

Traps for the Unwary: Code Section 410(b) Coverage Testing Concerns in Transactions

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With a recent uptick in mergers and transactions, we thought it would be worthwhile to provide a refresher on some coverage testing issues related to retirement plans. Although a seemingly mundane topic, coverage testing should be kept in mind in corporate transactions where the buyer is acquiring an entity that sponsors a 401(k) plan and the fate of that plan is not resolved prior to the closing of the transaction. Failure to consider coverage testing concerns in the years following an acquisition can lead to qualification failures in retirement plans, which potentially can require millions of dollars to correct.



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By way of background, Section 410(b) of the Internal Revenue Code of 1986, as amended, requires that a 401(k) plan cover a certain percentage of an employer's non-highly compensated employees (NHCEs). Without getting too far into the weeds, one simple way that Section 410(b) testing is satisfied is by having a plan that covers 70 percent of the employer's NHCEs. (Other, more complicated tests may be used if a plan fails this simplified test.) However, when considering the employee population for Section 410(b) coverage testing, the employees in the entire controlled group (i.e., all of the entities under common ownership) must be included—not just the employees of the employer sponsoring the plan being tested.

Although two plans within a controlled group of companies may be combined for coverage testing purposes (and treated as one plan), there are a handful of scenarios in which the plans cannot be aggregated (for example, when one plan is a safe harbor 401(k) plan and the other is not). When plans cannot be aggregated, they must be tested separately for purposes of Section 410(b) coverage testing,

which is where we have seen testing failures—especially where the buyer is significantly larger than the acquired company.

For example, assume that Employer A has 1,000 employees, 950 of whom are NHCEs. Employer A acquires Employer B, which has 100 employees, 80 of whom are NHCEs. Employer A and Employer B each sponsor a 401(k) plan (respectively, Plan A and Plan B) and will not merge the plans following the transaction. Further assume that all NHCEs are eligible to participate in the plan sponsored by their respective employer and that the plans cannot be aggregated for coverage testing purposes.

Prior to the transaction, both Plan A and Plan B pass Section 410(b) coverage testing because at least 70 percent of the respective NHCEs benefit under each plan. However, following the acquisition, the 70 percent threshold must be determined by combining the employee count of both Employer A and Employer B. Plan A still passes testing because it benefits roughly 92 percent of the NHCEs in the controlled group (950 of the 1,030 NHCEs within the controlled group). However, Plan B now benefits approximately 7.75 percent of the NHCEs (80 of the 1,030 NHCEs within the controlled group). Accordingly, Plan B does not satisfy the simplified Section 410(b) analysis (and will fail the more complex analyses as well).

A failure of Section 410(b) coverage testing is a qualification failure under the Internal Revenue Code that could result in the Internal Revenue Service “disqualifying” the plan (i.e., removing the plan’s tax-favored status and taxing all monies contributed to the plan). Accordingly, if a Section 410(b) coverage testing failure occurs, the employer will need to explore how to correct it. The by-the-book approach to correcting such a failure is to make a contribution to other NHCEs so that more NHCEs benefit under the plan that is failing. However, in our example above, all NHCEs of Employer B already are benefiting under Plan B, so NHCEs of Employer A would receive a corrective contribution *under Plan B* to increase the percentage of NHCEs benefiting under Plan B. When a Section 410(b) coverage testing failure continues for multiple years, the cost of corrective contributions can be substantial. There are other potential options to correct a Section 410(b) coverage testing failure that—depending on the costs and number of years involved—may be more appropriate for a specific plan and/or employer.

Although Section 410(b) coverage issues (in addition to a host of other benefits-related items) are relevant during corporate transactions, Section 410(b) does include a transition rule that allows plans to be tested separately for coverage testing purposes (i.e., as if the employers remained separate) until the end of the first year following the year of the transaction. (For example, in a transaction that closed in March 2018, the employers could utilize the Section 410(b) transition rule through December 31, 2019.) We note, however, that although most plans may use this transition rule, there are circumstances when the transition period will not be available.

If a transaction occurred recently or is about to occur, there is still time to consider how the buyer wishes to handle the seller’s benefit plans and to develop a strategy for integrating the plans as

appropriate. If a transaction closed several years ago and another 401(k) plan was acquired, the buyer should confirm whether a Section 410(b) coverage analysis was performed in conjunction with the transaction.

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