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Integrating An Acquired Company's Retirement Plans Can Be A Can Of Worms

By Norman J. Misher and Allen J. Erreich

As part of the due diligence process in any merger or acquisition, the acquiring company will review the acquired company's tax-qualified retirement plans. Because this is considered a low risk area, the scope of these reviews, whether performed internally or by a member of the outside team, is normally limited. It usually includes a brief review of the plans and a confirmation that they have received IRS determination letters regarding their tax-qualified status. It may also include representations that the plans have been maintained in material compliance with all applicable requirements of the Internal Revenue Code and the Employee Retirement Income Security Act of 1974.

Once the transaction is completed, management's focus is directed naturally to the integration of the acquired workforce. But at some point in the immediate future the question will arise as to whether separate plans should be continued. The continuation of separate plans often results in duplicative costs for separate annual audits of each plan, preparation of annual returns (Form 5500), and plan administration costs for company personnel to administer each plan, as well as third party administration expenses, such as recordkeeping for 401(k) plans and actuarial services for pension plans.

Norman J. Misher and *Allen J. Erreich*, *Partners in Roberts & Holland LLP, both concentrate in the taxation of employee benefits and executive compensation. They design and implement qualified retirement and welfare plans, as well as plans that supplement qualified and nonqualified plans. Roberts & Holland confines its practice to tax matters, with 40 tax lawyers in its New York City and Washington, DC offices.*

Every tax-qualified plan is subject to strict IRS rules which require that the composition of the group of employees eligible to receive benefits under the plan and the actual benefits provided do not discriminate in favor of highly compensated employees. A corporate acquisition can affect compliance with these tests, since after the acquisition these tests must generally be applied to the employee group on a combined basis. For example, if the acquiring company's workforce has a significantly greater percentage of highly compensated employees and it also provides better benefits than the acquired company's plans, the addition of the latter's workforce might result in the acquiring company's plans violating the IRS nondiscrimination rules. Thus, in order to keep their plans in compliance with the IRS nondiscrimination requirements, help with the integration of the acquired workforce, and reduce duplicative costs, a decision is often made to combine or merge the plans.

Problems That Can Be Encountered

Notwithstanding the due diligence performed prior to the acquisition and the representations and warranties that may have been provided, it is difficult to determine whether the acquired company's plans have in fact been operated in accordance with the many IRS requirements applicable to tax-qualified retirement plans. Problems normally encountered do not relate to the design or terms of the plan, but to the application of the complicated rules and requirements to individual situations and circumstances. For example, we have encountered situations where a 401(k) plan was drafted to comply with all of the IRS requirements, but employees who became eligible to participate in the plan were not timely advised of their eligibility and consequently were deprived of the opportunity to make contributions to the plan, which caused the plan to be in violation of its terms. We also encountered a plan which provided that participants were to fully vest after five years of service, but found that the administrator counted the five years from the date on which the employees began their participation, rather than the date they were employed, as required. This caused the plan to be in violation of the statutory vesting rules, as well as failing to operate in accordance with its terms.

Qualification Of The Acquiring Company's Plans Could Be Threatened

Prior to moving forward with a plan to merge plans, it is important to determine whether the acquired company's plans are in violation of any IRS requirements because when the plans are combined, any failures or defects in the operation of the acquired company's plans carry over to the transferee plans. Thus, if the acquired company's plans have not been operated in accordance with the highly technical IRS rules, the tax-qualified status of the acquiring company's plans could be jeopardized. For example, if subsequent to a merger of the plans, the IRS were to audit a plan of the acquired company for a year before it was merged and discover any qualification defects, the IRS could seek to impose substantial penalties, including monetary sanctions, on the acquiring company's tax-qualified plans, which they ordinarily would do in lieu of actually

disqualifying the plan itself for failure to operate in accordance with the tax qualification requirements. These sanctions are generally based on the amount of tax that would be payable if the plan were actually disqualified by the IRS. The maximum amount of the penalty is generally based upon the employer deductions that would have been disallowed and the income tax that would have been owed by the trust and plan participants if the plan were disqualified. Obviously, this could involve significant dollars. Fortunately, as discussed below, the IRS has established a program that allows plan sponsors to avoid the risk of having these monetary sanctions imposed by providing the opportunity for plan sponsors to correct defects before they are discovered by the IRS.

How To Avoid Trouble

Therefore, before implementing a merger of the plans, it is imperative that the acquiring company undertake a thorough review to determine whether the acquired company's plans have actually been operated in accordance with the terms of the plans and the requirements of the IRS. The purpose of such a review is to identify and correct any deficiencies prior to the combination. Although such a review may be performed by company personnel, the review is best accomplished by engaging a team of specialized outside consultants. Benefits attorneys who specialize in this arcane area of the tax law are best equipped to spot deficiencies and shortfalls in the application of somewhat complicated and detailed tax rules, and working together with benefits consultants can effectively oversee a thorough compliance review and operational audit of the plans.

