REPORT #745

TAX SECTION

New York State Bar Association

Report on Benefit Issues in Mergers and Acquisitions

January 8, 1993

Table of Contents

Cover Letter: i

INTRODUCTION 1

GENERAL RECOMMENDATIONS 2

1. Minimum Service Credit for Eligibility and Vesting 5

2. Benefit Service 7

  a. No Required Recognition of Service 7

  b. Voluntary Grants of Past Service Credit 8

3. Code Limits on Contributions Made and Benefits Accrued on Behalf of Individuals 9

4. Nondiscrimination Testing 10

5. Distributions from Seller's Plan 13

6. Partial Termination 15

  Circumstances Requiring Special Scrutiny 16

EXAMPLES 18

  TRANSACTION I: Defined Benefit Plans – Transfer of 18

  Assumed Facts 18

Variation 1: Fresh-Start Formula "Without Wear-Away" 19

  Facts 19

  Recommendations 19

    Eligibility and Vesting Service 19

    Benefit Service 20

    Fresh Start 20

    Benefit Limits 21

    Nondiscrimination Testing 21

    Partial Termination 21

Variation 2: Fresh-Start Formula "With Wear-Away" 22

  Facts 22

Recommendations 22
Variation 3: Compensation Increases Applied to Seller’s Formul 23
Facts 23
Recommendations 24
Variation 4: Fresh-Start Formula "With Extended Wear-Away 24
Facts 24
Recommendations 24
Variation 5: Early Retirement Subsidy (Seller Formula Only) 25
Facts 25
Recommendations 25
Variation 6: Early Retirement Subsidy (Total Benefit) 26
Facts 26
Recommendations 26
TRANSACTION II: Defined Benefit Plans 26
Assumed Facts 27
Variation 1: Freeze Benefit Accruals/No Past Service Credit 27
Facts 27
Recommendations on Variation 1 27
Eligibility and Vesting Service. 27
Benefit Limits. 27
Nondiscrimination Testing. 27
Distributions from Seller’s Plan.. 28
Partial Termination. 28
Variation 2: Buyer Grants Past Service Credit for Eligibility and vesting 28
Variation 3: Buyer Grants Past Service For Accrual/Offset of Seller’s Plan Benefit 28
Variation 4: Additional Accruals Under Seller's Plan 28
Variation 5: Additional Accruals and Early Retirement Eligibility Under Seller's Plan 29
Recommendations on variations 2-5 29
TRANSACTION III: Defined Contribution Plans 31
Assumed Facts 32
Variation 1: No Asset Transfer 33
Facts 33
Recommendations 33
Variation 2: Transfer of Assets 33
Facts 33
Recommendations 34
Variation 3: Stand-Alone Plan 35
Facts 35

Recommendations 35
TRANSACTION IV: Circumstances Requiring Special Scrutiny 36
Assumed Facts 36
Variation 1 36
Recommendations 37
Variation 2 38
Recommendations 39

TAX SECTION
New York State Bar Association

OFFICERS
JOHN A. CORRY
Chair
450 Lexington Avenue
New York City 10117
212/450-4608
PETER C. CANELLOS
First Vice-Chair
299 Park Avenue
New York City 10171
212/371-9200
MICHAEL L. SCHLER
Second Vice-Chair
Worldwide Plaza
825 Eighth Avenue
New York City 10019
212/474-1588
CAROLYN JOY LEE ICHEL
Secretary
30 Rockefeller Plaza
New York City 10112
212/903-8761

COMMITTEE CHAIRS
Bankruptcy
Stuart J. Golding New York City
Dennis E. Ross, New York City
Compliance and Penalties
Robert S. Fink, New York City
Arnold Y. Kapiloff, New York City
Consolidated Returns
Yaron Z. Reich, New York City
Irving Salem, New York City
Continuing Legal Education
Brookes D. Billman, Jr., New York City
Thomas V. Glynn, New York City
Corporations
Richard L. Reinhold, New York City
Dana Trier, New York City
Estate and Trusts
Kim E. Baptiste, New York City
Steven M. Loeb, New York City
Financial Instruments
Jodi J. Schwartz, New York City
Esta E. Stecher, New York City
Financial Intermediaries
Bruce Kayle, New York City
Hugh T. McCormick, New York City
Foreign Activities of U.S. Taxpayers
Stanley I. Rubenfeld, New York City
Steven C. Todrys, New York City
Income from Real Property
Stephen L. Millman, New York City
Michelle P. Scott, Newark, NJ
Individuals
Michael Hirschfeld, New York City
Sherry S. Kraus, Rochester
Net Operating Losses
Jeffrey M. Cole, New York City
Kenneth H. Heitner, New York City
New York City Tax Matters
Robert J. Levinsohn, New York City
Robert Plautz, New York City
New York State Tax Maters
Robert E. Brown, Rochester
James A. Locke, Buffalo
Nonqualified Employee Benefits
Stephen T. Lindo, New York City
Loran T. Thompson, New York City
Partnerships
Joe Scharstein, New York City
R. Donald Turlington, New York City
Pass-Through Entities
William B. Brannan, New York City
Thomas A. Humphreys, New York City
Practice and Procedure
Donald C. Alexander, Washington, D. C.
Victor F. Keen, New York City
Qualified Plans
Stuart N. Alperin, New York City
Kenneth C. Edgar, Jr., New York City
Reorganizations
Robert A. Jacobs, New York City
Richard M. Leder, New York City
Sales, Property and Miscellaneous
E. Parker Brown, II, Syracuse
Paul R. Comeau, Buffalo
State and Local
Arthur R. Rosen, New York City
Sterling L. Weaver, Rochester
Tax Accounting Matters
Elliot Pisem, New York City
Mary Kate Wold, New York City
Tax Exempt Bonds
Linda D'Onofrio, New York City
Patti T. Wu, New York City
Tax Exempt Entitles
Harvey P. Dale, New York City
Franklin L. Green, New York City
Tax Policy
Andrew N. Berg, New York City
Victor Zonana, New York City
Tax Preferences and AMT
Katherine M. Bristor, New York City
Stuart J. Gross, New York City
U.S. Activities of Foreign Taxpayers
Roger J. Baneman, New York City
Kenneth R. Silbergleit, New York City

MEMBERS-AT-LARGE OF EXECUTIVE COMMITTEE
M. Bernard Aidinoff
Reuven Avi-Yonah
David H. Brockway
Cynthia G. Beerbower
William M. Colby
Harold R. Handler
Edward D. Kleinbard
James A. Levitan
Richard O. Loengard, Jr.
Charles M. Morgan, III
Ronald A. Pearlman
Mikel M. Rollyson
Eugene L. Vogel
David E. Watts
Philip R. West

January 8, 1993

The Honorable Shirley D. Peterson
Commissioner
Internal Revenue Service
1111 Constitution Avenue, N.W.
Room 3000
Washington, D.C. 20224

Dear Commissioner Peterson:

I am enclosing our report on benefits issues arising in mergers and acquisitions.

The report was prepared by a subcommittee of the Committee on Qualified Plans and the Committee on Nonqualified Employee Benefits. Stuart N. Alperin and Kenneth C. Edgar, Jr., Co-Chairs of the Committee on Qualified Plans, and Stephen T. Lindo and Lauren T. Thompson, Co-Chairs of the Committee on Nonqualified Employee Benefits, were the principal editors of the report.

We would be glad to discuss this report with you or members of your staff.

