Introductions

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Please note that the following is intended to be used for general guidance purposes only — it is not intended to constitute tax or legal advice. Any question of application of the law should be addressed to legal or tax counsel. The information is current as of January 24, 2024.
M&A Benefits Compliance

Agenda

• Background & Preliminary Points
  • Asset vs. Stock Transactions
• ERISA Considerations
• ACA Employer Mandate
• COBRA Obligations
• Cafeteria Plans/FSA Options
• Nondiscrimination Rules
• Key Takeaways
• This presentation is going to focus on the health and welfare concepts that are most affected by M&A situations.

• There are a good deal of implications on the retirement side, too.

• Employers should consult with their counsel, plan financial advisors, record keepers and other retirement plan vendors when there are retirement plans that are affected.
Background & Preliminary Points
M&A activity has slowed down recently.
  • High interest rates and increased costs dampened enthusiasm.

That said, the stock market is going strong, which may make M&As an attractive option in 2024.

In any event, employee benefits normally do not drive the transaction.
  • Unfortunately, benefits are often overlooked until after the closing date.
  • This can result in compliance and employee relation issues, and potential liabilities.
Inquire about the other party’s benefit plans as early as possible.

Highlight benefit compliance issues requiring review during the due diligence process.

Understand the structure of the transaction:
- Determine if it is a stock or asset purchase.
- Verify controlled group status.

Know the default rules applicable in M&As (e.g., COBRA).

Engage employee benefits counsel.

Determine each party’s benefit plan obligations and incorporate in the contract.
Stock Purchase

Defined

• Buyer purchases the stock or ownership in the seller’s business (or a unit thereof).

Example

• Seller owns Company A and Company B. Buyer purchases all the stock of Company A from Seller.

Result

• Company A is now owned by Buyer and is a member of Buyer’s controlled group.
• With a stock purchase, employees of the purchased business would continue to be employed by the same legal entity, but ownership of the entity is transferred from seller to buyer.

A merger (i.e., entities merge into a single business) usually occurs in connection with a stock purchase.
Asset Purchase

**Defined**
- Buyer is purchasing some or all of the assets of the seller’s trade or business (and may be assuming certain liabilities).

**Example**
- Buyer purchases a manufacturing plant and equipment from Seller.

**Result**
- Buyer owns the purchased assets, but has no ownership interest in Seller’s company.
- Employees of the purchased entity would normally be considered terminated employees of the seller (and may be entitled to COBRA as a result).
- If these employees are rehired by the buyer, they would be new employees of the buyer.
ERISA Considerations
Ideally, ERISA compliance begins during due diligence, so the buyer can evaluate potential risks associated with seller’s plans.

- Liabilities can arise from past failures (late or unfiled Form 5500s).
  - This is of particular concern with a stock purchase, where the buyer is purchasing ownership in the entity and would generally be assuming the liabilities of the entity.
  - By contrast, with an asset purchase, the buyer is selecting assets to purchase, so past liabilities generally remain with the seller (although the buyer could agree to assume certain liabilities under the contract).

- Copies of plan documents, SPDs and Form 5500 filings should be reviewed.

- Buyer should understand funding of seller’s plans and ensure plan assets are properly handled.
  - If seller maintained a trust, fidelity bond and other requirements attach.

- Buyer may want to review the terms of any existing fiduciary liability coverage to determine whether changes will be necessary because of the transaction.
For ERISA and other purposes, with any acquisition, it’s important to understand the controlled group status of the entities under Code Section 414 rules. There are 2 basic types of controlled groups:

1. **Parent/subsidiary** – One or more corporations are connected through stock ownership with a common parent.
   - The parent must own 80% of the stock of at least one other corporation; and
   - 80% of the stock of each other corporation must be owned by one or more corporations in the group.

   **Example:** Parent Corp. owns 100% of Subsidiary A, which owns 80% of Subsidiary B and 90% of Subsidiary C.

   **Result:** Parent and Subsidiaries A, B and C are a controlled group and therefore, one employer under Code Section 414(b) rules.

Note: Code Section 414 Rules are not limited to public corporations but also apply to other ownership forms (e.g., partnerships).
2. **Brother/sister** – A group of corporations in which five or fewer common owners (who are individuals, estates or trusts) directly or indirectly have:

- A controlling interest (generally, 80% or more) in the stock of each corporation; and
- Effective control, which generally requires 50% ownership of the stock of each corporation, but only to the extent stock ownership is identical with respect to such corporation.

