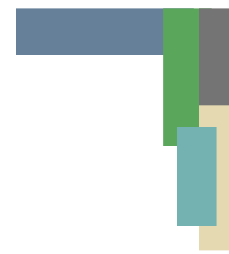

PRUDENTIAL RETIREMENT

Important Information | **Plan Administration and Operation** | **August 2003***

IRS Issues Final Catch-Up Contribution Rules

WHO'S AFFECTED   This information applies to sponsors of 401(k) plans, 403(b) programs and governmental section 457 plans that allow participants age 50 and older to make catch-up contributions.

BACKGROUND AND SUMMARY   Recently, the IRS published final rules regarding the availability of catch-up contributions. The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) introduced the catch-up contribution rules that allow a participant age 50 or older to make elective deferral contributions exceeding the standard annual deferral limit. For 2003, the standard annual deferral limit is $12,000 and the catch-up limit is $2,000.

The final rules apply to contributions made in tax years beginning after December 31, 2003. In general, these rules are consistent with the proposed rules, which were issued in October 2001. However, they do reflect modifications made by the Job Creation and Worker Assistance Act of 2002 (JCWAA). This new guidance:

- Clarifies that a participant is eligible to make catch-up contributions as of January 1 of the calendar year he reaches age 50, regardless of the plan's plan year;
- Clarifies that the catch-up contribution determination is made at the end of the plan year regardless of the type of limit that is applied;
- Expands the methods of determining when an employer-provided limit has been exceeded when a plan provides multiple definitions of compensation for different plan purposes (e.g. contributions, nondiscrimination testing, etc.);
- Allows collectively-bargained employees and certain nonresident aliens to be disregarded for purposes of applying the universal availability requirements; and
- Provides for a transition period for plans involved in merger and acquisition transactions to comply with the universal availability requirements.

ACTION AND NEXT STEPS   Plan sponsors that are interested in offering or that already offer participants the ability to make catch-up contributions should carefully review the rules described in this publication. If you have specific questions about how these rules affect your plan, please contact your Prudential Retirement representative.

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Prudential Financial

Pension ANALYST

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Since January 1, 2002, participants age 50 or older have been able to make "catch-up contributions" to employer-sponsored plans that permit these contributions. This opportunity to make additional elective deferral contributions is intended to help individuals who are nearing retirement make up for retirement savings opportunities that were either lost due to interruptions in their careers, or simply not available earlier in their careers. For 2003, the catch-up contribution limit is $2,000. For 2004, the limit will be $3,000.

The IRS has now published final rules for making catch-up contributions to 401(k) plans, 403(b) programs, and governmental section 457 plans. These rules apply to contributions made after December 31, 2003. This *Pension Analyst* summarizes these rules and highlights changes made to the proposed rules.

Eligible Employees

A participant is eligible to make catch-up contributions as of January 1 of the calendar year that includes his 50th birthday. A plan that has a non-calendar plan year will have to offer participants who turn age 50 during the calendar year that begins in that plan year the opportunity to make catch-up contributions mid-plan year. *For example, if a plan that offers catch-up contributions has a plan year that runs July 1, 2003, through June 30, 2004, and Laura Jones will reach age 50 on February 2, 2004, Laura will have to be able to make catch-up contributions beginning January 1, 2004*.

Types of Catch-Up Contributions

The IRS rules identify three types of catch-up contributions:

- "Statutory limit" catch-ups are contributions made in excess of some legal limit, such as the standard deferral limit (i.e., $12,000 in 2003) or the annual additions limit (i.e., lesser of $40,000 or 100% of compensation).
- "Employer-provided limit" catch-ups are contributions made in excess of a plan-imposed limit (e.g., plan limits 401(k) deferrals to 15% of compensation).

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- "ADP limit" catch-ups are deferrals made by Highly Compensated Employees (HCEs) that exceed the limit determined by the Actual Deferral Percentage (ADP) test, and would otherwise be returned to the employee through a corrective distribution.

Once a participant exceeds any one of the limits in a plan year, he is eligible to make catch-up contributions.