Sincerely yours,

John A. Corry

Enclosure

FORMER CHAIRS OF SECTION
Howard O. Colgan
Charles L. Kades
Carter T. Louthan
Samuel Brodsky
Thomas C. Plowden-Wardlaw
Edwin M. Jones
Hon. Hugh R. Jones
Peter Miller
John W. Fager
John E. Morrissey Jr.
Charles E. Heming
Richard H. Appert
Ralph O. Winger
Hewitt A. Conway
Martin D. Ginsburg
Peter L. Faber
Renato Beghe
Alfred D. Youngwood
Gordon D. Henderson
David Sachs
Ruth G. Schapiro
J. Roger Mentz
Willard B. Taylor
Richard J. Hiegel
Dale S. Collinson
Richard G. Cohen
Donald Schapiro
Herbert L. Camp
William L. Burke
Arthur A. Feder
James M. Peaslee

cc: Abraham N.M. Shashy, Jr., Esq.
Chief Counsel
Internal Revenue Service
1111 Constitution Avenue, N.W.
Room 3026
Washington, D.C. 20224

Thomas R. Hood, Esq.
Counsellor to the Commissioner Internal
Revenue Service 1111 Constitution Avenue,
N.W.
Room 3316
Washington, D.C. 20224

Mary L. Harmon, Esq.
Special Assistant to Chief Counsel
Internal Revenue Service
1111 Constitution Avenue, N.W.
Room 3034
Washington, D.C. 20224

Thomas G. Schendt, Esq.
Internal Revenue Service 1111 Constitution
Avenue, N.W.
Room 3708
Washington, D.C. 20224

Rhonda Midgail, Esq.
Technical Assistant Internal Revenue Service
1111 Constitution Avenue, N.W.
Room 3700
Washington, D.C. 20224

Mary E. Oppenheimer, Esq.
Deputy Assistant Chief Counsel Office of
Assistant Chief Counsel Employee Benefits &
Exempt Organizations Internal Revenue
Service CC:EE Room 5213
1111 Constitution Avenue, N.W.
Washington, D.C. 20224

Martin I. Slate
Director/Employee Plans, Technical &
Actuarial Division Employee Plans & Exempt
Organizations Internal Revenue Service E:EP
Room 6526-IR 1111 Constitution Avenue, N.W.
Washington, D.C. 20224

Alan J. Wilensky, Esq.
Deputy Assistant Secretary of the Treasury
for Tax Policy 3108 Main Treasury 1500
Pennsylvania Avenue, N.W. Washington, D.C.
20220

Terrill A. Hyde, Esq.
Tax Legislative Counsel for Regulatory
Affairs Department of the Treasury 3046 Main
Treasury 1500 Pennsylvania Avenue, N.W.
Washington, D.C. 20220

Evelyn A. Petschek, Esq.
Benefits Tax Counsel Department of the
Treasury 3111 Main Treasury 1500
Pennsylvania Avenue, N.W. Washington, D.C.
20220

Harry L. Gutman, Esq.
Chief of Staff
Joint Committee on Taxation
1015 Longworth House Office Building
Washington, D.C. 20515

NEW YORK STATE BAR ASSOCIATION
TAX SECTION
COMMITTEE ON QUALIFIED PLANS AND COMMITTEE
ON NONQUALIFIED EMPLOYEE BENEFITS

Report on Benefit Issues in Mergers and Acquisitions

January 8, 1993

INTRODUCTION

This report of the Committee on Qualified Plans and the Committee on Nonqualified Employee Benefits (collectively, the "committee") of the Tax Section of the New York State Bar Association [1]is in response to the solicitation of views by the Treasury Department ("Treasury") and the Internal Revenue Service (the "Service") (see T.D. 8360, 1991-2 C.B. 98, 110) with respect to qualified plan issues arising in connection with mergers and acquisitions.

The committee believes that in order to address merger and acquisition issues faced by qualified plans and their sponsors in a consistent and cohesive manner there must be a clear understanding and articulation of the legal principles and practical considerations which underlie any regulatory or other applicable authority.

[1] This report was prepared by a subcommittee of the Committee on Qualified Plans and the Committee on Nonqualified Employee Benefits/ consisting of Stuart N. Alperin and Kenneth C. Edgar, Jr., co-chairs of the Committee on Qualified Plans, and Stephen T. Lindo and Loran T. Thompson, co chairs of the Committee on Nonqualified Employee Benefits, who were the principal editors of the report, Stanley Baum, Matthew Eilenberg, Susan E. Stoffer and Alan N. Tawshunsky. Helpful comments were received from William K. Bortz, John A. Corry, Steven G. Lockwood, Michael L. Schler and Susan P. Serota.

This report proposes a set of underlying principles which the committee believes will rationalize many of the issues confronted by employers who participate in such transactions. It also provides illustrative examples applying such principles and suggests how they might be implemented by applicable regulations or other authorities.

GENERAL RECOMMENDATIONS

The committee's views are premised on the following principles, which it believes are desirable elements of any system which would regulate the treatment of qualified plans in the context of mergers and acquisitions:[2]

1. There should be a recognition that, in general, arm's-length business transactions conducted between unrelated entities are designed to meet a variety of legitimate business objectives of the buyer and seller. Applicable regulations should be drafted on the assumption that, absent extraordinary circumstances, such as clear evidence of abuse, such transactions are entered into and structured for non-benefit reasons, are not inherently suspect and therefore should not necessarily be subject to any special scrutiny.

2. The rules should be flexible, free from unnecessary complexity, and easily adapted to a multiplicity of

[2] Unless otherwise indicated, it is assumed throughout this report that the parties to the merger or acquisition transaction are not, prior to the transaction, members of the same controlled group under Section 414(b) or (c), are not members of the same affiliated service group under Section 414(m), and are not deemed affiliated under Section 415(h). All Section references herein are to the Internal Revenue Code of 1986, as amended (the "Code"), unless otherwise indicated.

transactional structures.

3. The rules should be transaction-neutral; i.e., they should apply without regard to the structure of an acquisition. Applicable regulations should not encourage employers to alter transaction structures to meet benefit objectives.

4. Predictability of results is a desirable goal. In addition to being internally consistent, the rules should wherever possible be consistent with long-standing statutory and regulatory positions.

5. The rules should not disrupt, except where necessary, business practices which have emerged since the passage of the Employee Retirement Income Security Act of 1974, as amended ("ERISA") some 18 years ago.

6. The rules should be consistent with ERISA's underlying intent of protecting benefits of plan participants; however, they should not provide more extensive protection to employees in a merger or acquisition transaction than is provided in the absence of such a transaction.

Legal Principles

The committee's legal principles begin with existing concepts, particularly G.C.M. 39824 (August 15, 1990), which articulated the following relatively simple but helpful general rule[3]: if in any transaction there is a transfer of assets and

[3] The G.C.M. formulated this rule as a basis for identifying the circumstances, in a variety of acquisition contexts# in which a seller's pension plan may make distributions of benefits to employees who are transferred to the buyer.

liabilities[4] from a former employer's plan to a new employer's plan, and the employee continues to be employed by the employer maintaining the plan, the employee's service with the new employer is deemed to be a continuation of the prior employment relationship of the employee affected by the transfer. This conclusion holds whether or not the common law employment of the affected employee with the former employer has terminated, and therefore applies equally to asset and stock transactions. Conversely, if there is no transfer of assets and liabilities with respect to the affected employee, the parties to the transaction may elect to treat such employee as having separated from the employment of the seller, and by implication, as newly hired by the buyer.