<table>
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<tr>
<th>Shareholder</th>
<th>D Corp</th>
<th>E Corp</th>
<th>Shareholder</th>
<th>(\text{Effective Control: Identical Ownership in Both Corps})</th>
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<td>TOTAL</td>
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**Result:** D Corp and E Corp are members of the same controlled group and one employer under Section 414.

*Employers should verify controlled group status with a tax professional or counsel.*
Why does controlled group status matter?

- Generally, members of a controlled group are considered one employer under ERISA.
  - Employees of controlled group members can participate in one group health or welfare plan following the transaction.
  - If arrangement is not a controlled group, then allowing employees of more than one employer to participate in a plan creates a multiple employer welfare arrangement (MEWA).
    - MEWAs are subject to additional federal and state law obligations.
    - The DOL regulates MEWA reporting, disclosures and fiduciary conduct on the federal level.
    - State laws may require licensure, registration, funding, etc. or not even permit new MEWAs; navigating these laws can be onerous!
  - With M&As, MEWA concerns can arise, for example, in an asset sale if the seller allows former employees now working for the buyer to remain on the seller’s group health plan after the transaction date.
**M&A Benefits Compliance: Plan Options**

- **The buyer will need to decide whether to:**

- **Continue to maintain the seller’s plans for the acquired employees.**
  
  Buyer could retain plans indefinitely for a temporary period (e.g., through the end of the plan year).

- **Create new plans for the acquired employees.**

- **Cover the acquired employees under its own existing plans.**
  
  This is more typical.
  Buyer may even want to transition employees to buyer’s plans as of the closing date.

**Absent specific provisions in the transaction agreement, the buyer generally has discretion to determine how to address the benefits for newly acquired employees.**
<table>
<thead>
<tr>
<th>Maintaining Seller’s Plans</th>
<th>Covering Acquired Employees under Buyer’s Plans</th>
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<tr>
<td>• This can ease the transition for acquired employees.</td>
<td>• This may help to integrate employees into the buyer’s organization.</td>
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<td>• Employees can continue with coverage tailored to their population.</td>
<td>• Inclusion in one plan avoids costs and administrative burdens of maintaining several plans.</td>
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<td><strong>Considerations:</strong></td>
<td>• Plan document may need to be updated.</td>
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<tr>
<td>• Works against goals of uniformity in corporate culture and benefits.</td>
<td>• Plan disclosures (e.g., SBCs/SPDs) must be provided to acquired employees.</td>
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<tr>
<td>• Creates additional costs and plan administrative/legal requirements due to multiple Form 5500 filings, plan documents, SPDs, and communications.</td>
<td><strong>Considerations:</strong></td>
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<tr>
<td>• Buyer will need to ensure contracts with carriers and service providers are updated to reflect new sponsorship.</td>
<td>• If mid plan-year, affected employees may experience disruptions in coverage and additional costs.</td>
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<td>• Deductible and out-of-pocket credits may be possible under buyer’s plan.</td>
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<td>• Buyer should review options in advance with insurer/stop loss carrier.</td>
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<td>• Seller should also review contracts and notify carrier and TPA as necessary.</td>
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<td>• If seller’s plan will be terminated, a Final Form 5500 will need to be filed.</td>
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ACA Employer Mandate
Refresh – Coverage Offers

• The ACA requires that an applicable large employer (ALE) comply with the employer mandate.

• An employer (as defined on a controlled group basis) is an ALE if it employed at least 50 full-time employees on business days during the preceding calendar year.

• To avoid “pay or play” penalties, an ALE must:
  • Extend an offer of minimum essential coverage to at least 95% of FT employees (and dependent children to age 26).
  • Ensure coverage is affordable, meaning the cost of self-only coverage does not exceed a percentage (8.39% in 2024) of the employee’s earnings (as determined by one of three affordability safe harvests).

• If ALE is a controlled group of related entities with separate EINs (ALE members), these requirements and potential penalties apply on an ALE member basis.

• Annually, each ALE member must report coverage offers on IRS Forms 1094/1095-C.
What happens when an ALE acquires a non-ALE?

- General view is that non-ALE becomes subject to mandate as of the transaction date.

- **Example**: ALE Patrick's Pizzeria (200 FT EEs) acquires all the ownership of non-ALE Carol's Coffee Co. (40 FT EEs) on August 31, 2023. Both entities keep separate EINS and corporate structures.
  
  - **Result**: Carol's Coffee Co. becomes an ALE Member subject to employer mandate as of the August 31, 2023, transaction closing date.
  
  - If Carol's Coffee Co. fails to offer coverage to at least 95% of its full-time employees in any subsequent month, Carol's Coffee Co. could be subject to Penalty A.
  
