What is a Successor Plan & Does it Prevent Me from Starting a New 401(k) Plan?

Facts

My company used to sponsor a 401(k) plan for my employees. Due to an unforeseen financial hardship, we terminated the plan two years ago. Now that we are back on solid footing, I would like to start up another 401(k) plan. I checked with the TPA we were working with, and they said something about a possible successor plan issue. I'm not really sure what that means.

Question

What is a successor plan and what is the issue? I am just trying to find out if I can start a new plan. Am I allowed to do that?

Answer

The short answer is yes! You are allowed to establish another plan. The longer answer is, well, a little bit longer.

A little bit of background can be helpful in understanding all this. As you might recall from your previous plan, there are restrictions on when a participant can take money out of a 401(k) plan. Those distributions are generally limited to a participant terminating employment, a participant reaching age 59 ½, and the company terminating the plan altogether.

Congress was concerned that a company might decide to terminate its 401(k) plan as a way to get around those distribution restrictions, so it created the so-called successor plan rule. We won't bore you with all the gory details, but the gist of that rule is that when a company terminates its 401(k) plan, no distributions can be paid if the same company (or a related company) sets up a new plan covering the same general group of participants within 12 months of the date the prior plan was terminated. Even though that is not what you were trying to do, you (and all other companies that sponsor 401(k) plans) are still subject to the rule.

While that seems pretty cut and dried, there are a couple nuances to remember. Since it is not unusual for distributions to drag out for months following the start of the termination process, it is critical to properly identify the date that the successor plan rule's 12-month clock starts ticking. For this purpose, the plan is not considered terminated until the last dollar has been distributed.

Consider this example. End of the Road, Inc. signs a resolution to terminate its 401(k) plan on July 1, 2018. All but two of the participants withdraw their money from the plan within 60 days, but those last two do not take their distributions until April 30, 2019. In that scenario, the earliest date End of the Road can start a new plan is May 1, 2020 (a year after the last distribution was paid).

We should note that the successor plan rule is not absolute in that there are certain types of plans you can setup more quickly without violating the rule. These include ESOPs, SEPs and SIMPLE IRAs, 403(b) plans, and defined benefit plans.

Pulling all of this together: as long as the last distribution was paid out of your previous 401(k) plan more than a year ago, you are in the clear to setup a new 401(k) plan whenever you are ready. If it’s been less than a year, you will need to wait a bit longer.

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