COMMENT LETTER

January 31, 2002

Comment Letter on Proposed Regulation of Catch-Up Provisions, January 2002

By Hand Delivery

January 31, 2002

CC:IT&A:RU (REG-142499-01)

Courier's Desk
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, D.C. 20224

Re: Proposed Regulations under Code section 414(v)

Ladies and Gentlemen:

The Investment Company Institute[1] commends the Treasury Department and the Internal Revenue Service for the expeditious issuance of helpful guidance—the proposed regulations issued under Code section 414(v) (Proposed Regulations)[2] and Notice 2002-4[3]—that implements the catch-up provisions of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA). The catch-up provisions will enhance the retirement security of many Americans by enabling them to save additional amounts for retirement.

While we generally support the Proposed Regulations, this letter urges several modifications that we believe would mitigate unnecessary administrative burdens that could diminish opportunities to make catch-up contributions. By exercising your regulatory authority and providing plans with operational flexibility in implementing the catch-up provisions of EGTRRA, Treasury and the IRS will further improve the retirement security of America's workers. Additional flexibility is particularly important to avoid undercutting the simplification in plan testing and in corresponding recordkeeping requirements that has been achieved in recent years through both legislative and regulatory action.

One of the Institute's principal concerns arises from the requirement in the Proposed Regulations that catch-up contributions be determined only at year-end. We believe that this will give rise to new administrative burdens at a time when employers and recordkeepers are already engaged in other compliance activities. As you are aware, nondiscrimination testing at the end of each plan year is a complicated process. Even for the most sophisticated plan sponsors, nondiscrimination testing involves various steps and coordination among different parties, including the employer, recordkeeper and payroll administrator.

The steps involved in the nondiscrimination testing process include identifying highly compensated and non-highly compensated employees, organizing their contribution data, applying the nondiscrimination tests, calculating any excess contributions and allocable income, and, if necessary, making corrective distributions. End-of-the-year activities also include reconciling account balances and checking for compliance with section 415 and other Code limits. Requiring that plans determine catch-up contributions only at year-end adds another test that must be completed in a relatively short time frame. Moreover, a plan with a catch-up contribution feature will need to calculate catch-up contributions in excess of Code and plan limits before the nondiscrimination tests can even be run. The Institute’s first recommendation set forth below would address this concern by allowing plans at their option to determine catch-up contributions on a contemporaneous basis that is more consistent with their recordkeeping methods.

Our recommendations are as follows: First, plans that impose limits on a payroll-period basis should have the option of using an irrevocable payroll approach to determine catch-up contributions. Second, given the complications that catch-up contributions will create for nondiscrimination testing, transition relief should be provided for the 2002 plan year from the excise tax under Code section 4979. Third, clarification should be provided that employer-imposed deferral limits do not violate the tax-qualification rules. Fourth, the rules governing matching contributions to SIMPLE plans should be clarified. Finally, the “universal availability” rule under the Proposed Regulations should be modified to incorporate existing disaggregation rules. We believe that these recommendations are consistent with applicable statutory requirements under Code section 414(v) and would provide administrable rules that will encourage plans to offer catch-up contributions.

I. Payroll-Period Determination of Catch-Up Contributions

Under the Proposed Regulations, the determination of whether a contribution is a catch-up contribution would be made at the end of the plan year.[4] We recognize that this year-end approach may be appropriate for many plans. For plans that impose limits on a payroll-period basis, however, this approach is generally not consistent with the way their recordkeeping systems typically operate and would significantly increase the year-end administrative burdens for these plans. Accordingly, we recommend that plans with payroll period limits also have the option of determining catch-up contributions on an irrevocable payroll basis. Plans that wish to use the year-end approach set forth in the Proposed Regulations should be permitted to do so.

At the outset, we note that the payroll-period approach already has been approved by the IRS in a comparable area. Notice 2000-3 permits matching contributions to be made to safe harbor 401(k) plans on a payroll-by-payroll basis. This payroll option, which had not been permitted when guidance on the safe harbor plan rules was initially issued in Notice 98-52, was added in response to comments that a year-end requirement was inconsistent with the way many plans operate and might require year-end true-ups by employers who make matching contributions on a payroll basis.

