

CLIENT ALERT

New Catch-Up Contribution Regulations

Require Immediate
Employer Action



In June, the IRS published final regulations (the “Final Regulations”) governing “catch-up” contributions made under 401(k) plans. The Final Regulations apply to catch-up contributions made on or after January 1, 2004.

With 2004 just around the corner, now is an opportune time to highlight the impact of the Final Regulations on 401(k) plans. Suffice it to say, the Final Regulations require that employers take certain actions to ensure that the catch-up contributions being made under their 401(k) plans continue to comply with IRS rules.

This Client Alert does two things. First, it reacquaints employers with the basic elements of a catch-up contribution and the primary reason for making catch-up contributions available to eligible employees. Second, it explores the actions required of employers that sponsor 401(k) plans under the Final Regulations.

What Is a Catch-Up Contribution?

As most employers now know, a “catch-up” contribution is a pre-tax contribution made by a 401(k) plan participant who is age 50 or older, or who will turn age 50 at any time during a taxable year, that exceeds an “applicable limit.” An “applicable limit,” in turn, is a legal limit (e.g., the annual elective deferral limit, \$13,000 for 2004), a plan limit (e.g., 10% of compensation) or a nondiscrimination testing limit (i.e. the maximum deferral permitted under the actual deferral percentage, or “ADP” test). A participant whose deferrals exceed *any* applicable limit and who is 50 or who will turn age 50 before the end of the year may defer up to the “catch-up limit” for the year (\$3,000 for 2004).

For instance, an employee who makes \$130,000 in 2004 must be allowed to make up to \$3,000 in catch-up contributions during such year, irrespective of whether the plan limit equals the legal limit or the ADP limit. To make things simple, assume

that the ADP limit does not apply and that the plan limit equals either 5% or 10% of compensation. At 5%, the plan limit, as applied to the employee, would be \$6,500. At 10%, the plan limit, as applied to the employee, would be \$13,000. This also would be the legal limit on regular deferrals for 2004. In both cases, however, the employee would have to be allowed to make up to \$3,000 in catch-up contributions.

Certain other rules apply to catch-up contributions. Most notably, an employer that offers catch-up contributions must make them available to all employees in all of its 401(k) plans who otherwise qualify. Catch-up contributions are not subject to any of the limitations that otherwise would apply to plan contributions.

Why Should an Employer Offer Catch-Up Contributions?

The short answer is to maintain a competitive employee benefits package. In many cases, the employees who are over age 50 are essential to the financial success of the company. Offering catch-up contributions to those employees is an inexpensive way to maintain employee loyalty and continue to attract and retain valuable employees.

What's Different About the Final Regulations and What Must I Do to Comply?

The Final Regulations add a number of wrinkles to the law governing catch-up contributions, none more important than the clarification of the “universal availability” rule. This rule requires that *all catch-up eligible participants be provided with the same “effective opportunity” to make the same dollar amount of catch-up contributions.*

What the Final Regulations make absolutely clear is that a plan fails to provide an “effective opportunity” to make catch-up contributions if it has an applicable limit that applies to a catch-up eligible participant and does not permit the participant to make elective deferrals in excess of that limit. In other words, any plan that limits *total* deferrals (i.e., regular deferrals plus catch-up contributions) to a fixed percentage of compensation stands a great chance of violating the universal availability rule.

Taking the example from above, if the 10% limit under the plan applies to *total* deferrals, a catch-up eligible participant who earns \$130,000 would be precluded from making any catch-up contributions, let alone \$3,000 in such contributions. At 10% of compensation, the participant would hit the legal limit of \$13,000 in regular deferrals, but because the participant also would hit the plan limit of \$13,000 in total deferrals, the participant would not be able to make any catch-up contributions.

What should an employer do to avoid violating the universal availability requirement?

■ **Review the plan document and deferral form.** If either the plan or the deferral form imposes a limit that applies to *total* deferrals, the employer has a universal availability issue on its hands. The employer would have to amend the plan and/or deferral form using one of the methods described below.

■ **Amend the plan and/or deferral form to use *pro rata* method.**

A plan does not violate the universal availability rule merely because it allows participants to defer an amount equal to a specified percentage of compensation for each payroll period and for each payroll period permits each catch-up eligible participant to defer a *pro rata* share of the applicable catch-up limit (e.g., \$3,000 in 2004) in addition to that amount.

■ **Amend the plan and/or deferral form to increase the total deferral limit to 75% of compensation.**

The Final Regulations make it clear that a plan does not violate the universal availability rule merely because it restricts the elective deferrals of any employee (including a catch-up eligible participant) to amounts available after other withholding from the employee's pay (e.g., after deduction of all applicable income and employment taxes). For this purpose, a *total* (regular plus catch-up) deferral limit of 75% or higher is deemed to be acceptable.

To be sure, no employer relishes the possibility of having to amend its plan, especially so close to the beginning of a new plan year. However, the alternative to not doing so could be multiple violations of the universal availability rule and, as a result, the disqualification of the plan.

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