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EMPLOYEE BENEFIT PLAN ISSUES WHERE BUSINESS STRUCTURE IS CHANGED

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Part One - Qualified Retirement Plan Matters

I. Background - Employee benefit plans can have a major impact on a merger, acquisition or divestiture. The status of these plans can affect the method used to accomplish a plan, the price of the acquired or divested entity and even the viability of the transaction.

A. Types of Plans to Consider

1. Qualified Retirement Plans
   a. Defined Benefit Pension Plans
   b. ESOPs, TRASOPs and PAYSOPs
   c. Money Purchase Pension Plans
   d. Profit Sharing and Stock Bonus Plans
   e. Savings, Thrift and 401(k) Plans
   f. Multiemployer Plans

2. Other Fringe Benefit Plans - life insurance, medical insurance, etc. Special care must be taken with any self-insured plans.

3. Non-Qualified Deferred Compensation Plans

4. Incentive Compensation and Bonus Arrangements

5. Golden Parachute Plans

The scope of this portion of this outline is limited to qualified retirement plan issues other than multiemployer plans. These comments focus upon the issues presented by the acquisition or divestiture of a business segment.
Specific issues related to other fringe benefit plans are covered in part two of the outline. Part three of the outline deals with employee benefit issues peculiar to certain forms of doing business. Part four deals with issues related to the change in fiscal year and/or plan year that may be associated with changes in business structure.

B. Economic and Employee Relations Issues

1. Purchaser’s Needs

   a. Facts - How many plans, what types, pending claims or litigation on the plans, copy of union contracts or key employee contracts, etc.

   b. Documents - The buyer must obtain all current and prior plan documents. These should be reviewed in light of the following:

      i. Plan terms in relation to the terms of the buyer’s plans.

      ii. Amendment provisions.

      iii. Effect of termination and distribution upon the residual assets of any defined benefit program. Remember, after TAMRA, any amendment to revert excess defined benefit assets to the employer, rather than the employees has a five year waiting period before it is effective.

      iv. All post-ERISA applications to the IRS for determination letters and any correspondence between the seller and the IRS regarding the same. Remember, in the event any question is raised on the determination letter, your defense is generally limited to the facts that were presented during the determination letter process.

      v. Detailed records of all former participants for the prior five plan years.
c. Determination of controlled group issues

d. Financial Statements - For each plan the buyer should obtain annual financial statements for the last 3 years. These should be reviewed with attention to:

i. Asset value, quality and liquidity.

ii. Liabilities.

iii. Cash flow.

iv. If audited, the nature of the auditor's opinion.

e. Total benefit package - existing plans of acquiring company versus existing plans of acquired company. Are they compatible? What were seller's objectives for the plans? What are buyer's objectives? How different are they? Will they change with the change in the workforce?

f. Buyer must determine who maintains the participant records; the state of these records and the ability to obtain all the necessary information when needed. Remember five year look-back period. Buyers may wish some indemnification on balances accrued prior to acquisition.

g. For any defined benefit plans of the seller, the buyer should obtain all actuarial reports for the last 3-5 years. These should be reviewed in light of the following:

i. Actuarial assumption and methods.

ii. Any changes in above.

iii. Status of the Funding Standard Account.

iv. Status of vested and all benefits in light of continued operations or a potential plan termination.
v. If not all employees under the plan are to be acquired, are separate valuations for the appropriate populations available?

i. Some indemnification with respect to any ERISA penalties for failure to have satisfied the reporting and disclosure standards.

2. Seller's Needs

a. Continuing benefits for former employees.

b. Liabilities for prior service.

c. Who will receive credit for any excess assets available upon the termination of the seller's defined benefit plan.

d. Protection from acts of buyer that can come back against the seller. The greatest risk here is associated with the distress termination of a defined benefit plan that is subject to the PBGC.

C. Basic Alternatives

1. Terminate the Plan - The plan could be terminated by the seller before the acquisition or by the buyer after the acquisition. It might constitute a complete termination, a partial termination or simply a freezing of the plan. The buyer may or may not give credit for service with the seller for purposes of determining vesting, participation or benefits under any new plan.

2. Buyer takes over the Plan - The buyer may become the new sponsor for the existing plan or a portion of the existing plan. The buyer could establish a parallel plan which assures the liabilities of the seller's plan and receives the assets. Alternatively the buyer could terminate or freeze the seller's plan, merge in its assets and integrate its benefits with the buyer's plan.

3. Seller keeps the Plan - Seller may or may not give vesting credit with service for the buyer.
II. Plan Termination - Pension Benefit Guarantee Corporation

A. Covered Plans

1. Defined Benefit Plans

2. Exceptions - ERISA Section 4021(b)

   a. Individual accounts plans under ERISA Section 3(34).

   b. Governmental plans.

   c. Church plans as defined in IRS Section 414(e), unless the plan has elected to be subject to Title IV of ERISA.

   d. Plans established and maintained by organizations described in IRC Section 501(c)(8), (9) or (18).

   e. Plans to which the employer has made no contributions since the date of enactment of ERISA.

   f. An unfunded plan of deferred compensation for a select group of highly compensated employees.

   g. Plans established and maintained outside the U.S. primarily for the benefit of nonresident aliens.

   h. Excess benefit plans.

   i. Plans covering only substantial owners as defined in ERISA Section 4022(b)(6).

   j. Plans of an international organization exempt from income tax under the International Organizations Immunities Act.

   k. Plans maintained solely to comply with the applicable workmen's compensation, unemployment insurance or disability insurance laws.

   l. Defined benefit plans which are treated as individual account plans under ERISA Section 3(35)(B).
m. Plans established by a professional service employer which does not at any time have more than 25 active participants in the plan.

B. What is Termination Insurance?

1. It is not insurance.
   a. No choice on the payment of the premiums.
   b. Premiums are based upon funded status of the plan, $16-$50 per participant.
   c. Not all benefits are guaranteed.
   d. The liability does not shift.

C. How does it work?

1. Standard Termination of a Single Employer Plan under the Single Employee Pension Plan Amendments Act of 1986 "SEPPAA". [ERISA Section 4041(b)]
   a. One of two exclusive methods to voluntarily terminate a defined benefit plan. Available only if plan assets are sufficient to pay "benefit liabilities."
   b. Notice of Intent to Terminate "NOIT". [PBGC Prop. Reg. Section 2617.12]
      i. Who is to receive - All "affected parties." Includes participants, beneficiaries of deceased participants, alternate payees pursuant to a QDRO [IRC Section 414(p)], and each employee organization representing participants. Note: does not include PBGC or IRS. [PBGC Prop. Reg. Section 2617.2]
      ii. Timing - At least 60 days but not more than 180 days, before the proposed date of termination.
      iii. Method of Notice - Either hand-delivered or delivered by first-class mail or courier service to the affected party's last known address.
iv. Contents - See PBGC Prop. Reg. 2617.12. Includes plan identification information as well as a statement of the intent to terminate and the proposed termination date.


i. Who is to receive - PBGC.

ii. Timing - No later than 60 days after the proposed date of termination specified in the NOIT.

iii. Content - Modified Form 5310. Includes certification by an enrolled actuary that plan assets on the proposed date of termination are sufficient to pay benefit liabilities. Additional information is necessary when the termination will result in an asset reversion to the employer.


i. Who is to receive - All participants, beneficiaries of deceased participants and alternate payees under a QDRO.

ii. Timing - No later then the filing of the Standard Termination Notice with the PBGC.

iii. Method of Notice - Either hand-delivered or delivered by first-class mail or courier service to the party's last known address.

iv. Content - See PBGC Prop. Reg. 2617.14. Generally, includes an estimate of the amount of benefit which will be payable upon the proposed termination date and the form of benefit available. If known, amount may be the accrued benefit as of
the proposed termination date. Notice must be written in a manner which is likely to be understood by an average participant or beneficiary, i.e. foreign language.

e. Notice of Noncompliance [ERISA Section 4041(b)(2)(D) and PBGC Prop. Reg. 2617.17]

i. After a Standard Termination Notice has been filed, the PBGC has 60 days to issue a Notice of Noncompliance. Absent such a notice within the 60 days, plan assets must be distributed.

ii. If a Notice of Noncompliance is issued by the PBGC within 60 days of filing, the proposed termination date is nullified and the plan is treated as an ongoing plan.

iii. Appeal procedures are available to the plan administrator.

f. Agreement to make Plan Sufficient

i. If plan assets are not sufficient to cover the benefit liabilities, but the employer is solvent and wished to fund the benefit liabilities, the plan sponsor may enter into an agreement with the PBGC to make the plan sufficient as of the proposed date of benefit distribution. A special form has been established for this. See PBGC Prop. Reg. Section 2617, closing appendix.

ii. If the employer fails to satisfy its commitment to make the plan sufficient, the termination is nullified and the plan is treated as an ongoing plan.

g. Asset Distribution [PBGC Prop. Reg. 2617.18]

i. All assets must be distributed within 30 days of the expiration of the PBGC's 60 day period to issue a Notice of Noncompliance.
As a practical matter this may be nearly impossible in any case where the plan sponsor intends to apply for an IRS Determination upon termination. Experience has shown that the PBGC will be flexible on the required distribution date to accommodate the IRS approval period. However, any practitioner should verify this with the PBGC for the period that his particular case is under review as this is apparently an administrative policy that could change at any time.

ii. The assets will be distributed by the purchase of an annuity or other form as specified by the plan which is actuarially equivalent (i.e. lump sum).

iii. Failure to comply with this time frame could nullify the termination of the plan.

iv. A 45 day extension may be available upon request with the PBGC.

v. Within 30 days of the completion of distributions, the plan administrator shall file a certification that assets have been distributed.