  - If Carol's Coffee Co. offers coverage to 95% of FT employees, but it is not affordable and of minimum value, the company could be subject to Penalty B.
  
  - Both Patrick's Pizzeria and Carol's Coffee Co. have Form 1094/1095-C reporting obligations for 2023.
What if two non-ALEs merge?

• **Example:** John’s Jellybeans (25 FTEs) merges with Carol’s Coffee Shop (30 FTEs) in September 2023.

• **Result:** Unfortunately, the guidance is not clear as to whether combined entity would be subject to the ER mandate in the first year of the merger.
  - Special rule states whether a new employer is an ALE during its first calendar year is based on the employer’s reasonable expectations at the time the business comes into existence.
  - Conservative approach is to treat newly formed entity as an ALE, offer coverage prospectively to FTEs, and satisfy reporting requirements.
  - Employer should consult with counsel for guidance.
M&A Benefits Compliance: Full-time Status

Measurement Methods

- Per ACA, full-time = 30 or more hours per week (130 hours or more per month).
- Full-time status is measured by:
  - *Monthly measurement method* – employee’s hours of service are evaluated monthly.
  - *Look-back measurement method* – employee’s hours of service are evaluated during a measurement period to lock in full-time or part-time status for an associated stability period.

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**What happens if one company acquires another with different measurement periods?**

1. Treat acquired employees as if they transferred to a new position with different measurement and stability periods.
   - If an acquired employee is in a stability period under the seller’s plan as of the transaction date, that employee’s status remains in effect until the end of the seller’s stability period. The buyer’s measurement and stability periods would then apply.
   - If an acquired employee has not yet completed an initial measurement period as of the transaction date, the employee’s status will be determined using the buyer’s measurement and stability periods, but taking into account hours of service with the seller.

2. Continue to apply the seller’s measurement method to the acquired employees during a transition period following the transaction date.
Which party is responsible for the 1094/5 reporting?

• For a **stock transaction**, there are two possible approaches.
  1. Buyer treats itself as a continuation of the seller and files reporting information on the acquired employees for the entire year under the buyer’s EIN.
  2. Two separate returns are filed for the acquired employees; one under the seller’s EIN for the period prior to the closing date and the second under the buyer’s EIN for the period after the closing date.

• For an **asset transaction**, there is no ownership transfer, so the seller would normally be responsible for the reporting prior to the closing date.

  • However, if the buyer hired any former employees of the seller, the buyer would report on those employees from the hire date, as they would with any other newly hired employees.
COBRA Obligations
Let's Get Together: Mergers, Acquisitions & Benefits Compliance

M&A Benefits Compliance: COBRA Obligations

- Will the transaction itself create COBRA qualifying events for the seller’s employees (and dependents)?
- Which party is responsible for providing coverage to the M&A COBRA qualified beneficiaries?
- What happens if the responsible party (e.g., the seller in a spinoff transaction) does not maintain the plan that previously covered the employees? Or does not maintain any plan?
- If two small employers (e.g., each with < 20 employees) merge together, when does the COBRA obligation begin?
- And many more depending upon the particular transaction…
Does a COBRA qualifying event result from a stock purchase?

- **Stock purchase** – If employees continue employment with the acquired company after the purchase, there is no qualifying event.
  - There is no termination of employment.

- **Example**: Buyer acquires 100% of the stock of Seller and employs all of Seller’s employees. The employees were previously covered under the Seller’s group health plan, but the plan was terminated on the closing date.

- **Result**: Acquired employees and dependents lose coverage but are not entitled to COBRA because there is no qualifying event.
  - Buyer is generally viewed as the successor employer to the Seller’s employees.
  - Very likely the Buyer will offer coverage to the acquired employees.
  - Even if Buyer does not, there typically is no COBRA qualifying event.
Does a COBRA qualifying event result from an asset purchase?

- **Asset purchase** - Employees who lose group health plan (GHP) coverage due to an asset purchase generally have a qualifying event.
  - Employees have a termination of employment with the seller, even if hired by the buyer.

**Example:** Seller has 3 divisions (T,U,V) and provides GHP coverage to employees of each division. Seller sells division V to Buyer on August 31, 2023. V employees are terminated from employment with Seller and lose eligibility for Seller’s GHP coverage on this date. Buyer hires all of the V employees and offers GHP coverage.

**Result:** All the division V employees (and their spouses and dependents) are COBRA qualified beneficiaries.

**Exception:** No qualifying event if buyer is considered a “successor employer” because:
  - The seller stops providing any group health plan coverage in connection with the transaction; and
  - The buyer “continues the business operations associated with the assets purchased without interruption or substantial change.”
Which party is responsible for providing coverage to the M&A COBRA qualified beneficiaries?

