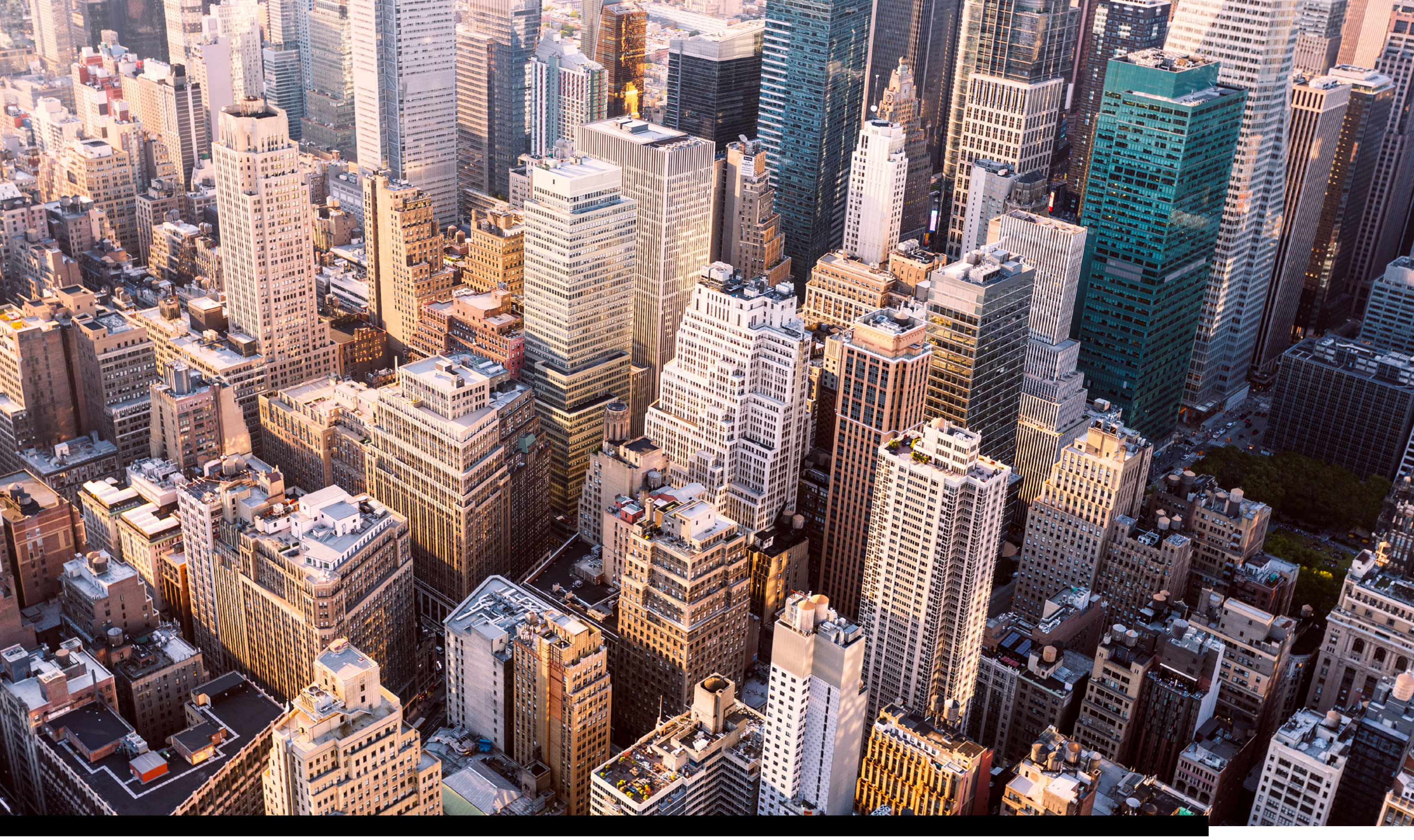


Deal Playbook Section 3:

SECURE 2.0: M&A Retirement Plan Considerations

September 2023

LOCKTON®

SECURE 2.0: M&A Retirement Plan Considerations

In December 2019, President Trump signed the Setting Every Community Up for Retirement (SECURE) Act. Three years later, President Biden signed the Consolidated Appropriations Act of 2023, which included new provisions (SECURE 2.0) that expanded the SECURE Act of 2019 (collectively called SECURE).

