CASE STUDY: Business Acquisition and Retirement Plans

At times, clients face unforeseen circumstances which require quick and decisive action. It is in those situations when clients look to their advisor for guidance. This case was no different: an associate at a medical practice was presented with an opportunity to purchase her employer's practice. The opportunity surfaced unexpectedly when the seller was diagnosed with a terminal illness. The buyer had to act immediately. Aside from the financial matters, she needed to facilitate the transaction in a way that was least disruptive to practice employees who already had to deal with a very emotional situation. Given a very short timeline, it was also of utmost importance to create adequate space and flexibility for future adjustments as the acquired practice gradually returns to steady state. Retirement Services was approached for assistance in evaluation of the seller's retirement plan and creation of a smooth transition strategy.

Facts

- Seller maintained a 401(k) profit-sharing plan.
- 90% of eligible employees participated in the seller's 401(k) plan with the average deferral rate of 6%.
- Buyer maintained a separate individual 401(k) plan through the sole proprietorship used for her independent contractor work.
- Practice acquisition was structured as an asset transaction.

Goal

- Evaluate buyer and seller plans.
- Build in flexibility for the buyer with respect to benefit plans offered at the acquired practice.
- Facilitate a seamless benefit plan transition for employees: contributions and transfer of current balances.

Summary of Recommendations

Plan sponsored by the seller's business

- Seller sponsored a 401(k) profit-sharing plan where 90% of employees made salary deferrals. Historically, employees received a safe harbor contribution and a profit-sharing contribution. Employees directed their investment accounts. Plan had two outstanding participant loans.
- Generally, in the asset sale, the buyer doesn't become a successor of the plan sponsored by the buyer. This approach offered maximum flexibility and better liability shield for the buyer who did not assume sponsorship of the existing plan.
- We recommended review of the buy-sell agreement to confirm that the seller was not assuming sponsorship of the 401(k).
- Employee balances in the seller's plan:
    a. In an asset sale, employees are treated as terminating service from the seller's plan, which entitles them to a distribution from the plan. All participants become vested in those funds.
    b. To help employees keep their retirement assets in one account, the new plan (more on it below) will provide an opportunity to receive rollovers from the seller's plan. To discourage employees from cashing out their balances, we offered a newsletter which outlined distribution options and described benefits of keeping funds in a tax-deferred account until retirement.
- Plan loans:
    a. At termination, participants are given an opportunity to repay remaining loan balances.
    b. Unpaid loan balances are treated as distributions subject to income tax and premature distribution penalty of 10% for those younger than 59 1/2.
    c. Having participants come up with cash to repay plan loans would likely constitute a hardship, therefore the new plan would allow employees to transfer their loan balances from the seller's plan and continue repayment without a creating disruption.

Plan sponsored by the buyer's sole proprietorship, Plan One

- The buyer intended to incorporate before the transaction date. The new corporation would take over sponsorship of the Individual 401(k) plan (Plan One). Service performed and compensation earned in the sole proprietorship would be counted in Plan One, which will be helpful to maximize contributions in the transition year.
- Buyer's Individual 401(k) plan used a simplified language which was no longer suitable now that she was acquiring a new practice, for example, it provided immediate eligibility. We recommended that before the effective date of the transaction, the individual 401(k) be amended to require one year of service for eligibility so when new employees get hired by her new business they do not automatically enter the plan.
- Because of a special testing rule, the buyer would be able to maximize plan funding in Plan One in the transaction year and in the following year. At the same time, she would retain maximum flexibility to determine amount of contributions for the employees in Plan Two which was to be established as a companion plan for the initial two years.

New plan of the buyer's new corporation, Plan Two

- To provide continuity for the employees while providing most flexibility for the buyer; the new corporation would establish a new 401(k) plan.
- Employees joining the practice as a result of the transaction would immediately enter the plan; future hires would be required to perform one year of service to the business and be at least 21 before they can participate.
- To eliminate the need for enrollment paperwork and reduce the enrollment timeline, current employees' deferral elections would 'move' into the new plan via auto-enrollment feature.
- Employee contributions would be automatically invested (defaulted) into Target Date Funds, plan's Qualified Default Investment Alternative, one of Department of Labor's safe harbor investment options. Employees would be given opportunity modify their salary deferral elections and reallocate investments at a later date, if they desire to do so. These options would be outlined in a special plan notice distributed to them when they become employees of the buyer's practice.
- Because of this two-plan approach, the buyer would not be required to make contributions for the employees in the first two years. However, if desired, she could make a discretionary contribution up to the due date of the new corporation's extended tax return. This contribution could align with the benefit which was customary under the seller's plan or any other amount deemed appropriate by the buyer.

Coordination of Plans

Year three will be a transitional year:

- There will be no advantage to continue two separate plans; therefore we recommended merging Plan One and Plan Two at that time.
- Plan Two will incorporate a 'maybe 3% safe harbor' feature. It will give the owner ability to maximize deferrals, take care of the top-heavy contribution minimum, but provides an exit if required. The seller will have up to November of year three to determine whether or not to make that 3% contribution for the year, based on the financials and employee benefit plan goals at that time.
- Discretionary profit-sharing contributions, allocation method and conditions, may also be addressed around the same time.

Summary

Proactive consulting before the transaction's effective date allowed the seller to coordinate current retirement plans in a way that was least disruptive to employees and the newly acquired practice. At the same time, she was able to maintain maximum flexibility in addressing retirement savings goals, managing acquisition costs, and providing a valuable benefit to employees. It helped reduce account leakage upon termination of the seller's plan and provided continuity to employees. Lastly, this process offered a path for future planning as the practice moves forward.

Interested in exploring potential benefits of this design for your clients and prospects?
Reach out to your First Allied Retirement Services SMEs

first allied

pensions@firstallied.com 866-350-4237 www.firstalliedretirement.com