

7 For more information about the benefits and considerations of a reenrollment strategy, please see *Reenrollment in a QDIA improves plan diversification.*

Certain optional forms of benefit may be eliminated if a lump-sum distribution option is available on identical terms to replace the options that were removed. For example, if a plan permits a terminated participant to begin receiving monthly installment payments at age 50, but the same participant cannot take a lump-sum distribution of his or her account until reaching age 65, the installment payment option cannot be eliminated. On the other hand, if the plan permits all participants to take a lump-sum distribution upon termination of employment, then the monthly installment payment option at age 50 may be eliminated. Additionally, provided the merging plans are nonpension plans (e.g., 401(k) profit-sharing plans) and have no former money purchase pension plan assets, a qualified joint and survivor annuity (QJSA) optional form of benefit may be eliminated if the surviving plan offers a lump-sum distribution upon termination of employment.

While not an exhaustive list, the following commonly available provisions are not protected benefits under IRC §411(d)(6) and may be eliminated prospectively:

- Hardship withdrawals
- Loans
- The right to make elective deferrals
- The right to make after-tax contributions

Although the above may be eliminated prospectively, the plan sponsor will want to weigh these decisions before proceeding and determine the goals of the retirement plan, taking into consideration the impact to the participants.

Automatic enrollment

Automatic enrollment, a plan feature by which employees are defaulted into participation in the plan at a default deferral rate unless they opt out, has been proven to increase participation rates significantly relative to voluntary enrollment. In fact, among employees who have been subjected to an automatic enrollment feature in their plan, the overall participation rate in Vanguard plans is 88%, whereas the participant rate of employees hired under plans with voluntary enrollment is 58%.[8]

The success of this feature has contributed to a rapid increase in its adoption since Congress endorsed its use through the PPA. As of 2015, more than half of all Vanguard plans with more than 500 employees include an automatic enrollment feature.[9]

If the surviving plan offers automatic enrollment, the plan sponsor must determine whether non-participating employees of the acquired plan will be automatically enrolled during the merger. This will certainly improve plan participation among this group. Consideration may also be given to "sweeping" employees who are saving less than the default deferral rate into the automatic enrollment program. In considering how to apply the automatic enrollment feature during the merger, the employer who matches employee contributions must also calculate the additional cost that will be involved as a result.

Special attention must be paid to Qualified Automatic Contribution Arrangement (QACA) safe harbor plans. By design, they require the automatic enrollment of all eligible employees who have not previously made an affirmative election. If the surviving plan is a QACA plan, the plan sponsor should engage its ERISA counsel to ensure all requirements are met in enrolling the acquired employee population.

If the surviving plan has not previously adopted an autopilot plan design, one in which employees are automatically enrolled into a QDIA and the deferral rate is increased annually, a plan merger may present an opportune time to adopt the design for all employees. Not only can this design improve participant outcomes, it can also improve nondiscrimination testing results if one or both of the plans being merged has failed nondiscrimination testing in the past. The testing results will improve more rapidly if nonparticipants are automatically enrolled, in addition to enrolling new hires prospectively, but again, the employer who matches employee contributions must prepare for increased matching costs.

8 *How America Saves 2016: A report on Vanguard 2015 defined contribution plan data.* Vanguard, 2016.

9 *How America Saves 2016: A report on Vanguard 2015 defined contribution plan data.* Vanguard, 2016.

Roth and other changes "while the hood is up"

In the case of a plan merger, the merged plan is considered a continuation of the transferred plan. Therefore, elections such as deferral elections generally remain in effect, and transferred employees are not required to make new elections. However, a challenge can present itself if one of the merged plans offers Roth elective deferrals, but the other plan does not. The popularity of the Roth elective deferral option continues to grow, as evidenced by the fact that 60% of all Vanguard defined contribution (DC) plans offered Roth contributions at the end of 2015.[10] Therefore, it is not uncommon in approaching plan mergers for one plan to offer Roth while the other does not. Current IRS guidance does not address whether a plan with Roth contributions can be merged with a plan that does not provide for Roth contributions. One alternative to address this uncertainty is to add Roth contribution features to the plan that does not have them prior to the date of the plan merger. Existing Roth assets must be transferred into the surviving plan, retaining any necessary protected benefits and information to determine when the Roth assets satisfy the five-year holding period generally required for a qualified withdrawal.[11]

Congress continues to pass legislation and discuss budget considerations that encourage adopting Roth features, and many consider offering Roth deferrals to be a best practice for plan design because it encourages future tax diversification. That said, the plan sponsor must also recognize that permitting Roth elective deferrals requires payroll programming to accommodate an additional tax deferral and plan accordingly.