Universal Availability Requirements

Catch-up contributions are subject to a universal availability requirement. All eligible plans sponsored by a single employer must offer the catch-up opportunity, or none of those plans may do so. For this purpose, all plans maintained by employers of a controlled group of employers are treated as a single plan.

Even though the universal availability requirement applies to all eligible plans of the plan sponsor, there are a few exceptions to this rule:

- Defined benefit plans do not have to offer catch-up contributions. In fact, defined benefit plans cannot offer catch-up contributions.
- Collectively-bargained employees and certain nonresident aliens are disregarded for purposes of applying this requirement. *For example, if ABC Company sponsors a Union 401(k) Plan that covers just its collectively-bargained employees, and a separate Non-Union 401(k) Plan that covers the non-collectively bargained employees, catch-up contributions may be offered under the Non-Union Plan even if they are not offered under the Union Plan.*
- A plan may restrict catch-up contributions under a cash availability limit. A cash availability limit is a limit that restricts pre-tax contributions to amounts available after deduction of all applicable income and employment taxes. A limit of 75% of compensation or higher will be treated as an acceptable cash availability limit.
- A plan may apply different employer-provided limits to different groups of employees. However, a plan may not apply a lower employer-provided limit to catch-up eligible employees.
- In merger and acquisition situations, employers have until the end of the plan year following the plan year in which the merger or acquisition transaction occurred to comply with the universal availability requirement.
- Puerto Rican qualified plans do not have to offer catch-up contributions.

Application of the Catch-Up Limit

A participant must exceed at least one of the three limits (statutory, employer-provided or ADP) to make catch-up contributions. The rules indicate that as long as an *employer-provided limit* is permissible under the basic plan qualification rules requiring a definite written program that limit will be applicable for catch-up contribution purposes. This means a plan limit either must be explicitly stated in the plan document or must be established pursuant to authority granted in the plan document.

If an employer-provided limit is applied on a payroll by payroll basis, the ultimate catch-up contribution determination must still be made at the end of the plan year.

> *For example, if the ABC Company 401(k) plan limits deferrals to 6% of compensation and a catch-up eligible employee makes a 6% deferral election and also elects to defer a pro-rata portion of the $5,000 catch-up limit for 2006 with each paycheck, the contributions exceeding the 6% limit will not be considered catch-up contributions until the end of the plan year. If the employee stops making deferral contributions mid-year, those additional contributions may very well end up not being catch-up contributions.*

Determination of Catch-Up Contributions

If a catch-up eligible individual participates in just one plan (which uses a calendar plan and limitation year) during an entire calendar year, it is fairly simple to determine which limits are exceeded and the amount of the participant's catch-up contributions. However, special coordination rules apply when:

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- A plan is amended mid-year to change an employer-provided limit;
- An individual participates in multiple plans, sponsored by the same or different employers, during a single plan year; or
- A plan uses a non-calendar plan year.

Mid-Year Changes to Employer-Provided Limits

If a plan is amended during the plan year to change an employer-provided limit on deferrals, the applicable limit for that year is generally the sum of the dollar amounts of the limits for each portion of the year.

> *For example, the XYZ Company Plan limited highly compensated employee (HCE) deferrals for the first three months of the year to 10% of compensation, but lowered that limit to 7% of compensation for the last nine months of the year. Joe's compensation for the first three months was $40,000 and his compensation for the last six months was $80,000. Any contributions that Joe makes exceeding $9,600 [(10% of $40,000) + (7% of $80,000)] are considered catch-up contributions.*

Like the proposed rules, the final rules provide an alternative method of determining the overall employer-provided limit in this type of situation. Under this method, the plan may provide that the overall limit is based on the participant's full year compensation times the time-weighted average of the plan's deferral limits.

> *In the example above, this method would consider any contributions that Joe makes exceeding $9,300 to be catch-up contributions, because the time-weighted average limit is 7.75% [(10% x .25 year) + (7% x .75 year)].*

In addition, if a plan applies one definition of compensation for purposes of determining elective deferral contribution amounts and a different definition of compensation for Actual Deferral Percentage (ADP) testing purposes, the final rules permit the plan to provide that the ADP testing compensation will be used to determine the employer-provided limit. This option was intended to ease data collection burdens. It may be used with the time-weighted average method, if an employer-provided limit changes during the year, or by itself, if there is no change in that limit.