These concepts are referred to herein as the "continuity of plan sponsorship" principle. This principle is rooted in statutory provisions which have survived intact since the enactment of ERISA, as well as in long-standing regulations and interpretations of the Service.[5]

However, by itself the continuity of plan sponsorship principle is insufficient to form the entire basis for the regulatory treatment of qualified plans affected by mergers and acquisitions, due to the complexity of the statutory scheme. The committee believes there are several discrete contexts which must be addressed, only some of which are satisfactorily dealt with by the continuity of plan sponsorship analysis. They are:

---

[4] For purposes of this report, references to plan asset and liability transfers include assumption of an entire plan by the buyer as well as a continuation (within the buyer's group) of a preexisting stand-alone plan.

[5] See. §§ 414(a) and 414(l); Reg. § 1.401-1(b)(1)(i); G.C.M. 39824 (August 15, 1990).

1. Minimum standards for the crediting of service for purposes of eligibility to participate in, and vesting under, the qualified plan of the new employer (e.g., Section 414(a)(1) and (a)(2));

2. The crediting of service for purposes of benefit accrual or benefit entitlement (e.g., eligibility for early retirement) under such plan;

3. Code limits on contributions made and benefits accrued on behalf of individuals (e.g., Sections 401(a)(17) and 415);

4. Nondiscrimination standards (e.g., Sections 401(a)(4), 401(k), 401(m), 410(b), 414(q), and 416); and

5. Distributions by the seller's plan to employees affected by the transaction.

6. Partial terminations.

1. Minimum Service Credit for Eligibility and Vesting.

As indicated, the existing statutory rules governing merger and acquisition transactions are the underpinnings for the continuity of plan sponsorship principle, and the committee believes they are the proper basis for future regulatory and interpretive authority in this area.

Section 414(a)(1) provides for mandatory crediting of service with the seller by a buyer that maintains a plan of the seller. This mandatory grant of service needs, however, to be clarified. In the committee's view, Section 414(a)(1) requires past service credit only to the extent the transferee plan continues to cover employees with respect to whom plan assets were transferred to the buyer's plan.[6] For example, if the seller' seller's plan is merged into the buyer's plan, and the seller's plan had covered only eight out of the ten employees who became employed by the buyer, only those eight employees should

[6] Regulations might also require that past service credit be given for eligibility and vesting purposes to otherwise eligible employees who had not yet satisfied the age and service requirements of the transferor plan.

receive mandatory service credit under Section 414(a)(1). The basis for this view is that, with respect to the two ineligible employees, the buyer is not maintaining a plan of the seller.[7] Any other interpretation would, in the committee's view, unnecessarily increase the cost to the buyer. This result is more clearly illustrated if, in the foregoing example, 10,000 employees in total were transferred from the seller to the buyer but the plan merger affected only 100 of those employees. There is no logical or policy reason why the status of the remaining employees should be dictated by the plan merger affecting the 100 employees.

Failure to adhere to this rule would significantly complicate the situation in the case of employees who may have left the seller to join the buyer prior to the transaction. For example, if Employee A served four years with the seller, terminated employment with the seller and joined the buyer four years prior to the transaction, and if the buyer assumed a plan of the seller (which formerly covered Employee A) in the transaction, does A have four years or eight years of vesting service with the buyer? To avoid significant record-keeping problems, and in fairness to the parties to the transaction, the committee suggests that Employee A should only have four years of credit with the buyer under the buyer's plan. (If, however, the seller's plan were merged into the buyer's plan, which currently covers A, A's prior four years with the seller would have to be restored to A under Section 414(a)(1), thus giving A eight years

---

[7] In the committee's view, the Service should have the authority under appropriate circumstances to require that a plan maintained by the buyer, <u>other</u> <u>than</u> a transferee plan, nevertheless be treated as though it were a transferee plan (<u>e.g.</u>, following a transfer of assets and liabilities, accruals are frozen under the transferee plan and the transferred employees commence participation in another plan of the same type -- defined benefit or defined contribution -- maintained by the buyer).

of service for eligibility and vesting.) The equities here are apparent. Employee A, who had no reason to expect additional service when he or she originally joined the buyer (i.e., before the transaction) should not automatically receive a windfall in the form of additional vesting and eligibility service with the buyer, but if the buyer voluntarily chooses to merge the seller's plan into the buyer's plan, Section 414(a)(1) would appear to mandate the grant of such additional service credit.

Under Section 414(a)(2), where a former employee of the seller becomes covered by a buyer's plan which was not maintained by the seller (which the committee interprets to mean that no plan of the buyer has received a transfer of assets and liabilities from a plan maintained by the seller covering such employee), service with the seller must be credited as service with the buyer only to the extent provided in regulations. As of this date, no such regulations have been issued. The committee submits that such regulations should take the position that the employment relationship is not deemed to continue where no transfer of assets and liabilities has occurred, and therefore in any case described in Section 414(a)(2) the buyer should never be required to give credit for service with the seller.

2. Benefit Service.

a. No Required Recognition of Service.

The committee does not believe that Sections 414(a)(1) or (2) have any application to the determination of an employee's benefit service with respect to benefits accrued under the buyer's plan after the date of the transaction. Accordingly, the buyer's plan should not have to provide any past service credit for (i) benefit accrual service or (ii) eligibility for early

retirement under its benefit formula, regardless of whether that plan received a transfer of assets and liabilities from the seller's plan. Any other conclusion would be anomalous because (1) such an approach would afford employees greater rights than would exist in the absence of a transaction[8] and (2) the buyer's plan accrual formula in all probability will differ from the seller's plan accrual formula.

For example, if the seller's plan had a 1% per year accrual formula and the buyer's plan had a 2% per year accrual formula, an employee who had completed four years of accrual service under the seller's plan and then joined the buyer's plan should not receive four years of credit under the buyer's plan accrual formula, whether or not a transfer of the seller's plan assets and liabilities to the buyer's plan has occurred. Similarly, the buyer's plan should not be required to provide past service credit towards early retirement thresholds under the buyer's plan on account of service with the seller, whether or not early retirement benefits are actuarially subsidized. Of course, if the buyer's plan had received a transfer of the seller's plan assets and liabilities, preservation of previously accrued benefits would be required to the extent provided under Section 411(d)(6).

b. Voluntary Grants of Past Service Credit.

If the buyer does grant past service credit to the seller's employees, such grant would be tested under the appropriate provision of Section 401(a)(4), Reg. § 1.401(a)(4)-5(a) and other relevant authorities. In this regard, with the

[8] In this regard, the committee notes that plan sponsors are free to freeze accruals, eliminate early retirement subsidies with respect to future benefit accruals, or terminate a plan entirely, subject to appropriate protection of previously accrued benefits.

exceptions noted below, the committee wishes to endorse the Service's recently published proposals on this subject. As discussed below, the committee believes that the portions of Notice 92-31, 1992-29 I.R.B. 6 (July 20, 1992) discussed below represent positive steps in addressing practical issues faced by acquirors.[9]

3. Code Limits on Contributions Made and Benefits Accrued on Behalf of Individuals.

The Code contains provisions, notably Sections 401(a)(17) and 415, which directly or indirectly limit contributions made and benefits accrued by an employer on behalf of any employee.[10] The question which arises in the context of an acquisition is whether the employee's past history with the seller should affect contributions and accruals which occur under the buyer's plan after the transaction.

