4

Pension Plan Considerations

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Employers have an obligation to provide benefits and satisfy the requirements of the Employee Retirement Income Security Act (ERISA) for managing and administering private pension and welfare plans. The provisions of title I of ERISA cover most private sector employee benefit plans. The Pension and Welfare Benefits Administration has principal jurisdiction over title I of ERISA, which requires persons and entities who manage and control plan funds to:

(a) *manage plans for the exclusive benefit of participants and beneficiaries;*
(b) *carry out their duties in a prudent manner and refrain from conflict of interest transactions expressly prohibited by law;*
(c) *comply with limitations on certain plans' investments in employer securities and properties;*
(d) *fund benefits in accordance with the law and plan rules.*

The Pension and Welfare Benefits Administration also has jurisdiction over the prohibited transaction provisions of title II of ERISA. However, the IRS administers the rest of title II of ERISA, as well as the vesting, participation, nondiscrimination, and funding standards of title I of ERISA.

The purchaser in any acquisition should examine the employee benefit plans. The failure to properly plan prior to a merger or acquisition can create potential liability for the acquirer. In a stock transfer, the purchaser assumes the seller's pension plan and may continue it after closing. In an asset purchase, the purchaser normally does not assume the plan. If the asset purchaser should assume the plan, the length of employees' service will be counted for vesting purposes. Due to the potential exposure to liability, the warranty and indemnification provisions should address pension plan issues in detail.

Seek Representations and Warranties

The purchaser should seek representations and warranties on these matters:

- *Has there been general compliance with ERISA?*
  - *Has the determination letter been received?*
  - *Have the reporting and disclosure requirements been satisfied?*
  - *Are the PBGC premiums paid?*
  - *Are all amendments covered by the latest favorable determination letter?*
  - *Is the administration of the plan in compliance with applicable laws?*
- *Could there be liability for excise tax on prohibited transactions (26 U.S.C. § 4975) and violation of ERISA's fiduciary responsibility provisions (part 4 of subtitle B of title I of ERISA)?*

Tax on Prohibited Transactions—§ 4975

There is a tax of 5 percent of the amount involved with respect to a prohibited transaction for each year in the taxable period. If the transaction is not corrected within the taxable period, a tax equal to 100 percent is imposed.

Prohibited transactions include the following:

(a) *sale or exchange or the leasing of any property between a plan and a disqualified person;*

(b) *lending money or extending credit between a plan and disqualified person;*

(c) *furnishing of goods or services or providing facilities between a plan and disqualified person;*

(d) *transfer to, or use by or for the benefit of, a disqualified person, of the income or assets of the plan;*

(e) *any acts by a fiduciary whereby he or she is treating the plan's assets or income as his or her own;*

(f) *receipt by a fiduciary of personal remuneration from any party involved with the assets or income of the plan.*

One exception to the above-mentioned prohibited transaction is a merger of multi-employer plans, or the transfer of assets or liabilities between multi-employer plans determined by the Pension Benefit Guaranty Corporation to meet the requirements of section 4231 of ERISA. Even in these circumstances, however, prohibited acts include (e) and (f) as stated above.

- *Could there be excise tax liability for failure to meet minimum funding standards under 26 U.S.C. § 412 and § 4971?*

Defined benefit plans and money purchase plans must meet minimum funding requirements. Under the Tax Relief Act, the required annual valuation must be made during the current plan. 26 U.S.C. § 412(c)(9)(B)(i). In the alternative, the act permits the employer to use a prior year's valuation, but only if the pension assets exceed 125 percent of the current liability. 26 U.S.C. § 412(c)(9)(B)(i). If a prior valuation date is used, it must be actuarially adjusted. The effective date of these changes is for plan years after December 31, 2001.

Excise Tax Relief

Section 4971 of the Internal Revenue Code describes in detail the taxes on failure to meet minimum funding standards. For each taxable year of an employer who maintains a plan to which section 412 applies, there is imposed a tax of 10 percent (or 5 percent in the case of a multi-employer plan) on the amount of the accumulated funding deficiency under the plan. If the deficiency is not corrected within the taxable period, an additional tax of 100 percent of the deficiency not corrected is assessed. This tax is paid by the employer responsible for contributing to or under the plan the amount described in section 412(b)(3)(A). If the employer is a member of a controlled group, each member could be jointly and severally liable.

