Benefits in Corporate Asset Sales: Guidance Takes Two Steps Forward, One Step Back

As the corporate reorganization boom of the last five years appears to be drawing to a close, the Treasury and Labor Departments have shown a new willingness to issue guidance for practitioners dealing with the many complexities that surround the treatment of employee benefits in these transactions, particularly those involving the sale of corporate assets.

Since the beginning of the year, (1) the IRS has relaxed the rules governing distributions to 401(k) plan participants under the "same-desk" rule following an asset sale; (2) the Labor Department has partially addressed the treatment of accidental multiple employer welfare arrangements, or "MEWAs," arising from the parties' agreements to provide uninterrupted post-sale coverage to affected employees; and (3) the IRS has issued statements on the treatment of unused balances in flexible spending accounts after an asset sale.

We would call these efforts, respectively, two small steps forward and one large step back.

Asset Sales and the "Same-Desk" Ban on 401(k) Plan Distributions

Employees' elective contributions to a 401(k) plan (and matching contributions) may not be distributed before the attainment of death, disability, or age 59-1/2. There are a number of exceptions to this rule, of which we consider two: distributions may be made upon (1) the employee's "separation from service" (Code Section 401(k)(2)(B)(i)(I)); and (2) upon the disposition by the sponsoring corporation of "substantially all" the assets of a "trade or business" with respect to any employee who continues employment with the corporation who acquires those assets (Code Section 401(k)(10)(A)(i)). For brevity, we refer to this second exception as the 401(k)(10) rule.

© 2000 Aspen Publishers, Inc.

Review of the 401(k)(10) Rule

To meet the 401(k)(10) rule, an asset sale has to jump through a number of hoops set by statute and regulation:

- By statute, both the buying and selling entity must be corporations; the transfer of assets to a joint venture does not meet the 401(k)(10) exception.
- Under regulations, "substantially all" means 85 percent or more of the assets of a separate trade or business (Treas. Reg. §1.401(k)-1(d)(4)(iv)). A "trade or business" is defined under regulations by a multi-factor test.
- Distributions are not permitted if the buyer adopts the seller's plan, if the seller's plan is merged with any plan of the buyer, or if the seller's plan is transferred into buyer's plan in a transaction subject to Code Section 414(*l*). Because they are all basically the same rule, we call all three rules the "no-asset-transfer rule."

  For purposes of the no-asset-transfer rule, regulations further state that certain *elective* asset transfers—that is, plan-to-plan transfers of accounts without all protected options, where the participant may elect to leave his account balance in the transferor plan—are not considered a transfer or merger. The elective-transfer exception to the no-asset-transfer rule may appear a little confusing, but actually makes sense. For most Code purposes, elective transfers without all protected benefit options are considered to be distributions (Treas. Reg. §1.411(d)-4, Q&A-3(b)(2)). So the elective-transfer exception merely clarifies that certain "distributions" do not nullify the 401(k)(10) rule's condition for distributions merely because these "distributions" may also technically be "transfers."
- Distributions must be in lump sum form, and must be "in connection" with the disposition of assets, which, under regulations, generally means the distributions must take place by the end of the second calendar year following the calendar year of the disposition.

The Old "Same-Desk" Rule

If an asset sale does not meet all the conditions of the 401(k)(10) rule, then distributions are not permitted to transferred employees

unless they meet another statutory exception. The simplest to meet for all transferred employees, of course, should be the "separation from service" exception. (The other available statutory exceptions: death, disability, attainment of age 59-1/2, and termination of the plan under certain circumstances, are obviously limited in utility.) But until recently, the IRS has enforced the "same-desk" rule to block this route. Under the same-desk rule, an employee who is transferred from buyer to seller in an asset sale is presumed not to have "separation from service" if he or she works in a comparable position.

The combination of the rigid 401(k)(10) rule and the IRS's same-desk rule cause problems for both buyer and seller in an asset sale. Unless a transaction meets all the requirements of Code Section 401(k)(10)(A)(i), most sellers of corporate assets have been unwilling to permit transferred employees to take distributions, for fear of violating the same-desk rule.