SECURE is a major piece of 401(k) legislation that has far-reaching implications for mergers and acquisitions and businesses alike. It is important to understand the complexities of this legislation, as it will require careful planning and execution to ensure compliance. However, the end result will be a more secure and stable retirement for millions of Americans.

What the SECURE Act means for M&A

These new laws revamped decades-old regulations on 401(k) and other retirement plans, with provisions that will impact mergers and acquisitions. Specifically, SECURE 2.0:

- Broadens eligibility for part-time employees
- Introduces auto-enrollment/annual escalation requirements
- Makes changes to catch-up contributions
- Introduces pooled employer plans, or PEPs, formerly known as multiple employer plans or MEPs
- Allows Roth employer contributions
- Allows 401(k) plans to recognize student loan repayments
- Adds flexibility for:
  - Safe Harbor plans
  - Qualified automatic contribution arrangement (QACA) provisions
  - SIMPLE IRA plans
  - In-service distributions

Under SECURE, M&A transactions have become increasingly complex. As target companies may have selected more alternatives for their retirement programs, buyers must consider two essential questions:

01 **Will our employer retirement plan costs increase after the transaction?**

02 **If there are post-closing retirement plan changes, will employees affected by the transaction lose benefits they value?**

Optional and mandatory provisions, such as increased distribution flexibility, Roth employer contributions, auto-enrollment/annual escalation, and broader part-time eligibility, will complicate M&A.

OPTIONAL PROVISIONS

Optional provisions of SECURE an employer chooses will vary based on the employer's objectives. The buyer in an M&A transaction may not offer some optional provisions in an existing 401(k) plan that the seller provides prior to the deal. Hence, the buyer may consider adding provisions to its existing 401(k) plan to appease acquired employees. The potential costs of such changes must be assessed to determine if they are financially viable.

MANDATORY PROVISIONS

Mandatory provisions may also impact a buyer's decisions and plan design alternatives. For example, auto-enrollment/annual escalation, which must be incorporated in a 401(k) plan adopted after December 29, 2022, may be costly for the buyer in an M&A transaction. If a new plan is adopted under SECURE, these provisions will increase any employer matching contribution. The sum of matching contributions will increase due to these provisions' efficacy: Average 401(k) enrollment of approximately 75% nationwide without auto-enrollment increases to around 95% with auto-enrollment.

An employer in this situation is faced with increasing the cost of annual matching contributions or reducing the rate of match provided to each participant, including those who affirmatively elected to defer and value retirement benefits the most. Historically, a buyer had the option to terminate a seller's 401(k), a choice that was especially likely if compliance concerns were observed during diligence.

Buyers must also consider broader part-time eligibility in M&A transactions. A buyer acquiring a company with many part-time employees must decide if long-term part-time employees will be excluded from employer contributions. If the sum of the employer match remains constant but must be allocated to more employees, the match rate to each participant must decrease.

Hypothetical M&A SECURE Scenario 1

Company A is under a letter of intent to be acquired by a private equity firm in a stock transaction. Company A has 2,000 employees in an industry that traditionally has poor 401(k) participation (for example, manufacturing or construction), which results in 50% of employees participating in the 401(k) plan. Company A matches 100% of participants' deferrals up to 3% of pay, which results in a plan cost of $1.4 million in employer contributions.

Due to potential compliance concerns or because the seller will retain its 401(k) plan, the buyer's advisors determine that the pre-close plan should be terminated, and a new plan will be implemented after closing.

