The Asset Management Industry
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IRS ISSUES FINAL REGULATIONS ON "CATCH-UP" CONTRIBUTIONS TO DEFINED CONTRIBUTION PLANS

[16290] July 11, 2003 TO: PENSION MEMBERS No. 32-03 PENSION OPERATIONS ADVISORY COMMITTEE No. 41-03 RE: IRS ISSUES FINAL REGULATIONS ON “CATCH-UP” CONTRIBUTIONS TO DEFINED CONTRIBUTION PLANS The Internal Revenue Service has issued final regulations on “catch-up” contributions that may be made to retirement plans by individuals age 50 or over. These regulations implement the catch-up provisions of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), codified in Code section 414(v).1 While the final regulations generally retain the structure set forth in the proposed regulations issued in October 2001,2 they contain a number of clarifications, including several suggested by the Institute, as well as the statutory changes enacted as part of the Job Creation and Worker Assistance Act of 2002 (JCWAA).3 In General. As in the proposed regulations, the final regulations provide that catch-up contributions are elective deferrals made by a catch-up eligible participant that exceed an otherwise applicable limit — a statutory limit, an employer-provided limit or an actual deferral percentage (ADP) limit — and that are treated as catch-up contributions under the plan, subject to the maximum amount of catch-up contributions allowed for the taxable year. Applicable employer plans include section 401(k) plans, SIMPLE IRAs, simplified employee pensions (SEPs), 403(b) plans or contracts, and governmental section 457 plans. A participant is catch-up eligible if the participant is otherwise eligible to make elective deferrals under the plan and would attain age 50 or older before the end of the participant’s taxable year.4 To the extent that elective deferrals are considered catch-up contributions, they are not subject to otherwise 1 See Institute Memorandum to Pension Members No. 21-01 and Pension Operations Advisory Committee No. 35-01 (13566), dated May 31, 2001. 2 See Institute Memorandum to Pension Members No. 32-01 and Pension Operations Advisory Committee No. 67-01 (14079), dated October 23, 2001. 3 See Institute Memorandum to Tax Members No. 12-02, Accounting/Treasurers Committee 11-02, Transfer Agent Advisory Committee No. 22-02, Pension Members No. 10-02 and Pension Operations Advisory Committee No. 16-02 (14553), dated March 19, 2002. 4 In the case of a non-calendar year plan, a participant is eligible to make catch-up contributions beginning on January 1 of the calendar year that includes the participant’s 50th birthday, without regard to the plan year. 2 applicable limitations on elective deferrals and are excluded from consideration under certain nondiscrimination tests.5 Clarification of Employer-provided Limit. As suggested by the Institute,6 the final regulations clarify the requirement set forth in the proposed regulations that an employer- provided limit be “contained in the terms of the plan.” Specifically, the preamble to the final regulations provides that if a limit is otherwise permissible under a section 401(k) plan, that limit will also satisfy the requirement under the catch-up

contribution rules that such a limit be contained in the terms of the plan. Universal Availability. Consistent with the Institute's comments, the final regulations provide that employee groups under section 410(b)(3), including collectively bargained employees, may be disregarded for purposes of determining whether a plan complies with the "universal availability" requirement. The final regulations, however, do not allow plans to disregard participants in different qualified separate lines of business or participants who have not met minimum age and service requirements. The preamble notes that such exclusions would be based on plan design and testing choices.7 Additionally, under the final regulations, a plan does not fail the universal availability requirement because it restricts elective deferrals (including catch-up contributions) under a "cash availability limit"— a limit that restricts elective deferrals to amounts available after withholding from the employee's pay (e.g., after deduction of all applicable income and employment taxes). For purposes of this rule, a limit of 75 percent of compensation or higher will be treated as limiting employees to amounts available after other withholdings. The final regulations also contain an exception to the universal availability requirement for transition periods under section 410(b)(6)(C) (relating to certain acquisitions or dispositions by members of a controlled group), in a manner consistent with JCWAA. Determination of Catch-up Contributions. The final regulations retain the general rule that catch-up contributions are determined as of the end of a plan year, rather than adopting the "payroll-by-payroll" method suggested as an optional approach by the Institute.8 To address administrative concerns raised by the Institute and other commentators, however, the regulations expand the "alternative method" for determining an employer-provided limit. 5 Catch-up contributions are not taken into account in applying the limits of Code sections 401(a)(30), 402(h), 403(b), 408, 415(c) or 457(b)(2) to other contributions or benefits under the plan offering catch-up contributions or under any other plan of the employer. Furthermore, for purposes of ADP testing, elective deferrals treated as catch-up contributions under 401(k) plans because they exceed a statutory or employer-provided limit are subtracted from participants' elective deferrals for the plan year. 6 See Institute Memorandum to Pension Committee No. 4-02 and Pension Operations Advisory Committee No. 7-02 (14417), dated January 31, 2002. 7 See Institute Memorandum to Pension Members No. 40-01 and Pension Operations Advisory Committee No. 78-01 (14276), dated December 21, 2001 (IRS Notice 2002-4 providing transition relief under the universal availability requirement). 8 The preamble provides that Treasury and the IRS determined that the need for rules to prevent abuse associated with a payroll-by-payroll method of determining catch-up contributions outweighs the relative administrative advantages of that method. 3 Specifically, a plan that determines the amount that is in excess of an employer-provided limit under the alternative method9 may provide that the applicable limit for the plan year is determined as the product of the catch-up eligible participant's compensation used for purposes of the ADP test and the time-weighted average of the deferral percentage limits. (This alternative calculation is available regardless of whether the deferral percentage limits change during the plan year.) The preamble explains that the purpose of this modification is to enable plans that use two different definitions of compensation for elective deferrals and ADP testing to avoid having to collect and retain two separate sets of data to determine the catch-up status of contributions. Matching Contributions. In response to comments that some employers may not want to provide matching contributions on catch-up contributions, the preamble to the final regulations provides that employers can achieve this goal by specifying which contributions will be matched, rather than which contributions will not be matched. For instance, if an employer-provided limit on elective deferrals is 10 percent of compensation for each payroll period, the plan can specify that matching contributions will be made based on elective deferrals that do not exceed 10 percent of compensation for that payroll period (not exceeding a statutory limit), and that matching contributions on