The Tax Relief Act creates an exception to the excise tax described in section 4972 on these nondeductible employer contributions to defined benefit plans. The employer will have the option of electing not to take into account any contributions to a defined benefit plan except to the extent that the contributions exceed the full-funding limitation (as defined in 26 U.S.C. § 412(c)(7) but determined without regard to the current liability limit in section 412(c)(7)(A)(i)(1)).

- *Has the seller satisfied quarterly contribution requirements under 26 U.S.C. § 412(m)? Any such underpayment is required to incur an interest charge to the funding standard account.*
- *Could contributions or benefits have exceeded allowable limits under section 415?*

Effective for the years beginning after 2001, the definition of compensation for purposes of the deduction rules includes salary reduction amounts treated as compensation under Internal Revenue Code section 415. The annual limitation on the amount of deductible contributions to a profit sharing or stock bonus plan is increased from 15 percent to 20 percent of compensation of the employees covered by the plan for the year.

- *Could there be excise tax liability for making nondeductible contributions under 26 U.S.C. § 404 and § 4972?*
- *Are actuarial assumptions reasonable? Buyers should carefully review actuarial assumptions because a penalty of 20 percent of the tax underpayment resulting from a 200 percent or more overstatement of pension liabilities (as long as the tax underpayment exceeds $1,000) will be imposed on the plan sponsor. 26 U.S.C. § 6652(a), (b), and (f).*
- *What is the amortization rate for past service costs?*
- *Have the requirements of 26 U.S.C. § 414(l) been satisfied if there is going to be a transfer of assets and liabilities between plans?*
- *Has any reportable event, as defined in § 4043 of ERISA occurred?*
- *What is the amount, if any, of underfunding of benefit liabilities, assuming termination of the plan?*
    - *In the event of termination, the acquiring corporation is liable to Pension Benefit Guaranty Corporation (PBGC) for 100 percent of the unfunded benefit liabilities, plus interest.*
    - *Benefit liabilities generally include all accrued benefits, even those that have not vested, as well as subsidized retirement benefits (even if employees have not yet met the condition for the subsidy).*
    - *All employers under common control are treated as one employer for these purposes. ERISA § 4001(b).*
- *What is the PBGC premium rate? Since the PBGC premium rate is now variable, a buyer should ascertain the PBGC premium rate for the plan of the acquired business. If the plan is seriously underfunded, or if any plan of a member of a controlled group of employers is underfunded, the PBGC premium rate will be significantly higher. There is a risk-related premium for each $1,000 of unfounded vested benefits, up to a maximum per participant. ERISA § 4006(a)(3).*
- *Did the seller make nondeductible contributions? Buyers should confirm that nondeductible contributions to qualified retirement plans were not made by the seller because such contributions are subject to a 10 percent excise tax. 26 U.S.C. § 404 and § 4972.*

Elective Deferrals

Employer contributions to one or more qualified retirement plans are deductible subject to certain limits. For purposes of the deduction limits, employee elective deferral contributions to an Internal Revenue Code section 401(k) plan are treated as employer contributions and thus, are subject to the generally applicable deduction limits. Subject to certain exceptions, nondeductible contributions are subject to a 10 percent excise tax.

Effective for tax years beginning after 2001, elective deferral contributions are not subject to the deduction limits, and the application of a deduction limitation to any other employer contribution to a qualified retirement plan does not take into account elective deferral contributions.

Employer Contribution to Tax-Favored Retirement Plans

In the case of qualified defined contribution plans, the limit on annual additions that can be made on behalf of an employee is the lesser of $40,000, or 25 percent of the employee's compensation. In the case of a 403(b) annuity, the annual contribution cannot exceed the lesser of the exclusion allowance or the section 415(c) defined contribution limit.

A section 401(k) plan or a section 403(b) annuity is permitted to include a "qualified plus contribution program" that permits a participant to elect to have all or a portion of the participant's elective deferrals under the plan treated as designated plus contributions.

