Legal Alert:

IRS Publishes Final Regulations on Catch-Up Contributions

July 14, 2003

In 2001, the Internal Revenue Code of 1986 (the “Code”) was amended to add section 414(v), which permits individuals age 50 or older to make additional elective deferrals each year, up to a specified dollar limit, if certain requirements are met. On October 23, 2001, the Internal Revenue Service published proposed regulations on catch-up contributions. On July 8, 2003, the IRS finalized the regulations, making certain significant changes and other minor clarifications and changes to reflect technical corrections made by the Job Creation and Worker Assistance Act of 2002 (“JCWAA”).

This Legal Alert discusses the final regulations, focusing on the significant changes made to the proposed regulations and certain revisions that commentators requested but the IRS declined to make.

**Determination of Catch-Up Contributions**

Catch-up contributions can be made under 401(k) and eligible governmental 457 plans, 403(b) arrangements, SEPs, and SIMPLEs. The final regulations provide, as did the proposed regulations, that an elective deferral made by a catch-up eligible participant is treated as a catch-up contribution if it exceeds an otherwise applicable limit and does not exceed the maximum dollar amount permitted for catch-up contributions. The applicable limits are statutory limits, employer-provided limits, and the actual deferral percentage (“ADP”) limit.

- The proposed regulations defined an employer-provided limit as one that is contained in the terms of the plan, other than a limit required by the Code. Because many plans provide that the plan administrator can set a limit on elective deferrals, particularly with respect to highly compensated employees’ contributions, a number of commentators requested that the final regulations recognize that a limit set by the plan administrator constitutes an employer-provided limit. The IRS did not change the language of the regulations on this point, but it did note in the preamble to the final regulations that “if a limit is otherwise permissible under a section 401(k) plan, the limit will also satisfy the requirement . . . that the limit be contained in the terms of the plan.” Therefore, it appears that, at least in the case of a plan that has obtained a favorable determination.
letter, a limit on elective deferrals imposed pursuant to a plan provision authorizing the administrator to do so should be considered an employer-provided limit.

The proposed regulations provided that catch-up contributions are determined on an annual basis. Thus, even if the employer-provided limit applies on a payroll-by-payroll basis, the amount of a participant’s catch-up contributions would be determined based on whether the participant’s contributions for the whole year exceed the employer-provided limit for the year. Commentators requested that plans be permitted to determine whether amounts are catch-up contributions on a payroll-by-payroll basis to eliminate the need for the extra, administratively burdensome step of an annual determination. The IRS, citing a risk that ADP testing could be distorted through manipulation of payroll-by-payroll employer-provided limits, declined to change the annual determination in the final regulations.

The IRS simplified one aspect of the annual determination of catch-up contributions in the final regulations. Some plans use a different definition of compensation for ADP testing than they use for determining elective deferrals in each payroll period. Thus, some plan administrators found it burdensome to retain data on compensation used for determining elective deferrals in each payroll period for use in the annual determination of catch-up contributions under an employer-provided limit. Under the final regulations, plans are permitted to apply the definition of compensation that is used for ADP testing for the purpose of the annual determination of catch-up contributions, eliminating the need to retain other compensation data.

In the preamble to the final regulations, the IRS recognized that administration can be complicated for a plan that does not provide matching contributions on catch-up contributions if the plan’s matching contributions are made on a payroll-by-payroll basis rather than annually. The IRS stated that these complications can be overcome by specifying which contributions will be matched, rather than which contributions will not be matched (e.g., only contributions up to 10 percent per payroll period will be matched). For certain plan designs, this may be effective, but in other situations, this approach may not achieve the desired results and may raise questions as to whether the match must be tested for compliance with the benefits, rights, and features nondiscrimination rules and satisfies other provisions of the Code.
Universal Availability

Code section 414(v)(4)(A) provides that a plan that offers catch-up contributions does not comply with the nondiscrimination requirements of section 401(a)(4) unless it allows all catch-up eligible participants to make catch-up elections on the same basis – this is referred to as the “universal availability” requirement. The proposed regulations included certain limited exceptions and a transition rule for collectively bargained employees, but no exclusion for these employees. The final regulations modify these rules.

- Under the final regulations, employees described in Code section 410(b)(3) are disregarded in determining whether a plan complies with the universal availability requirement. Specifically, plans are permitted to exclude from eligibility for catch-up contributions employees who are covered by a collective bargaining agreement under which retirement benefits were the subject of good faith bargaining. In addition, certain nonresident aliens and air travel employees may be excluded. The IRS did not, however, extend the rule to permit exclusion of participants who have not met statutory minimum age and service requirements or participants in different qualified separate lines of businesses, on the theory that these exclusions under Code section 410(b)(4) and (5) are based on plan design and nondiscrimination testing choices and do not apply to all plans.

- The final regulations also include a new exception to the universal availability requirement to reflect employer payroll withholding concerns. The regulations provide that a plan will satisfy the universal availability requirement even if it contains a “cash availability limit” on all elective deferrals, including catch-up contributions. Such a limit restricts deferrals to amounts available from an employee’s pay after withholding, such as withholding for income and employment taxes. As a safe harbor, the regulations provide that a limit of 75 percent of compensation or higher is treated as a permissible cash availability limit.

- The proposed regulations provided that a plan would not fail to satisfy the universal availability requirement solely because of a corporate disposition or acquisition, subject to the condition that the employer’s plans permit all catch-up eligible participants to make catch-up contributions as soon as practicable after the corporate transaction, but no later than the end of the transition period for nondiscrimination testing determined under Code section 410(b)(6)(C) (i.e., the end of the first plan year following the plan year in which the transaction occurs). In accordance with a technical correction made by JCWAA, the “as soon as practicable” requirement has been eliminated.
Section 402(g) Changes

JCWAA made a technical correction to Code section 402(g) to provide that the elective deferral limit is increased by the amount of permitted catch-up contributions for the taxable year. In connection with the final catch-up contribution regulations, the IRS has issued proposed Treas. Reg. § 1.402(g)-2 to reflect the JCWAA technical regulation. The proposed regulation provides that the increased elective deferral limit applies without regard to whether the applicable employer plan treat the contributions as catch-up contributions. Thus, for example, a catch-up eligible participant who participates in more than one employer’s plan in a year could exclude elective deferrals from gross income up to the increased Code section 402(g) limit, even though neither employer’s plan permits catch-up contributions.

Effective Date

The final regulations apply to catch-up contributions in tax years beginning on or after January 1, 2004. Taxpayers may, however, rely on the final regulations or the proposed regulations for tax years before January 1, 2004.

Should you have questions concerning the final regulations or any issues affecting employee benefits generally, please contact any of the following members of our Employee Benefits and Executive Compensation practice.

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