> *For example, the BigCo 401(k) Plan only permits employees to make deferral contributions from their base pay, not from bonuses. However, the ADP test uses employees' total compensation including bonuses. John's base pay is $80,000 and he receives a $10,000 bonus. The plan limits deferrals to 6% of compensation. John is catch-up eligible and elects to defer 8% of his compensation, so his deferrals total$6,400. At year-end, the 6% limit is based on his $90,000 total compensation. As a result, John has made only $1,000 of catch-up contributions ($6,400 minus 6% of $90,000, when he thought he was making $1,600 of catch-up contributions ($6,400 minus 6% of $80,000).*

Participation in Multiple Plans Sponsored by the Same Employer

Statutory Limits. Some statutory limits are applied at both the participant level and the employer level. For example, in 2003, an individual may make total deferrals of no more than $12,000, to all 401(k) plans and 403(b) programs in which he participates. In addition, if an individual participates in multiple 401(k) or 403(b) plans sponsored by the same employer (determined on a controlled group basis), those plans can keep only a total of $12,000 of deferrals made by that participant.

The annual additions limit applies in a similar manner across all plans sponsored by the same employer. However, there are special rules that apply when determining the controlled group of employers for annual additions purposes, which bring in employers that are not normally members of the group.

The IRS rules provide that the catch-up limit is applied across plans sponsored by related employers in the same manner that the underlying statutory limit applies.

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Employer-Provided Limits. If an employer sponsors multiple plans that impose different plan limits on deferrals, a single catch-up limit applies across those plans. In this situation, the plan sponsor would typically determine if an individual has exceeded the overall employer-provided limit by adding together the dollar amounts of the limits provided under each plan. Alternatively, the plans could provide that the overall limit is based on the participant's full year compensation times the time-weighted average of the plans' deferral limits.

Participation in Multiple Plans Sponsored by Unrelated Employers

Statutory Limits. When an individual participates in multiple 401(k) or 403(b) plans sponsored by unrelated employers during the same calendar year, only the participant-level deferral limit applies. As noted above, in 2003, an individual may make total deferrals of no more than $12,000, to all 401(k) plans and 403(b) programs in which he participates. However, he could make $12,000 of deferral contributions to more than one plan, and those plans would not be penalized and would count all $12,000 as deferrals, included in the plans' ADP tests.

> *For example, Jane, who is catch-up eligible, participates in the SmallCo 401(k) Plan for the first six months of 2003. She makes deferral contributions during that period totaling $7,000. Jane participates in the MegaCo 401(k) Plan for the last six months of 2003. She also makes $7,000 of deferral contributions to that plan. Jane's $14,000 of total deferral contributions includes $12,000 of basic deferrals and $2,000 of catch-up contributions. However the SmallCo Plan includes all $7,000 of her deferrals to that Plan in its ADP testing for the year. Likewise, MegaCo Plan includes all $7,000 of her deferrals to that Plan in its ADP testing for the year.*

In contrast to the rules that apply to the annual deferral limit, an individual who participates in multiple plans sponsored by unrelated employers would simply have separate annual additions limits under each employer's plan.

Employer-Provided Limits. When an individual participates in multiple plans sponsored by unrelated employers, the full catch-up amount is available under all of the plans, but the individual still has just one catch-up limit.

> *For example, in 2003, Joe participates in three 401(k) plans sponsored by three unrelated employers. All three plans contain relatively low employer-provided limits on deferrals. Since Joe is catch-up eligible, he makes $2,000 in catch-up contributions to each plan, but never hits any statutory limits. All of the plans would disregard the full $2000 catch-up amounts in their ADP tests, but Joe has exceeded the catch-up limit by $4,000.*

Interestingly, the IRS rules do not indicate how excess catch-up contributions should be corrected if the standard deferral limit itself (e.g., $12,000 for 2003) is not exceeded.

