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Qualified Plan Issues in Corporate Transactions: When Does a Corporate Transaction Trigger a 401(k) Participant's Right to a Distribution?

It is widely predicted that the rate of merger and acquisition activity in corporate America will continue to rise throughout 2024. Often, considerations relating to a seller's qualified plans are treated as an afterthought when structuring a transaction. However, leaders of selling entities that sponsor 401(k) plans may find themselves hearing the same question over and over from employees – "when can I get my money?" To accurately answer that question – and to avoid potentially costly operation errors – sponsors of 401(k) plans who intend to participate in corporate transactions should be well versed in the applicable distribution rules under the Internal Revenue Code and how they apply to various transaction scenarios. This alert focuses on the rules applicable to 401(k) plans, although much of the guidance discussed is applicable to 403(b) and 457(b) plans as well.

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What is a Severance of Employment?

401(k) plans may only permit distribution of a participant's elective deferrals upon the occurrence of certain events. Amidst a corporate transaction, the permissible distribution event most likely to occur is known as a severance of employment. 401(k) plans are not required to permit distributions upon a severance of employment, but the vast majority do.

While some plans use the "severance of employment" language when listing permissible distribution events, others often substitute more commonplace language, saying that a participant is permitted to receive a distribution upon "termination of employment." Replacing the phrase "severance of employment" with simplified language such as "termination of employment" is not necessarily a compliance issue for plans. However, plan sponsors should be aware that the phrase "severance of employment" is a term of art with a very specific meaning, and that meaning is not a perfect match to what the average employee would consider a "termination of employment." This means that when considering whether a corporate transaction will result in participants becoming entitled to a plan distribution, plan sponsors should not simply assume that a change in a participant's common law employer will entitle the participant to a distribution.

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It is important to note that the phrase “severance of employment” and the phrase “separation from service” are distinct concepts under the Internal Revenue Code with separate definitions. It is possible for a participant to experience one of these events but not the other. Prior to 2002, “separation from service” was listed as a distributable 401(k) event in place of “severance from employment.” The “same desk rule” that is sometimes discussed regarding issues relating to vesting and service crediting is tied to “separation from service” – not “severance of employment.” Confusingly, the "separation from service” concept still exists in the Internal Revenue Code, and is a standard used to determine whether a participant qualifies for exceptions to the premature distribution penalties.

Under current guidance, a participant experiences a “severance of employment” when the participant is no longer working for the employer who maintains the plan. The seemingly straightforward definition can quickly become complicated to apply for a couple of reasons. First, for qualified plan purposes, the Internal Revenue Service (IRS) considers groups of related companies with common ownership (commonly referred to as "control groups" or "affiliated service groups") to be a single employer even when the underlying companies are distinct legal entities. Second, corporate transactions often result in changes to qualified plans, including plan spinoffs, plan mergers and changes in the plan sponsor. This makes applying the rule a challenge.

According to the IRS, the main factor that determines whether a participant will experience a severance of employment as a result of a corporate transaction is the structure of the transaction. IRS guidance generally addresses two types of corporate transactions: asset sales and stock sales.

Asset Sales

Generally, asset sales involve one company acquiring the business assets of another company. In situations where the buyer will purchase substantially all the seller’s assets it is common for the buyer to agree to hire some, or all, of the seller’s workforce.

If a seller maintains a 401(k) plan for its employees and some, or all, of the seller’s employees are hired by the buyer as a result of the sale, then those employees will generally experience a severance from employment. This means that, assuming the seller’s plan permits distributions upon a severance from employment, the affected employees will be eligible to request a distribution once they are hired by the buyer. The affected employees may elect to roll over their

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distribution into the buyer's 401(k).

However, employees who go to work for the buyer following an asset sale will not experience a severance from employment if the buyer “continues” the seller’s 401(k) plan. A buyer is treated as “continuing” the seller’s plan if it: (1) adopts the seller’s plan as the new plan sponsor; or (2) assets from the seller’s plan are directly transferred via a trustee-to-trustee transfer to a plan maintained by the buyer.

Stock Sales

In a stock sale, the buyer purchases stock of the selling company from the owner of the selling company and after the transaction owns all or a portion of the selling business entity. Generally, participants will not have a severance from employment simply because all, or a portion of the stock of their employer, is sold. However, there can be certain stock sale structures that trigger a severance of employment even if the employee does not have a change in their common law employer. This will typically arise in the stock sale of a subsidiary and, while the analysis can be quite complex, one factor that must be true for there to be a severance of employment for plan purposes is that subsidiary is no longer a participating employer in the 401(k) plan.

Applying Cookie Cutter Guidance to Complicated Realities

The existing guidance on how the severance of employment rules apply to corporate transactions is very limited. The sum total of guidance from the IRS includes some passing references in the 401(k) regulations, a General Counsel Memorandum from 1990 and a 2002 Notice. In addition to the scarce number of guiding documents, the scope of existing guidance is limited as well. The commentary the IRS has provided to date generally addresses sales involving a buyer purchasing 100 percent of a buyer’s assets or stock. In reality, the structure of corporate transactions is often far more nuanced.

Therefore, when it comes to determining whether participants will experience a severance of employment and be entitled to a 401(k) distribution as a result of a corporate transaction, there may not always be a clear answer. While the stakes may seem low, this confusion can quickly spiral into costly issues for plan sponsors – participants denied a distribution could bring legal action, while impermissibly allowing participants to receive a distribution can create plan qualification issues subject to review by the IRS. For this reason, we recommend that plan sponsors involved in a corporate transaction work closely with their

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Reinhart attorney to determine how to best apply existing guidance to their unique situation.

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