At the very least, the ban on plan asset distributions creates employee relations problems among transferred employees. More serious, from the point of view of the buyer, is the high price of pension "portability." Since distributions are not allowed, neither are rollovers. The plan accounts of transferred employees can be shifted from the seller's plan to the buyer's plan only via a plan-to-plan transfer of the entire account balance, with all protected benefit options intact. This means the buyer's plan must accept, for example, after-tax moneys in the transferred accounts, any distribution options permitted by the seller's plan, and outstanding loan balances—even if the buyer has not previously permitted any of these features in its own plan.

Revenue Ruling 2000-27—Same-Desk Rule Revised

Revenue Ruling 2000-27 is a partial reversal of the long-standing same-desk rule, and is in some ways a neat solution to the rigidities of the 401(k)(10) rule. The ruling provides that, for dispositions of less than 85 percent of the assets of a trade or business, transferred employees are considered to have had a "separation from service." Because a separation from service has occurred, distributions are permitted to these employees by Code Section 401(k)(2)(B)(i)(I) (and are indeed probably required to be made available by the terms of the seller's plan).

Revenue Ruling 2000-27 seeks to make the 85-percent test a bright line rule, on a prospective basis. For asset sales on or after September 1, 2000, the disposition of less than 85 percent of the

assets of a trade or business is (with some exceptions, which we explore below) a separation from service for transferred employees, and is governed by Revenue Ruling 2000-27. The disposition of 85 percent or more of the assets of a trade or business does not trigger a separation from service, and is governed by Code Section 401(k)(10).

Because it is merely an administrative clarification of when a "separation from service" occurs in the context of an asset sale, Revenue Ruling 2000-27 dispenses with a lot of rigidities imposed by statute on the 401(k)(10) rule. Revenue Ruling 2000-27 applies whether or not buyer, seller, or both, are corporations; it applies to distributions in any form, and not just lump sum distributions; and it applies without regard to whether the distribution is before or after the end of the year following the year in which the disposition occurred.

Nonetheless, Revenue Ruling 2000-27 contains some puzzling limitations:

1. It does not apply to outsourcing situations. The facts of the ruling expressly state that the transferred employees do not provide services for the transferor entity. IRS officials have said this detail was included because the treatment of outsourcing is still under consideration.
2. It does not apply to the creation of a joint venture absent the transfer of assets to the joint venture by the entity who transfers employees, according to IRS officials.
3. It does not apply to any transaction in which assets are transferred from the seller's plan to the buyer's plan. (The ruling's exception for rollovers is irrelevant, as rollovers are not transfers.)

Revenue Ruling 2000-27 reduces many of the plan administrator's dilemmas upon an asset sale. For example, assume that a corporation sells one of its divisions to a corporate buyer; no assets are transferred from the seller's plan to the buyer's plan; and distributions are permitted by the seller's plan only in lump sum form. In this transaction, distributions are unambiguously permitted to transferred employees—whether under Section 401(k)(10) or Revenue Ruling 2000-27—at least until the end of the second year after the year of the asset disposition.

But some of its restrictions are puzzling. First, like the 401(k)(10) rule, Revenue Ruling 2000-27 includes an apparent no-asset-transfer

rule. (As noted, the Revenue Ruling on its face does not cover transactions where any plan assets are transferred from the seller's plan to the buyer's plan.)

It is not entirely clear whether an elective-transfer exception applies to the no-asset-transfer rule of Revenue Ruling 2000-27, as it does to the no-asset-transfer rule of Section 401(k)(10). This is an important question, as many participants will prefer to move their account balances from the seller's plan to the buyer's plan via a plan-to-plan transfer rather than a distribution/rollover. For example, these participants may have after-tax amounts in their accounts (which by statute cannot be transferred via rollover). Or they may have an outstanding loan balance, and the seller's plan does not permit the eligible rollover distribution amount to include the note.

A sensible surmise is that the elective-transfer exception does apply. That is, participants can be given the choice (as under Section 401(k)(10)) of (1) leaving their account balances in the seller's plan; (2) transferring them to the buyer's plan; or (3) taking a distribution from the seller's plan, with or without the option of a direct rollover to the buyer's plan. We think this assumption is a reasonable one. It is supported by the IRS's rule that elective transfers are generally treated as distributions. It is consistent with the rules of Section 401(k)(10). It is also consistent with the unofficial statements of Treasury officials that the seller can as a practical matter treat some participants as separating from service by not transferring their accounts, and treat others as separating from service. But while reasonable, the exception is not apparent on the face of Revenue Ruling 2000-27.