- **General Default Rule**: If the seller maintains *any* group health plan after the transaction, the seller must provide COBRA coverage to M&A qualified beneficiaries.
  
  - If seller terminates the plan of a sold-off asset (e.g., division), seller must provide coverage under another of its plans.
  
  - **Example**: Seller sponsors a GHP for each of its 3 divisions (T,U,V). Seller sells division T to Buyer and terminates the Division T GHP.
  
  - **Result**: Seller must provide COBRA to former T EEs (as applicable) under either the Division U or V GHP.

- **Exception**: If the seller ceases to maintain *any* GHP, then the buyer’s GHP must provide the COBRA coverage if:
  
  - The buyer maintains a GHP; and
  
  - In the case of an asset purchase, the buyer is a successor employer.
# M&A Benefits Compliance: COBRA Obligation and IRS Default Rules

## M&A Benefits Compliance: COBRA Obligation and IRS Default Rules

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<thead>
<tr>
<th>Transaction Defined</th>
<th>Stock Purchase</th>
<th>Asset Purchase</th>
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| **Transaction Defined** | • Buyer is purchasing all the stock or ownership in the seller’s business (or a unit thereof).  
• Employees of the purchased business would continue to be employed by the same legal entity.  
• But the ownership of that entity is transferred from seller to buyer. | • Buyer is purchasing some or all the seller’s assets (and may also be assuming certain liabilities).  
• Employees of the purchased entity would normally be considered terminated employees of the seller.  
• But often these employees will be rehired by the buyer (i.e., new employees of the buyer). |

## Default COBRA Rules

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<th>Default COBRA Rules</th>
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<th>Asset Purchase</th>
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| **Default COBRA Rules** | If seller maintains any group health plan after the transaction, the seller is responsible for offering and maintaining COBRA coverage for any COBRA beneficiaries.  
If seller does not maintain any group health plan after the transaction: |  
• Any terminated employees and any present COBRA participants under the seller’s plan would be eligible to continue coverage through the buyer’s plan. |  
• Any terminated/not rehired employees and any present COBRA participants under the seller’s COBRA plan would be eligible to continue coverage through the buyer’s COBRA plan, if the buyer is a successor employer.* |

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*The buyer continues the business operations associated with the assets purchased without interruption or substantial change.*
If two small employers (e.g., each with < 20 employees) merge together, when does the COBRA obligation begin?

- Small employer exemption from COBRA applies to employers (as defined on a controlled group basis) with less than 20 employees on at least 50% of its typical business days in the prior year.

**With a stock transaction** (e.g., merger), the employees of both entities in the prior year must be counted for purposes of the exception.

  - **Example**: Company A merges into Company M on October 1, 2023. Each company had 12 employees in 2022.
  - **Result**: Surviving Company M is subject to COBRA as of October 1, 2023, because the combined employee total in 2022 was 24 (i.e., 20 or greater).

**With an asset purchase**, the parties do not become related entities as a result of the transaction, so their employees in the prior year do not need to be counted together.

  - **Example**: Buyer purchases Division D from Seller on February 1, 2023, and hires all 10 Division D employees. In 2022, Buyer had 15 employees and Seller had 30 employees, including the 10 in Division D.
  - **Result**: Buyer’s plan would continue to be exempt from COBRA in 2023, but COBRA would apply as of January 1, 2024 (because Buyer employed 20 or more employees on at least 50% of its typical business days in 2023).
Cafeteria Plans/FSA Options
M&A Benefits Compliance: Cafeteria Plan Considerations

How should the cafeteria plan and health FSAs be addressed in the M&A context?

**Stock Purchase**
- With a **stock purchase**, the buyer typically assumes sponsorship of the seller’s plans.
- Plan participation and elections would continue for acquired employees, who are bound by prior elections.
- The buyer may prefer to terminate the seller’s plan as of the transaction date; in such event, it is unclear whether new mid-year benefit elections would be permitted under the buyer’s cafeteria plan.
- Additionally, issues may arise with a mid-year plan termination if participants are not provided with sufficient notice to use their existing balances.

**Asset Purchase**
- With an **asset purchase**, for employees of the acquired business employment is terminated with the seller.
- Their participation and elections in any cafeteria plan and health FSA benefits maintained by the seller would typically terminate on the transaction date.
- Employees hired by the buyer may be offered participation in the buyer’s cafeteria plan and health FSA benefits and would be given the opportunity to make new elections.
- But these employees may have large forfeitures under the seller’s plan...
IRS addresses health FSA options for asset purchases.
  • IRS has informally stated options also apply to stock purchases.

