What Is the Successor Plan Rule?

The successor plan rule prohibits an employer from terminating a 401(k) plan, distributing the plan assets to participants, and, then, starting a new plan within 12 months after the original plan is terminated. However, as with every rule, there are some exceptions.

The Rule's Purpose

Because 401(k) plans are for retirement savings, in-service distributions of elective deferrals generally cannot be made before a participant reaches age 59½. The successor plan rule was created to stop employers from circumventing this restriction by terminating a plan and turning around and starting a new one. In most instances, if an employer does so, both the original plan and the successor plan lose their tax-exempt status and the plan sponsor — and possibly, the participants — becomes liable for substantial tax penalties.

Exceptions

Tax regulations provide two exceptions to the successor plan rule. First, an employer can terminate a 401(k) plan and replace it with an employee stock ownership plan, a defined benefit plan, or a simplified employee pension plan (SEP). Proposed 401(k) regulations would add SIMPLE IRAs, 403(b) tax-sheltered annuities, and governmental 457 plans to the list of acceptable replacement plans. The earliest this change would take place is January 1, 2006 (for calendar-year plans).

Second, if during the 24-month period beginning 12 months before the termination, fewer than 2% of the eligible employees in the terminating 401(k) plan were eligible to participate in the replacement plan, the replacement plan is not considered a successor plan. Eligible employees are those who were benefiting under the original plan on the termination date.

Another exception exists for the termination of a retirement plan that does not have elective deferrals. For example, an employer that terminates a profit sharing plan and distributes the plan assets to participants could create a 401(k) plan within 12 months of the termination without violating the successor plan rules.

Sales and Acquisitions

No successor plan issues arise if a 401(k) is terminated before the sale of the assets of the business or the entity becomes part of the buyer’s controlled group (because of the acquisition of its stock). However, if the plan is terminated after the acquisition is completed, then the employer that maintains or creates another plan would be subject to the rules. Some exceptions apply.

The successor plan rules are complicated. Please talk with us if you are contemplating a plan termination.
Are Automatic Plan Features the Answer?

Employers are always looking for ways to increase participation in their 401(k) plans. Adding plan features that automatically make retirement decisions for employees — such as automatic enrollment — is one approach increasing numbers of plan sponsors are trying. Recent IRS guidance on the automatic enrollment rules may enhance sponsors’ — and employees’ — success.

The Path of Least Resistance

One much-cited study shows that employees tend to settle for the path of least resistance when it comes to retirement planning.1 For example, few employees who are automatically enrolled in a plan opt out of that enrollment. Other research from Boston College’s Center for Retirement Research finds that many employees are not availing themselves of the opportunities offered by their employers’ plans.2 For example, according to the Boston College research:

- One out of four eligible employees never joins his or her employer’s retirement plan.
- Nearly half of plan participants don’t contribute enough to receive the full employer matching contribution.
- Less than 10% of participants contribute the maximum amount allowed under their plans.

These studies suggest that automatic plan features could help sponsors increase plan participation and employees save enough for retirement.

Enrollment

With automatic enrollment — or negative election — preset elective employee deferrals to a 401(k) or 403(b) plan begin as soon as an employee becomes eligible to participate in his or her employer’s plan, unless the employee elects to receive cash or have another amount contributed. The set percentage of the employee’s compensation is withheld automatically and deposited in the employee’s plan account.

For example, Company’s 401(k) plan provides for an automatic enrollment contribution of 3% of eligible compensation. Jessica begins working for Company and is immediately eligible to participate in the plan. She does not elect to receive cash in place of making a plan contribution. Nor does she choose to contribute a different amount to her plan account. Thus, Company automatically withholds 3% of Jessica’s compensation from her paycheck and contributes it to her plan account.

Automatic enrollment is not limited to new employees. An employer that adds this feature to its plan can, then, automatically enroll all eligible employees, provided the employees are given the chance to decline participation.