Consistency with Statute. While we agree that a catch-up contribution must be a contribution that is in addition to deferrals otherwise allowed under the plan, we do not believe that the year-end approach taken in the Proposed Regulations is required by statute. The definition of “eligible participant” in Code section 414(v)(5) suggests that an applicable limit for purposes of determining catch-up contributions must be a limit “for the plan year.” A payroll limit is essentially a limit for the plan year that applies on a periodic basis, i.e., an employee who fails to defer the maximum percentage or amount of compensation in any payroll period cannot make up for it by deferring more than that limit in a subsequent period. Payroll limits therefore may be viewed as “comparable limitations or restrictions contained in the terms of the plan” for purposes of section 414(v)(5). As a result, plans should be allowed to irrevocably designate contributions in excess of such limits as catch-up contributions as they are made, rather than be required to wait to make a year-end determination based on aggregated numbers.

Consistency with Current Recordkeeping Methods. An irrevocable payroll approach is consistent not only with the provisions of Code section 414(v), but also with the way the recordkeeping systems for plans with payroll-period limits typically operate. The Institute understands that many plans currently enforce plan limits on a payroll basis, not on an annual basis. Plans have been moving closer to “real time” administration, with contributions characterized for recordkeeping purposes as they are made to the plan. For example, separate “buckets” may be maintained for elective deferrals (which might be divided between matched and unmatched deferrals), matching contributions, and profit-sharing contributions. These buckets are used to track contributions with different match eligibility, vesting schedules, distribution restrictions, and other distinct features. Furthermore, the availability of this information to participants during the course of the year enhances their ability to plan their retirement savings strategy accordingly.

In the context of catch-up contributions, real time administration would mean that catch-up contributions could be separately tracked as they are made to the plan, rather than being grouped with other elective deferrals. This goal can be achieved only if the plan has the option of determining catch-up contributions that exceed a payroll limit on an irrevocable payroll basis. By contrast, under the year-end approach in the Proposed Regulations, catch-up contributions could not be determined as they are made to the plan. Such contributions could, at best, be designated as catch-up contributions on a preliminary basis, subject to possible recharacterization at the end of the year. While we recognize that recharacterization is not a difficult concept, as a practical matter, this additional requirement would add significant administrative steps and costs.

Additional Administrative Burdens Under Year-end Approach. As discussed above, plans must already undertake various compliance functions at the end of each plan year. By adding new year-end administrative requirements, the year-end approach to determine catch-up contributions would complicate these other activities.

First, the year-end determination of catch-up contributions would add additional steps to the nondiscrimination testing process for many plans. Under the Proposed Regulations, catch-up contributions that exceed an employer-provided limit or statutory limit would be disregarded in calculating an employee’s actual deferral ratio (ADR) for the year used for actual deferral percentage (ADP) testing. This rule would apply for both highly compensated employees (HCEs) and non-highly compensated employees (NHCEs).[5] If catch-up contributions can be calculated and subtracted from employees’ ADRs only at the end of the plan year, the ADP testing process will become more time consuming and costly. The difficulties will be exacerbated for plans that monitor HCE deferrals and adjust plan limits during the year. For those plans, determining catch-up contributions would likely require manual calculations. By contrast, under the irrevocable payroll approach, catch-up contributions could be separately tracked as they are made, thereby simplifying year-end calculations.

Second, the year-end approach would cause particular problems for plans that use the prior-year method of ADP testing (i.e., where deferrals by HCEs for the current plan year are limited by deferrals by NHCEs for the prior year) and perhaps seriously undermine the usefulness of this testing option. The value of the prior-year testing method for employers is that it allows them to prospectively monitor and limit contributions by HCEs in order to avoid ADP test failures and the need to make corrective distributions after the end of the plan year. In order for prior-year testing to be an effective tool, however, an employer must be able to determine as of December 31 of each year, or very shortly thereafter, the ADP for NHCEs for that year, so that the employer can immediately calculate the limit on HCE contributions for the following year and begin applying it in the first payroll period. The year-end approach to determining catch-up contributions, however, would delay the calculation of the NHCEs' ADP (as noted above, by requiring the additional step at year end of calculating catch-up contributions and subtracting them from the employees' ADRs), possibly for more than a month after the end of the year. Thus, the ability of plans to use prior-year testing to prospectively limit HCE deferrals would be impaired. Under the payroll approach, in contrast, this type of delay should not be an issue.

Third, the complexities caused by the year-end approach would be magnified for fiscal year plans. The determination of whether contributions constitute catch-ups will be more difficult for these plans because the different limits that give rise to catch-up contributions will apply to different annual periods. In our view, while the irrevocable payroll approach would not completely eliminate the difficulties for fiscal year plans, it would help to reduce them by allowing catch-up contributions in excess of payroll limits to be determined on a contemporaneous basis.