An examination of the future offerings of the merged plan would be incomplete without a review of the options to assist participants in selecting investments. As previously noted, proper diversification of one's investment portfolio is a key driver for long-term investing success. By offering professionally managed allocations such as target-date funds and managed account advisory services, as well as a range of advice programs, a plan sponsor can help significantly improve participant investment outcomes.

By the end of 2015, 90% of all Vanguard DC plans offered target-date funds, and 3 out of 4 large plans offered at least one advice program. Providing a suite of options provides participants the ability to choose the most preferred elements for their individual approach to investing. Responsibility for selecting and monitoring the fund lineup and advice products rests with the plan fiduciaries, but if plan sponsors perform their due diligence, they will generally not be responsible for investment losses associated with the actual advice provided to participants.

"Transition" benefits for certain employees?

A company-level transaction may result in the provision of transition benefits offered in the retirement plan for certain employees. For example, the agreement of sale may require that the buyer make an employer contribution on behalf of the acquired employees, or a subset of the employees, for a period of time. Another possible scenario is when the buyer or seller offers a defined benefit (DB) pension plan to their employees, but the buyer determines it does not want to extend the DB benefit to more employees. Instead, it may decide to make a contribution to the DC plan for those employees who are not eligible for the DB plan. When a non-match employer contribution is provided to a select group, it will be subject to general testing under IRC section 401(a)(4) to ensure that it is nondiscriminatory. The plan sponsor should notify the plan administrator of the transition benefit to discuss the necessary testing and identify assistance for completing it.

10 *How America Saves 2016: A report on Vanguard 2015 defined contribution plan data.* Vanguard, 2016.

11 A withdrawal of Roth 401(k) assets is generally a qualified withdrawal (i.e., tax-free) if the Roth source has been established for at least five years and the participant is at least age 59½ at the time of the withdrawal.

Additional plan merger considerations

Utilization of forfeiture account

The acquired plan may have a balance in a forfeiture account. The plan sponsor should review the document of the acquired plan to determine the permissible uses of the forfeiture account. To the extent possible, the forfeiture account should be appropriately exhausted prior to merging the plan with the surviving plan. After the merger occurs, any remaining forfeitures become assets of the surviving plan and are subject to the permissible uses under that plan.

Outstanding loans

Outstanding loans are another important element of the acquired plan requiring attention. They may introduce many complications, particularly if the surviving plan does not offer loans or if loan repayments occur through payroll deduction and participants' payroll frequency changes as a result of the acquisition.

A participant who has an outstanding loan has an ongoing obligation to continue to repay it until it is paid in full or the loan becomes distributable. Keeping the loan current is critical in order to avoid the tax consequences under IRC §72(p), as the Code provides no exception for meeting the loan repayment requirements during acquisitions and resulting plan-level transactions.

If the surviving plan does not permit loans, or permits fewer loans outstanding than the acquired plan, the plan sponsor has the option to "grandfather" these loans when the plans are merged. Most commonly, plan sponsors choose to grandfather these loans, if this is administratively feasible, in order to avoid immediate taxable consequences for those participants who do not have the means available to pay back their loans. Once the grandfathered loans are repaid, the participants of the acquired plan are subject to the loan provisions of the surviving plan as they relate to the number of outstanding loans, etc.

Often loan repayments are set up based on the participant's payroll frequency, as payments are deducted through payroll. If the acquisition results in a different pay frequency, the IRS permits reamortization of the loans to match the new pay frequency. Reamortizing the loans will likely result in a change to the payment amounts, which the plan sponsor will want to clearly communicate to the affected participants.

IRC §410(b) and "transitional relief" under IRC §410(b)(6)(C)

After an acquisition or divestiture, the composition of the buyer and seller's plans may differ significantly from their composition before the transaction. However, the plans will need to continue to satisfy the minimum coverage requirements in Code section 410(b). The coverage requirements may be satisfied by the plan on a stand-alone basis or on an aggregated basis with another plan maintained by the new controlled group in accordance with Treasury Regulations section 1.410(b)-7. If the plan is aggregated, however, all nondiscrimination testing will be performed with respect to the aggregated plan. This includes Actual Deferral Percentage (ADP) and Actual Contribution Percentage (ACP) testing under IRC §401(k) and §401(m), respectively.