Here again, the committee believes that significant reliance should be placed on continuity of plan sponsorship principles; i.e., if there is a transfer of assets and liabilities from the seller's plan to the buyer's plan, the past history of an affected employee should be taken into account for purposes of Sections 401(a)(17) and 415. On the other hand, if no transfer of assets and liabilities is agreed upon by seller and buyer, past employment history, compensation, contributions

---

[9] See pp. 24 - 27, infra. Notice 92-31 liberalized previously issued guidelines for qualification as a safe-harbor plan for nondiscrimination purposes. See also Notice 92-37, 1992-37 I.R.B. 18 (September 8, 1992).

[10] Section 402(g) imposes a single limit on the amount of elective (401(k)) deferrals any one individual can make, regardless of the number of employers or their degree of affiliation. Since this rule is not affected by a merger or acquisition, it is not specifically discussed herein.

and accruals to and under the seller's plans should be ignored for these purposes.[11] This relatively simple rule achieves symmetry with Section 414(a)(1) and (2), as previously discussed, and provides an easily administrable "bright-line" test.

One area where this rule could produce difficulty is in determining the defined contribution fraction for purposes of the Section 415(e) test. The continuity of plan sponsorship approach could require the buyer to obtain from the seller the employee's compensation and contribution history, which might be administratively burdensome to the buyer. The committee believes that the buyer should be permitted a "fresh start" with respect to the defined contribution plan component of the Section 415(e) fraction, subject to testing for potentially abusive circumstances as noted below.

4. Nondiscrimination Testing.

In the area of nondiscrimination, the committee is guided by two major principles: (i) the buyer and seller should not both be subjected to testing with respect to a single pre-closing or post-closing time period (e.g., contributions made on behalf of a participant should affect nondiscrimination testing (such as 401(k) and (m) testing) for either the buyer or the seller, but not both); and (ii) neither party to a transaction should be "tainted" or "saved" by the discriminatory (or nondiscriminatory) practices of the other party. These two principles generally support the conclusion that for purposes of

[11] The committee notes that, in this circumstance, the ability of a transferred employee to accrue benefits under a defined benefit plan of the buyer will be substantially limited by the provisions of Section 415(b)(5), which restricts the annual accrual of benefits under the buyer's plan to one tenth of the overall dollar limitation then in effect under Section 415(b).

nondiscrimination testing, all employees affected by a sale are treated as newly-hired employees of the buyer. From the buyer's perspective, no past history with the seller is relevant.

To illustrate, the committee believes that for purposes of Section 401(k) and (m) testing, the seller's group should retain the contribution history of affected employees prior to the transaction and the buyer's group should not be affected by any pre-transaction contribution history.[12] Similarly, the committee believes that for purposes of determining whether individuals are highly compensated employees, for purposes of determining whether an employee is a key employee for purposes of top heavy testing, and for every other purpose relevant to nondiscrimination testing, employees joining the buyer as a result of the transaction should normally be treated as new hires who do not automatically carry over with them any contribution or compensation history or previous status as highly compensated or key employees of the seller.

However, where the buyer is seeking the benefit of a special relief provision which requires that it meet nondiscrimination safeguards (e.g., the fresh-start provision set forth in Part VII.C.2 of Notice 92-31, which requires Section

[12] The committee recognizes that, in certain circumstances, the seller might not be able to satisfy Sections 401(k) and 401(m) if required to test as of the date of the transaction, even though compliance would have been possible based on full-year compensation. For example, because of the fixed Section 402(g) limit, highly compensated employees often reach the annual limit well before year end, and their actual deferral percentage becomes progressively smaller as full-year compensation is taken into account. The committee suggests a limited liberalization that would allow the seller to annualize compensation of highly compensated employees, with a corresponding projection of annual contributions, in each case taking in account the limitations of Sections 401(a)(17) and 402(g). There is no abuse because the 402(g) limitation is available only once, regardless of the number of employers. If the seller is still unable to satisfy the applicable limitations after annualizing compensation, corrective action would be required.

410(b) testing of the transferee group at some point during the Section 410(b)(6)(C) transition period), a separate rule for determining highly compensated status is essential. Under these circumstances, the committee suggests that employees be classified, at the election of the buyer (made on a transaction by transaction basis), as highly or nonhighly compensated either on the basis of (i) their classification with the seller immediately before the closing date, (ii) their actual aggregate compensation with the seller and the buyer for the plan year in which the transaction occurs, or (iii) their annualized compensation with the buyer for the first post-transaction plan year or part thereof, using any definition of compensation that otherwise complies with Section 414(s).

To this analysis must, of course, be added the effect of Section 410(b)(6)(C), which provides relief from certain coverage testing during the "transition period" commencing on the date of the transaction and ending with the last day of the first full plan year which occurs after the transaction. Section 410(b)(6)(C), to the extent its terms are met, protects both the buyer and the seller from encountering precipitous nondiscrimination testing problems during the transition period, but does not alter the committee's basic premise that the employees should be treated as newly hired by the buyer.

5. Distributions from Seller's Plan.

Considerable uncertainty has surrounded the ability of a seller's defined benefit plan[13] to make distributions to affected employees where the buyer has not become the sponsor of the seller's plan by reason of a transfer of assets and liabilities to the buyer's plan. In 1990 the Service expressed the view in G.C.M. 39824 (discussed above) that the seller's plan could make a distribution in these circumstances even though the affected employees had not incurred a "separation from service." Given the state of confusion that the lack of official authority in this area has generated, the committee recommends as a procedural matter that the principles of G.C.M. 39824 be incorporated into a regulation or published ruling.

An issue not addressed by the G.C.M., and for which guidance should be provided in regulations or rulings, is the circumstances under which the anti-cutback prohibitions of Section 411(d)(6) may require the seller's plan to make a distribution where plan assets are not transferred to the buyer's plan[14]. The committee believes there are certain contexts in which the application of Section 411(d)(6) is clear. For example,

---

[13] Although the question of a seller plan's ability to make a distribution to transferred employees arises most commonly in the context of defined benefit plans, the ability of a 401(k) plan maintained by the seller to make such a distribution is subject to the constraints of Section 401(k)(10). In that connection, while beyond the scope of this report, the committee notes that Section 401(k)(10) precludes distributions to affected employees in some circumstances, depending upon the form of the buying entity. (See PLR 9102044 (Oct. 19, 1990), which precluded distribution of benefits from a seller's 401(k) plan in a transaction involving a sale to a partnership.) Achieving a uniform rule that is independent of the form of the acquiring entity would seemingly require a revision to the statute, which the committee recommends be addressed at an early date.

[14] The discussion assumes that the seller's plan otherwise permits a distribution on termination of employment and that the participant has requested such a distribution.

if the seller's plan has followed a consistent pattern of making distributions to employees affected by a sale, the seller would be precluded by Section 411(d)(6) from discontinuing its prior practice.[15] At the other extreme, a seller who has consistently applied the same-desk rule[16] and denied distributions to employees affected by a transaction should not be required to change its prior practice, even if the plan was previously silent on the treatment of employees in these circumstances.

If, between these extremes, the seller's plan historically has followed no consistent practice of treating affected employees in a particular manner, the correct analysis under Section 411(d)(6) is less apparent. In that connection, the committee believes that prospective guidance should require that a plan specify how transferred employees affected by a transaction will be treated in situations where there is no transfer of assets and liabilities to the buyer's plan. Where the seller's plan provides that no distributions will be made to employees affected by a sale of a subsidiary or division, such guidance should prescribe limited circumstances in which the seller's plan may deviate from that general rule.