2. Distress Terminations [ERISA Section 4041(c)]

a. Second method of voluntarily terminating a defined benefit plan. Available only if the contributing sponsor and each substantial member (defined as 5 percent or more of gross assets of the controlled group) of its controlled group meets one of the following tests [ERISA Section 4041(c)(2)(B) and PBGC Prop. Reg. 2616.3(d)]:

i. Liquidation in bankruptcy.

ii. Reorganization in bankruptcy, with approval from the bankruptcy court.

iii. Inability to continue in business.

iv. Unreasonably burdensome pension costs.
b. Notice to Interested Parties "NOIT" [PBGC Prop. Reg. 2616.12]

i. Generally, procedures for a NOIT in a distress termination are similar to a NOIT in a standard termination. However, "affected parties" for purposes of this 60 day notice includes the PBGC.

ii. The NOIT is deemed to be issued to the PBGC when it is received by the PBGC. Therefore, if the NOIT is received on a weekend, legal holiday or after 4:00 p.m., the NOIT will be deemed received on the next business day.

iii. Contents to participants, etc. are similar to the standard termination NOIT except that a statement must be included indicating that certain minimum benefits are guaranteed by the PBGC. Retired participants shall receive a statement that their monthly benefit may be reduced, but not below PBGC minimums, due to the plan termination.

iv. Contents of the NOIT to the PBGC shall include information concerning which distress test is met by each substantial member of the controlled group.

v. Once a NOIT is filed, no distributions shall be made until the PBGC has issued a distribution notice. [PBGC Prop. Reg. 2616.4]


i. Who is to receive - PBGC.

ii. Timing - No later than 60 days after the proposed date of termination specified in the NOIT.

iii. Content - Includes specific information on the distress tests on which the distress termination is based for each substantial member of the controlled
group. Specifics include, but are not limited to, the last five years financial statements of each entity and the controlled group and any other relevant information concerning the reasons for the distress termination. A copy of the plan document, list of plan participants and beneficiaries, and a certification by the enrolled actuary are also required in the distress termination notice. The actuary shall certify whether plan assets are either 1) insufficient to provide PBGC guaranteed benefits under ERISA Section 4044(a), 2) sufficient to provide PBGC guaranteed benefits, or 3) sufficient to provide all benefit liabilities under the plan.

d. PBGC Determination of Distress Termination Compliance [PBGC Prop. Reg. 2616.15]

i. The PBGC will determine whether or not the requirements of a distress termination have been satisfied based upon the information contained in the NOIT, the distress termination notice, and any other information submitted by an affected party.

ii. The PBGC shall notify the plan administrator of either the satisfaction of the distress requirements or the failure to meet the requirements.

iii. If a failure to meet the requirements is due to a timely filed yet incomplete distress termination notice, the plan administrator shall be able to provide the incomplete information to the PBGC no later than 60 days after the proposed termination date or 20 days after the date of the PBGC notice of incompleteness, whichever is later.

iv. Failure to satisfy the distress requirements will result in a nullification of the termination. The PBGC shall notify the plan administrator if such is the case.
e. Participant Data Schedules [PBGC Prop. Reg. 2616.14(d)]

i. These schedules provide information concerning the accrued benefits of the participants and the basis for determining those accrued benefits.

ii. If plan assets are sufficient to provide all benefits liabilities, the plan administrator shall file with the PBGC and deliver to all participants a notice of benefit liabilities. [PBGC Prop. Regs. 2616.14(e), 2617.13, and 2617.14]

iii. These schedules and notices must be delivered or filed within 20 days of receipt of the PBGC's determination of the distress termination requirements.

f. PBGC Determination of Sufficiency/Insufficiency [PBGC Prop. Reg. 2616.16]

i. Upon receipt of participant data schedules or notice of benefit liabilities, the PBGC shall determine and notify the plan administrator of the plan's degree of sufficiency.

ii. The PBGC may issue a "notice of inability to determine sufficiency" in instances where it cannot be determined whether assets are sufficient to provide guaranteed benefits. In such a situation, distributions shall not be made and the termination will be completed pursuant to ERISA Section 4042.

iii. The PBGC may determine that a plan is sufficient to provide for guaranteed benefits. In such a situation, the PBGC will issue a "distribution notice".

iv. The PBGC may also determine that the plan is sufficient to provide benefit liabilities. In such an instance, a "distribution notice" shall be issued by the PBGC.
v. Sufficiency is verified prior to close out of a plan in addition to the original determination. This takes into account subsequent events of the plan. [PBGC Prop. Reg. 2616.17]

g. Close out of Plan [PBGC Prop. Reg. 2616.18]

i. Once a distribution notice is received from the PBGC, the plan administrator shall make final distributions to participants and beneficiaries within 30 days of receipt of such notice.

ii. The distributions shall be made by purchasing annuities or such other allowable form.

iii. The plan administrator shall file with the PBGC a certification that assets were distributed pursuant to the requirements. This certification should be filed within 30 days of completion of the distributions.

3. Since a standard and distress terminations are the only methods available for a voluntary termination, it is wise to at least freeze plan benefits in order to reduce the risk for future plan accruals in the case of a failure to get approval of the plan termination, either standard or distress.

D. Extent of PBGC Guarantee of Benefits [ERISA Section 4022]

1. PBGC guarantees the payment of all nonforfeitable benefits under the plan when it terminates except for benefits which become nonforfeitable solely on account of the termination of the plan. [ERISA Section 4022(a)]

2. This guarantee is phased in at the rate of 20 percent per year until the plan benefit has been in effect for 5 years. [ERISA Section 4022(b)(7)]

3. A plan which was established in contemplation of termination is not an insurable plan. [PBGC Opinion No. 81-7]
4. Special rules apply to the guarantee of benefits to individuals who are substantial owners of the employer. [ERISA Section 4022(b)(5); PBGC Reg. 2621.7]

5. A termination of the seller's plan does not occur for purposes of PBGC insurance even if no benefits continue to accrue under the plan provided that the seller continues to contribute to the plan and satisfies the minimum funding standard requirements of IRC Section 412. [PBGC Opinions Nos. 78-11 and 76-77]

E. Extent of the Employer Liability in a Distress Termination [ERISA Section 4062]

1. Employer liability to the PBGC is equal to the full unfunded benefit liabilities, not just guaranteed benefits, plus a reasonable interest charge from the date of termination.

2. The PBGC has a lien for this liability up to 30 percent of the collective net worth of the employer. [ERISA Sections 4062(d) and 4068]

F. Allocation of Plan Assets Upon Termination

1. At termination the assets of a single employer plan are allocated in the following order:

   To the accrued benefits funded with voluntary employee contributions.

   To accrued benefits funded with mandatory employee contributions.

   To benefits that were in pay status three years before the date of termination or could have been in pay status if the participant had retired at that time.

   To other guaranteed benefits.

   To vested benefits that are not guaranteed by the PBGC. (The guaranteed benefits are limited to a life annuity beginning at age 65 equal to the lesser of:
The average monthly gross income of the participant from his employer during the 5 consecutive year period, or the actual number of years during which he participated in the plan if less, in which his gross income from the employer is greater than in any other period of his employment by the plan sponsor, or

The sum of $750 adjusted to take into account increases after 1974 in the contribution and benefits bases under the Social Security Act at the time the plan terminates. [PBGC Reg. 2621.3]

To all other benefits under the plan. [ERISA Section 4044(a) and PBGC Regs. 2618, subpart B]

2. Any residual assets attributable to employee contributions must be distributed among the contributing employees or their beneficiaries in accordance with their contributions. [ERISA Section 4044(d)(3) and PBGC Reg. 2618.31 and .32]

Unless there is evidence to the contrary, the PBGC assumes that residual assets in a plan which provides for employee contributions are attributable to those employee contributions.

To Van Orman v. American Insurance Co. (680 F.2d 301, 3rd Cir. 1982), employee contributions in excess of vested benefits in a frozen plan were allowed to be used to fund newly accrued benefits when the plan was later amended to allow further benefit accruals.

Residual assets of a single employer plan that are attributable to employer contributions may be distributed to the employer if the plan document and local law allow such distribution. [ERISA Section 4044(d)(1) and PBGC Reg. Section 2618.30] See also Pollock vs. Castrovinci, 476 F. Supp. 606 (S.D.N.Y. 1979), aff'd mem., 622 F.2d 575 (2nd Cir. 1980); In re C. D. Moyer Trust Fund, 441 F. Supp 1128 (E.D. Pa. 1977), aff'd mem., 582 F.2d 1273, 1275 (3d Cir. 1978); PBGC Opinion No. 81-24.