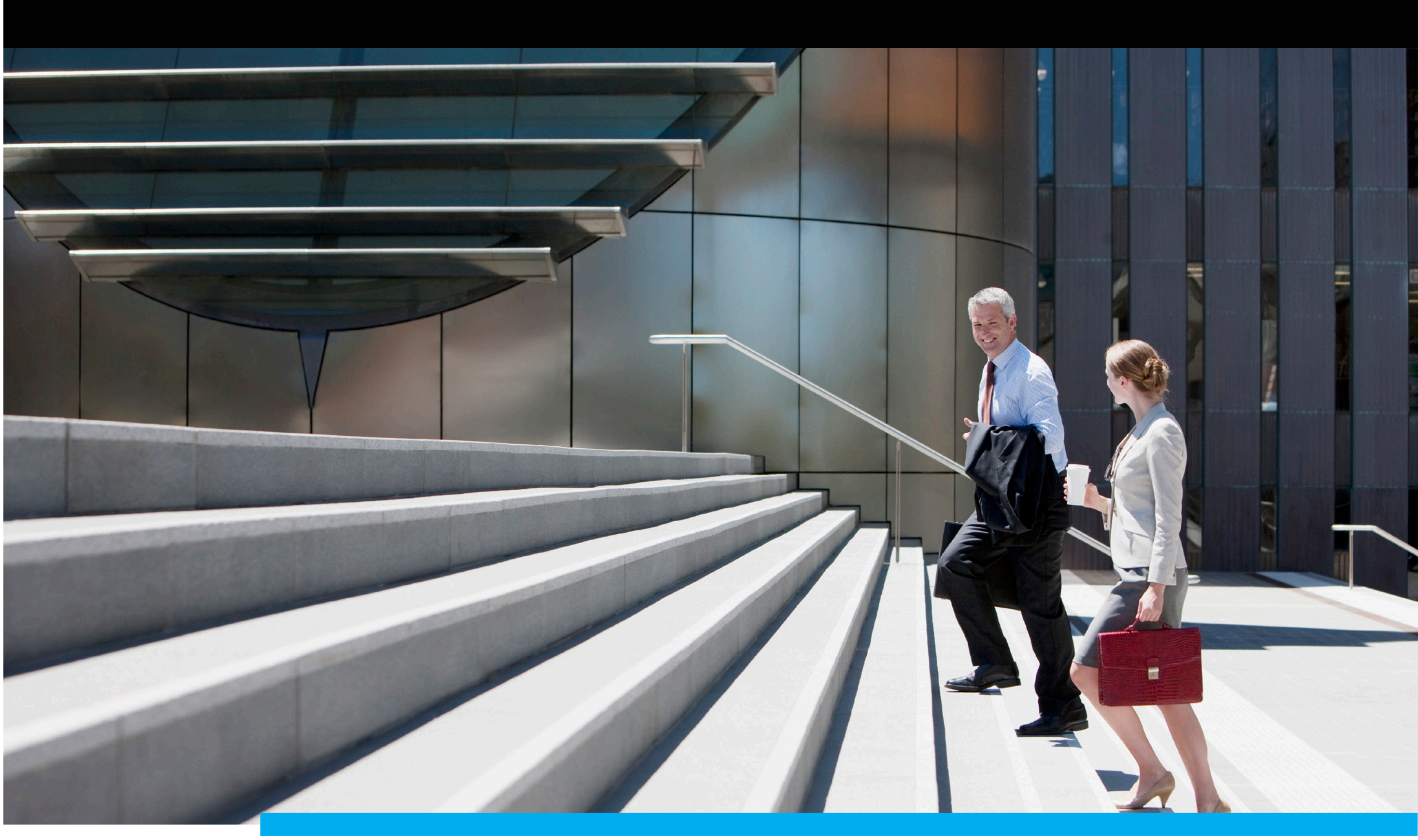
SECURE's requirements mean that all participants will be auto-enrolled in the new plan. As a result, participation goes from 50% to 95%, and corresponding matching contributions increase to $2.6 million.

Hypothetical SECURE Scenario 2

Company B has a workforce of 750 full-time employees and 250 part-time employees. Of the part-time employees, 175 have worked for Company B for over two years. Before January 1, 2024, Company B allowed only full-time employees to participate in its 401(k) plan.