Such a review would start with the attorney's review of the plans and related materials to determine the types of qualification defects that are likely to exist for those plans and the best methods for discovering whether such defects exist. Working with an outside benefits consultant, who would be engaged (usually on a privileged basis) to perform an operational audit of the plans, they would determine the extent of any defects in the operation of the plans. In determining how to best correct qualification defects, the attorney would take into account various factors, such as which methods of correction for such defects have been approved or are likely to be approved by the IRS, as well as the costs and/or administrative burden to the company of implementing a particular method of correction.

The IRS Encourages Compliance Reviews Of Tax-Qualified Plans

The IRS has established a program called the Employee Plans Compliance Resolution System ("EPCRS") which permits and encourages sponsors of tax-qualified plans to correct qualification defects.[1] This program was established by the IRS to encourage plan sponsors to establish administrative practices and procedures in order to discover qualified plan defects and allow them to make voluntary and timely corrections of such defects. The EPCRS program allows plan sponsors to self-correct qualification failures that are considered to be "insignificant" at any time without informing the IRS or paying any penalties.

More importantly, the EPCRS program allows plan sponsors to correct significant qualification failures provided that they are corrected no later than the end of the second plan year following the year in which the failure occurred. In this connection, the EPCRS program provides that in the context of a corporate transaction, the self-correction period for significant failures is extended until the *end* of the first plan year that begins after the transaction. This extension applies to any pre-existing failures under a plan from which there has been an asset transfer or with which a merger took place or any plans that were assumed in connection with a corporate transaction. For example, if an acquiring company completed its acquisition in 2003, it has until the end of 2004 to self-correct any qualification defects that it discovers in the acquired company's plans no matter when they occurred, without informing the IRS or paying any penalties.

In order to be eligible to self-correct qualification defects, the IRS requires that a plan must have and follow established internal practices and procedures (formal or informal) reasonably designed to promote and facilitate overall compliance with the qualification rules. In the case of corporate transactions, a plan is deemed to meet this requirement so long as adequate practices and procedures are put in place by the end of the first plan year following the year in which the corporate transaction took place. The IRS is clearly sending a message that it strongly encourages companies to investigate whether the plans of companies that they acquire have any qualification defects and that, as an incentive for promoting such investigations, they will give companies until the end of the year following the year in which the acquisition occurs to perform a compliance review of the acquired company's plans and correct any qualification defects that are discovered.

The EPCRS program also encourages sponsors of plans that are not eligible for self-correction to take proactive measures to discover qualification defects and not wait for them to be discovered through an IRS audit. Defects that are not eligible for self-correction which are discovered by a plan sponsor prior to an IRS audit, may generally be corrected with IRS approval and the payment of a fixed fee which may range from $750 to $25,000 depending upon the number of participants in the Plan.

As a general rule, in order to correct a defect under the EPCRS program, the defect must be fully corrected both retroactively and prospectively. In order for a correction to be considered acceptable to the IRS, participants must, to the extent possible, be put in the position in which they would have been had the defect not occurred. The IRS has issued guidance as part of the EPCRS program describing various acceptable correction methods for many common operational failures occurring under tax-qualified plans.[2]

Conclusion

Before combining or merging tax-qualified plans, it is important that a compliance review and audit of the acquired company's plans be undertaken on a timely basis. In order to take full advantage of the opportunity to self-correct plan defects under the EPCRS program, the compliance review as well as the correction of all qualification defects discovered during the review should be corrected by the end of the plan year following the year in which the acquisition occurs. Even if a plan is not eligible for self-correction, it is important to discover qualification defects before they are discovered by the IRS. As the IRS said recently on the subject of tax-qualified retirement plan corrections: "What you don't know CAN hurt you."

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[1] *Revenue Procedure 2003-44, 2003-25 I.R.B. 1051.*

[2] *The Department of Labor also has two self-correction programs – the Delinquent Filer Voluntary Compliance Program (67 Fed. Reg. 15051), which allows plans that have been delinquent in filing their Form 5500 annual returns, to file the delinquent returns and pay a reduced penalty and the Voluntary Fiduciary Correction Program (PTE 2002-51, 67 Fed. Reg. 70623), which allows plan sponsors to correct certain prohibited transactions that are covered under the program (e.g., the late deposit by plan sponsors of 401(k) contributions withheld from participants' salary).*