What about the seller who wants to rid its plan of the accounts of transferred employees? Without the no-asset-transfer rule, the seller would permit distributions to transferred employees (as almost certainly required by the terms of its plan because of their deemed separation from service). Seller would then make mandatory transfers of those accounts for which distributions were not elected. But if the no-asset-transfer rule applies to Revenue Ruling 2000-27—as it apparently does—the seller can take this route, if at all, only under a three-step process: First, allow distributions (as required by the plan); second, split off those accounts from which no distributions were made, in to a new "plan"; and third, transfer the split-off plan to the buyer's plan. Alternatively, the seller could take the position that the no-asset-transfer rule applies only to the accounts of participants who take a distribution. Under this reading of the Revenue Ruling, distributions, followed by mandatory transfers to the buyer's plan of

undistributed accounts, would be permitted. Neither approach is expressly supported by the Revenue Ruling, and both are subject to some risk.

We find the apparent inclusion of the no-asset-transfer rule a needless encumbrance on the parties' ability to structure their deal. IRS officials state unofficially that the underlying rationale of Revenue Ruling 2000-27 is that, in sales of less than 85 percent of the assets of a trade or business, the identity of the employer changes, so a "separation from service" results. Even assuming this rationale hangs together as a general matter, it makes no sense to make an exception for employees who transfer with their account balances intact.

Also, by apparently adopting the no-asset-transfer rule, Revenue Ruling 2000-27 further adds to the hodgepodge of rules affecting plan transfers in a corporate asset sale. The rule may be consistent with the treatment of 401(k) plans under the 401(k)(10) rule, but both rules are inconsistent with the same-desk rule as applied to defined benefit plans. Under GCM 39824 (which to date is the IRS's only defined benefit plan-related guidance on this matter), it would appear that after a corporate asset sale, the plan-to-plan transfer of assets for any one employee forestalls permissible distributions for that one employee. For those employees for whom a plan-to-plan transfer is not made, however, distributions are permitted. (Specifically, the GCM states that a distribution is not available if there is a transfer of any portion of "the employee's benefit"—implying that, in contrast to the 401(k)(10) rule, a transfer of one employee's account does not block permitted distributions for all employees.)

Another puzzling limitation is IRS officials' position that the ruling does not extend to the creation of joint ventures by an entity that does not contribute assets to the venture. If the disposition of 20 percent of assets is a separation from service, why not zero percent? What about the creation of a joint venture accompanied by, for example, the transfer of a typewriter?

The ruling on its face applies to asset dispositions in which "most" of the employees associated with the transferred assets are transferred to the buyer. While unclear, this may imply a substantiality test with respect to the transferred assets. Under this reading, the transfer of a typewriter would not qualify the transferred employees for distributions under Revenue Ruling 2000-27. The "most employees" rule also creates problems in other contexts. What if, for example, a division is sold but "most" of the related employees are terminated outright, rather than transferred? Revenue Ruling 2000-27

on its face does not cover this transaction, although there would appear to be no policy reason that its rationale should not apply.

Finally, the ruling's dependence on a bright line number (85 percent of the assets of a trade or business) obscures the basic subjectivity underlying the rule, as in many of the IRS's objective tests. The significance of the percentage depends entirely on how the parties define a "trade or business." Before this issuance of Revenue Ruling 2000-27, the parties had an incentive to define this term as narrowly as possible. Now we suspect they will have an incentive to define the term as broadly as possible.

Accidental MEWAs after a Corporate Reorganization

One of the many legal issues that springs up in the course of an asset sale is the question of whether the parties have unintentionally created a strange legal creature called a multiple employer welfare arrangement (MEWA). ERISA Section 3(40) defines a MEWA as a plan or "other arrangement" established or maintained to provide welfare benefits to the employees of two or more employers. It is the potential breadth of the word "arrangement" that raises concerns in the corporate reorganization context.

In the typical asset sale, the buyer and seller negotiate the uninterrupted health coverage of transferred employees. But in many cases the buyer is simply incapable of immediately assuming the administration of health benefits for transferred employees. The reasons for this are many: Transferred employees may prefer to retain coverage in the seller's plan for some period, to take advantage of already-incurred co-pays and deductibles, or to stay with covered providers. The buyer may simply lack the payroll capacity to enroll large numbers of new entrants into its own plan on a single day.