Due to SECURE's requirement that retirement benefits be offered to long-term part-time employees beginning January 1, 2024, the additional 175 long-term part-time employees become eligible to participate in the company's 401(k) plan.

Before January 1, 2024, Company B's total matching contributions were $800,000 annually. With the increase in eligible employees and a matching contribution allocated to all employees, Company B's annual matching contribution increases to $900,000.



Hypothetical M&A SECURE Scenario 3

Company C is in an industry with a highly competitive labor market. Its current 250 employees are loyal, mature, long-term employees. Its employee benefits program is generous, with a 401(k) matching contribution of 100% of deferrals up to 6% of pay, and 225 employees (90%) are participating. The average per employee per year (PEPY) matching contribution is $3,400.

The private equity owner of Company C identifies an acquisition (Company D) that provides complementary services with a different employee demographic. Company D's employees are younger and more mobile. During diligence, Company C's owner learns that Company D has a new 401(k) plan adopted under SECURE with automatic enrollment and annual escalation. Company D's 175 employees do not have the same appreciation of retirement benefits as Company C's workforce. Due to the increased participation automatic enrollment creates and employees' reduced value of retirement benefits, Company D's matching contribution is limited to 25% of deferrals to 4% of pay, resulting in a retirement contribution cost of $800 PEPY.

Company C negotiates an equity acquisition of Company D. The 401(k) plan sponsored by Company D can be assumed and operated under a transition rule for a period. Within 12 to 23 months, however, the 401(k) plans of Company C and Company D must pass combined nondiscrimination tests that will not be satisfied based on the disparity in employer contributions.

To transition Company D employees to the 401(k) plan sponsored by Company C would require an additional expense of $2,600 PEPY. Alternatively, Company C could reduce its contribution rate, but this would alienate its legacy employees.

Based on current 401(k) participation among Company D employees, this represents an annual cost increase of $432,000, and the sale price multiple of 15x EBITDA suggests a valuation adjustment of $6.48 million.

SECURE Changes Implemented Before January 1, 2023

MANDATORY PROVISIONS

Provision	Description	Potential M&A Implications
Broader part-time eligibility	For plan years beginning after December 31, 2020, employees who work 500+ hours in three consecutive 12-month periods must be eligible to participate in any 401(k) plan sponsored by an employer. Hours worked before January 1, 2021, are not considered to determine eligibility.	In a stock transaction, a buyer must collect information about hours worked annually for part-time employees beginning January 1, 2021, to determine if they must be offered 401(k) plan enrollment starting January 1, 2024. Failure to provide enrollment is considered erroneous exclusion, potentially resulting in required employer contributions on part-time employees' behalf.

OPTIONAL PROVISIONS

Provision	Description	Potential M&A Implications
Safe harbor non-elective contribution plan flexibility	A 401(k) plan that failed the previous year's nondiscrimination test can be retroactively declared a safe harbor for 401(k) testing purposes until the end of the year following the year of the failed test (by December 31, 2023, for a test failure for the year ending December 31, 2022). The safe harbor non-elective contribution must be at least 4% of pay for eligible employees, increased from the 3% required if the employer makes a timely safe harbor election.	Corrections for failed 401(k) tests in the prior year are now capped at 4% of eligible employees' pay. Highly compensated employees, often vital to a business's success, are not required to receive refunds of their 401(k) deferrals made for the previous year.
Qualified automatic contribution arrangement (QACA) annual escalation	An employer that offers a safe harbor QACA can increase a participant's deferral rate by 1% of their pay annually until it reaches 15%. Before SECURE, the annual escalation limit was 6% of pay.	If the buyer in a transaction has an existing 401(k) plan, automatic enrollment and annual escalation provisions should be compared to the seller's 401(k) plan. If automatic enrollment and annual escalation are not aligned, newly acquired employees should be alerted to the change to ensure a smooth benefits transition.
Multiple employer plans (MEP)	A new breed of MEP is created called a "pooled employer plan," (PEP) in which a service provider assumes some responsibilities for participating employers. The PEP allows unsophisticated employers to offer 401(k) plans with minor inconvenience.	A buyer that lacks the infrastructure to navigate the myriad of 401(k) plan complexities may choose the PEP as an alternative. Acquiring a company that does not offer a retirement plan could be an efficient means of enhancing benefits.