In sum, the benefits of the payroll-period approach to plans that operate on such a basis are clear. The ability to identify catch-up contributions as they are made to the plan would significantly simplify their administration. The Institute understands that Treasury and the IRS may have concerns about perceived abuses associated with the irrevocable payroll approach, e.g., the ability of employees to front-load catch-up contributions if a payroll limit is reduced for one or more payroll periods at the beginning of the plan year. We note, however, that at the end of a plan year, a highly compensated participant who wishes to maximize his or her deferrals cannot achieve more overall deferral by frontloading catch-up contributions. Nonetheless, we would be pleased to discuss these matters further, and to work with Treasury and the IRS to develop rules that would address your concerns regarding the payroll-period approach.

II. Excise Tax on Delayed Distribution of Excess Contributions

Under Code section 4979, an employer is subject to an excise tax equal to 10 percent of the amount of any excess contributions and excess aggregate contributions that are not distributed within 2½ months after the end of the plan year. Even before the implementation of the catch-up contribution provisions, this 2½-month deadline has been difficult for some plans and recordkeepers to meet given the various steps involved in the nondiscrimination testing process. As discussed above, a catch-up contribution feature will further complicate this process. The 2½-month deadline may be particularly problematic for the 2002 plan year when recordkeepers will be taking catch-up contributions into account for the first time when running these tests.

Plans have every incentive to expedite the calculation and distribution of excess contributions; however, given the new issues that plans offering catch-ups will face at the end of the 2002 plan year, we recommend that Treasury and the IRS provide transition relief by extending the deadline for making corrective distributions beyond the 2½ month period for the 2002 plan year. This could be done by providing, with respect to plans that implement catch-up contribution provisions in the 2002 plan year, a regulatory exclusion from the definitions of excess contributions and excess aggregate contributions for corrective distributions made within the extended period, such as 6 months, after the end of that year.

III. Employer-Provided Limits “Contained in the Terms of the Plan”

The Proposed Regulations define an “employer-provided limit” for purposes of determining catch-up contributions as a limit on elective deferrals that is “contained in the terms of the plan,” but that is not required under the Internal Revenue Code. The preamble to the Proposed Regulations states that the condition that an employer-provided limit be contained in the terms of the plan is intended to correspond with the requirements of Treas. Reg. § 1.401-1 that a qualified plan have a definite written program and provide for a definite predetermined formula for allocating contributions made to the plan.

The language in the preamble appears to suggest that an employer-provided limit established by plan language authorizing plan administrators to discretionarily adjust contribution limits during the plan year might raise qualification issues. We understand that such practices are longstanding and plan language allowing this approach has been approved repeatedly in the IRS determination letter process.

The Institute therefore recommends that the final regulations under Code section 414(v) more clearly recognize that where a plan document expressly gives the plan administrator discretion to set contribution limits for some or all participants, any such limit would be considered to be “contained in the terms of the plan” for purposes of determining catch-up contributions. This point could perhaps be clarified in the preamble to the final regulations or illustrated through an example describing a plan with such a limit.

IV. Matching Contribution Requirement for SIMPLE Plans

Although the Proposed Regulations apply to SIMPLE plans under Code section 408(p), they do not expressly address the interplay between catch-up contributions and matching contributions made to SIMPLEs. The Institute is accordingly requesting guidance on this issue.

In order to satisfy the requirements for SIMPLE plans under Code section 408(p), an employer must make either a 3 percent matching contribution or a 2 percent non-elective contribution to each employee’s account. It is not clear from either Code section 414(v) or the Proposed Regulations whether employers who select the 3 percent matching contribution option will be required to match catch-up contributions for certain highly paid employees.[6] The employees at issue are those whose compensation, when multiplied by 3 percent, exceeds the regular contribution limit under Code section 408(p) (and who make catch-up contributions). The Institute requests guidance as to whether or not employers may or must match catch-up contributions made by these employees.

V. Universal Availability Requirement

While the transition relief provided by Notice 2002-4 will help many plans implement the catch-up contribution provisions in 2002, the universal availability requirement in the Proposed Regulations will continue to present difficulties for many plans, particularly those that are part of a large controlled group. Accordingly, the universal availability requirement in Code section 414(v)(4) should be interpreted to incorporate the mandatory disaggregation rules under current Treasury Regulations.