In light of the confusion and inconsistency that have prevailed in this area, the committee believes that guidance should provide transitional relief to offer the seller's plan an opportunity to establish a consistent practice to be applied to

---

15 See Davis v. Burlington Industries. Inc., 966 F.2d 890 (4th Cir. 1992).

16 See Rev. Rul 81-141, 1981-1 C.B. 204; Rev. Rul. 79-336, 1979-2 C.B. 187; and Rev. Rul. 56-693, 1956-2 C.B. 282, as modified by Rev. Rul. 60-323. 1960-2 C.B. 148.

transactions occurring after publication of final guidance.[17] At a minimum, such a relief provision should protect sellers that either have followed a consistent practice of not distributing benefits upon a sale of a subsidiary or division where there is no transfer of plan assets and liabilities, or that have had no consistent pattern with respect to distributions in such circumstances. Such relief may be inappropriate, however, where there has been a consistent pattern of distributing benefits to employees affected by a transaction.

6. Partial Termination

Where a partial termination issue is raised in the context of a merger or acquisition transaction, the committee believes that, consistent with the case law,[18] the analysis should be governed by the continuity of plan sponsorship principle. From the seller's perspective, a transfer of assets and liabilities with respect to all affected employees involved in the transaction should obviate the need for any further partial termination inquiry as it relates to employees affected by that transaction. Similarly, affected employees should not be treated as having been terminated without vesting for purposes of analyzing partial termination questions that may be present with respect to the remaining participants in the seller's plans. On the other hand, if no such transfer should occur, the affected employees must be considered terminated employees in determining

17 A similar relief provision was made available in connection with the adoption of final regulations under Section 411(d)(6) with respect to plans that reserved to the plan sponsor the discretion to make available optional forms of benefit (such as lump-sum payments). See Reg. § 1.411(d)-4, Q&A-8.

18 See In re: Gulf Pension Litigation, 764 F.Supp. 1149, 1165-66 (S.D. Tex. 1991); See also Reg. § 1.411(d)-2(b)(1) (facts and circumstances which are relevant in determining a partial termination include "the exclusion, by reason of a ... severance by the employer, of a group of employees who have previously been covered by the plan").

whether a partial termination has occurred. With respect to the buyer, partial termination questions do not arise solely as a result of an acquisition. Subsequent declines in the number of plan participants or level of benefits afforded by the plan should be assessed in light of existing partial termination principles, with no special weight being given to whether terminated participants had prior plan participation with the seller.

Circumstances Requiring Special Scrutiny

The committee recognizes that under certain limited circumstances, application of the recommendations set forth above could allow one or both of the parties to a transaction to treat the qualified plan benefits of highly compensated transferred employees in a manner which is inconsistent with the nondiscrimination rules. Although the Service has issued regulations and other guidance which address potentially abusive circumstances,[19] the committee believes there may be circumstances involving merger and acquisition situations where additional safeguards are warranted if the principles articulated in this report are adopted.

To this end, the committee recommends that the Service be permitted to address clearly abusive situations by requiring that a party justify its treatment of qualified plan benefits attributable to transferred employees where potentially abusive circumstances can be shown to exist. Consistent with its underlying principles, the committee believes that this "potentially abusive circumstances" exception should be applied only in narrow, well-defined situations. Circumstances which

[19] See, e.g., Reg. §§ 1.401(a)-4, Q&A-2; 1.401(a)(4)-4(b), (c) and (d); and 1.401(a)(4)-5(a)(1); Notice 92-31, supra.

might constitute potentially abusive circumstances requiring special scrutiny should be specifically set forth in regulations. These circumstances would include one or more of the following:

1. The composition of the transferee group does not reflect a nondiscriminatory classification of the seller's employees does not represent a discrete operating unit of the seller as in effect prior to the transaction. For this purpose, the transferee group would be deemed to reflect a nondiscriminatory classification unless the group's nonhighly compensated employee percentage was less than the seller's "unsafe harbor percentage" under the Section 410(b) regulations.

2. The fact that, during the Section 410(b)(6)(C) transition period, the buyer terminates the employment of a substantial number of transferred employees and such terminations affect nonhighly compensated employees within the transferee group to a significantly disproportionate degree.

3. The degree of affiliation between the parties immediately prior to the transaction, including, for example, partial ownership of one entity by the other entity (or an affiliate thereof) or the fact that one or more highly compensated employees were employed by each of the parties to the transaction.

4. Facts evidencing that the particular treatment of plans has as a principal purpose allowing the aggregate benefits in respect of a highly compensated employee to exceed statutory limitations (assuming the entities were treated as one employer).

5. Facts evidencing that the particular treatment of plans has the effect of allowing highly compensated employees to duplicate benefits previously earned by such employees during the same period of service.[20]

In the presence of potentially abusive circumstances, the affected party would be able to establish conclusively the

[20] See IRS Notice 92-31, supra, Part IV.C.3.

absence of actual abuse by showing that such circumstances existed for reasons (or resulted from bona fide circumstances) substantially unrelated to the provision of discriminatory benefits to highly compensated transferred employees.

EXAMPLES

Having articulated its basic principles, the committee has set forth below examples of how such principles would apply to the affected Code sections in a variety of merger and acquisition contexts. Factual variations illustrate the application of the rules to some of the more commonly negotiated issues relating to defined benefit and defined contribution plans. The committee believes the benefit results reached in these examples are consistent with the underlying principles articulated at the outset of this report and wishes to emphasize that the results illustrated apply equally without regard to the form of the transaction chosen by the parties.

TRANSACTION I: Defined Benefit Plans – Transfer of Assets and Liabilities

Assumed Facts

The buyer acquires the stock or assets of one of the divisions or subsidiaries of the seller, a corporation unaffiliated with the buyer. Those employees of the acquired business who become employed by the buyer upon the closing of the transaction ("transferred employees") either represent substantially all the employees of the acquired business or satisfy as a group the Section 410(b) coverage test. Prior to the acquisition, the transferred employees participated in a defined benefit pension plan maintained by the seller.

The parties have negotiated for the assets and liabilities relating to the transferred employees under the seller's plan to be transferred to the buyer's plan in accordance with Section 414(1); the buyer's plan credits the transferred employees for eligibility and vesting purposes with their past service with the seller.

Prior to the consummation of the transaction, the buyer's and the seller's plans each separately satisfy the ratio percentage coverage test under Section 410(b) and each plan also meets the definition of a safe-harbor plan under the Section 401(a)(4) nondiscrimination rules.

Variation 1: Fresh-Start Formula "Without Wear-Away"

Facts

The retirement benefit formula under the buyer's plan for the transferred employees provides a benefit equal to the sum of (A) and (B) where:

(A) is equal to the transferred employee's frozen accrued benefit under the seller's plan determined as of the closing date of the transaction (which the buyer's plan employs as the "fresh-start date"), and

(B) is equal to the normal retirement benefit formula provided under the buyer's plan, but with credit given to the transferred employees only for service rendered after the fresh-start date.

Recommendations

Eligibility and Vesting Service. By assuming plan assets and liabilities with respect to the transferred employees, the buyer becomes a "successor employer." As such, Section 414(a)(1) requires the buyer to grant past service

credit to the transferred employees for service with the seller for purposes of eligibility to participate in, and vesting under, the buyer's plan.