Transfer of excess assets prior to termination, or merger of a plan having an actuarial surplus with an under-funded plan may cause fiduciary responsibility problems. See Wershkull v. United California Bank, 85 Cal. App. 3d 981, 149 Cal. Rptr. 829 (1978); see also
Audio Fidelity Corp. v. PBGC, 624 F.2d 512 (4th Cir. 1980). Post-termination amendment allowing for the reversion of surplus rejected based on ERISA's exclusive benefit rule; [PBGC Reg. Section 2618.4]

An amendment to a plan to allow for a reversion of residual assets to the employer will be allowed so long as the effective date of the amendment is not earlier than five years from the date of the adoption of the amendment. Therefore, an amendment to allow for a reversion may not occur right before the termination date. [ERISA Section 4044(d)(2)]

The PBGC's position that a portion of any residual assets will always be attributable to participants in plans which allow for participant contributions has been upheld. [LLC Corp. v. PBGC, 537 F. Supp. 355 (E.D. Mo. 1982)]

If the plan does not permit the reversion of plan assets to the employer or if the reversion would be prohibited by local law, the residual assets must be allocated among the pool of eligible participants and beneficiaries in accordance with PBGC. [Reg. Section 2618.30(b)]

G. Reorganization Issues

1. Certain events indicating the possible danger of plan termination are defined as "reportable events" and must be reported to the PBGC within 30 days after the event transpires. [PBGC Reg. Section 2615.3] "Reportable events" which may arise due to a corporate acquisition or divestiture are:

   a. The reduction of participants in a single plan to less than 80 percent of the number of participants as of the beginning of the current plan year or less than 75 percent of the number of participants as of the beginning of the prior plan year. This notice is not required for plans which has fewer than 100 participants as of the beginning of either year. [ERISA Section 4043(b)(3); PBGC Reg. Section 2615.14(b)]
b. A determination by the IRS that a termination or partial termination has occurred within the meaning of IRC Section 411(d)(3). The 30 day notice has been waived for all plans. [ERISA Section 4043(b)(4) and PBGC Reg. Section 2615.15(b)]

c. A freeze or cutback of benefit accruals. 30 day notice is waived where the plan has 100 or more participants, benefits have been cutback by more than 50 percent and the benefit cutback is not the result of a federal law requirement. [ERISA Section 4043(b)(9) and PBGC Reg. Sections 2515.13(a) and (b)]

When contemplating this do not forget the ERISA Title I freeze notice under Section 204(h). The due date for this notice is 15 days prior to the date of the freeze.

d. A plan merger, consolidation or transfer of plan assets or liabilities. The 30 day notice is waived in all cases. [ERISA Section 4043(b)(8) and PBGC Reg. Section 2615.19(b)]

e. A transaction leading to the liquidation or other dissolution of the employer other than one in which a subsidiary is liquidated into the parent or a reorganization involving a merger, consolidation, division or change in entity or form from which a successor corporation emerges. [ERISA Sections 4043(b)(9) and 4062(c) and PBGC Reg. Sections 2615.22(a), (b) and (c)]

f. Certain changes in ownership or transfers of assets of the plan sponsor with unfunded vested benefits in excess of $1,000,000. [ERISA Section 4043(b)(9) and PBGC Reg. Sections 2615.23(a), (b) and (c). See also PBGC Opinion No. 81-20]

Notice of the event must be given in the annual report. This is required regardless of whether the 30 day notice is waived. [PBGC Reg. Section 2615.4]
2. Consistent with the rules for tax qualification purposes, for ERISA Title IV purpose, all employees of commonly controlled trades or businesses are treated as employed by a single employer. [ERISA Section 4001(c)(1)]

a. "Common control" for this purpose has the same meaning as under IRC Code Section 414(c). Note this is not 414(m) or (o). [PBGC Reg. Section 2612.2]

b. Therefore, if a plan is terminated by a member of a controlled group of corporations, all members of the group are jointly and severally liable for any payment due to the PBGC. [PBGC v. Quimet Corp., 470 F. Supp 945 (D. Mass.), aff'd 630 F 2d 4 (1st Cir. 1980), cert. denied, 450 U.S. 914 (1981) and PBGC v. Anthony Co., 537 F. Supp. 1048 (N.D. Ill. 1982]

c. The former parent of a wholly-owned subsidiary would be protected from any liability to the PBGC where the former subsidiaries plans were subsequently terminated, even though those plans had been established while it was the parent and covered persons who were previously covered by the parent's plan if the parent sold its stock to an unrelated purchaser. [PBGC Opinion No. 82-70]

3. In the event the request for termination through the PBGC proves too costly, the PBGC may consent to the restoration of a plan after the Notice of Intent to Terminate has been filed. Note however, the PBGC has the authority to impose several conditions upon this reinstatement. The most severe of which may be extending the employer's liability upon any subsequent plan termination to something in excess of the normal 30 percent limitation. [PBGC Opinion 82-11] The Omnibus Budget Reconciliation Act of 1987 already increased this liability so the imposition of this condition is lessened.
4. If a single-employer defined benefit plan is terminated after an acquisition and if the acquired corporation ceased to exist because of the merger or consolidation, the acquiring corporation will be liable for the entire amount of unfunded benefit liabilities at the date of termination. [ERISA Section 4062]

   a. This liability arises even if the acquiring corporation did not have knowledge of the existence of the pension plan at the date of the merger or consolidation. [PBGC Opinion No. 76-92]

   b. Contingent liability should be taken into account when determining the purchase price. Alternatively, the plan should be terminated and any liability to the PBGC determined prior to the closing of the transaction.

5. If the acquiring corporation purchases a division of the seller and continues a defined benefit pension plan covering the employees of the division as a separate plan, the continuation of the plan is not subject to the benefit equivalency rule. [T.I.R. 1408, Q&A No. 12]

6. Where the seller participated in a plan under which more than one employer contributed, but which was not a multi-employer plan, and if the acquiring corporation continues to contribute to such plan, both the seller and the acquiring corporation may be liable for a portion of the unfunded guaranteed benefits should the plan terminate within the next 5 years. [ERISA Section 4064]

   a. Employer liability exists under ERISA Section 4064(a) for all employers who at any time within the 5 preceding plan years made contributions to a terminated plan.

   b. The total employer liability to the PBGC under such a plan at the date if the plan termination is determined by comparing the current value of the benefit liabilities on the date of termination with the current value of the plan assets allocable to such benefits on that date.
c. Each such employer's allocable portion of the total employer liability is determined under ERISA Section 4064(b).

d. Note the seller remains contingently liable to the PBGC for 5 full plan years after the acquisition is completed. This too should be covered in the papers on the sale.

7. Where the seller was a "substantial employer" under ERISA Section 4001(a)(2) at the time of plan termination under a multiple-employer plan, the withdrawing employer's liability to the PBGC is computed as though the entire plan had terminated on the date of the withdrawal. [ERISA Section 4063]

H. Planning Considerations

1. To avoid the problems and uncertainties associated with plan merger, consolidations and transfers of plan assets pursuant to business acquisitions and divestitures, the following possibilities should be considered during the negotiating process:

a. The sale and divestiture of a division could be treated as a "partial termination" of the accrued benefits of the separating participant's becoming fully vested to the extent funded. [IRC Section 411(d)(3)]

This is no more costly to the seller than the plan transfer as in order to satisfy the "benefit equivalency" rule, benefits must be determined and valued as if the plan had been terminated.

b. Alternatively, the seller's plan could be amended to provide that service with the acquiring corporation would be treated as service with the seller for purposes of determining a participant's vested interest in the benefit accrued under the seller's plan. Of course, future benefit accruals under the seller's plan would cease for those participant's transferred to the employ of the buyer.

This approach would be less costly to the seller assuming there is normal turnover. However, this approach is rarely seen.
c. The negotiated purchase/sales price could be reduced by the value of the nonvested accrued benefits of the participants who will be employed by the acquiring corporation in consideration of the acquiring corporation's agreement to establish a plan for such participants providing a past service benefit for each participant equal to the value of the nonvested accrued benefit of each participant under the seller's plan as of the date of closing.

III. Internal Revenue Service Issues

A. Qualification Issues

1. Benefit Equivalency Rule

a. For plan mergers, consolidations and transfers of plan assets after the effective date of ERISA, the remaining participants in the transferor plan and those participants who become participants of the transferee plan must be assured of an immediate post-combination/separation accrued benefit which is no less than their pre-combination/separation benefit. This benefit must be calculated as if both plans had been terminated as of the date of combination/separation. [IRC Section 401(a)(12) and 414(l); Reg. Section 1.414(l)-1(a)(2)]

b. The assets of separate plans can be commingled for investment purposes without constituting a plan merger, consolidation or transfer of plan assets of each plan. [Reg. Section 1.414(l)-1(b)(1)]

c. This rule must be satisfied where separate plans of a parent-subsidiary group are amended into a single plan. [PBGC Opinion No. 76-83]

d. The "benefit equivalency" rule has the following applications in the case of mergers or spinoffs of defined contribution plans:

i. In the case of a merger of defined contribution plans, the sum of the account balances in each plan must equal the fair market value as of the date of the merger. All the assets of each plan must be com-
bined to form the assets of the merged plans. Each participant in the merger plan must end up with an account balance equivalent to the account balance the participant had immediately preceding the merger. [Reg. Section 1.414(l)-1(d)]

ii. In the case of a spinoff of a defined contribution plan, the sum of the account balances for each of the participants in the resulting plans must equal the account balances of each participants in the plan immediately before the spinoff. The assets in each plan immediately after the spinoff must equal the sum of the account balances for all participants in that plan. [Reg. Section 1.414(l)-1(m)]


e. Somewhat different rules apply in reviewing the "benefit equivalency" rule from the perspective of a defined benefit plan.

i. In the case of a merger of two or more defined benefit plans, combining the assets and preserving each participant's accrued benefit is sufficient if the sum of the assets of all plans is not less than the sum of the present value of the accrued benefits, regardless of the vested percentage, of all plans. [Reg. Section 1.414(l)-1(e)(2)]

ii. In the case of a spinoff of a defined benefit plan, all of the accrued benefits of each participant must be allocated to only one of the spunoff plans, and the value of the assets allocated to each of the spunoff plans cannot be less than the sum of the present value of the benefits before the spinoff for all participants in that spunoff plan. [Reg. Section 1.414(l)-1(n)(1)]
iii. The benefit measured under the "benefit equivalency" rule for a defined benefit pension plan is the plan benefit, to the extent that it is funded, and not any additional unfunded benefit regardless of whether or not it is guaranteed by the PBGC. [Reg. Section 1.414(l)-1(b)(5)(i)]

f. Where a defined contribution plan and a defined benefit plan are combined, one should be converted into the other type of plan and the appropriate rule applied.