SECURE Changes Implemented After January 1, 2023

MANDATORY PROVISIONS

Provision	Description	Potential M&A Implications
Automatic enrollment and annual escalation	New 401(k) plans adopted after December 29, 2022, must begin automatically enrolling newly eligible employees with a 3% deferral rate (or higher) as of January 1, 2025. These plans must also include an annual escalation rate of at least 1% until an employee's deferral rate reaches 10% of pay (an employer can voluntarily elect to increase up to 15% of pay). Plans that existed before December 29, 2022, and those sponsored by employers with ten or fewer employers or in business for three years or less are exempt from these requirements. (Effective January 1, 2025)	Many ERISA attorneys have advised that a 401(k) plan should never be assumed. In an asset transaction, these professionals suggest that an existing 401(k) plan should not be assumed. In a stock transaction, advisors in this camp suggest that the seller's plan should be terminated before closing without regard to diligence findings. Some practitioners may now be influenced by the automatic enrollment requirement for newly adopted plans beginning January 1, 2025. Where diligence has suggested potential liabilities that a buyer might assume absent a plan termination, automatic enrollment might be unavoidable. Auto-enrollment is highly effective, with a national average “opt-out” rate of just 5% of employees to whom auto-enrollment applies. A 401(k) plan with 95% participation will result in much higher employer matching contributions than a plan with 75% participation.
Catch-up contribution changes	SECURE outlines two new provisions of catch-up contributions. • Participants age 60 through 63 can make catch-up contributions of the greater of $10,000 or 150% of the 2024 catch-up limit. (Beginning January 1, 2025) • Participants who made $145,000 annually in the previous year can now make only Roth catch-up deferrals. Historically, catch-up deferrals could be made as pre-tax or Roth contributions at the participant’s discretion. (Beginning January 1, 2026)	Increased maximum catch-up contributions beginning January 1, 2025, should be considered when determining if a buyer will match these contributions. The maximum catch-up contribution in 2023 is $7,500. Catch-up contributions for participants aged 60 to 63 will increase to 150% of the 2024 catch-up limit (not less than $11,250 based on current limits) with annually indexed increases. Suppose an employer’s current matching contribution provisions indicate catch up contributions will be matched. In that case, the potential contribution expense will be more significant for those able to make larger catch-up contributions. New catch-up contribution rules for employees with earnings of more than $145,000 in the previous year apply to participants in all 401(k) plans. A participant who has historically been permitted to make catch-up contributions as pre-tax or Roth may, however, believe that a recent change in ownership is the cause of this lost flexibility. Buyers can avoid dissatisfaction by clearly communicating this change that SECURE mandates as of January 1, 2026. Further, if a 401(k) plan does not currently allow Roth deferrals, immediate notice of difference to the plan’s service provider may be required to allow participants with $145,000 in prior year earnings to continue making catch-up contributions in 2026 and beyond.

Provision	Description	Potential M&A Implications
Even broader long-term part-time eligibility	Part-time employees who work 500+ hours in two consecutive 12-month periods must be eligible to participate in any 401(k) plan sponsored by the employer. (Beginning January 1, 2025)	A buyer completing a stock acquisition must obtain information about hours of service for 2023 and 2024 to effectively administer eligibility for long-term part-time employees in 2025. Consideration for employer contributions for these newly eligible employees will be necessary. As with earlier part-time employee eligibility, a failure to offer enrollment to these employees when required may result in employer contributions on behalf of wrongly excluded part-time employees.