Plans with Non-Calendar Plan Years

Employers that sponsor plans using non-calendar plan years are already familiar with the challenges created by having to measure the standard deferral limit on a calendar year basis. Now, they will also have to measure at least one part of the catch-up limit on this basis as well. They will have to monitor the catch-up limit on a plan year basis, with respect to any employer-provided limits and the ADP limit. The IRS rules indicate that the catch-up limit for a plan year (like the standard deferral limit) is the limit in effect for the calendar year in which the plan year ends. *For example, for a plan year beginning July 1, 2002, and ending June 30, 2003, the $2,000 catch-up limit applies. In later years, the mid-plan year changes in this limit and the timing of actual employee deferral contributions may further complicate plan administration.*

Coordination Across 401(k), 403(b) and Governmental Section 457 Plans

When an individual participates in multiple 401(k) and 403(b) plans, a single standard deferral limit ($12,000 in 2003) applies to all deferrals made under those plans during the calendar year. However, if the individual also participates in a governmental section 457 plan, a separate standard deferral limit (e.g., $12,000) applies to the deferrals made under that plan. Similar rules apply to the application of the catch-up limit. *For example, a 50-*

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year old employee could participate in both a 403(b) program and a governmental section 457 plan during 2003 and defer a total of $28,000 under the two plans.

The IRS rules do indicate that if an individual participates in a governmental section 457 plan and is eligible to make the special catch-up contributions available to employees who are within three years of normal retirement age, he can not also make the standard catch-up contributions. The IRS has not yet provided rules coordinating the special 403(b) catch-up contributions available to certain employees of certain entities with the new standard catch-up limit.

Effect of Catch-Up Contributions on Nondiscrimination Testing

While catch-up contributions are treated like standard deferrals for most plan purposes, such as the distribution rules, they do receive special treatment for some nondiscrimination testing purposes.

ADP Test

Statutory limit catch-ups and employer-provided limit catch-ups are not counted when determining a participant's actual deferral ratio for the ADP test. For example, if an eligible employee makes deferral contributions totaling $14,000 in 2003, $2,000 is considered catch-up contributions and only $12,000 would be tested in the ADP test. This rule applies to both HCEs and Non-Highly Compensated Employees (NHCEs).

If a plan that offers catch-up contributions performs its ADP test and determines that corrective distributions must be made to HCEs, the plan must reclassify and keep deferrals that do not exceed an eligible employee's catch-up limit. Any remaining ADP excesses would be distributed, with allocable earnings.

Excess contributions reclassified as catch-up contributions are still excess contributions for purposes of determining the impact to any associated matching contributions. The plan document should provide direction on whether associated matching contributions should be forfeited or remain in the participant's account when deferrals are reclassified as catch-up contributions.

ACP Test

An employer that matches regular deferral contributions does not have to match catch-up contributions. However, if the plan does provide for a match on catch-ups, that match must be included in the Actual Contribution Percentage (ACP) test. Of course, only one ACP test would be performed, taking into account *all* matching contributions.

If a plan document currently calls for matching contributions to be made on a specified percentage of deferrals and an employee's catch-up contributions fall under that matching threshold, those catch-ups will have to be matched unless the plan sponsor adopts an amendment that prohibits such a match.

Availability Test

If the plan applies a single matching formula to all deferral contributions, including catch-up contributions, the formula as applied to the catch-up eligible employees is not treated as a separate benefit, right or feature from the formula that is applied to all other employees. Therefore, it would not have to be tested for nondiscriminatory availability.

If deferrals that were reclassified as catch-ups at the end of the plan year were matched with employer contributions, and the plan does not match catch-up contributions, the match made on the reclassified deferrals would have to be forfeited, even if it was 100% vested.

Top-Heavy Test

When determining the amount of the top-heavy minimum contribution due for non-Key Employees, current year

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catch-up contributions made by Key Employees are not counted. However, prior year catch-ups made by both Key Employees and non-Key Employees are counted when determining if the plan is top-heavy.

Minimum Coverage Test

When performing the Average Benefits Percentage Test, current year catch-up contributions are not counted. But, if the accrued-to-date calculation method is used, prior year catch-up contributions are counted.