i. A defined benefit pension plan subject to Title IV of ERISA is treated as terminated under Title IV and IRC Section 411(d)(3) if such plan is amended into any type of defined contribution plan. [ERISA Section 4041(e); PBGC Opinions 76-30, 76-12 and 76-2; IRC Reg. Section 1.411(d)-2(c)(2)(i)]

ii. Prior to the SEPPA legislation, the PBGC had required that each participant file a written election covering whether he or she wished to receive a distribution of plan assets or to have the assets transferred to the new defined contribution plan. Special restrictions applied in cases where the defined contribution plan was to be invested largely in employer securities. This election by the participant could be deemed a sale under Section 2(3) of the 1938 Securities Act. Thereby, unless certain exemptions applied, the plan would have to comply with the registration requirements of the Act. [SEC Release No. 33-6281, 17 C.F.R. 231.6188]

With the SEPPA changes, we are not sure of the PBGC's standing on this matter. We have had no client situations where this has arisen. Note, under the final regula-
tions of IRC Section 411(d)(6), direct transfers from DB to DC plans are more problematic. Therefore, this issue may simply not come up. [See IRC Reg. 1.411(d)-4, A-3(a)(3)]

g. If a plan combination/separation complies with the "benefit equivalency" rule, the transferor plan is not considered to be terminated for the purposes of IRC Section 411(d)(3). [T.I.R. No. 1408 Q&A 16 and 18]

h. Peculiarly, a transfer of assets or liabilities does not occur Under IRC Section 414(1) merely because a defined contribution plan is amended to become a defined benefit plan. For this purpose, it is irrelevant whether the amendment constitutes a termination of the defined contribution plan under IRC Section 411(d)(3). [IRC Reg. Section 1.414(1)-l(c)(1)(i)]

i. The transfer of assets and liabilities from one qualified plan to another qualified plan which complies with the IRC Section 414(1) and which is made pursuant to a plan of corporate reorganization under IRC Section 368(a) does not adversely affect the qualified status of either plan. The predecessor's contribution to the plan prior to the consolidation was deductible. No taxable income was realized by the successor corporation due to the transfer of plan assets. [Rev. Rul. 82-60]

j. Any plan involved in a merger, consolidation or transfer of plan assets or liabilities must notify the IRS. This is accomplished by filing Form 5310 at least 30 days before the planned transaction. For defined benefit plans, an actuarial statement of valuation must accompany the form. Note, the form is to be filed by both the transferor and the transferee plans. Notification is also made on the Annual Return/Report of the plan (Form 5500).
2. Permanency

a. Where a plan is terminated due to a business reorganization, the issue is whether or not the plan satisfied the "permanency" requirement of IRC Reg. Section 1.401-1(b)(2).

i. Whether the plan satisfies the "permanency" requirement is determined by the facts and circumstances of each individual case. Since the intent of this rule is to insure that a plan was not established for the benefit of a few highly compensated individuals and then terminated once their needs were met, plan terminations resulting from changes in the business structure of the plan sponsor and which do not reflect any pattern of discrimination are rarely challenged by the Service.

ii. Where the plan is terminated within a very few years after its adoption there is a presumption that it was not intended to be a permanent program. This is a rebuttable presumption if the plan sponsor can provide that there was a business necessity leading to the termination. [Rev. Ruls. 69-25 and 69-24, PLR 7842008, Sutherland v. Commissioner, 78 T.C. 395 (1982); Estate of Benjamin v. Commissioner, 54 T.C. 953 (1970); Rev. Rul 74-419]

iii. Where the plan was terminated within a few years of adoption, but it was terminated after some kind of corporate reorganization, a slightly less stringent standard appears to apply. [See Rev. Rul. 69-25]

iv. If the plan has been in existence for several years, it is no longer necessary to prove business necessity in order for the plan to be considered permanent. Ten years is generally considered to be a safe minimum. [See Rev. Rul. 72-239]
b. As an alternative to the termination of the plan the acquiring company or the selling company, depending upon who maintains the responsibility for the plan benefits, may choose to simply freeze the plan. This avoids the immediate determination of any liability to the PBGC and avoids most questions regarding the permanency issue.

Note, a frozen plan must continue to be amended for any law changes. Also it may become disqualified when as a result of retirements and other separations, the plan becomes one that is operated solely for members of the prohibited group. This concern about coverage and qualification for a wasting trust is apparently less pressing now than in prior years. Both the proposed regulations under IRC Section 410 and 401(a)(26) grant exemptions from their rules for frozen plans. [Rev. Rul. 57-587 and Rev. Rul. 89-87]

3. Full Vesting

Where a plan is terminated, IRC Section 411(d)(3) requires that, as a condition of qualification, a plan must provide that all rights of all affected employees to benefits accrued to the date of termination, to the extend funded as of such date for a defined benefit plan or the amount credited to the employees' account for a defined contribution plan, must be nonforfeitable.

a. For this section a plan is considered terminated when the facts make it clear. [See Rev. Ruls. 72-181 and 73-450]

b. It appears to be the position of the IRS that all participants become vested as of the date of termination, even if they had separated from service prior to the termination as long as they had not yet incurred a break-in-service as of the date of termination. [IRC Section 411(a)(4)] Apparently the Service may make an exception from this for participants that have been cashed out prior to the termination, but
this is not certain. Our experience has demonstrated that this is a matter that varies dramatically from district to district and occasionally with the district between examiners.

Although there is a GCM out on this point, it deals with pre-REA'84 facts. Therefore, it is not clear how it might be applied in a post-REA situation. See GCM 39310.

4. Asset Allocation

a. IRC Reg. Section 1.411(d)-2(a)(2) requires that all unallocated funds be allocated to the plan participants as of the date of termination. As a practical matter, this allocation should follow the rules set forth in ERISA Section 4044.

b. This allocation can not result in prohibited discrimination. See Rev. Rul 80-229 regarding how plan assets may have to be reallocated to prevent prohibited discrimination.

c. During the last few years a controversy arose over this point. Certain plan terminations resulted in the participants contesting which benefits were in fact protected in the event of a premature termination of the plan. Claims were filed for early retirement benefits by persons who had met the service standard, but not the age and vice versa. This matter was resolved earlier this year by the Tilley case. Mead Corp. v. Tilley et al, SCt No. 87-1868, decided June 9, 1989. The case held that ERISA Section 4044(a) does not require a plan administrator to pay unreduced early retirement benefits before any assets can return to the employer. ERISA Section 4044(a)(6) does not create any benefit entitlement but simply an orderly method for allocating assets.

However, room was left open in the case for a new definition of the term "accrued benefits", so worse news may yet come.
d. In the case of an early termination of a defined benefit plan, special rules apply to avoid prohibited discrimination. Benefits allocated to the top 25 employees, measured by compensation, are limited until all rank and file participants have been allocated their benefits. This rule only applies if the plan is terminated before 10 years. If a plan has been adequately funded, these restrictions have no practical effect. They represent more of a nuisance for any of the top 25 employees which separate from service before the plan has been in existence for 10 years than anything else. [IRC Reg. Section 1.401-4(c)(2)(iii) and Rev. Ruls. 80-229, 81-135, 73-3 and 72-577]

e. Under IRC Section 401(a)(2) no assets of a plan can revert to the employer until all liabilities with respect to plan participants and their beneficiaries have been satisfied. However, IRC Reg. Section 1.401-2(b) allows an employer to recover assets from a terminated plan where the excess assets was due to erroneous actuarial computations. However, the plan document must provide for this reversion. Keep in mind the ERISA Section 4044(d) restrictions on amending a plan to provide for such a reversion. That is, the amendment cannot be effective for five years from date of adoption.

5. Discrimination

Prior to the passage of ERISA, the qualification of a plan was based upon the single employer, regardless of whether or not that employer was a member of a controlled group of corporations. [See Rev. Rul. 69-250] This had resulted in tremendous abuses, therefore ERISA added Sections 414(b) and (c) to the Internal Revenue Code. These sections require that controlled groups of corporations or commonly controlled trades or businesses be considered as one employer for purposes of IRC Section 401, 408(k), 410, 411, 415 and 416. [These rules were subsequently broadened by the addition of IRC Section 414(m), (n), and (o).]

This broadened scope creates some real issues regarding discrimination in coverage and benefits for employers acquiring entities with existing plans.
a. Participation and Coverage

i. For purposes of satisfying either the objective test or the average benefits test of IRC Code Section 410(b)(1) or (2), all employees of a controlled group of corporations, a group of trades or businesses under common control, an affiliated service group or leased employees are treated as being employed by a single employer. [IRC Section 414(b), (c), (m), (n), and (o)]

ii. These standards apply even if the controlled group of businesses are unrelated to each other and there is no evidence that the plan was established for purposes of providing some measure of discrimination in coverage. Fujinon Optical, Inc. v. Commissioner, 76 T.C. 499 (1981); see also Tamko Asphalt Products v. Commissioner, 658 F.2d 735 (10th Circuit 1981), aff'g 71 T.C. 824 (1979).

iii. It may be possible to exclude from consideration an unprofitable member of the group if it ceases operations at the same time as the qualification years at issue. [Sutherland v. Commissioner, 78 T.C. 395 (1982)]

iv. Standing alone, the plan of a member of a controlled group may have difficulty in meeting the mathematical test of Code Section 410(b)(1) on its own. It may satisfy the average benefits test of IRC 410(b)(2) if the employees of that member do represent a fair cross-section of the total workforce. Regulations are needed under IRC Sections 410(b)(2) and 401(a)(4) in order to make this determination.