Benefit Service. Section 411(d)(6) requires that the buyer's plan protect the accrued benefits of the transferred employees as determined under the seller's plan as of the closing date. The buyer's plan is, however, permitted to limit credited service used in calculating benefits under the buyer's plan formula to service rendered after the date of the acquisition (the fresh-start date in this example). The committee believes that no requirement should be introduced that would mandate more expansive crediting. The buyer's plan is not required to grant any credit for service with the seller in determining transferred employees' eligibility for early retirement under the buyer's plan, although Section 411(d)(6) does require that service with the buyer continue to be recognized in determining whether the transferred employee will receive any actuarial subsidy provided under the seller's plan formula.[21] Furthermore, the fact that the buyer's plan grants no past service credit should not affect the ability of the buyer's plan to qualify as a safe-harbor plan.

Fresh Start. The regulations permit a plan to make a "fresh start" with respect to the application of a benefit formula without jeopardizing the plan's safe-harbor status only if the fresh start applies to all employees who have accrued benefits as of the fresh-start date.[22] Notice 92-31 would liberalize these rules by permitting a plan to limit the fresh

---

[21] See Reg. § 1.411(d)-4, Q&A-2(a)(2)(iv). Ex. 1, Q&A-2(a)(3)(i); S. Rep. No. 575, 98th Cong., 2d Sess. 28-29 (1984).

[22] See Reg. §§ 1.401(a)(4)-3(b)(8)(viii) and 1.401(a)(4)-13(c)(1)(ii).

start to employees affected by a merger or acquisition, provided that the group of affected employees separately satisfies Section 410(b) (with respect to the buyer and without regard to Section 410(b)(6)(C)) either as of the date of the acquisition or merger or as of the fresh-start date.[23] account, as in Variation 1, the bifurcated formula is unlikely to favor the transferred employees relative to other employees of the buyer not affected by the acquisition, and in any event, the Section 411(d)(6) anti-cutback prohibition requires that pre-transaction accrued benefits be fully protected. Accordingly, coverage testing of the affected group should be unnecessary.

Benefit Limits. Pursuant to the continuity of plan sponsorship principle, accrued benefits transferred from the seller's plan should be taken into account under the buyer's plan in testing accruals under Sections 415(b) and 415(e) and the prior compensation history of each transferred employee should be taken into account for purposes of Section 401(a)(17).

Nondiscrimination Testing. Subject to the foregoing discussion on fresh start, transferred employees should, consistent with their treatment as new hires, begin new compensation histories with the buyer on the date of the transaction for purposes of nondiscrimination testing under buyer's plan.

Partial Termination. The seller's plan need not be tested, due to the transfer of assets and liabilities. The

[23] Under Notice 92-31, the fresh-start date could be any date during the transition period described in Section 410(b)(6)(C) with respect to the acquisition or, if later, the effective date of the regulations. In addition, the committee believes the buyer should be required, in conducting Section 410(b) testing, to determine the highly compensated status of employees by using one of the alternative methods set forth on page 14, supra.

buyer's decision to freeze further accruals under the seller's plan formula would be analyzed under otherwise applicable partial termination principles to determine whether full vesting is required for affected employees. The buyer's plan need not otherwise be tested for partial termination.

Variation 2: Fresh-Start Formula "With Wear-Away"

Facts

Same facts as Variation 1 except that the benefit formula provided for the transferred employees in the buyer's plan is the greater of (i) the buyer's normal retirement benefit formula applied to all years of service, including service with the seller and (ii) the transferred employee's frozen accrued benefit determined under the seller's plan as of the fresh-start date.

Recommendations

The buyer should be permitted to grant full credit for service credited to a transferred employee under the seller's plan, and such granting of past service credit should be disregarded in determining whether the buyer's plan is a safe-harbor plan, provided that the granting of past service credit satisfies nondiscrimination safeguards. In this regard, the regulations provide that a defined benefit plan (whether or not a safe-harbor plan) generally may not be amended to grant prior service credit if such grant discriminates significantly in favor of highly compensated employees, as determined based on all relevant facts and circumstances. Reg. § 1.401(a)(4)-5. Part IV of Notice 92-31 would modify the regulations to permit the granting of prior service credit to be disregarded in

determining whether a plan qualifies as a safe-harbor plan,[24] provided that (i) such crediting applies to all similarly situated nonhighly compensated employees, (ii) the employer has a legitimate business reason for crediting prior service (which would generally be the case if employees of one employer became employees of another employer as a result of an acquisition or merger), and (iii) in operation, and based on all the relevant facts and circumstances, the service credit does not discriminate significantly in favor of highly compensated employees.[25] The committee generally supports the criteria set forth in Notice 92-31.

With respect to partial terminations, the buyer's plan would be analyzed in the manner discussed under Variation 1, and the seller's plan need not be tested.

Variation 3: Compensation Increases Applied to Seller’s Formul

Facts

Same facts as in Variation 1 except that future compensation with the buyer is counted when calculating the portion of the transferred employee's benefit under the buyer's plan determined under the seller's plan formula.

---

[24] To qualify as a safe-harbor plan, the regulations impose the additional requirements that a defined benefit plan use the same definition of years of service for all purposes under the plan, and that only service with the employer or a predecessor employer within the meaning of Section 414(a) may be taken into account. Reg. § 1.401(a)(4)-3(b)(1)(v). The Service has proposed eliminating this requirement from the regulations. See Notice 92-31, Part III. The committee concurs.

[25] As discussed on page 14, supra, for the limited purpose of performing Section 410(b) or other nondiscrimination testing in the context of a special relief provision, such as past service grants or the fresh-start rule, transferred employees would be classified as highly or nonhighly compensated (as to the buyer) by using one of various special methods for determining annual compensation.

Recommendations

As discussed under Variation 1, the committee generally supports the fresh-start principles incorporated in Notice 92-31/ and recommends that they be applied to this fact pattern. Accordingly, future increases could, without affecting the safe-harbor status of the buyer's plan, be applied in calculating the portion of a transferred employee's benefit that is based on the seller plan's formula, provided that the group of affected employees separately satisfies Section 410(b) (with respect to the buyer and without regard to Section 410(b)(6)(C)) either as of the date of the acquisition or merger or as of the fresh-start date.[26]

Variation 4: Fresh-Start Formula "With Extended Wear-Away

Facts

Same facts as in Variation 1 except that the benefit formula provided for the transferred employees in the buyer's plan is equal to the greater of (i) the formula described in Variation 1 and (ii) the formula described in clause (i) of Variation 2.

Recommendations

The committee's recommendations are the same as for Variation 2.

---

[26] As discussed under Footnote 23, *supra*, special rules for determining highly compensated status would apply in performing Section 410(b) testing.

Variation 5: Early Retirement Subsidy (Seller Formula Only)

Facts

Same facts as in Variation 1 except that the seller's plan and the buyer's plan each contain subsidized early retirement features. Future service with the buyer is counted towards eligibility for such subsidy under the seller's plan formula (with respect to the frozen accrued benefit determined as of the fresh-start date), but no past service credit with the seller is counted for purposes of determining eligibility for the buyer's early retirement subsidy as applied to the portion of a transferred employee's benefit accrued after the fresh-start date.

Recommendations

The Section 411(d)(6) anti-cutback prohibition requires that the transferred employee's service with the buyer be taken into account for purposes of any minimum service requirements for eligibility for an early retirement subsidy, to the extent such subsidy is applied to the transferred employee's accrued benefit under the seller's plan formula as of the closing date.

With respect to benefits accrued under the buyer's plan after the acquisition, however, the buyer's plan should be permitted, as in Variation 1, to disregard pre-acquisition service in determining whether the employee qualifies for an early retirement subsidy with respect to the portion of his benefit under the buyer's plan accrued after the fresh-start date.