Requirements

To implement automatic enrollment, a plan sponsor must:

- Determine whether his Adoption Agreement or Plan Document needs to be amended. Please contact us if you would like to discuss this.
- Provide each eligible employee with an opportunity to elect not to participate in the plan.
- Notify the employee of the automatic enrollment arrangement and of his or her right to choose not to make salary deferral contributions as soon as the employee becomes eligible to participate in the plan.
- Allow the employee sufficient time after receiving notice to elect not to participate, and
- Give the employee the option of changing the election in the future.

Deferral percentages

While previous IRS revenue rulings set out deferral limits of 2%, 3%, and 4% of compensation, a recent general information letter from the IRS said that there is “no special maximum limit” — and no safe harbor — on a salary deferral plan’s automatic compensation reduction percentage.3 The Boston College researchers suggest setting the contribution percentage so that participants receive the full company match. An employer can set it higher, though. The IRS information letter specifically said that the compensation reduction percentage does not have to be limited to the employer’s matching percentage.

The letter also stated that an employer can increase the automatic compensation reduction percentage over time, as long as the increases are made in accordance with a specific schedule. The required employee notice must describe the amount of, and schedule for, any planned changes to the automatic compensation reduction percentage.

The letter further said that an employer can provide for percentage increases to be applied to future raises and bonuses. Such increases could apply only if the required notices described how the automatic compensation reduction election would apply to raises or bonuses.

An Added Benefit

Studies show that automatic enrollment increases plan participation. The Boston College research cites one instance where adding automatic enrollment increased participation from 49% to 86% of eligible employees. For employees earning less than $20,000, participation increased from 20% to 80%.

In addition to helping plans satisfy the nondiscrimination requirements, increased plan participation generated by automatic enrollment may allow higher paid employees to make larger contributions to their accounts. A higher actual deferral percentage for nonhighly compensated employees raises the percentage limits for highly compensated employees.

1Defined Contribution Pensions: Plan Rules, Participant Choices, and the Path of Least Resistance, James J. Choi and David Laibson, Department of Economics, Harvard University; Brigette C. Madrian, Graduate School of Business, University of Chicago; and Andrew Metrick, Wharton School of Business, University of Pennsylvania.


Many employers use their 401(k) plans to attract and retain qualified employees. However, these plans are failing to engage the interest of employees just entering the labor market — the “Millennials.” For 401(k) plans to remain a useful employment tool in the future, employers need to consider how younger employees’ values and beliefs differ from those of their Baby Boomer elders and, possibly, rethink how their plans are designed and presented.

Live for Today

Some of the differences are common generational differences. For example, in the third annual Workplace Report on Retirement Planning* more than half of the Millennials surveyed said their top financial concern is meeting everyday expenses or saving for a new house and car. When asked to describe their retirement planning state of mind, nearly half (49%) of the Millennials surveyed chose the response, “I’m living for today.”

Baby Boomers, in contrast, cited saving for retirement as their top financial concern, followed by paying for their children’s college education, and paying everyday expenses. They were far more likely than Millennials to say they are “eager beavers” in their approach to retirement planning (35% versus 21%).

These differences aren’t surprising, considering that Millennials are just beginning the accumulation phase of their adulthood, while Baby Boomers are ostensibly winding down theirs. And many employers’ employee education programs address this Millennial characteristic by stressing the advantages of tax deferral and employer matching contributions to show younger employees how they can afford to participate in their employer-sponsored retirement plan.

Don’t Worry About Tomorrow

But, unlike their co-workers, these youngest employees don’t seem to be concerned about whether they can afford to save for retirement or save enough for retirement. Rather, the report seems to indicate that, as a group, they simply don’t see a need or purpose for saving, or may see saving as futile. Part of this could be due to differences cited in the report that are more fundamental to the times in which the different groups grew up.

For instance, more than 44% of Millennials said their view of saving has been negatively affected by political instability in the world and ongoing reports of corporate malfeasance. Only about a quarter of the Baby Boomers held this view.

These differences appear to foster a rather unfavorable view of 401(k) plans in younger workers. Millennials were nearly 20% more likely than Baby Boomers to say 401(k) plans are “the benefit of yesterday.” Their participation rates reflect this view. According to the report, a third of Millennials who are eligible to participate in their employers’ plans do not — versus just 16% of Baby Boomers.