Code section 414(v)(4) provides that, in order to satisfy Code section 401(a)(4), a plan must allow all eligible participants to make the same election with respect to catch-up contributions. For this purpose, all plans maintained by employers that are treated as a single employer under Code section 414(b), (c), (m), or (o) (i.e., all plans in the controlled group), are treated as one plan. Under the universal availability requirement contained in the Proposed Regulations, a plan that offers catch-up contributions will not satisfy Code section 401(a)(4) unless all other applicable employer plans in the controlled group begin offering catch-up contributions as of the same effective date.

The Institute strongly supports the transition relief provided by Notice 2002-4; however, even with this relief, the universal availability requirement will continue to raise issues for many plans. Plan sponsors in large controlled groups, for example, who anticipate significant practical difficulties in coordinating a catch-up contribution structure, may not be able to take advantage of the relief provided by the Notice. The Institute believes that application of the mandatory disaggregation rules would help address these issues and would be consistent with current statutory and regulatory provisions. The requirement in Code section 414(v)(4) that eligible participants have the same election with respect to catch-up contributions derives, by its terms, from the nondiscrimination rules under Code section 401(a)(4). The regulations under Code section 401(a)(4) define a “plan” as a plan within the meaning of Treas. Reg. § 1.410(b)-7(a) and (b), after application of the mandatory disaggregation rules of Treas. Reg. § 1.410(b)-7(c).[7] These rules provide for the disaggregation of employees in each qualified separate line of business of the employer and of employees covered under collective bargaining agreements.[8] Thus, it follows that the requirement of Code section 414(v)(4) should be applied separately to these disaggregated employee groups, rather than to all controlled group employees.

Nonconforming state tax laws may also raise issues that implicate the universal availability requirement. Many state tax codes do not automatically reflect changes made to the Code, such as the provisions for catch-up contributions under Code section 414(v). For administrative reasons, employers may not want to offer catch-up contributions to individuals who are residents of a state that does not recognize an exclusion for these contributions. (For example, a plan sponsor may want to avoid the need to modify its payroll system to keep track of the different amounts of federal and state taxable income for these employees.) The universal availability requirement as articulated in the Proposed Regulations, however, would bar plans from offering catch-ups to any participants unless all eligible participants in the controlled group have this option. Although this issue principally involves state tax law, Treasury and the IRS should consider providing relief that will allow plans to offer catch-up contributions to employees in those states that conform to federal law.

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The Institute appreciates the ongoing commitment of the Treasury Department and the IRS to issuing guidance that will enhance the ability of Americans to save for retirement. Please do not hesitate to contact Keith Lawson at 202/326-5832 or me at 202/326-5837 if we can be of further assistance.

Sincerely,

Thomas T. Kim
Associate Counsel

cc: William F. Sweetnam, Jr., Department of the Treasury
Elizabeth Drigotas, Department of the Treasury
W. Thomas Reeder, Department of the Treasury
R. Lisa Mojiri-Azad, Internal Revenue Service
John T. Ricotta, Internal Revenue Service

ENDNOTES

1 The Investment Company Institute is the national association of the American investment company industry. Its membership includes 9,040 open-end investment companies ("mutual funds"), 484 closed-end investment companies and 6 sponsors of unit investment trusts. Its mutual fund members have assets of about $6.906 trillion, accounting for approximately 95% of total industry assets, and over 88.6 million individual shareholders.

2 66 Fed. Reg. 53555 (Oct. 23, 2001).

3 Notice 2002-4, 2002-2 I.R.B. 298.

4 Under Prop. Reg. § 1.414(v)-1(b)(2), the amount of elective deferrals in excess of an applicable plan year limit would be determined as of the end of the plan year by comparing total elective deferrals for the year with the limit for the year. In the case of a plan that provides for separate employer-provided limits for separate portions of the plan year (e.g., where the deferral limit is applied on a payroll basis), the limit for the plan year would be the sum of the dollar amounts of the limits for the separate portions. Alternatively, the plan could provide that the 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.

5 Prop. Reg. § 1.414(v)-1(d)(2).

6 This becomes an issue because the compensation limit under Code section 401(a)(17) appears not to be taken into account in determining the 3 percent matching contribution.

7 Treas. Reg. § 1.401(a)(4)-12.

8 Treas. Reg. § 1.410(b)-7(c)(4).