Variation 6: Early Retirement Subsidy (Total Benefit)

Facts

Same facts as in Variation 5, except that past service with the seller is counted for purposes of determining eligibility for the buyer's early retirement subsidy as applied to the transferred employee's benefit accrued both before and after the fresh-start date.

Recommendations

The buyer's plan should be permitted to take preacquisition service into account in determining whether the employee qualifies for an early retirement subsidy with respect to the portion of his benefit under the buyer's plan accrued after the fresh-start date. Given the close linkage between the early retirement subsidy and the calculation of a transferred employee's benefit, the committee recommends that the granting of prior service credit for determining early retirement subsidy eligibility for benefits accrued after the fresh-start date be permitted under the safe-harbor rules in the same circumstances as the granting of prior service credit for benefit accrual purposes — that is, whenever such grant does not discriminate significantly in favor of highly compensated employees.

TRANSACTION II: Defined Benefit Plans - No Transfer of Assets and Liabilities

Assumed Facts

Transaction II is identical to Transaction I except that the seller's plan retains all assets and liabilities with respect to the transferred employees.

Variation 1: Freeze Benefit Accruals/No Past Service Credit

Facts

Under this variation the seller freezes benefit accruals with respect to the transferred employees as of the closing date. Buyer treats the transferred employees as new hires as of the closing date with respect to the buyer's plan.

Recommendations on Variation 1

Eligibility and Vesting Service. Pursuant to the continuity of plan sponsorship principle, the buyer's plan will not be deemed to be a "successor plan" and the buyer should have no obligation to grant past service credit for any purpose in the buyer's plan.

Benefit Limits. Accrued benefits under the seller's plan should not be taken into account in testing accruals under Section 415(b) and Section 415(e) and prior compensation histories of transferred employees should not be taken into account for purposes of Section 401(a)(17).

Nondiscrimination Testing. As in Transaction I, transferred employees will be treated as new hires for all nondiscrimination testing purposes and thus will begin new compensation histories with the buyer on the date of the transaction.

Distributions from Seller’s Plan. In view of the absence of any transfer of assets and liabilities from the seller’s plan, under continuity of plan sponsorship principles the seller's plan, if it so provides, may distribute benefits to transferred employees upon consummation of the transaction (and indeed may be required to do so by application of Section 411(d)(6) if a consistent pattern of making distributions under similar circumstances has been established).

Partial Termination. The seller's plan would be tested to determine whether the decrease in plan participants warrants partial termination treatment. With respect to the buyer's plan, no partial termination testing is required.

Variation 2: Buyer Grants Past Service Credit for Eligibility and vesting

Same facts as described in Variation 1, except that the buyer grants past service credit with the seller for purposes of eligibility and vesting in the buyer's plan.

Variation 3: Buyer Grants Past Service For Accrual/Offset of Seller’s Plan Benefit

Same facts as described above in Variation 1, except that the buyer grants past service credit under the buyer's plan for service with the seller for purposes of eligibility, vesting and benefit accrual, but the buyer's plan accrued benefit will be offset by the transferred employee's accrued benefit under the seller's plan as of the closing date.

Variation 4: Additional Accruals Under Seller's Plan

Same facts as described above in Variation 1, except that the seller's plan recognizes future compensation with the buyer when determining the employee's accrued benefit under the seller's plan.

Variation 5: Additional Accruals and Early Retirement Eligibility Under Seller's Plan

Same facts as described above in Variation 4, except that the seller's plan gives credit for future service with the buyer for purposes of eligibility for the early retirement subsidy in the seller's plan.

Recommendations on variations 2-5

Each of Variations 2 through 5 involves a recognition of service and/or compensation with the predecessor or successor party# thereby to some extent mitigating the effect of the transaction on the transferred employees. The committee believes that, subject to adequate nondiscrimination safeguards, the buyer should be permitted to grant past service credit for eligibility, vesting and benefit accrual under the circumstances noted. Similarly, the seller generally should be permitted to take transferred employees* compensation with the buyer into account for purposes of the seller's benefit formula, and to take service with buyer into account for early retirement eligibility. The committee supports the proposal in Notice 92-31 (Part IV) that would impose in this context the same requirements that apply to the crediting of past benefit service — namely, that the same treatment apply to all similarly situated nonhighly compensated employees, that there be a legitimate business reason for such treatment, and that there be no significant discrimination in favor of highly compensated employees.

Notice 92-31 would also require, however, that to be a safe-harbor plan the seller's plan would have to satisfy Section 410(b) if coverage testing were performed by treating as not benefiting under the plan the nonhighly compensated employees in the plan who accrue benefits solely because of compensation increases. While the committee does not believe that a seller's plan that otherwise fails to satisfy Section 410(b) should be permitted to rely on the additional accruals of the transferred employees to "save" the plan by enabling it to satisfy minimum coverage requirements, the committee does not perceive a rationale for limiting the inclusion of transferred employees in performing the seller’s plan's coverage testing to those employees who are highly compensated.

The committee would propose substituting a requirement that the affected transferred employees satisfy Section 410(b) with respect to the seller immediately prior to the sale, and thereafter be disregarded by the seller for Section 410(b) testing purposes. This one-shot testing, coupled with the facts and circumstances requirement that the seller plan's treatment of transferred employees not discriminate significantly in favor of highly compensated employees and the "potentially abusive-circumstances" test described above, should provide adequate protection in these situations.

Thus, with respect to each of the alternatives described in Variations 2-5 above, and subject to the provisions of Notice 92-31, with the modifications noted, the committee recommends that:

(a) Buyer be allowed flexibility to grant credit under its plan for past service

with seller for purposes of eligibility and vesting in buyer's plan and such action should not be taken into account when determining whether buyer's plan continues to be a safe-harbor plan under Section 401(a)(4);

(b) Buyer be allowed flexibility to grant credit under its plan for past service with the seller for purposes of benefit accruals under the buyer's plan and to offset the benefit under the buyer's plan with the transferred employee's accrued benefit under the seller's plan. Such actions should not affect the status of the buyer's plan as a safe-harbor plan under Section 401(a)(4); and

(c) Seller be permitted (i) to grant credit under its plan for future service with the buyer for purposes of determining an employee's eligibility for early retirement benefits and (ii) to recognize future compensation with the buyer for purposes of determining the employee's benefit under the seller's plan as of the date of the transaction. Such actions should not be taken into consideration when determining whether the seller's plan continues to be a safe-harbor plan under Section 401(a)(4).

<u>TRANSACTION III</u>: Defined Contribution Plans

Assumed Facts

The buyer acquires the stock or assets of one of the divisions or subsidiaries of the seller. All employees of that division or subsidiary become employed by the buyer upon the closing of the transaction.

Prior to the acquisition, the transferred employees participate in a 401(k) profit-sharing plan maintained by the seller. The buyer also maintains a 401(k) profit-sharing plan for its employees, and the transferred employees begin participating in that plan as of the closing date. Both the buyer's plan and the seller's plan are calendar year plans providing for employer contributions equal to a percentage of each eligible employee's compensation, as well as matching contributions with respect to employees' elective deferrals.

Prior to the consummation of the transaction, the buyer's and seller's plans each separately satisfy the ratio percentage coverage test under Section 410(b). Each plan also meets the definition of a safe-harbor plan under the Section 401(a)(4) nondiscrimination rules.

Variation 1: No Asset Transfer

Facts

The acquisition agreement does not call for a transfer of assets and liabilities from the seller's plan to the buyer's plan.