The annual dollar limitation on a participant's designated plus contributions is the section 402(a) annual limitation on elective deferrals that the participant does not designate as designated plus contributions. Designated plus contributions are treated as any other elective deferral for purposes of nonforfeitability requirements and distribution restrictions. Under a section 401(k) plan, designated plus contributions also are treated as any other elective deferral for purposes of the special nondiscrimination requirements.

Effective for tax years 2001 and after, the act increases the 25 percent compensation limitation on annual additions under a defined contribution plan to 100 percent. It also repeals the exclusion allowance applicable to contributions made to tax-sheltered annuities.

- *Are there a significant number of "leased employees"? A buyer should determine the benefit costs for providing certain benefits to leased employees who may not appear as "employees" on the seller's records.*
- *Will the plan continue to qualify? The minimum participation rules under 26 U.S.C. § 401(a)(26) cannot be applied on a controlled group basis. Thus, buyers and sellers should find out whether their benefit plans will continue to qualify under section 401(a) of the code. Reg. § 1.401(a)(26)-1(b)(5)(i) provides that rules*

similar to those provided in section 410(b)(6)(C) apply for purposes of section 401(a)(26). Moreover, any combination of plans must be tested under section 401(a)(4) nondiscrimination regulations to make sure that a safe harbor is still available under Reg. § 1.401(a)(4)-2 or 3 and that all benefits, rights, and features remain nondiscriminatory.

In order for a pension, profit-sharing, or stock bonus trust to satisfy section 401, the plan under which such trust exists must expressly provide that, upon the termination of the plan or upon the complete discontinuance of contributions under the plan, the rights of each employee to benefits accrued to date are nonforfeitable. See Reg. § 1.401-6.

Whether a plan is terminated is a question to be determined with regard to all the facts and circumstances in a particular case. A plan is terminated when, in connection with the winding up of the employer's trade or business, the employer begins to discharge employees. A plan is not terminated merely because the employer sells or disposes of the trade or business if the acquiring employer continues the plan as a separate and distinct plan of its own, or consolidates or replaces that plan with a comparable plan. See Reg. § 1.401-6(b).

- *COBRA liabilities? Buyers should obtain warranties of the seller's existing and potential COBRA continuation liabilities as of the date of the sale and should obtain indemnification or other security for such liabilities. Prop. Reg. § 1.62-26, Q and A-5, say that the term "employer" includes a successor employer. Aimed at a corporate transaction situation, its purpose is to achieve parity between stock and asset sales. In an asset sale, if the buyer is a successor to the seller and the two are treated as a "single employer," continuing employees would not have the right to use COBRA to maintain any prior health coverage. However, the authority for the successor employer concept in the proposed regulations is not altogether clear. While reliance on it will protect an employer from IRS sanction, it may not provide comparable protection in an employee's ERISA suit.*
- *Are there threatened actions or asserted claims under ERISA?*
- *Which party will be responsible for making contributions with respect to periods prior to closing?*

Negotiate for Price

The seller should negotiate for a price increase to the extent that the plan is overfunded. There is a 20 percent excise tax on the amount of the plan assets that revert to the plan following a plan termination, but the excise tax is increased to 50 percent unless the employer establishes a qualified replacement plan to which an amount equal to 25 percent of the maximum employer reversion is transferred or the employer grants pro rata benefit increases to participants (based on accrued benefits) with not less than 20 percent of the maximum employer reversion. 26 U.S.C. § 4980(d).

In addition, since plan amendments that authorize reversions to the employer are ineffective for five years after the date such amendment is adopted, the buyer should find out whether the existing plan document authorizes employer reversions of excess assets. If excess pension assets were considered when making the offer to buy the business, the price may be adjusted to reflect the employer's inability to have access to such funds for the five-year period. ERISA § 4044(d)(2).

Due to the accelerated funding requirements and the restrictions on funding waivers, a buyer should find out whether the seller's plan is underfunded. If it is underfunded, the buyer should calculate whether the increased funding rules can be satisfied from anticipated receipts or whether a price adjustment is necessary. The accelerated funding rules only apply to plans with more than 100 participants. 26 U.S.C. § 412(l) and ERISA § 302(d).