OPTIONAL PROVISIONS

Provision	Description	Potential M&A Implications
Flexible distribution rules	SECURE allows participants to withdraw funds from their 401(k) plan in cases of emergency. Participants must be permitted to repay their withdrawals within three years. Participants are permitted to: • Withdraw any amount for terminally ill participants. (Beginning January 1, 2023) • Withdraw the lesser of 50% of account value or $10,000 for victims of domestic abuse. (Beginning January 1, 2024) • Create a post-tax (not Roth) account in a retirement plan, with up to 3% of pay from which the participant can receive emergency distributions. Alternatively, participants have the option to receive distributions of up to $1,000 every three years from retirement accounts to cover emergency expenses (not subject to hardship distribution rules). (Beginning January 1, 2024)	When assuming a retirement plan containing these flexible distribution rules, a buyer must ensure it receives sufficient information to determine participants eligible to repay distributions made in the past three years. Detailed plan records and cooperation from service providers will be necessary in plan mergers and service provider transitions. Employers considering post-tax emergency savings accounts (participant contributions of up to 3% of pay) need to consider the impact to nondiscrimination tests. Non-highly compensated employees (NHCs), who are more likely to value this opportunity, may choose emergency savings instead of 401(k) deferrals. Current regulations exclude emergency savings from nondiscrimination tests. If an NHC chooses emergency savings over 401(k) deferrals, the plan's nondiscrimination tests will be negatively affected.
Roth Employer Contributions	Participants can characterize employer contributions as Roth, if a 401(k) plan permits. (Beginning December 29, 2022)	A buyer that assumes or implements a 401(k) plan that permits participants to characterize employer contributions as Roth should consider the impact on other employer-related payroll expenses. Roth characterization of employer contributions will require that participants recognize these contributions as taxable earnings in the year the contribution is made. Until implications are identified and appropriate adjustments implemented by tax authorities and insurers, an employer could inadvertently increase other payroll-related expenses by offering this alternative.

SECURE Changes Implemented After January 1, 2023

OPTIONAL PROVISIONS

Provision	Description	Potential M&A Implications
SIMPLE IRA Deferrals	SECURE has outlined three changes to IRA plans: • SIMPLE IRAs can now accept Roth contributions. (Effective January 1, 2023) • A SIMPLE IRA can be replaced with a safe harbor 401(k) plan midyear. (Effective January 1, 2024) • An employer can make discretionary employer contributions to a SIMPLE IRA of up to the lesser of $5,000 or 10% of pay (pro-rate allocation only). (Effective January 1, 2024	Increasing SIMPLE IRA flexibility may encourage small employers' broader adoption of these plans. A buyer making a stock acquisition of an entity that sponsors a SIMPLE IRA have historically been required to maintain the SIMPLE until year-end, even if the buyer is an employer offering a robust 401(k) plan to other employees. In 2024, such a buyer will be able to transition employees of an acquired entity to a 401(k) plan if that plan satisfies a safe harbor for nondiscrimination test purposes. Caution should be exercised, however, if the buyer determines a midyear transition from SIMPLE IRA to 401(k) plan is desired and the buyer does not already maintain a 401(k) plan. SIMPLE IRA participation is voluntary and a new 401(k) plan (effective December 27, 2022 or later) is required to enroll eligible employees automatically. The employer's retirement contribution expense will dramatically increase.
Student Loan Repayment	A 401(k) plan can formally provide employer-matching contributions based on an employee's student loan repayment. (Beginning January 1, 2024)	Employers in competitive labor markets will have a new(ish) differentiator in recruiting. A new hire with student loan debt considering two or more opportunities will prefer an employer matching their student loan repayments with contributions under an employer's 401(k) plan. Note that SECURE formalizes this practice, but it has been in the market for at least ten years, using creative retirement plan designs to achieve the same goal.

How Lockton Can Help

There are other implications of SECURE on M&A transactions beyond the scope of this paper. Companies and private equity firms in acquisition mode can work with Lockton's Transaction Advisory Practice to better tackle issues brought by this new law. Our team consists of employee benefits specialists who can conduct a comprehensive review of your company's benefits program and recommend options that meet your specific objectives, whether the goal is cost savings, expense optimization, or recruiting.

Your Lockton Team

For more on this topic or how Lockton can help, contact a member of your Lockton team.

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