Recommendations

The buyer's plan should be permitted to treat the transferred employees as new employees, and not to take service with the seller into account for eligibility or vesting purposes. Permissive granting of such prior service credit should be allowed under the circumstances for the reasons set forth in Transaction II. The seller should be free to make the distribution if the plan so provides and the transaction satisfies Section 401(k)(10).

Nondiscrimination and Section 415 testing under the buyer's plan should be performed without regard to the transferred employees' history under the seller's plan.

Variation 2: Transfer of Assets

Facts

The parties have negotiated for the transfer of the assets and account balances of the transferred employees under the seller's plan to the buyer's plan. The transfer is delayed until the calendar year following the year in which the acquisition occurs.

Recommendations

Section 414(a)(1) requires the buyer's plan to credit service to the same extent it was credited under the seller's plan for eligibility and vesting purposes for those employees whose accounts are transferred to the buyer's plan. This requirement should apply as of the closing date even where the transfer of assets and liabilities of the seller plan is delayed, provided the transfer is required under the acquisition agreement.

With respect to nondiscrimination (including Section 401(k) and (m)) testing, the committee believes that the transferred employees should be treated by the buyer's plan as new employees. Thus nondiscrimination (including Section 401(k) and (m)) testing would be performed by the seller by treating the transferred employees as having discontinued participation in the seller's plan on the closing date,[27] while testing on the buyer's side would take only contributions and compensation attributable to post-closing date periods into account.[28] This approach avoids duplicative testing by the buyer and seller and should ensure that neither party will be "tainted" or "saved" by the discriminatory or nondiscriminatory practices of the other party.'

For Section 415 purposes, the committee advocates that generally the buyer's plan be viewed as a continuation of the

---

[27] As discussed in Footnote 12, the seller should be permitted to annualize the compensation of highly compensated employees in performing such tests.

[28] In many instances the transition-period coverage provisions of Section 410(b)(6)(C) will render nondiscrimination (other than 401(k) and (m)) and coverage testing unnecessary for the plan year that includes the closing date.

seller's plan, in accordance with continuity of plan sponsorship principles. In recognition of the practical difficulty that the buyer may experience in reconstructing prior contribution, benefit, and compensation histories of transferred employees, however, the committee recommends that the buyer be given the option to perform Section 415(e) testing on a fresh-start basis as of the closing date (subject to testing for potentially abusive circumstances, as noted above).

Variation 3: Stand-Alone Plan

Facts

The transferred employees are covered by a stand-alone plan sponsored by the acquired entity, and sponsorship of the plan remains with the entity following the acquisition.

Recommendations

The recommendations outlined above for Variation 2 would apply here with the following modifications.

For purposes of nondiscrimination (including 401(k) and (m)) testing, the committee recommends that as a general rule the plan year of the stand-alone plan be bifurcated, with nondiscrimination testing being applied separately to the periods preceding and following the acquisition.[29] If, by agreement between the buyer and seller, nondiscrimination testing of the plan were performed without aggregation with other plans of either the seller or the buyer, no bifurcation would be required.

---

[29] If this were not permitted, other seller plans which had been aggregated with the stand-alone plan for minimum coverage testing could face disqualification if they were unable to pass coverage without such aggregation.

Since sponsorship of the stand-alone plan would remain with the acquired entity, no additional burden normally would be imposed by requiring that Section 415(e) testing be performed by taking into account the entire history of participants' compensation, benefits, and contributions. In many of these cases, Section 415(e) testing can probably be performed without regard to the special fresh-start rule recommended for Variation 2. In view of the practical - difficulties noted in Variation 2 above, however, such as where plan records are not maintained by the acquired entity, the committee recommends that the buyer be given an option to use the fresh-start rule.

TRANSACTION IV: Circumstances Requiring Special Scrutiny

Assumed Facts

Company X is a publicly-traded corporation, 25% of the stock of which is owned by an individual (A), who was the founder of Company X and who presently serves as X's Chairman and Chief Executive Officer. X maintains a defined benefit plan (P) for its employees. A's accrued benefit under plan P has reached the limit prescribed by Section 415(b).

Variation 1

Company X wishes to spin off one of its businesses to its shareholders. Accordingly, X will form a new subsidiary (Y) to which it will transfer the assets of the business to be spun off. X will then proceed to distribute to its shareholders shares of Y, which will thereafter operate as an independent publicly traded entity.

In connection with the spinoff, employees of X who work for the Y business will become employed by Company Y. In addition, individual A will become the Chairman and Chief Executive Officer of Company Y. The employees of Company Y represent a nondiscriminatory classification of employees.

Plan P will retain all of the assets and liabilities attributable to those former employees of X who will become employees of Y. Effective as of the spinoff, Y will adopt a new defined benefit plan for its employees and will grant (i) full past service credit with Company X for purposes of eligibility and vesting and (ii) up to 5 years of past service credit with Company X for purposes of benefit accrual.

Recommendations

Under the general principles noted above, as a result of the spinoff Company X and Company Y may elect to treat the employees of Company Y as having separated from the employment of Company X and as having been newly hired by Company Y. However, "potentially abusive circumstances" exist under these facts since (1) the business to be operated by Company Y historically formed part of Company X, (2) the treatment of employees of Company Y as "newly hired/" together with the granting of past service credit for benefit accrual purposes (even though such grant falls within the regulatory safe harbor of Regulation Section 1.401(a)(4)-5(a)(5)), constitutes evidence that a principal purpose of the treatment of plans in the transaction was to permit individual A to accrue aggregate pension benefits in excess of the Section 415(b) limitations (determined as if Company X and Company Y were considered to be one employer), and (3) the treatment of plans has the effect of allowing individual A to duplicate benefits accrued in respect of prior periods of service with Company X.

Accordingly, additional accruals for the benefit of individual A would be prohibited (other than to reflect cost-of-living adjustments to the Section 415(b) limitations) unless an absence of abuse can be established by showing that such circumstances existed for reasons or resulted from bona fide circumstances substantially unrelated to the provision of benefits to individual A.

Variation 2

Company sells all of the assets of its Y division to an unaffiliated corporation (Z). Company X and Company Z agree that Plan P will transfer the assets and liabilities attributable to transferred employees to a safe harbor defined benefit plan (Plan Q) maintained by Z. Immediately following the date of sale, Company Z causes Plan Q to be amended# effective as of the effective date of sale, to provide that the benefit formula applicable to each transferred employee will be the greater of (1) the sum of (a) the transferred employee's frozen accrued benefit under Plan P as of the effective date of sale plus (b) the retirement benefit accrued under Plan Q, with the transferred employee being credited only with service rendered to Z after the date of sale, or (2) the retirement benefit accrued under Plan Q, taking into account for this purpose all prior service which was credited under Plan P. See Transaction I, Variation 4 above. Approximately 18 months following the sale, but prior to expiration of the Section 410(b)(6)(C) transition period, Company Z terminates a significant number of transferred employees, a disproportionate percentage of which consists of nonhighly compensated employees.

Recommendations

Under these facts, the terminations instituted by Company Z constitute "potentially abusive circumstances." However, since the terminated employees have received full credit under Plan Q for all of their prior service credited under Plan P, highly compensated tranferred employees will not have received discriminatory benefits. Thus, the absence of actual abuse can be established under these facts. The committee also notes in this regard that, in contrast to Variation 1, transferred employees' service with Z is deemed to be a continuation of their service with X. Thus, no highly compensated individual would be eligible to accrue benefits in excess of the Section 415(b) limitations.