In order for plan sponsors to have a reasonable amount of time to determine how best to structure the delivery of qualified plan benefits in a manner that complies with the minimum coverage requirements, IRC §410(b)(6)(c) provides transitional relief, which begins when an entity becomes or ceases to be a member of a controlled group as a result of acquisition or disposition. Acquisitions and dispositions may refer to a stock or asset transaction. Note: The coverage transition rule may only be triggered where there is a company-level transaction (not plan-level), and use of this rule is optional.

The requirements of 410(b)(6)(c) are met if:

- IRC §410(b) requirements were met immediately before each such change; and
- The coverage under the plan is not significantly changed during the transition period, other than a change directly resulting from the acquisition or disposition (e.g., an amendment during the transition period to exclude hourly paid employees would violate this rule because the exclusion of hourly paid employees is not directly related to the acquisition or disposition—loss of the transition rule would be on a prospective basis from this point).

The transition period means the period:

- Beginning on the date of the change in members of a controlled group; and
- Ending on the last day of the first plan year beginning after the date of the change in the controlled group.

By applying this rule, coverage is deemed to be satisfied during a transition period by any plan maintained by an employer involved in the company-level transaction. This gives the employers some flexibility in maintaining separate plans, at least during the transition period, while options are analyzed for the plans in the post-transition years.

ADP/ACP Testing

Once a controlled group has satisfied the requirements of IRC §410(b), the manner in which the plans were structured for coverage testing will determine how ADP and ACP testing will be performed. Special concerns arise when testing is required after a corporate transaction, particularly if the transaction's close does not coincide with the end of the plan year.

Plan sponsors need to determine the data required to apply the ADP/ACP testing rules. This is made all the more difficult since the IRS has never provided definitive guidance on the testing requirements for a plan merger or spin-off that occurs in the context of a business transaction.[12] The following example illustrates the ADP/ACP testing options when two previously unrelated employers maintain plans that are merged during the respective plan years:

> Company X and Company Y are not part of the same controlled group until March 31, and their respective plans, both calendar plan years, are merged April 15. Prior to April 1, these two plans were maintained by unrelated employers, and the coverage transition rule under IRC §410(b)(6)(C) should be available in this instance to alleviate the need to perform a coverage test for the current plan year and the next plan year. However, both plans allow pretax deferrals with employer match, so there is still a need to perform ADP and ACP testing. Any of the following three approaches should be considered reasonable:
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> Option #1: Treat the plan as a single plan for the entire plan year in which the merger occurs, and apply any applicable nondiscrimination tests as if there was one plan for that year. This is effectively a "permissive aggregation" election. Note: If the "merged" plan uses the prior year testing methodology for ADP and ACP testing, special rules apply. See below for a discussion of these rules.
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> Option #2: Treat Company X's plan as terminating as of the merger date (April 15). The applicable tests are performed for X's plan for the short period of January 1–April 15, based on contributions made during that period. Company Y's plan performs the applicable tests for the entire calendar plan year, but treats Company X's employees as eligible for the Y plan as of April 15, and takes into account only their contributions to the Y plan for the period April 15–December 31.
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> Option #3: Treat Company X's and Company Y's plans as terminating on April 15, creating two short plan year tests for X and Y for the period January 1–April 15 that includes only those contributions for that period. The merged plan then performs a separate test for April 15–December 31, including only contributions for that period.

Another way to deal with the nondiscrimination testing issue is to postpone the merger of the two plans until the beginning of the next plan year. Again, this is facilitated by the use of the §410(b) transition rule; with coverage testing satisfied, nondiscrimination testing may continue to be performed separately during the transition period.

The Code provides for the use of prior year data in determining ADP/ACP for non-highly compensated employees (NHCEs), while continuing to provide the use of current year data for highly compensated employees (HCEs). The Code also provides for the use of current year data for NHCEs upon election, subject to certain restrictions. Treasury regulations provide a special acquisition-related rule permitting a change to the prior year methodology if a transaction described in Code Section 410(b)(c)(i) and Treasury regulations section 1.410(b)-2(f) occurs and as a result of the transaction, the employer maintains both a plan using the prior year method and a plan using the current year method. The change must occur during the IRC §410(b)(6)(c)(ii) transition period. Absent the special

12 Other than the "plan coverage change" rules, which are found under IRC §401(k) and were originally published in IRS Notice 98-1, the IRS has not provided any guidance on how to address the ADP and ACP tests when plans are merged or spun off, particularly when the transaction occurs on a date other than the first day of the plan year. With regard to the Options below, the guidance in IRS Notice 98-1 would suggest the IRS may prefer Option #1 when the plan years for the merged plans are the same; Options #2 and #3 are primarily for situations with different plan years, but some practitioners use these methods even when the plan year is the same. It is recommended that employers seek the advice of counsel to determine what options might be available to a plan sponsor.

transition rule, a plan may change to the prior year method only if it is not the result of the aggregation of two or more plans and it used the current year method for the five preceding years (or the number of years the plan has been in existence, if fewer, including the years in which the plan was a portion of another plan). In case of an aggregated plan, all component plans must satisfy this five-year rule.

