Final Regs Modify Catch-up Contribution Rules

The IRS has released final regulations* governing catch-up contributions by plan participants age 50 or older to 401(k) plans, 403(b) tax-sheltered annuities, SIMPLE IRA plans, simplified employee pension plans, and 457 eligible governmental plans. While the final regs generally adopt the provisions of proposed regulations issued in 2001, they do contain some modifications plan sponsors will want to be aware of.

EMPLOYER-PROVIDED LIMIT CLARIFIED

One of the situations under which a plan sponsor can characterize a participant’s elective deferral as a catch-up contribution is if the deferral exceeds “an employer-provided limit” contained in the plan. In response to comments it received on the proposed regulations, the IRS clarified that the employer may not use an administrative procedure to set a plan limit on elective deferrals. A qualified plan limit on elective deferrals must be a definite written program providing a definite predetermined formula for allocating contributions and, thus, the limit must be in the plan document.

RECORDKEEPING RELIEF

Plan sponsors with plans that use one definition of compensation for purposes of actual deferral percentage (ADP) nondiscrimination testing and another definition to determine elective deferrals gain some recordkeeping relief under the new regulations.

Plans generally determine elective deferrals in excess of an applicable limit at the end of the plan year by comparing a participant’s total elective deferrals for the year with the applicable limit. Under both the proposed and final regs, this annual method for determining excess amounts — including those amounts that can be characterized as catch-up contributions — applies even if the plan sponsor imposes its employer-provided limit on a payroll-by-payroll basis.

Thus, plan sponsors that use one definition of compensation for annual ADP testing and another during the year to determine elective deferrals must collect and retain payroll-by-payroll compensation records. Then, at the end of the year they have to calculate the employer-provided limit on an annual basis before determining the amount of elective deferrals that are catch-up contributions.

To decrease the recordkeeping burden, the final regulations expand the alternative methods for determining an employer-provided limit so that these plans are not required to collect and retain records on both definitions of compensation.

WEIGHTED-AVERAGE SIMPLIFICATION

Under both the proposed and final regs, a plan that changes an employer-provided limit during the plan year can use a time-weighted average of these limits as the employer-provided limit. To illustrate, a plan that has an employer-provided limit of 9% for the first six months of the year and 11% for the second six months can use 10% as the employer-provided limit for the plan year. And the final regs add a provision permitting plans to use the definition of compensation used for ADP testing for this weighted-average simplification.

EXCLUDING PARTICIPANTS

Plan sponsors have a little more leeway under the final regs to exclude certain participants from making catch-up contributions. In general, a plan must extend the option of making catch-up contributions to all

*68 Federal Register 40510-40520 (July 8, 2003)

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catch-up eligible participants. The proposed regs included an exception for employees covered by certain mergers and acquisitions. The final regs add employees covered by collective-bargaining contracts and certain nonresident aliens. They also state that a plan that restricts elective deferrals, including elective deferrals by catch-up contribution eligible participants, under a cash availability limit does not violate the universal availability requirement. A cash availability limit is one that restricts elective deferrals to amounts available after withholding all applicable income and employment taxes from a participant’s pay. For this purpose, a limit of 75% of compensation or higher is treated as limiting participants to amounts available after other withholdings.

The final regulations are effective July 8, 2003, and apply to contributions made in taxable years beginning on or after January 1, 2004.

IRS Streamlines Correction Program

Plan sponsors should welcome the new, “sleeker”, Employee Plans Compliance Resolution System (EPCRS) the IRS unveiled in a recent revenue procedure.* The EPCRS changes are twofold: to make it easier for retirement plans to comply with IRS requirements and to reduce certain barriers that discourage some businesses, smaller businesses in particular, from offering retirement plans.

SAME COMPONENTS

The EPCRS continues to have the same basic components:

- **Self-Correction Program (SCP)** which allows the sponsor of an IRS-approved plan to identify and correct operational failures in its plan without notifying the IRS or paying any fee.
- **Voluntary Correction Program (VCP)**, under which a plan sponsor can submit corrections of various types of qualification failures to the IRS for approval, pay a small fee, and receive written “reliable assurance” from the IRS that the changes have been accepted.
- **Audit Closing Agreement Program (Audit CAP)** which permits a plan sponsor to correct failures with IRS approval when its plan is under examination.

NEW FEATURES

Here are highlights of some of the more significant changes to the EPCRS.