Under present law, defined benefit pension plans are subject to minimum funding requirements designed to ensure that pension plans have sufficient assets to pay benefits. A defined benefit pension plan is funded using one of a number of acceptable actuarial cost methods. No contribution is required under the minimum funding rules in excess of the full funding limit. The full funding limit is generally defined as the excess, if any, of (1) the lesser of (a) the accrued liability under the plan or 160 percent of the plan's current liability, over the value of the plan's assets. See 26 U.S.C. § 412(c)(7). In general, current liability is all liabilities to plan participants and beneficiaries accrued to date, whereas the accrued liability full funding limit is based on projected benefits.

An employer sponsoring a defined benefit pension plan generally may deduct amounts contributed to satisfy the minimum funding standard for the plan year. Contributions in excess of the full funding limit generally are not deductible. Present law also provides that contributions to defined contribution plans are deductible, subject to certain limitations.

Subject to certain exceptions, an employer that makes nondeductible contributions to a plan is subject to an excise tax equal to 10 percent of the amount of the nondeductible contribution for the year. The 10 percent excise tax does not apply to contributions to certain terminating defined benefit plans.

The new act allows that in determining the amount of nondeductible contributions, the employer is permitted to elect not to take into account contributions to a defined benefit pension plan except to the extent they exceed the accrued liability full funding limit. Thus, if an employer elects, contributions in excess of the current liability full funding limits are not subject to the excise tax on nondeductible contributions.

The key figure used by management evaluating the financial strength of the pension plan is pension costs as a percentage of payroll. This should be a stable number of 5 percent to 7 percent. Knowing the size of the pension assets and total liability, it is possible to see how any move in the markets might affect the total unfunded liabilities. The actuarial assumption about interest rates must be related to the salary growth rate assumption. When looking at an acquisition of a company, unfunded past and prior service costs have the characteristics of debt. Because the amortization of these costs is tax deductible, they may be treated as off-balance-sheet debt.

Another point to keep in mind is if the pension plan is terminated for whatever reason, the accumulated benefit obligation becomes significant. The accumulated benefit obligation is the value of the pension liability on a termination basis. This is to be compared with the projected benefit obligation that represents the value of the pension liability on an ongoing concern basis.

When a purchaser acquires all of the employer, it becomes a successor employer and responsible for satisfying the minimum cost requirements. The final rules provide a special rule that allows, but does not require, the employer responsible for maintenance of effort to take credit for the buyer's provision of retiree health benefits in certain situations. However, if the buyer initially provided retiree health benefits and later amended its plan to discontinue those benefits, the employer would have to treat those individuals as having lost coverage as a result of employer action.

Under the Single-Employer Pension Plan Amendments Act (SEPPAA) and the Multi-Employer Pension Plan Amendments Act (MEPPAA), there is a potential five-year window period in which buyers and/or sellers may be liable for insufficient assets as a result of a plan termination. This liability extends to all members of an employer's controlled group or affiliated service group. A buyer should receive representations and security (or price adjustments) that will prevent potential liability for the individual employer or any controlled group member.

Transfer of Excess Pension Assets to Retiree Health Accounts

Under section 420, which was added by the Revenue Reconciliation Act of 1990, employers can transfer excess of assets from a defined benefit plan to retiree health account, provided that health expenditures for retirees are maintained at a minimum dollar level for five years following the transfer. The final rules on transferring this excess pension asset to health accounts was issued on June 19, 2001. The IRS stated that the minimum cost requirement is not met if the employer reduces retiree health coverage during the cost maintenance period. An employer would not satisfy the minimum cost requirement under the regulations if the percentage exceeds 10 percent in any year or if the sum of the annual percentage decreases during the cost maintenance period exceeds 20 percent. Employer action can be defined to include the sale or transfer of all or part of the employer's business. The IRS further has explained that in cases in which the buyer acquires the entire employer sponsoring the pension plan that is subject to the maintenance of the requirement as set forth in section 420(c)(3)(E), no special rule is required because a buyer is responsible for continuing to satisfy the minimum cost requirements of section 420(c)(3), with respect to the transfer.

The final regulations do provide, however, the special rule that allows the employer responsible for satisfying the requirement of section 420(c)(3)(E) to take credit for a buyer's provision of retiree health benefits in certain circumstances.