For certain groups a separate testing option may be available where the separate entities can qualify as separate lines of business under IRC Section 414(r). Unfortunately, we do not yet have any regulations to tell us what that means.
v. All plans of a controlled group can be combined to satisfy the coverage test, however, that will not be effective if the benefits provided under the different plans do not satisfy the nondiscrimination requirements of IRC Section 401(a)(4). [IRC Reg. Section 1.410(b)-1(d)(3)(1); Rev. Rul. 81-202]

vi. The proposed regulations to IRC Section 410(b) do provide some relief for certain acquisitions or dispositions to the immediate requirements of 410(b) in the 1989 plan year and after. [IRC Prop. Reg. 1.410(b)-2(d) and IRC Section 410(b)(6)(C)] This section deems a plan to satisfy 410(b) until the end of the first plan year following the change in controlled group structure. This allows an employer time to make the necessary changes.


viii. Beginning in 1989 plan years, each plan of an employer must meet the requirements of IRC Section 401(a)(26). This minimum participation rule will make it more difficult for smaller employers who have plans which cover less than 50 employees to change their corporate or entity structure without also changing its plan structure. Since each plan must cover the lesser of 40% of employees of the employer or 50 employees, more plans will need to be merged when smaller entities combine.

ix. The proposed regulations to IRC Section 401(a)(26) also provide some special rules. One exception would not apply the rule to plans which are frozen. Another
exempts plans which do not cover any highly compensated employees as defined in IRC Section 414(q). [See IRC Prop. Reg. 1.401(a)(26)-1(c)]

A defined benefit plan could not benefit a highly compensated employee in any of the five preceding years to take advantage of this rule.

Also, a relaxed rule for the 50 employee requirement states that a plan may provide benefits for as few as 20 employees if it is part of a larger plan which satisfies IRC 401(a)(26) and the 20 employee plan benefits a group which consists of at least 70% nonhighly compensated employees. [IRC Prop. Reg. 1.401(a)(26)-1(c)(2)]

x. This shows that an employer must also look at the size of its own plans and the acquired company's plans before making the transaction. If not done, the plans may no longer satisfy the participation requirements. These proposed regulations also allow a correction by the end of the plan year to satisfy IRC Section 401(a)(26) for the whole year. [IRC Prop. Reg. 1.401(a)(26)-1(c)(1) and -5(a)(2)] This includes a merger of plans.

b. Participation and Vesting

Service with any member of a controlled group, any trade or business under common control or any affiliated service group is considered as service with any other member of the controlled group or employer related to that member. This is regardless of whether or not the member for which the service was performed had adopted any plan. [IRC Reg. Sections 1.410(b)-1(d)(8) and 1.411(a)-5(b)(3)(iv)(B)]

However, it is only the longer of the service while a member of the controlled group or while the plan was maintained by the member.
c. Exclusions

The statutory exclusions are equally applicable to controlled groups, etc. as single employers. Thus employees which can be excluded from coverage pursuant to IRC Section 410(b)(3) and (4) also can be excluded here.
On this point, pay careful attention to the plan language. Many of the master plans or other plans provided by service centers count all years of service with an affiliate without regard to the term that the organization has been affiliated.

d. Service with Acquired Corporation

i. If the acquiring corporation maintains the plan of the acquired corporation, service the acquired corporation is also treated as service with the acquiring corporation. [IRC Section 414(a)] This cannot be avoided by nominally discontinuing the plan. [H.R. Rept. No. 1280 93rd Cong., 2d Sess. 264, 1974-3 C.B. 415,425]

ii. Where the acquiring corporations discontinues the plan of the acquired corporation, regulations are to be issued by the Treasury regarding what, if any, service with the acquired corporations must be recognized under the plan of the acquiring corporation. [IRC Section 414(a)(2)] Note this does not preclude the acquiring corporation from recognizing service with the acquiring corporation in certain cases. [See PLR 7742003 and Rev. Rul. 81-49. On the opposite side, see Rev. Rul. 81-248.]

e. Benefits

The acquiring corporation may maintain or establish a separate plan for the employees of the acquired corporation. If that is the case, it is necessary to determine whether the separate plan satisfies the nondiscrimination requirements for qualification regarding benefits.

i. The Service has established a number of revenue rulings which the practitioner can use in making this determination. In spite of all this guidance, or perhaps because of all this guidance, this is not a simple determination to make. It is complicated further by the fact that the plans must stand up both in design and
operation. Therefore the situation must be reviewed annually. For this we must be grateful for the advent of the personal computer.

For guidance in this determination, refer to:


All of this body of information must be applied in light of the new standards of IRC Sections 401(a)(26) and 410(b). The mathematical loops of these sections further illustrate the need for personal computers.

6. Top Heavy

An acquiring corporation must review the status of the target plan in light of the top heavy regulations. Otherwise, the plan of the acquiring corporation might find itself top heavy after the acquisition, even if it was not even close before the acquisition. For example, acquiring corporation has a new plan with only $100,000 of total assets. Target corporation has a mature plan with $1,000,000 of total assets of which $900,000 is attributable to the accounts of key employees.

a. Even if key employee balances are distributed there may be a problem due to the look back rules. [See IRC Reg. Section 1.416-1(T-6)]
b. The plan of the target corporation must be aggregated with the acquiring corporation since there are key employees in both plans. There is no exclusion for key employees who separate incidental to a corporate acquisition.

c. No different standards apply if the plans are aggregated or merged. A termination of the plan of the target company and distribution of assets prior to the closing of the purchase may be the only solution. [See IRC Reg. Section 1.416-1(T-32)]

B. Contribution Deduction Issues

1. Contribution Carryovers and Credit Carryovers Defined

a. Under a profit sharing or stock bonus plan, if the employer contributes less than 15 percent of pay, a "credit" carryover results. This is a dollar amount representing the difference between the amount actually contributed and 15 percent of covered compensation. This amount can be used in future periods providing the employer with the potential for a deduction equal to 25 percent of pay. [IRC Section 404(a)(3)(A)] No more carryovers can be created in years after 1986. However, pre-1987 carryovers can still be utilized.

b. For either a defined contribution plan or a defined benefit plan in the event an employer contributes more than the deductible limit a "contribution" carryover results. This amount can be deducted in future years whenever the current contribution is less than the maximum allowable. [IRC Section 404(a)(1)(D) and 404(a)(3)(A)] However, the nondeductible penalty of IRC Section 4972 may still apply.

2. Issues in Corporate Acquisitions and Divestitures

a. Where a portion of the assets of the seller's plan is transferred to the plan of the acquiring corporation, but the seller remains in existence and continues to maintain its plan,
the deduction limitations and any related credit or contribution carryovers will continue to apply to the seller's plan. None will be transferred to the plan of the acquiring corporation.

b. In an acquisition to which IRC Section 381(a) applies, unused deductions and any carryovers may be carried over to the plan of the acquiring corporation. [IRC Section 381(c)(11)]

i. If the plan of the acquired corporation is terminated, any contribution deduction carryforwards may be deducted by the acquiring corporation subject to the restrictions set forth in the regulations. [IRC Regulation Sections 1.381(c)(11)-1(d)(3), 1.404(a)-7(b), 1.404(a)-9(a)(2), 1.404(a)-13(a)]

ii. If the plan of the acquired corporation is a profit sharing or stock bonus plan, any unused deduction carryover is deductible by the acquiring corporation only if the acquiring corporation contributes to the same plan or consolidates or replaces that plan with a comparable plan. [IRC Reg. Section 1.381(c)(11)-1(d)(3)]

c. A purchase price adjustment reflected in the sales agreement, to cover any employer contingent liability could affect the deductibility of the contribution by the acquiring corporation to the plan of the acquired corporation. [IRC Section 381(c)(6)]

d. Numerous private letter rulings have allowed the acquiring corporation to claim a deduction for contributions made to fund a past service liability created under the acquired corporations plan as long as there is no duplication of benefits. [PLRs 8202115, 8202107, 8152055 and 8124016]
e. However, if the acquiring corporation fails to make a timely contribution, it will lose the deduction under IRC Section 404(a)(1) and will not be allowed to increase its cost basis in the assets acquired. *(F&D Rentals, 44 T.C. 335 (1965), aff'd 365 F.2d 34 (7th Cir.) cert.den. 385 U.S. 1004 (1967))*

f. An aberration in this law is present in *David R. Webb Co., Inc.* 77 T.C. 1134 (1981) *arr’d 708 F.2d 1254 (7th Cir. 1983)*. In this case it was held that a corporation which acquired all the assets of another corporation could not deduct the unfunded payments to the widow of a former employee because such payments were not ordinary and necessary business expenses of the acquiring corporation, but were in fact a liability assumed and part of the cost basis of the property acquired. Note however, the liability was not put on the books as of the date of purchase. Rather the basis of assets was adjusted as the payments were made. To date there has been no published ruling which applies this rational to the past service liability of a qualified plan. However, the IRS has left it open that there may be situation which because of a unique set of facts, this theory could be applied.

C. Minimum Funding Requirements

1. A separate funding standard account must be established for each separate defined benefit plan even if the plans are sponsored by corporations that are included within the same controlled group. *(Rev. Rul. 81-137)*

2. A defined benefit plan that is subject to the minimum funding requirements of IRC Section 412 may be converted into a plan described in IRC Section 412(i) that is exempt from the minimum funding requirements as a plan funded exclusively by the purchase of individual insurance contracts provided that:

   a. Benefits accrued to the conversion date are fully guaranteed under insurance contracts which have a cash value equal to the present value of the accrued benefits, and
b. All benefit accruals after the conversion date are funded exclusively by insurance contracts which provide for level annual payments with respect to such accruals ending not later than the participant's normal retirement age. [Rev. Rul. 81-196]

3. The Service has provided guidelines for determining minimum funding requirements after a single plan spins off assets and liabilities to another plan. [Rev. Rul. 81-212] However, TAMRA revised these rules somewhat. TAMRA Act Section 6067 added IRC Section 414(l)(2)(G) which provides that in the spin-off assets must be allocated proportionately among the plans. This stopped a plan sponsors ability to allocate all of the excess to the plan of former employees, terminate that plan and recover all of the excess without vesting the continuing employees. This new rule applies to transactions occurring after July 26, 1988 unless approved by the board before that date. There are some special transition rules, so watch out.