If a plan results from or is affected by a "plan coverage change" during the testing year, and the prior year methodology is applied, the prior year nonhighly compensated employee (NHCE) ADP/ACP is a weighted average of the ADPs and ACPs for the prior year subgroups. A "prior-year subgroup" is defined as all NHCEs who were eligible employees under a specific 401(k) plan maintained by the employer and who would have been eligible employees in the prior year under the plan being tested if the plan coverage change had been effective as of the first day of the prior-year instead of effective in the testing year. Note: There is an exception for minor plan coverage changes: If 90% or more of the NCHEs are in a single prior-year subgroup, the employer may use the ADP and ACP percentage from that plan's testing.

A "plan coverage change" includes (1) changes in the group of employees eligible under a plan due to the establishment or amendment of a plan, (2) a plan merger, consolidation, or spin-off under Code Section 414(l), (3) changes in plan aggregation or reclassification of a substantial group of employees that has the effect of amending the plan (e.g., a transfer of a substantial number of employees from one division to another), or any combination of (1), (2), or (3)).

Note: The severance from employment rule is applicable to determine whether the buyer in a company-level transaction treats acquired employees as new employees to determine whether they are highly compensated employees.

Safe harbor plans

A plan may satisfy the ADP and ACP requirements on the basis of the safe harbors contained in IRC §401(k)(12) and §401(m)(11), respectively, if a prescribed level of matching or nonelective contributions are made on behalf of all eligible NHCEs and notice is given to employees of their rights and obligations under the plan.

If a merger of two safe harbor plans occurs during a plan year, they may be treated as a single plan for the entire plan year and the merger should not affect the ADP and ACP safe harbors. This assumes that the plans have the same plan year and all participants are subject to the same safe harbor matching formula or nonelective contribution, unless employees within the respective plans are part of a disaggregated group under Treasury regulation §1.410(b)-7(c) (e.g., one union plan and one nonunion plan).

If the plans have the same plan year, but different matching contribution formulas, the merger of the plans will likely cause the plans to fail the safe harbor requirements, and ADP and ACP testing will be required. This is due to the potential for any highly compensated employees (HCE) to receive a higher rate of match than an NHCE with the same deferral rate, which violates the nondiscriminatory rate of match requirements under IRC §401(k)(12) and §401(k)(13) for both "traditional" and Qualified Automatic Contribution Arrangement (QACA) safe harbor plan designs.

If the merging plans have different plan years, at least one of the plans would need to treat its plan year as ending as of the date of the merger for ADP/ACP purposes (see Options #2 and #3 in the ADP/ACP testing section, above). Ending the plan year as of the date of the merger would result in a short plan year for testing purposes (i.e., less than twelve months), which generally precludes reliance on the ADP and ACP testing safe harbors. However, if a plan year change results in a short plan year, the plan may be deemed to satisfy the twelve-month plan year requirement as long as it satisfied the plan year durational requirements in the immediately preceding year and satisfies them in the immediately following year.

Notice 2016-16 should be consulted for the effect of any mid-year amendment on a safe-harbor plan.

Form 5500 requirements

The Form 5500 serves as a qualified plan's annual return to provide the government with statistical information about the plan and plan sponsor, to report financial information about the plan, and to demonstrate compliance with various legal requirements. Employers with more than one plan must file Form 5500 for each plan.

Accordingly, each plan involved in a plan merger is required to timely file Form 5500 annually until such time as both plans are merged. "Timely filed" means filed by the last day of the seventh month after the plan year ends (assuming no extensions). By filing Form 5558, the plan sponsor can obtain an automatic two-and-one-half-month extension of the 5500 filing deadline. If the fiscal year is the same as the plan year and the employer has filed an extension for its corporate tax return, then the Form 5500 has an automatic extension up to the date that the plan sponsor must file its corporate tax return. In a merger situation, once both plans are merged, a final Form 5500 should be filed for the acquired plan.

