The "Successor Plan" Rules Explained

401(k) plans can only permit distributions of elective contributions on certain "distributable events" including severance from employment, death, disability, hardship and attainment of age 59 ½. Another event entitling a distribution of elective contributions is plan termination. That's where the "successor plan" rule (now known as the "alternative defined contribution plan" rule) comes in.

Upon plan termination, no distribution can be made if the employer establishes or maintains an "alternative defined contribution plan."

What is an "alternative defined contribution plan"?

An "alternative defined contribution plan" (sometimes referred to as a "successor plan" based on the prior guidance) is a plan established or maintained by the employer:

- That exists at any time during the period beginning on the date of plan termination through
- The date that is 12 months after distribution of all assets from the terminated plan.

As an example: An employer terminates its 401(k) plan on September 15, 2011 and distributes all elective deferrals by January 25, 2012. A new 401(k) plan may not be established until 12 months after the distribution of all elective deferrals. So, a new 401(k) plan cannot be established before January 25, 2013.

When does this come up as an issue?

Often we see this topic arise as an issue in the context of corporate acquisitions, and usually in relation to a stock acquisition. There are circumstances when the Buyer assumes sponsorship of the Seller's retirement plan. If the Seller's retirement plan is not terminated prior to the closing date for the acquisition, then the Buyer now has a new 401(k) plan on its hands. If the Buyer already maintains a 401(k) plan, or intends to create a new one, then its hands are tied due to this "alternative defined contribution plan" rule and would be unable to terminate the Seller's 401(k) plan and distribute the elective contributions from it.

This is why – especially in the context of corporate acquisition – for a Buyer to understand the importance of requiring the termination of the Seller's 401(k) plan prior to or coincident with the purchase date.

Are there exceptions that would permit an employer to create another 401(k) plan after the existing 401(k) plan's termination?

Yes. The employer can establish or maintain a new 401(k) plan if:

- At all times during the 12 months before the plan termination date and the 12 months after the 401(k) plan termination date (so for a full 24-month period)
- Fewer than 2 percent of the employees who were eligible under the 401(k) plan as of the plan termination date are eligible under the new 401(k) plan.

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Are there any types of plans that are not considered alternative defined contribution plans?

Yes, the following plans could be established by the employer without triggering this issue:

- 403(b) tax-sheltered annuity plan
- 457(b) or 457(f) deferred comp plan
- Simplified employee pension (SEP)
- SIMPLE IRA
- Employee stock ownership plan (ESOP)
- Tax credit ESOP

Are there other circumstances that would not trigger the adverse consequences of this rule?

Yes. For example:

- **Rollovers:** The acceptance of rollovers from a former employer's plan does not constitute the acceptance of an "alternative defined contribution plan."

- **Corporate acquisitions where Seller retains plan:** If the Seller's 401(k) plan is not terminated and continues to be maintained, then the employees who are employed by the Buyer are deemed to have severed employment with the Seller and may receive distributions and roll them over into the Buyer's 401(k) plan.

- **Termination of a profit sharing plan only.** This rule only impacts plans with elective contributions. The termination of a profit sharing plan – with no deferrals – would not trigger this rule.

What happens if the "alternative defined contribution plan" rule is violated?

Where one 401(k) is terminated and another is established or maintained, then both the original 401(k) and the new alternative plan will lose their tax-favored status.

Why does this "alternative defined contribution plan" rule exist?

Because the Internal Revenue Code creates specific "distributable events," Congress wanted to ensure that an employer couldn't abuse the "plan termination" event by terminating its 401(k) plan, allowing participants to take distributions, then creating a new 401(k) plan.

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