The 10 percent annual limit is effective for taxable years beginning after February 4, 2001. The 20 percent cumulative limit is effective with respect to the cost maintenance periods pertaining to any transfers made on or after December 18, 1999. If an employer reduces retiree health coverage by more than 20 percent during the initial period and does not correct it, by providing coverage for individuals who lost the coverage in the first place, the employer would fail the cumulative 20 percent test.

Finally, the annual test of significant reduction applies only to taxable years beginning on or after January 1, 2002.

Analyze Coverage Rules

Whether or not the buyer continues the plan, the coverage rules should be analyzed to ensure that the overall coverage of acquitted and existing employees does not become discriminatory. 26 U.S.C. § 410. The minimum coverage rules of 26 U.S.C. § 410 apply on a controlled group basis and the addition of new employees and a new plan in the controlled group may have an impact on the satisfaction of the coverage requirements of the seller's plan and the buyer's existing plans. To mitigate this situation, section 410(b)(6)(C) provides that the minimum coverage requirements will be treated as satisfied by a plan for a transition period following any circumstance when a person becomes or ceases to be a member of a controlled group and certain other conditions are satisfied.

Treatment of Forms of Distribution under the Tax Relief Reconciliation Act of 2001

An amendment of a qualified retirement plan may not decrease the accrued benefit of a participant. The prohibition against this eliminating or reducing of early retirement benefits does not apply to (1) a defined contribution plan that offers a lump sum at the same time as the form being eliminated if the participant receives at least 90 days advance notice of the elimination, or (2) a voluntary transfer between defined contribution plans, subject to the requirements that a transfer from a money purchase pension plan, an ESOP, or section 401(k) plan must be to a plan of the same type and that transfer be made in connection with certain corporate mergers, acquisitions, or similar transactions or changes in employment status.

Under the act for years after 2001, a defined contribution plan to which benefits are transferred will not be treated as reducing a participant's benefit even though it does not provide all of the forms of distribution previously available under the transferor plan if (1) the plan receives from another defined contribution plan, a direct transfer of the participant's or beneficiary's benefit accrued under the transferor plan or the plan results from a merger or other transaction that has the effect of a direct transfer (including consolidations of benefits attributable to different employees within a multiple employer plan), (2) the terms of the transferor and transferee plan authorize the transfer, (3) the transfer occurs pursuant to a voluntary election by the participant or beneficiary that is made after the participant or beneficiary received a notice describing the consequences of making the election, and (4) the transferee plan allows the participant or beneficiary to receive distribution of his or her benefit in a lump sum distribution. The act does not modify the rules relating to section 417, relating to survivor annuities.

The act modifies the distribution restrictions applicable to section 401(k) plans, 403(b) annuities, and section 457 plans to provide that distribution may occur upon severance from employment rather than separation from service. Provisions for distribution from 401(k) plans based upon a corporation's disposition of its assets or a subsidiary are repealed. Defined benefit pension plans are subject to minimum funding requirements. The act provides for a current liability full funding limit of 165 percent of current liability for plan years beginning in 2002, and 170 percent for years beginning in 2003. The full funding limit is repealed for plan years beginning in 2004 and thereafter.

Plan Loans for Subchapter S Owners, Partners, and Sole Proprietors under Section 612

Loans between a qualified plan and disqualified person generally are deemed to be prohibited transactions subject to excise taxes as described in 26 U.S.C. § 4973(c).

The Tax Relief Act, however, changed and lessened the restrictions for owner-employers for purposes of the prohibited transaction rules. S corporation shareholders, partners in partnerships, and sole proprietors of unincorporated businesses are permitted to borrow from qualified plans now if the requirements for exemption from the prohibited transaction rules are satisfied. 26 U.S.C. § 4975(f)(6)(B)(iii) and ERISA § 408(d)(2)(c).

These changes are effective for plan years beginning December 31, 2001.

Check for Multi-employer Collective Bargaining Unit

The buyer should find out whether the seller is a member of a multi-employer collective bargaining unit as defined in the 1980 amendments to title IV of ERISA (MEPPAA).