Employees can of course always elect COBRA coverage, but this is expensive and disruptive. More orderly transition devices include coordination agreements whereby the seller agrees to administer its old health plan for transferred employees for some period of time, or the buyer agrees to let transferred employees pay premiums to its own buyer's cafeteria plan for coverage under the seller's plan.

Many of these agreements involve some degree of coordination between buyer and seller. Is this coordination an "arrangement" for the provision of health benefits to the employees of more than one employer? If so, it is arguably a MEWA, and highly undesirable to both parties. The law is complex and unclear, but very generally the consequence of MEWA status is loss of ERISA preemption: A MEWA

is subject to state law, either exclusively or in tandem with ERISA, which can include state insurance laws and state premium taxes.

Without resolving the legal issue, the Labor Department this year intensified the problems caused by the lack of an adequate MEWA definition. On February 10, the Department released interim final regulations requiring MEWA administrators to file Form "M-1" with the Department. Penalties of up to $1,000 per day apply for failure to file the form.

Under the regulation, parties to an asset sale are caught in a bind. File the M-1, and subject the coordination agreement to state law, state premium taxes, and so on. Fail to file the M-1, and risk the imposition of significant penalties. No written guidance exists to help resolve this dilemma.

Having brought the issue to a crisis, the Labor Department backed off. In new guidance issued in "Q&A" form, the Labor Department states that a "good-faith" exception applies to the M-1 filing requirement with respect to arrangements following an asset sale, for a period ending on the last day of the year following the year of the sale.

The underlying legal issue, of course, remains and awaits resolution by the Labor Department.

Unused Balances in Flexible Spending Accounts

A third source of headaches for the benefits administrator following an asset sale is the treatment of flexible spending accounts under Code Section 125, or "FSAs." In the typical FSA, the participant elects to reduce some amount of salary in return for a medical reimbursement account. For example, a $100-per-month pre-tax salary reduction may buy $1,200 of medical reimbursements for the year on a tax-free basis. In the case of terminated employees—including all transferred employees in an asset sale—the FSA creates great hardship for the participant whose paid-in premium exceeds incurred expenses as of the sale date. For example, in a July 1 sale, the transferred or terminated employee may have paid in $600 of premiums, but incurred zero in claims. If her coverage ends on the date of the sale, she is irrevocably out the $600, and she may feel "cheated."

One sensible and neat solution to this problem is to let the employees affected by the asset sale (either terminated outright or transferred to the buyer) retroactively to elect FSA coverage equal to the amount of premiums already paid in. In our above example, the

transferred employee would still be able to submit for reimbursements of up to $600, even for claims incurred after the July 1 asset sale, and even though she paid in no further premiums. For an excellent and clear description of this "spend-down" option, see Hamelburg and Bauserman, "Flexible Spending Arrangements in Asset Sales: Law and Transition Options," 13 *Benefits Law Journal* 23 (Spring 2000).

While the FSA regulations remain unclear, it is our firm view that the better legal arguments support the spend-down solution. In March of this year, however, the IRS released new final regulations on the tax treatment of cafeteria plans (T.D. 8878, 65 Fed. Reg. 15548, March 23, 2000). While not addressing the basic rules that (in our view) allow the spend-down option, the regulation's preamble states that the option is not consistent with the "risk shifting" and "risk distribution" characteristics required of FSAs.

Conclusion

As any practitioner knows who has sought to deal with the complexity of employee benefits in an asset sale, the many resulting questions are almost lacking in definitive answers. Guidance is issued, if at all, in piecemeal and incomplete fashion. Moreover, the resulting hodgepodge has no consistency with one another in mechanics or apparent rationale.

This incomplete, hodgepodge guidance is particularly unfair to participants. Their lives already disrupted by a change in their employer, they are the ones who actually have to live with the sometimes byzantine benefit structures put together by employers and their advisors in order to provide uninterrupted benefit coverage without running afoul of the many traps set by current law. We would urge that the Treasury and Labor Departments stop their desultory development of guidance in a way that leaves gaps and inconsistencies, and concentrate on developing clear and coherent packages for employees and employers dealing with these disruptive events.

Rosina B. Barker and Kevin P. O'Brien
Editors-in-Chief
Ivins, Phillips & Barker, Washington, DC