Questions Remain Unresolved

When the proposed rules were issued in October 2001, there were some questions and concerns around certain issues. The following issues appear to remain unresolved under the final rules:

- It is not clear how the universal availability requirement applies to multiple employer plans and their sponsoring employers.
- The rules have not provided guidance about providing catch-up contributions under plans that meet the ADP/ACP Safe Harbor design rules.
- It is unclear if the catch-up limit should be pro-rated with respect to an employer provided limit, when a plan has a short plan year.
- The rules do not provide guidance on the timing of amendments and participant notices when an employer wishes to adopt the catch-up contribution provisions.
- It is not clear how or if the annual compensation limit is applied on an employer-provided limit that is set on a payroll by payroll basis.

Plan Sponsor Next Steps

Sponsors of eligible plans that are interested in offering or already offer participants the ability to make catch-up contributions should carefully review the rules described in this publication. If you have specific questions about how these rules affect your plan, please contact your Prudential Retirement representative.

COMPLIANCE CLIPS

IRS Publishes Consolidated 401(k) and 401(m) Plan Rules

The IRS recently published proposed 401(k) and 401(m) plan rules, which consolidate the final rules published in 1991 and 1994, with other notices and formal guidance published since then to reflect later changes in the underlying law. For the most part, these comprehensive proposed rules do not make major changes to existing guidance, but simply bring all that guidance together in one place. For example, these rules reflect:

- The elimination of the aggregate limit/multiple use test for plans that contain both a 401(k) feature and a 401(m) feature;
- The existence of the ADP/ACP Safe Harbor Plan design;
- The existence of SIMPLE 401(k) Plans; and
- The automatic enrollment concept.

In addition, these regulations clarify some existing rules. They also contain some unanticipated proposals. *For example, under these rules, plans would have to pay "gap period" income on corrective distributions.* ***However, plan sponsors should not attempt to comply with any of the new proposals at this time because the IRS is not offering reliance on them.***

The IRS has requested written comments on these proposals. The comment deadline is October 22, 2003, and a

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public hearing is scheduled for November 12, 2003. The final rules will apply no earlier than 12 months after they are published. *For example, if the final rules are published on December 31, 2003 (which is unlikely), they would apply to plans with calendar plan years no earlier than January 1, 2005.*

IRS Proposal Eliminates Advance Notice Requirement for Removing Optional Forms of Payment

In September 2000, the IRS published final rules making it easier for certain defined contribution plan sponsors to amend their plan documents to eliminate periodic payment options that are rarely used (such as annuities and installments). To remove periodic payment options under those rules, a plan must provide a single sum payment option after the amendment. This single sum payment option must:

- Be available on the same payment beginning dates as the eliminated forms would've been available;
- Be available in the same medium as the eliminated forms of payment (e.g., cash or inkind); and
- Not impose any eligibility requirement not imposed on the eliminated forms of payment.

If an annuity or installment option is removed, the final rules also require that form of payment to remain available to any participant who has an Annuity Starting Date (generally, this means "payment date") that precedes the earlier of:

- The 90th day after the date the participant is given a Summary of Material Modification (SMM) reflecting the amendment, or
- The first day of the second plan year following the amendment adoption date.

The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) revised the Internal Revenue Code to be consistent with these rules in allowing the elimination of certain optional forms of benefit. However, the EGTRRA provision does not contain the advance notice requirement. As a result, the IRS has now issued proposed rules that eliminate the advance notice requirement before removing an annuity or installment option from a plan. However, plans subject to ERISA's disclosure rules will continue to be subject to the normal summary of material modification (SMM) and summary plan description (SPD) timing rules. Under those rules, plan sponsors must furnish an SMM or updated SPD no later than 210 days after the close of the plan year for which the plan amendment was adopted.

The IRS is seeking comments on the proposed rules until October 6, 2003, which are not effective until after final rules are published. We will keep you informed in the event these proposed rules become final. Until these rules are finalized, plan sponsors that eliminate periodic payment options must continue to comply with the advance notice rules set forth in the 2000 final rules.

Pension Analyst by Prudential Retirement
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