4. After a spinoff the resulting plans may change their actuarial funding method and assumptions. A change in the funding method, however, requires IRS approval under IRC Section 412(c)(5). However, in certain cases automatic approval is provided. [Rev. Proc. 80-50 and Rev. Proc. 81-29]

D. Tax Consequences to the Participant

1. If the acquired corporation's plan is terminated at the date of the acquisition and single sum distributions are made to the participants, the distribution will not qualify for favorable tax treatment to the participants under IRC Section 402(a)(2) and 402(e) unless the participant has attained age 59 1/2 or the distribution is deemed to be made "on account of the employee's separation from service" and the participant was over age 50 on January 1, 1986. [IRC Section 402(e)(4)(A), as amended by TRA'86, see special transition rules for phase out of old averaging rules.]

   a. A distribution from a qualified plan does not constitute a distribution on account of separation from service when:
i. An employee of a terminated corporation or partnership continues employment with the successor entity. [Rev. Rul. 80-129]

ii. The workforce remain employed by the same corporation after it has gone through a change in ownership. [Rev. Rul. 81-141 and PLR 8138023]


b. In contrast, a distribution on account of separation from service with one employer was treated as a lump sum distribution within the meaning of IRC Section 402(e)(4)(A), even though the employee continued employment with a second employer who also funded its qualified plan with contributions to the same trust as the former employer. [Rev. Rul. 80-128]

This rule applies even if the second employer is a member of the same controlled group which includes the former employer. [PLR 8138023]

Please note, the controlled group, etc. rules of IRC Section 414(b),(c), (m), (n), and (o) do not apply to IRC Section 402.

c. A separation from service was deemed to have occurred when a corporation was liquidated under IRC Section 337 and its employees were terminated, even though the shareholders had organized another corporation to engage in similar activi-
ties. The employees of the liquidated corporation were not promised any employment with the new corporation as it was located in a new location. [PLR 7846040]

d. A separation from service was deemed to have occurred after the employer's stock was acquired by a new corporation - none of the employees were employed by the acquiring corporation. [PLR 7843137]

2. Recognition of Years of Service

In the case of plan mergers, the Service previously took the position that "years of participation" for purposes of determining the capital gain and ordinary income portions of a lump sum distribution meant only years of participation under the plan from which the distribution is made. [Prop. Reg. Section 1.402(e)-2(d)(3)(i)(A); PLRs 8201073, 8123138, 8009066, 8007047, 8005023, 7953025; but for a different view see PLR 7748052] However, beginning with private letter rulings issued in the fall of 1984, the Service reversed this position and began tacking years of service for both 10 year averaging and the capital gains/ordinary income split. [Contrast PLR 7943119 with PLR 8441068]

a. This lack of tacking has also been applied for rollover contributions. [PLR 8134110]

b. The Service has changed its mind with respect to what years of participation apply for purposes of the 5 year requirement of IRC Section 402(e)(4)(H). [See PLRs 8149036, 8123138, 8037102, 8012037, 8006111, 7953025]

3. Regardless of the dispute regarding the 5 year rule, if the acquired corporation's plan is terminated at the date of the acquisition and single sum distributions are made to the participants, current income tax consequences can be avoided by rolling the amounts over into IRAs or another qualified plan. [IRC Section 402(a)(5)]

Note, however, any TEFRA 242(b)(2) elections that had been in effect with respect to the terminated plan
will be cancelled upon that plan’s liquidation. Only a merger under which the participant cannot elect a distribution, in lieu of the merger, will serve to protect the TEFRA elections.

Obviously, in any plan takeover situation, copies should be obtained of any TEFRA elections.

4. This same rollover treatment is available if the seller’s plan remains in existence but some employees of a separated subsidiary or division receive a total distribution in connection with this sale or transfer, as long as:

   a. These employees are not active participants in the seller’s plan at the time of the distribution, and

   b. The distribution is made before the end of the second calendar year after the calendar year in which the acquisition occurred. [IRC Section 402(a)(6)(B)]

5. Care must be taken to protect the qualified status of the plan during this whole process. If the distribution is made from a plan that is found to be non-qualified it is the position of the Service that no portion of the distribution will be treated as coming from a qualified plan. Therefore none of the special options would be available. [See Woodson v. Commissioner, 651 F.2d 1094 (5th Cir. 1981); in contrast Greenwald v. Commissioner, 366 F.2d 538 (2d. Cir 1966)]

IV. Special Considerations - Plans Which Hold Employer Securities

These issues are beyond the scope of this program. They are simply highlighted here for a reminder.

A. Need to protect, if possible, any net unrealized appreciation on employer securities.

B. Use and abuse of ESOPs in a tender offer.

C. Status of employer securities in an ESOP, TRASOP or PAYSOP during an acquisition or divestiture. When will these shares be converted into shares of the acquiring company. PAYSOPs and TRASOPs have been eliminated after 1986. Many have been terminated or converted into ESOPs.
Part Two - Other Fringe Benefit Issues

I. Benefits Provided Under Certain Employee Benefit Plans - Section 89

Generally, Section 89 provides that certain types of employee benefit plans must meet mandatory nondiscrimination tests in order to prohibit discrimination in favor of highly compensated individuals. These nondiscrimination tests are performed for each plan type, whether the plan is insured or self-insured. In addition, plans must meet expanded qualification tests and are faced with additional reporting and documentation requirements.

A. Nondiscrimination Rules

1. Special Transition Rule for Certain Dispositions or Acquisitions

   a. A plan of an employer who becomes or ceases to be a member of a controlled or affiliated group [as defined in IRS Section 414(b), (c), (m) or (o)], will be deemed to satisfy the nondiscrimination rules during a transition period provided that:

      i. The nondiscrimination rules were satisfied immediately before the acquisition or disposition; and

      ii. The coverage under the plan (or under another plan on which the plan relied to satisfy the nondiscrimination rules) does not change significantly during the transition period (other than by reason of the acquisition or disposition). [IRC Section 89(j)(8)(A)]

   b. The transition period begins on the date of the acquisition or disposition and ends on the last day of the first plan year beginning after the transaction. [IRC Section 89(j)(8)(B)]

   c. If an employer tests using the separate line of business rules, the transition rule above only applies to the plans in the line of business affected by the acquisition or disposition. (1986 Act Blue Book at 794)
d. Employers with frequent acquisitions or dispositions are not necessarily required to determine if the nondiscrimination rules are satisfied prior to each new transaction.

i. ISSUE: Could the transition period be extended by each subsequent acquisition or disposition thereby allowing an acquiring employer to be perpetually in compliance with the nondiscrimination rules.

ii. TAMRA authorized the IRS to issue regulations to ease the application of Section 89 to these transactions. At the same time the regulations should ensure that repeated transactions do not provide a means if avoiding the nondiscrimination rules.

e. There is a special rule for acquisitions or dispositions occurring before December 31, 1988 (i.e. prior to the effective date of Section 89.) Prop. Reg. 1.89(a)-1 (Q&A-10) provides that the employer can apply the transition rule requiring discrimination testing immediately before the change in the group as if the Section 89 rules were in effect during 1988.

i. Presumably this rule would apply to 1989 transactions since the Section 89 rules will most likely be delayed until 1990.

f. As an alternative to the above transition rule, for testing years beginning in 1989, an employer can elect to apply the nondiscrimination rules separately to all of the separate members of the group involved in the change, as if they did not become part of the same group until December 31, 1989.

2. Identifying Highly Compensated Employees

a. The definition of the highly compensated employees is based on the number of officers and employees based on the current year and the previous year. The effect of acquisitions or dispositions on this definition has not yet been explored.
B. Qualification Rules

1. The transition rule for nondiscrimination testing does not extend to the qualification rules. Therefore, a plan subject to the qualification rules must comply during the transition period without regard to the fact that the employer maintaining the plan has been involved in a merger, consolidation or similar transaction. [Prop. Reg. 1.89(k)-1 (Q&A-2(h)]

C. Planning Consideration

1. Care should be taken to determine if the plans of the employers involved in the acquisition or disposition are in compliance with the qualification rules.

2. Unless the transaction involves an insignificant employer plan, planning should be done to determine how the plans will be tested in order to meet the transition rule.

3. Consider the costs involved in testing using the transitional rule versus testing after the transaction on a separate or controlled group basis. Determine whether the plans should be maintained separately or combined.

4. It is unlikely that the Section 89 requirement would require a change in the negotiated purchase/sales price. However, the parties to the transaction should make sure their insurer’s are informed. In addition, because the penalties for failing the qualification rules are severe, the parties may want to consider an indemnification provision in the contract in the event of a failure to comply prior to the transaction.

II. COBRA Continuation Coverage - Section 4980B

A. COBRA continuation coverage provides generally that a group health plan must offer each qualified beneficiary who would otherwise lose coverage under the plan as a result of a qualifying event an opportunity to elect, within the applicable election period, continuation coverage under the plan. The law pertains to insured and uninsured health plans. The COBRA rules become effective for the first day of the plan year beginning on or after July 1, 1986.
B. It is not clear whether or not a termination of a employment (activating the COBRA rules) occurs when there is a sale of assets causing a transfer of employees. However, it is unlikely that a change in stock ownership would be treated as giving rise to a termination of employment. In either case, if the successor employer is treated as the employer, then there would be no termination of employment and therefore, no COBRA affect.