elective deferrals in excess of the ADP limit will be forfeited. Participants in Multiple Plans. The final regulations provide guidance on the coordination of employer-provided limits and ADP limits on a controlled-group basis, in light of JCWAA's technical corrections providing that all applicable employer plans of an employer are treated as one plan for purposes of determining the amount of catch-up contributions. Specifically, the regulations allow a plan to permit an eligible participant to defer an amount in addition to the amount allowed under the employer-provided limit, without regard to whether the employee has already utilized his or her catch-up opportunity under another plan of the same employer. To the extent that elective deferrals under another plan maintained by the employer have already been treated as catch-up contributions during the taxable year, the elective deferrals under the plan may be treated as catch-up contributions only up to the amount remaining under the catch-up limit for that year. Any other elective deferrals that exceed the employer-provided limit may not be treated as catch-up contributions and must satisfy the otherwise applicable nondiscrimination rules (including the "benefits, rights and features" test of section 1.401(a)(4)-4 of the Treasury regulations). Additionally, contributions in excess of the employer-provided limit are taken into account under the ADP test to the extent they are not catch-up contributions. 9 Under both the proposed and final regulations, the alternative method provides that if the plan limits elective deferrals for separate portions of the plan year (e.g., on a payroll-by-payroll basis), then, solely for purposes of determining the amount that is in excess of an employer-provided limit, the plan is permitted to provide that the applicable limit for the plan year is the product of the employee's plan year compensation and the time-weighted average of the deferral percentage limits, rather than determining the employer-provided limit as the sum of the limits for the separate portions of the year. For example, where highly compensated employees are limited to 8 percent of compensation during the first half of the plan year and 10 percent of compensation for the second half, the plan is permitted to provide that the applicable limit for such an employee is 9 percent of the employee's plan year compensation. 4 The final regulations also retain the allocation rules in the proposed regulations. Thus, where a participant is eligible under more than one applicable employer plan maintained by the same employer, the specific plan under which amounts in excess of an applicable limit are treated as catch-up contributions is permitted to be determined in any manner that is not inconsistent with the manner in which the amounts were actually deferred under the plans. Excludability of Catch-up Contributions. The final regulations contain new section 1.402(g)-2, which reflects JCWAA's amendment to Code section 402(g) that increased the elective deferral limit for a catch-up eligible participant by the amount of allowable catch-up contributions for the taxable year. The preamble explains that this rule is not affected by whether a plan treats a participant's elective deferrals as catch-up contributions. Accordingly, a catch-up eligible participant who participates in plans of two or more employers is permitted to exclude from income elective deferrals that exceed the section 402(g) limit, even though neither plan treats those deferrals as catch-up contributions. Furthermore, a participant's treatment of elective deferrals as catch-up contributions does not affect either employer's plan. Applicability Date. The final regulations apply to contributions in taxable years beginning on or after January 1, 2004. Thomas T. Kim Associate Counsel Note: Not all recipients receive the attachment. To obtain a copy of the attachment, please visit our members website (http://members.ici.org) and search for memo 16290, or call the ICI Library at (202) 326-8304 and request the attachment for memo 16290. Attachment (in .pdf format)