When an employer ceases to have an obligation to contribute to a multi-employer plan with respect to its operations, this action may constitute a complete or partial withdrawal that triggers withdrawal liability to the plan. The employer's liability is its allocable share of the plan's unfounded vested benefits adjusted by the following:

- *any de minimus reduction applicable (ERISA § 4209)*
- *any limitation on account of the sale of assets (ERISA § 4225)*

- *any limitation on partial withdrawal (ERISA § 4206)*
- *the 20-year cap (ERISA § 4219(c)(1)(B))*

Generally, a sale of stock does not trigger MEPPAA liability. All the potential liabilities, together with the contribution history that is used to measure an employer's withdrawal liability, are transferred to the buyer. However, if a principal purpose of any transaction is to evade or avoid withdrawal liability, the withdrawal liability will be determined and collected without regard to such transaction. Moreover, under ERISA section 4204, there is no withdrawal liability as a result of a sale of assets if:

- *The buyer is obligated to contribute to the plan for the same operations and substantially the same number of contribution base units for which the seller was obligated to contribute;*
- *The buyer provides a bond for five plan years beginning after the date of the sale to cover, generally, the amount of one year's contribution;*
- *The contract provides that if the buyer withdraws within five years from the date of sale, the seller is secondarily liable for its withdrawal liability if the buyer does not pay its own liability.*

A sale of the assets would cause a withdrawal unless it would not be a complete withdrawal and unless it would not cause a sufficient reduction in contributions (70 percent or more) to trigger a partial withdrawal.

Some of the consequences of structuring a sale to comply with the sale of assets exemption are these:

- *The buyer's withdrawal liability is determined as if it contributed to the plan in the year of sale and in the four preceding plan years the amounts that the seller was required to contribute.*
- *If the buyer withdraws within five years and does not make withdrawal payments when due, then the seller must make the withdrawal payments to the plan it otherwise would have had to make.*
- *If the seller is liquidated within five years, then it too must provide a bond in the amount of the present value of its otherwise applicable withdrawal liability.*
- *The buyer will not want to assume any withdrawal liability under the sale of assets exemption if it is not going to continue the business or is uncertain about the future of the business.*
- *By agreeing to comply with the sale of assets exemption, the buyer most likely will be giving up the right to make contributions to a multi-employer plan for six years before being held responsible for withdrawal liability if the multi-employer plan includes such a provision. The "six year free look rule" applies if certain conditions*

are met with respect to an employer that first begins to make contributions to a multi-employer plan and does not assume the seller's contribution history.

Another technique is to have the buyer assume or indemnify the seller for its withdrawal liability in consideration of a reduction in the purchase price; the seller should obtain adequate security to support this obligation.

Modifications to Section 415 Limits for Multi-employer Plans Contained in the Tax Relief Reconciliation Act of 2001

If the seller withdraws from the multi-employer plan negotiated by the union with several different employers in various states, the withdrawing employer may be required to pay a proportionate share of unfounded vested benefits. This liability may be avoided if the employer's contribution to the plan remains unchanged despite any changes in the capital structure or corporate organization.

Modifications to section 415 of the Internal Revenue Code, pertaining to multi-employer plans, provide that, effective for years after 2001, the 100 percent of compensation defined benefit plan limit does not apply to multi-employer plans. The act provides that multi-employer plans are not aggregated with single-employer defined benefit plans maintained by an employer contributing to the multi-employer plan for purposes of applying the 100 percent of compensation limit to such single-employer plan. Further, a multi-employer plan will not be combined or aggregated with any other multi-employer plan for purposes of applying the section 415 benefit and contribution limits. 26 U.S.C. § 415(f)(3)(B).

Under prior law, for example, multi-employer plans maintained under a collective bargaining agreement as described in section 414(f) are not aggregated with other multi-employer plans. However, if an employer maintained both a plan that was not a multi-employer plan and a multi-employer plan, the plan that was not a multi-employer plan controls to the extent the benefits provided under the multi-employer plan were provided as to a common participant.

The act also clarifies that a determination that contributions to multi-employer pension plans are on the account of a prior year will not be treated as a change in a method of accounting. Thus, any taxpayer that begins to deduct contributions to multi-employer plans has not changed its method of accounting and is not subject to an adjustment under section 481. Since pension benefits under multi-employer plans are often based on factors other than compensation, the 100 percent of compensation limit frequently resulted in benefit reductions for employees in industries where wages vary significantly from year to year.

See checklist O on page 257 of this book for futher MEPPAA issues.