- SIMPLE IRAs are included in the EPCRS. VCP is available to SIMPLE IRAs — and simplified employee pension plans (SEPs) — but only if the failure is “insignificant” and the plans are established and maintained under IRS-approved documents.
- Anonymous and group submissions under VCP are extended to SIMPLE IRAs and SEPs. To simplify group submissions, the IRS has replaced the requirement that each plan have a power of attorney with notice and certification requirements.
- Plan sponsors must notify participants who receive overpayments from the plan of $100 or less (the limit for which plans are not required to seek repayment) that the overpayment amount is not eligible for favorable tax treatment, specifically tax-free rollover.
- The revenue procedure adds a correction method for failure to obtain spousal consent.
- “Under examination” is redefined to include any determination letter submission in which an IRS agent notifies the plan sponsor of possible qualification failure or requests additional information that indicates a qualification failure exists that the sponsor has not previously identified.

The revised EPCRS is effective October 1, 2003, but plan sponsors can choose to apply the provisions any time on or after June 5, 2003.

**DOL**

The U.S. Department of Labor (DOL) has changed its position on allocating expenses attributable to administering qualified domestic relations orders (QDROs). Previously, these expenses could be charged to the plan at large, but not to the individual plan participant or beneficiary submitting the QDRO. Under the DOL’s new position, a plan sponsor can choose to bear plan expenses itself, charge them to the plan at large, or assess them only to plan participants or beneficiaries who incur the specific expenses, provided the expenses are justified. Thus, in addition to QDRO expenses, a sponsor could require individual participants to pay plan expenses such as the administrative cost of distributions and hardship withdrawals and the calculation of benefits payable under different payment options (Field Assistance Bulletin, 2003-3, 5/19/03).

**EBSA**

In conjunction with its Saving Matters Retirement Savings Education Campaign, the Employee Benefits Security Administration has teamed with the Certified Financial Planner Board of Standards, Inc. to publish a guide on setting financial and retirement savings goals. Plan sponsors may want to use the guide as a reference in determining what to stress in their employee education programs. The guide — *Savings Fitness: A Guide to Your Money and Your Financial Future* — is available online at [www.dol.gov/ebsa](http://www.dol.gov/ebsa).

**IRS**

Time is growing short for plan sponsors that use master and prototype (M&P) plans and volume submitter plans to amend their plans for recent tax law changes (known collectively as “GUST”). Under Revenue Ruling 2000-20, these sponsors were granted an amendment extension to September 30, 2003. To keep a plan qualified, a sponsor who has made changes to a preapproved M&P or volume submitter plan — other than changes allowed by the M&P adoption agreement or options permitted under the volume submitter document — also must file an application for a determination letter by September 30, 2003 (IRS Employee Plans News, June 2003).

The Economic Growth and Tax Relief Reconciliation Act of 2001 made changes that affect the elimination of optional forms of benefits from defined contribution plans. To reflect these changes, the IRS has issued proposed regulations that would, among other things, modify the existing final regulations to eliminate the advance notice rule. Under the proposed regulations, a plan sponsor could amend its defined contribution plans to eliminate or restrict a participant’s right to receive payment of accrued benefits under a particular optional form of benefit without violating the tax law’s anti-cutback rules, as long as certain requirements were met. Once the plan amendment took effect for a participant, the alternative forms of payment that remained available to the participant would have to include payment in a single-sum distribution form that was “otherwise identical” to the optional form of benefit being eliminated or restricted (Prop. Reg. Section 1.411(d)-4, Q&A 2(e)(1)).

As part of a continuing effort to help plan sponsors and administrators find missing participants, the IRS has collected some helpful tools for locating lost participants and placed them on its website, [www.irs.gov/ep](http://www.irs.gov/ep). There, plan sponsors can click on “More Topics” and go to “Contacting Missing Participants or Beneficiaries.”

Corporations may choose to wait until October 1, 2003, to pay 25% of the estimated tax payment due September 15, 2003, because of a provision in the Jobs and Growth Tax Relief Reconciliation Act of 2003.
The Employee Benefit Research Institute’s 2003 Retirement Confidence Survey reports numerous contradictions that may help plan sponsors develop effective employee education programs. For example, the study shows that trying to calculate retirement income needs helps participants focus more attention on retirement savings. Among the survey participants who tried to calculate how much they need to save for retirement, 64% started to save more and 26% changed their asset allocation. But, overall, more than 60% of the participants haven’t even tried to figure out how much they will need.

The latest analysis conducted by the Institute of Management and Administration, Inc. (IOMA) shows that defined contribution plan participants have shifted a considerable amount of plan assets out of company stock and into other investments over the past several years. In April 2003, 29% of the assets held by the plans studied was invested in company stock. A similar IOMA study conducted two and a half years earlier reported that 34.2% of the plans’ assets were in company stock. The analysis seems to show that some plan sponsors have been successful in warning their participants that investing too much of their 401(k) plan accounts in company stock can place their future retirement security in jeopardy.

*As measured by the S&P 500 Stock Index. Sources: Profit Sharing/401(k) Council of America, www.psca.org, Russell Data Services, and NPI