Guidance provides two possible transition approaches, which would apply if:
  • The seller continues its business operations and health FSA after the asset purchase; and
  • The buyer either has or will create a cafeteria plan that offers health FSA coverage.

• **Option 1:**
  • The parties could agree to have the transferred employees continue to participate in the seller’s FSA plan through the end of the plan year.
  • Employee salary reduction elections would continue, but as if made under the buyer’s plan.

• **Option 2:**
  • The buyer could agree to cover the transferred employees under its health FSA for the remainder of the plan year.
  • Employee account balances (whether underspent or overspent) under the seller’s health FSA would be rolled over to the buyer’s health FSA.
    • Claims for reimbursement after the asset purchase would be submitted to the buyer’s health FSA (including claims incurred before the transaction that were not yet reimbursed).
    • Employee elections would continue for the balance of the plan year under the buyer’s plan.
M&A Benefits Compliance: Dependent Care FSA Considerations

• IRS guidance does not specifically extend to dependent care FSAs.
  • Counsel should be consulted for guidance.

• In the event of an **asset purchase**, the seller could consider adopting a spend-down feature.
  • A spend-down would allow the terminated employees to be reimbursed from their dependent care FSA balances for eligible expenses incurred during the remainder of the plan year.
    • So, expenses could be reimbursed while employees were working for the buyer.
    • Otherwise, employees may be limited to reimbursement for expenses incurred prior to their termination dates.
M&A Benefits Compliance: Cafeteria Plans

Can the various members of a controlled group participate in the same cafeteria or group health plan?

• Businesses that are part of a controlled group may provide a single cafeteria or group health plan for all their employees.

• Alternatively, one or more of the businesses may have separate plans for their own employees.

• But the plans would need to satisfy the applicable nondiscrimination rules.
Nondiscrimination Rules
M&A Benefits Compliance: Nondiscrimination Rules

Can the benefit offerings vary for different controlled group members?

• Plan eligibility, benefits and contributions can be varied for bona fide business classifications of employees.
  • Variances based upon geographic location, entity, business line or occupation would generally be permitted.
  
• But any variances must comply with the applicable nondiscrimination rules.

• The Section 125 nondiscrimination rules apply to pre-tax benefits under a cafeteria plan and prohibit variances in eligibility, benefits and contributions that disproportionately favor key or highly compensated employees (HCEs).

• The Section 105 nondiscrimination rules apply to self-insured plans and are also designed to prevent discrimination in favor of HCEs, although the HCE definition and tests vary from those under the Section 125 rules.

• The Section 125 and Section 105 tests take the employer’s entire controlled group into account.
How does controlled group status factor into the nondiscrimination tests?

- First, the determination of HCEs is based on the entire controlled group.
- Under the Section 125 rules, an HCE includes any officer, a > 5% owner or any individual who earned more than $150,000 in 2023 (or $155,000 in 2024).
- Under the Section 105 rules, an HCE is one of the top five paid officers, a >10% shareholder and the top 25% of all employees.

- **Section 125 HCE:**
  - Any officer
  - > 5% shareholder
  - Any individual w/ >$150k in 2023

- **Section 105 HCE:**
  - Top 5 paid officer
  - > 10% shareholder
  - Top 25% of all employees
How do mergers and acquisitions impact the nondiscrimination testing?

- A merger, acquisition or other transaction typically results in changes to the buyer’s and seller’s controlled groups.

- Since aspects of nondiscrimination testing consider the employer’s entire controlled group, a business reorganization can impact the testing results.
  - For example, an acquisition or spinoff can change the HCE population and benefit offerings of the controlled group.

- If the buyer will be taking over the plans of the seller in a stock purchase, those plans will need to be included in the testing.

- The employer should consult with the party responsible for the nondiscrimination testing in advance of the transaction, if possible.

- In any event, midyear testing is advisable, so the employer may make necessary adjustments before year end.
  - This helps to prevent tax consequences to HCEs.
Key Takeaways
Employers should consider benefits administration early on during due diligence.

Counsel should be involved.

Know the type of the transaction (i.e., asset/stock), ownership structure and controlled group status.

Default rules exist for COBRA and health FSAs.

Parties can negotiate other terms that should be included in the purchase agreement.

Communicate any benefit plan changes in advance with employees.

Ask your consultant or broker for a copy of our M&A employee benefits publication.
Thank you for joining us. Please let us know if you have any questions.