Plan documents

It is important to analyze both the acquired and surviving plan documents prior to the plan merger and adopt any necessary amendments in a timely manner. Often the acquired company's employees will begin participating in the surviving plan prior to the date the plans are actually merged. In this situation, as well as when eligibility and the plan merger date occur concurrently, the surviving plan usually must be amended to specify eligibility of the acquired company's employees as of a certain date, grandfather any protected benefits, possibly provide transition benefits as previously discussed, and incorporate any other custom provisions that may exist and will be retained.

Depending on the terms of the acquired plan as well as the plan merger timing, it may be necessary to also amend the acquired plan to freeze benefit accruals and specify any other custom or clarifying provisions. In practice, sometimes the amendment that is created for the surviving plan specifies that it also serves as an amendment to the acquired plan. Depending on the facts and circumstances, this consolidated approach may yield time and cost efficiencies. Of course, all of these amendment considerations may vary depending upon whether the plans involved are on individually designed (i.e., custom) and/or pre-approved plan documents. In general, if the surviving plan is on a pre-approved plan document, there may be some challenges in being able to remain on the document if the ongoing provisions for the merged plan are complex (e.g., transition benefits, protected benefits, etc.). A document analysis should be performed to determine if the merged plan can remain on a pre-approved document or if it must be converted to an individually designed document.

Participant communications

As is always the case with retirement plans, communicating with participants plays a critical role. While there will be some regulatory-required communications and notices provided to affected participants, there will almost always be supplemental communications provided early on and throughout the process to help participants understand what is happening and when.

Required communications (if applicable) to affected participants along with the general timing to provide often include:

- A participant fee disclosure notice—on or before the date a participant can first direct his or her investments.
- Sarbanes-Oxley notice (required if there is a blackout period affecting a participant's ability to exercise his or her investment/loan/distribution or other rights under the plan for more than three consecutive business days)—no less than 30 days and no more than 60 days prior to the start of the blackout period.
- ERISA §204(h) notice for cessation of benefit accruals (e.g., if the acquired plan merging into the surviving plan is a pension plan such as a money purchase plan)—no less than 45 days prior to the effective date of the cessation of benefit accruals.

- SPD/Summary of Material Modifications (SMM)—SPD due within 90 days after becoming a participant; SMM due within 210 days after the end of the plan year in which a change to the provisions of the SPD change was made.
- Safe harbor plan notice—provided to new employees in a safe harbor plan no earlier than 90 days prior to an employee's eligibility date and no later than on the eligibility date. Thereafter, an annual notice to be provided within a "reasonable period" before each plan year thereafter. Reasonable period isn't defined but is deemed to be satisfied if provided no less than 30 days and no more than 90 days before the start of the plan year.
- Automatic contribution arrangement notice—within a "reasonable period" before the employee first becomes eligible under the arrangement and before each plan year thereafter. Reasonable period isn't defined but is deemed to be satisfied if provided as soon as practicable for a newly eligible employee and no less than 30 days and no more than 90 days before the start of each plan year thereafter.
- QDIA notice—provided at least 30 days in advance of either (1) the date of plan eligibility, or (2) the date of the initial investment in the QDIA. Thereafter, an annual notice is to be provided at least 30 days before the start of the plan year.
- Fund mapping notice—provided at least 30 days in advance of the date that the proceeds of an investment fund are transferred or "mapped" to a similar or "like" investment fund.

Two to three supplemental communications are usually provided over the few-month process of merging the plans. Unlike required communications, which are written in a more limited manner to address the mandatory content, supplemental communications are generally broader and written in a more "participant-friendly" format. The intent is to educate the participants in a format that is both easy to read and understand. Content may be provided in the form of visual diagrams, timeline charts, FAQs, etc. and in multiple channels including paper, email, and intranet. Often face-to-face presentations and/or webinars may also be conducted for the affected participants.

Conclusion

A corporate transaction can have a significant impact on a seller and buyer's DC and DB plans and on their respective employees. It is therefore imperative that plan sponsors consider this potential impact—and the need to mitigate risk—while negotiating the terms of corporate transactions. With proper attention and planning, plan events, such as spin-offs and mergers, can result in the smooth integration of retirement benefits and may even offer the opportunity to reexamine plan design and plan-related procedures. As with any important action, plan sponsors should take care to make well-informed, prudent choices and to carefully document all decisions.

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MAPPR 122016