1. Congressional intent is that if there is no effective termination of employment (i.e. separation from service) there is no COBRA requirement.

2. The proposed regulations support this argument in a sale of assets situation since the "employer" is defined to include "any successor employer." [Prop. Reg. 1.162-26 (Q&A-5)]

C. The following points should be kept in mind when contemplating the acquisition or disposition of an existing business with a health plan:

1. The seller is not relieved of the COBRA liability, rather there is a joint and severable liability.

2. The document should provide for indemnification provisions in the event the COBRA rules have not been complied with prior to the transaction since there may be potential penalties.

3. Liability insurers should be informed of the transfer.

4. The document should state who will be responsible for COBRA coverage.

5. Many states now have laws similar to COBRA that may apply to the transaction.

D. Special Penalty Rules for Business Acquisitions Prior to the 1989 Plan Year

1. The proposed regulations provide that if an employer that violated the COBRA rules is aggregated with another employer before correcting the violation, the new employer will not lose its deduction because of the past violation if:
a. The new employer did not maintain the plan before the combination date; and

b. The violation is corrected before the end of the first tax year of the new employer that begins after the combination date. [Prop. Reg. 1.162-26 (Q&A-3(b)]

2. Presumably this rule will not apply beginning after the 1988 plan years when the penalty for noncompliance becomes a nondeductible excise tax on the employer.

E. Other Issues

1. Premium Changes

a. COBRA premiums are supposed to be fixed for a 12-month period. [Prop. Reg. 1.162-26 (Q&A-45)] However, employers may be faced with a mid-year adjustment in the event of an acquisition or disposition.

i. There are limited circumstances in which an employer can change the amount of COBRA premium. Generally, these involve a change in coverage, i.e. switching from an HMO to a indemnity plan or a change in the number of people covered.

ii. IRS will probably allow a mid-year adjustment if the increase is imposed by the insurer. Probably will not allow in a self-funded arrangement.

iii. Unlikely that IRS will look favorably upon a mid-year increase imposed by a new employer after acquisition or disposition if there is no change in coverage.
Part Three - Special Rules Applicable to Certain Business Forms

I. S-Corporation

A. Qualified Retirement Plan Considerations

The requirements for qualified retirement plans of S-Corporations and C-Corporations are generally the same. Thus, they are subject to the same deduction limitations under IRC Section 404(a), the same coverage limitations under IRC Section 410(b), the same contribution limitations under IRC Section 415 and other qualified plan rules.

The few differences do require careful planning when making the S-Corporation election.

1. Qualified Plans

   a. S-Corporation may not have as a shareholder a qualified retirement plan as defined under IRC Section 401(a) pursuant to IRC Section 1361(b)(1). Thus if a C-Corporation is going to convert to an S-Corporation, its qualified retirement plans that hold any stock must sell such stock before the election is effective.

2. ESOPs

   a. The problem is amplified if the C-Corporation has a ESOP. If a C-Corporation has a leveraged ESOP loan that it is amortizing, the corporation will probably not be able to convert to an S-Corporation until the ESOP loan is repaid. The IRS has indicated that if a loan is paid off in a plan year, such payments will be considered contributions to the plan and thus subject such contributions to the limitations under IRC Section 404(a)(6) and IRC Section 415(c). If the balance of the principal payments are greater than 25 percent of the eligible employees' compensation, there will be a non-deductible contribution. In addition the amount that can be allocated to any employee will be limited to 25 percent of any employees compensation.
b. Holding period requirement of IRC Section 4978. If a shareholder elects the non-recognition treatment of IRC Section 1042, the ESOP must hold the employer securities acquired for at least 3 years. Failure to meet this requirement results in a 10 percent excise tax on the employer.

3. Loans to Shareholders
   a. IRC Section 4975 provides that a loan to a more than 5 percent shareholder of an S-Corporation is a prohibited transaction. Thus all loans to such shareholders must be repaid prior to the "effective date" of the S-Corporation election.
   b. The consequences of not repaying the loan before the effective date of the election is the imposition of a 5 percent excise tax on the amount of the interest on the loan due each year that the prohibited transaction continues. The tax is 100 percent of the loan if the prohibited transaction is not corrected within the taxable year. In addition, if the loan is secured by the participants account balance, this is a prohibited alienation under IRC Section 401(a)(13) and can lead to disqualification of the plan.
   c. An unanswered question is what is the "effective date" of the S-Corporation election? For instance, if a calendar year corporation makes an election by March 15, the election can be effective retroactive to January 1. If the shareholder loans are not repaid until March when the application is made, are they prohibited transactions since the election is a effective January 1? Most commentators feel that the effective date should be the date of the application. However, the IRS has not ruled on this issue.

B. Fringe Benefit Plan Considerations

1. An S-Corporation is treated as a partnership for employee fringe benefit purposes and any greater than 2 percent shareholder will be treated as a partner. [IRC Section 1372(a)].
a. The constructive ownership rules of IRC Section 318(a) apply to determine level of ownership.

b. Greater than 2 percent partners are not eligible for the following fringe benefit exclusions from income that are available to common-law employees:

   i. Amounts paid under an accident and health plan [IRC Section 105(b), (c) and (d)];

   ii. Amounts paid by an employer to an accident and health plan [IRC Section 106];

   iii. The cost of up to $50,000 of group-term life insurance [IRC Section 79];

   iv. Meals or lodging furnished for the convenience of the employer [IRC Section 119];

   v. The $5,000 death benefit, unless paid out of a qualified plan [IRC Section 101(b)]; and

   vi. Cafeteria plans [IRC Section 125].

c. The treatment of the fringe benefit is a function of the section that covers it. Where the fringe benefit deals with an exclusion from otherwise taxable income, presumably that exclusion is not available, but the S shareholder/employee is taxed. In that case the S Corporation would receive the deduction. If only a deduction is at stake, presumably the corporation loses the deduction. This is the only reasonable approach where the fringe benefits are not spread evenly with stock ownership.

   i. Not clear whether special allocations can be made. Not an issue if fringe benefits are pro-rata for all 2 percent shareholders.
ii. Shareholders can take a deduction on their personal return under IRC Section 162(1) for 25 percent of the health premiums passed through. The other 75 percent may be deductible as an itemized deduction for medical expenses under IRC Section 213.Apparently there is some controversy over this as the proposed OBRA legislation clarifies that S shareholders would be allowed this deduction.

d. Fringe benefits for 2 percent or less shareholders are deductible by the corporation as a business expense.

2. Effect of Section 89 on Health Plans of S-Corporations

a. For purposes of applying the nondiscrimination rules to health plans, the term "employee" includes greater than 2 percent S-Corporation shareholders.

i. The effect of this provision is to count a shareholder as an employee even though the benefits received are taxable. Generally, this will facilitate compliance with the nondiscrimination rules, since self-employed individuals, who generally are highly compensated employees, are taken into account but treated only as eligible for and receiving benefits that are excludable or deductible. Thus, for example, with respect to health benefits, the shareholder is treated as receiving a benefit equal to 25 percent of the amount paid for health insurance, since that is the only amount that is tax-favored.

ii. The 25 percent deduction under IRC Section 162(1) is not allowed unless the plans providing health coverage meet the requirements of Section 89.
iii. Consider foregoing the 25 percent deduction, reporting 100 percent of the health premiums and not performing the Section 89 tests. (Presumes there are no non-shareholder highly compensated employees.)

II. Partnerships

Most of the special rules for partnerships are the same as those discussed above for S Corporation shareholders. You should note that as S Corporation shareholders are classed into groups of more than 5 percent, more than 2 percent and other shareholders; partners are also classed between 10 percent or more partners (owner-employees) and other partners.

A. Qualified Plan Rules

1. Plan Loans

Only owner-employees are prohibited from obtaining plan loans. Other partners are treated the same as common-law employees.

2. Aggregation

IRC Section 401(d) provides much more stringent aggregation rules for plans which cover owner employees, than those found in IRC Section 414 for other forms of business operation.

3. Discretionary Contributions

Prior to August, 1988 plans of partnerships were allowed to provide individual contribution levels for each partner, up to the level contributed on behalf of common-law employees. Although not found anywhere in the Code, this was a traditional standing.

Last August, the IRS issued proposed regulations under IRC Section 401(k), as amended by TRA'86. Contained at section 1.401(k) - 1(a)(6), the IRS dropped the bombshell that these plans would be subject to the 401(k) rules. This rule is proposed to be effective for 1989 plan years. It has prompted a great deal of controversy. The IRS is planning on issuing a follow-up notice, but nothing has been received to date.
B. Other Fringe Benefits

The rules discussed above for S Corporations apply here. The exception is that special allocations should be available.

Part Four - Fiscal/Plan Year Conformity Issues

I. Deduction limits

A. Defined Contribution Plans

1. Discretionary Contribution Plans

The IRC Section 404 limit is based upon the compensation paid or accrued in the taxable year which ends with or within the plan year. IRC Reg. Section 1.404(a)-9(b)(1).

This means that you can leave the plan year alone, even if it does not coincide with your new fiscal year. In doing this however you need to pay attention to prior practices. If the contribution has historically been related to actual profits for a period, some change may have to be made to make sure that the contribution retains some credibility.