Of equal or greater concern to many employers, 67% of Millennials reported that their employer’s 401(k) plan has little or no effect on whether they would stay with their current employer or accept another job (see graph).

May Others Plan Their Future

What can employers do to make their 401(k) plans more effective as a recruitment and retention tool for younger employees? The report points to several ways to make 401(k) plans more relevant to Millennials:

- Tailor education and communication programs to specific life stages,
- Keep educational materials simple and focused on one topic,
- Target educational materials and communications to one specific result, such as increasing participation or increasing deferrals,
- Measure results to see if the plan is meeting employee needs, and
- Try new and different messages about why saving for retirement is important and “outside the box” methods for delivering those messages.

Employers also may want to consider adding automatic enrollment and offering lifestyle funds to appeal to Millennials’ higher respect for authority, their preference for clear rules and guidelines, and their aversion to risk.
Choosing Default Investments for Your Plan

**SITUATION:** The default investment for Employer’s tax-qualified retirement savings plan is a money market fund. Employer chose the fund several years ago because of its low risk. Now, a member of the plan’s investment committee is wondering whether a balanced fund might be a better choice.

**QUESTION:** Does it make sense for a retirement savings plan to have a highly conservative default investment?

**ANSWER:** Employer should look at this issue closely. Employer has a fiduciary responsibility to invest prudently on behalf of employees who have not given investment instructions. Employer shouldn’t select a “safe” default investment without carefully analyzing other options.

**DISCUSSION:** Plans that give employees the opportunity to direct their investments typically have a default investment. The plan invests contributions in the default when employees haven’t made their own investment selections.

Many employers simply assume that a highly conservative default investment is appropriate. After all, a more risky default investment could leave the employer exposed if the investment experiences losses and employees whose accounts are invested in the default option complain.

On the other hand, the long-term returns from money market funds, stable value funds, and other similarly conservative choices are likely to be relatively low. Employees whose accounts are invested in a plan’s conservative default investment for many years could end up feeling shortchanged if riskier plan investments substantially outperform the default.

Both arguments have merit. Practically speaking, then, what should an employer do? No matter which path an employer takes, one point is clear: There needs to be a selection process and it needs to be well documented. It’s a mistake to choose a default option with little review and rarely, if ever, look at it again.

As employers work through the selection process, they should keep in mind that “prudent” investing isn’t necessarily “safe” investing. A plan fiduciary is allowed to take investment risks as long as those risks are in keeping with the plan’s objectives. Questions to ask:

- Should a plan have different default investments for young, mid-career, and older employees?
- Should a plan ever have a fund that invests in stocks as its default?
- How often should an employer review the plan’s default investment?
- What review criteria should an employer use?

These are just some of the questions we can help employers answer. If you would like to discuss your plan’s default investment, please let us know.

Recent Developments In Benefit Plans

- **Fiduciary Education.** Employers that sponsor retirement plans can learn more about their fiduciary obligations at www.dol.gov/ebsa. The site, sponsored by the U.S. Department of Labor (DOL), includes educational materials on topics such as selecting a plan auditor. The DOL is also holding seminars across the country as part of its campaign to educate plan fiduciaries about their responsibilities.

- **Prohibited Transaction.** In a recent case, the Tax Court held that Z, president and sole shareholder of a corporation that sponsored a profit sharing plan (of which Z was sole trustee), had to pay excise taxes on loans made by the plan to Z and a company owned by Z because they were prohibited transactions. The loans were not made in the best interests of the plan and its participants (Ralph Zacky, TC Memo. 2004-130).

- **Unclaimed Benefits.** The Pension Benefit Guaranty Corporation (PBGC) reports that it is holding $75 million in unclaimed pension benefits for 26,000 individuals. The benefits are from terminated defined benefit plans and range from $1 up to $264,548. The average benefit is approximately $3,675. Individuals can use the PBGC’s Pension Search Directory (www.pbgc.gov/search) to track down lost pensions.

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