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IRS Issues Final Regulations on Catch-Up Contributions and Proposed Regulations on Optional Forms of Distribution in Defined Contribution Plans

Catch-Up Contributions

The Internal Revenue Service has issued final regulations concerning catch-up contributions. Catch-up contributions are additional elective deferrals which may be made by individuals who are age 50 or older to 401(k) plans, 403(b) plans, SIMPLE IRA plans, simplified employee pensions and 457 eligible governmental plans. The final regulations are applicable to contributions in taxable years beginning on or after January 1, 2004. Taxpayers are, however, permitted to rely on the final regulations and proposed regulations now.

Catch-up contributions were created pursuant to the Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA") and are provided for under Section 414(v) of the Internal Revenue Code. Section 414(v) permits an individual who will be age 50 or older before the end of the applicable year to make additional elective deferrals, if certain requirements are satisfied. The maximum amount of catch-up contributions an individual may generally contribute to an applicable plan is $2,000 for 2003, $3,000 for 2004, $4,000 for 2005 and $5,000 for 2006.[1] After 2006, the applicable dollar catch-up limit will be adjusted for cost-of-living increases in $500 increments. These additional elective deferrals are not subject to certain otherwise applicable limitations on elective deferrals and are excluded from consideration for certain nondiscrimination tests.

The final regulations generally adopt the provisions of the proposed regulations issued in 2001, with certain modifications.

Determination of Catch-up Contributions

The final regulations retain the same basic structure for determining catch-up contributions as provided in the proposed regulations. Catch-up contributions are elective deferrals that exceed one of three types of limits: the statutory limit (*e.g.*, under Section 402(g)), an employer-provided limit, or the actual deferral percentage (ADP) limit. The final regulations clarify that an employer-provided limit must be contained in the written plan document providing a definite predetermined formula and may not be determined pursuant to administrative procedures or in a summary plan description.

The final regulations also retain the rule that the amount of elective deferrals in excess of an applicable limit must generally be determined at the end of a plan year and not on a payroll-by-payroll basis. However, to address administrative concerns raised by commentators, the regulations allow for alternative methods of determining an employer-provided limit in order to avoid requiring plans that use different definitions of compensation for elective deferrals and ADP testing to collect and retain data on both definitions.

Matching Contributions

If a plan provides for matching contributions on all elective deferrals, regardless of whether they are catch-up contributions, the match on the catch-up contributions should not be tested separately for nondiscrimination purposes. All matching contributions under the plan, including those attributable

[1] The maximum amount that may be contributed as a catch-up contribution to a SIMPLE 401(k) plan or a SIMPLE IRA plan is one-half of the foregoing amounts.

to catch-up contributions, must however, satisfy the actual contribution percentage (ACP) test.

The final regulations do not address how matching contributions made on a periodic basis should relate to catch-up contributions. In most cases, an employer cannot determine whether an elective deferral is a catch-up contribution until the end of the plan year. Accordingly, if an employer wishes to make matching contributions throughout the plan year, rather than wait until the end of the plan year, the employer may be forced to make matching contributions with respect to catch-up contributions even if this was not the intended plan design. Rather than directly addressing this issue in the final regulations, the IRS has stated that it believes that employers should specify which contributions will be matched instead of which contributions will not be matched. For example, elective deferrals up to a specified percentage of compensation will be matched and matching contributions on elective deferrals in excess of the ADP limit will be forfeited.

Universal Availability

The proposed regulations had provided that if a plan permits catch-up contributions, all other applicable plans maintained by employers in the controlled group must also permit catch-up contributions for all catch-up eligible participants. This is known as the "universal availability requirement." The final regulations clarify that collectively bargained employees are excluded from this universal availability requirement. Therefore, an employer may offer the opportunity to make catch-up contributions to non-union employees and, depending upon collective bargaining, offer such opportunity to union employees.

A plan also will not be deemed to fail the universal availability requirement because an employer-provided limit does not apply to all employees or if different employer-provided limits apply to different groups of employees, as long as the limit otherwise satisfies nondiscrimination testing. Accordingly, a plan may impose a contribution limit with respect to highly compensated employees (and allow for catch-up contributions in excess of that limit) without causing a universal availability failure. In addition, a plan will not fail the universal availability requirement because it subjects elective deferrals (including catch-up contributions) to a cash availability limit which restricts elective deferrals to amounts available after withholding from the employee's pay. For this purpose, a limit of 75% of compensation or higher will be treated as such a cash availability limit.

The final regulations provide for a broader transition rule for corporate mergers and acquisitions than was included in the proposed regulations. A plan that satisfies the universal availability requirement before a merger or acquisition will continue to satisfy that requirement through the end of the plan year following the plan year in which the merger or acquisition occurs. Finally, the final regulations do not affect the previously issued transitional relief[2] that effectively disregards plans qualified under Puerto Rico law from the universal availability requirement.

Participants in Multiple Plans

All plans in a controlled group, other than 457 eligible governmental plans are treated as one plan for purposes of determining the amount of catch-up contributions. The final regulations provide guidance on coordination of catch-up contributions on a controlled group basis in cases where an employee participates in more than one plan. In the cases where an individual participates in plans of employers in different controlled groups and does not exceed the catch-up threshold in any plan, the individual may nonetheless exceed the statutory limit (under Section 402(g)) when combining the elective deferrals made to all plans.

Grandfathering of Optional Forms of Distribution No Longer Required for Defined Contributions Plans

The IRS has recently released proposed regulations that modify the circumstances under which certain forms of distribution previously available are permitted to be eliminated from defined contribution plans (e.g., 401(k) plans). While these regulations are in proposed form and may not yet be relied upon, they are expected to be finalized shortly since they merely reflect changes made under EGTRRA.

Pursuant to EGTRRA, a defined contribution plan may be amended to eliminate or restrict a participant's right to receive payment of accrued benefits under a particular optional form of benefit without violating the Internal Revenue Code's anti-cutback rules. This type of amendment is permitted as long as a distribution in the form of a lump sum remains available to the participant. In conformance with EGTRRA, the proposed regulations remove a current requirement that participants be given 90 days notice before an optional form of distribution can be eliminated. Participants should, however, be notified of the change either through a summary of material modifications or a new summary plan description.

The removal of the 90 day notice requirement will allow plan sponsors to eliminate unnecessary annuity and installment distribution options more easily. This will be particularly helpful in the case of plan mergers, where previously, various optional distribution forms were required to be grandfathered.

[2] Granted pursuant to IRS Notice 2002-4.

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Client Alert

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