2. Defined Contribution Pension Plans

In the case of a money purchase plan, generally, the contribution may not be fixed until the year has closed. It is not until that time that all the events have passed to fix the liability, i.e. wages, employment at year-end, etc. Although it may be possible to make the contribution fixed and determinable without changing the plan year, that too might require a plan amendment. Especially where the plan has an end of plan year employment requirement. This controversy stems from the inclusion in the IRC Section 404 regulations, references to the normal deduction standards of IRC Section 162 or 212. Presumably this would include the normal fixed and determinable standard.

Clearly, a deduction could be taken for a defined contribution pension plan without changing the plan year if the compensation year and, possibly, the definition of year of service was changed to the fiscal year and the required date of employment to
receive an allocation was changed to the fiscal year. This may not be completely simplified as it may require that two sets of records on hours be maintained.

The Bruce Moore, Pension Plans of Denver, service goes even further. They are of the opinion that a money purchase plan sponsor can deduct the required contribution, say 10 percent of pay, on the short period return without making any changes in the plan. This position is clearly correct if the plan does not require employment at the end of the plan year and it cannot be terminated without making the required contribution. Therefore, once paid, it has become fixed and determinable so it satisfies IRC Section 162 or 212.

This position is further supported by a thorough study of the IRS interpretation of IRC Section 404(a)(6). The basic standard for reading this section is contained in Rev. Rul. 76-28, 1976-1 C.B. 106. This ruling provides that a contribution is deductible if it is paid by the extended due date of the employer's return and is deducted on that return or has been communicated in writing to the trustee as being attributable to that tax period. Being attributable to that tax period means that the plan will treat it in the same manner as if it had been received on the last day of the tax year.

This ruling has been discussed in a number of private letter rulings. See PLR 8822104 and PLR 8526068. These rulings provide that contributions made attributable to wages earned after the end of the tax year, but within the plan year are still deductible. This is because these contributions are treated the same with respect to the tax year as they would have been had they been made by the last day of the tax year.

3. Defined Benefit Plans
   a. General Rule

   The deduction for a defined benefit plan can be determined under any of the following methods:

      i. The funding requirement for the plan year beginning within the tax year;
ii. The funding requirement for the plan year ending within the tax year; or

iii. A weighted average of i and ii.

Once selected, the method constitutes an accounting method and cannot be changed without IRS approval. IRC Reg. Section 1.404(a)-14(c).

However, if the change in business structure causes the plan year and fiscal year to vary for the first time, i.e. previously they had always been the same, this first year of change would be the period in which the taxpayer could select its accounting method.

b. Impact of a Short Period

The effect that a short period has on the deduction limit for a defined benefit plan is discussed in Rev. Rul. 80-267. This ruling is somewhat limited as it only applies to the case where the taxpayer has consistently determined the deductible limit for each year based upon the plan year beginning within that year.

If the plan and fiscal year were previously the same, does this ruling apply? One could as easily argue that the deduction was consistently based upon the plan year ending within the fiscal year.

In any event, the conclusion of the ruling is that the deduction limitation for the short period must be prorated based upon the number of months in the short period. For example, if the minimum funding requirement was $120,000 and the short period was 5 months, the allowable deduction would only be $50,000. The remaining $70,000, which was required to be contributed, would be either the next year, if the weighted average method was used or ratably over the next 10 years if the Special allowance method was used. Revenue Procedure 80-27, discussed below, requires a similar treatment if the employer desires to change the plan year without requesting approval.
Planning Opportunity: An opportunity apparently exists to maintain the old plan year and claim a deduction for a full year's contribution in the short period. This argument is based upon the literal language of IRC Reg. Section 1.404(a)-14(c). This language was affirmed in Plastic Engineering & Manufacturing Co. v. Comm 78 TC 1187 (1982). Note, however, this case dealt with a new corporation, not a change in fiscal year. Also be advised, in certain cases the IRS has succeeded in raising an unreasonable compensation argument where significant pension contributions have been made for short periods. See Bianchi v. Commissioner 66 TC 324 (1976) and LaMastro v. Commissioner 72 TC 377 (1979).

II. Allocation limits

A. Limitation Year

1. The general rule is that no plan participant can accrue a benefit in excess of the IRC Section 415 limits. To fix a period for measuring compliance with this rule, the term "limitation year" was added to the Code. This is a 12 month period within which all plan annual additions or benefit accruals fall for measurement purposes.

2. A single corporation offering multiple plans or a controlled group of corporations with separate plans must operate all plans on a uniform limitation year, unless they have elected under Rev. Rul. 79-5, 1979-1 C.B. 12 to use different years. Therefore, a change in limitation year may be forced upon any entity acquiring control of another. The change may be in their plan or the other plan. The ruling itself does not severely limit the right to maintain separate limitation years. Compliance is simply an administrative burden.

This change may also be advisable where the fiscal year of an entity changes because of a change in form.

B. Change in Limitation Year
1. The change in the limitation year is done through a board resolution. It may require a plan amendment, but not all plans define the limitation year. Officially the limitation year was to be set by a board resolution in 1976 or at the commencement of the plan, if later. If no such action was taken, the regulations put the plan on a calendar limitation year. Note: Although the IRS has the authority of the regulations behind them to force you on a calendar year limitation year, if your plan had no resolution for a fiscal year, we have only had an IRS examiner raise the issue once.

2. Very specific rules are contained within the regulations at 1.415-2(b) covering a change in a limitation year. The critical element to consider here is that a limitation year must always be 12 months. When changing a limitation year, the change must be done within the current year. Thus, for example, a change to a calendar year limitation year will be as of January 1, 1989, not effective December 31, 1988.

This may appear to be a minor difference. However, in ruling policy it makes a significant difference. In PLR 7908068 a taxpayer attempted to change from a July 1 to June 30 limitation year to a December 1 to November 30 limitation year. Their application proposed that the limitation year change would be effective for the first period ending November 30. This resulted in a request for a limitation year of 5 months. The ruling held that the plan would be disqualified as a result of this change.

What the taxpayer should have done in this case was to define the new limitation year to begin with the first December 1. This would follow the language contained in IRC Reg. Section 1.415-2(b)(4) and examples. The new limitation year would have been twelve months - 12/1 to 11/30 of the succeeding year. This 12 month period being satisfied, the consequence of the change would have been the Section 415(c) limitation for the limitation year which "begins with the first day of the current limitation year and which ends on the day before the first day of the first limitation year.
for which the change is effective", i.e. the new limitation year, is prorated based upon the number of months in that period divided by 12. In the example in the ruling, it would have been 5/12ths.

This proration problem does not exist for a defined benefit plan. In that case the impact of a change in limitation year is only procedural.

3. Why change?

IRC Section 404(j) limits a taxpayer deduction to the amount that can be allocated within the IRC Section 415 limits. If the limitation year is not changed at the same time as the plan year, you may easily run afoul of these regulations.

III. Amendments

A. If you are choosing to retain an existing plan year, but make other changes to make administration simpler or to guarantee the deduction for the short period, we recommend that those amendments be made prior to the end of the short period. These changes would include a change in limitation year, a change in compensation year and a change in the date that employment is required in order to receive an allocation.

If you are choosing to leave the plan alone, check to make sure that the plan year is not defined to be the same as the fiscal year. If it is, you will have to amend the plan to retain the old plan year. This too should be done before the end of the short period.

B. Normally a change in plan year is accomplished by filing Form 5308 for the change in the trust year. (Plans without trusts are not required to file this form.) This is filed with the Commissioner of Revenue, Washington, D.C. 20224, Attention:OP:E:EF:R. The filing instructions contain this information. The form is due on or before the last day of the end of the short period required to make the change.

IV. Administrative Matters

A. Eligibility: Where there is a change in year, you must make certain that eligibility is determined correctly pursuant to IRC Section 410(a)(4), i.e. no participant can be required to wait longer that 18 months (30 months in a full vesting plan) before entering the plan.
Years of service when measured by plan years must always be a twelve month period. This results in double counting some months. If the plan uses plan years for eligibility a participant may enter the plan earlier than expected. ERISA Reg. Section 2530.203-2(c)(1)

B. Vesting: When an employer changes the plan year, the Department of Labor regulations, cited above, require that a "year of service" for vesting purposes be calculated as if the plan year included a full twelve months. For example, if an employer using a September 30 year end switched to a calendar plan year end, the following vesting periods would apply:

October 1, 1988 through September 30, 1989
January 1, 1989 through December 31, 1989

Thus, the hours worked from January 1 through September 30 are counted twice.

C. Accrual of benefits: Generally defined contribution plans require 1,000 of service within the plan year to be eligible for a current benefit. The plan sponsor may wish to waive this requirement or lower it for the short period. If no clarification is made a controversy will arise regarding whether the 1,000 period applies to the short plan period or does the overlapping rules of years of service apply and the 1,000 hour rule applies to the new "as if" 12 month plan year?

For a defined benefit plan, the accrual of benefits is usually based upon plan years of service, not specifically 1,000 hours of service. Thus, the overlapping of hours of service in measuring the new year of service could apply and, generally, no amendment should be required. Note ERISA Reg. 2530.204-2(e) does not require that this overlapping years of service rule be applied.

D. Social Security Integration: IRC Section 401(1) does not require that the FICA wage base be prorated to calculate integration for the short period.

E. $200,000 salary limit: Neither IRC Sections 416 nor 401(a)(17) require that the limit on salaries be prorated for a short period. However, the full top heavy minimum accruals must be made for the full period.

F. 401(k) or 401(m) discrimination: The Average Deferral Rate and Average Contribution Percentage Rate analyses for discrimination must be based upon the deferrals for the plan year. Thus, if you end up with a short plan year for the affected plan, your discrimination testing will be accelerated.
CHAOS IN WONDERLAND
A REVIEW OF THE REGULATIONS ISSUED UNDER IRC SECTION 89

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