

## **The True Story on the Age 50 Catch-up: A Simple Calculation or a Big Headache?**

When it comes to simplification and 403(b) limitation testing, you should be cautious when using both terms in the same sentence!

On July 8, 2003, the Internal Revenue Service issued final regulations providing much needed guidance on the requirements for retirement plans providing catch-up contributions, including 403(b) and 457(b) plans. These regulations outline how to use the IRC § 414(v) (“Age 50” catch-up) contributions in conjunction with other salary contributions as defined in § 402(g).

Although briefly commented, this notice outlines an ordering requirement for catch-up contributions in 403(b) plans which many are not aware of when performing limitation testing. If overlooked, it opens many plan sponsors up to substantial risk of excess contributions in current and future years and therefore increases their liability as the employer.

In 403(b) plan arrangements beginning after December 31, 2001, employees age 50 and older are eligible to make additional contributions over the “standard” § 402(g) limitation. These additional “age 50” catch-up contributions may not exceed \$1,000 for 2002, \$2,000 for 2003, \$3,000 for 2004, \$4,000 for 2005 and \$5,000 for 2006 and later years.

The 402(g) limit is calculated individually by participant. Standard dollar limits for the regular contribution are provided in the Code, and if the participant has at least 15 years of service with certain qualified employers, such as a public school, the “standard” § 402(g) limit is increased further by up to \$3,000 per year until the total “15 years of service” catch-up contributions equal the lifetime maximum of \$15,000. In addition, annual contributions made to the 403(b) plan may not exceed the lesser of \$40,000 or 100% of the participant’s compensation.

The final regulation clarifies the order of applying the catch-up amounts for participants qualifying for both the “age 50” and the “15 years of service” catch-ups. The “age 50” catch-up contribution is in addition to the 402(g) regular and “15 years of service” contribution amounts and only comes into play after the employee has maximized all amounts under that limit. Because of this ordering, many employers may have excess contributions and not even know it.

Let’s look at an example:

Employee A has the following work and contribution history, no prior contributions and assumes he is taking advantage of the “age 50” catch-up:

<u>Year</u>	<u>YOS</u>	<u>Age</u>	<u>Contribution Amount</u>
2002	15	50	\$12,000 (\$11,000 plus \$1,000 in catch-up)
2003	16	51	\$14,000 (\$12,000 plus \$2,000 in catch-up)
2004	17	52	\$16,000 (\$13,000 plus \$3,000 in catch-up)
2005	18	53	\$18,000 (\$14,000 plus \$4,000 in catch-up)
2006	19	54	\$20,000 (\$15,000 plus \$5,000 in catch-up)
2007	20	55	\$20,000 (\$15,000 plus \$5,000 in catch-up)

In 2008, Employee A decides it is time to “start” taking advantage of the “15 years of service” catch-up and provides his district payroll processor an updated Salary Reduction Agreement requesting to contribute \$23,000 (\$15,000 (Base limit) plus \$5,000 (“age 50” catch-up) and \$3,000 (“15 years of service” catch-up)) for the calendar year. Can he?

**The answer is No!** Employee A is attempting to use the special “15 years of service” catch-up provisions under § 402(g)(7), but based on his past catch-up contribution history is not eligible to do so. Employee A does not realize that he has already been utilizing the “15 years of service” catch-up during the past 6 years, and NOT the “age 50” catch-up exclusively. The IRS regulations state that the “15 years of service” catch-up must be applied first and then the “age 50” catch-up is used only for any remaining funds.

To be eligible for the “15 years of service” catch-up, the contribution history and prior catch-ups are considered for passage of a three part test. For 2008, the three part test is as follows -

- Test 1: Catch-up can not exceed \$3,000 **PASS**
- Test 2:  $(5,000 \times (\text{YOS})) - \text{All Prior Contributions} = \text{Catch-up Amount}$
- Example:**  $(5,000 \times 21) 105,000 - 100,000 = \$5,000$  **PASS**
- Test 3:  $15,000 - \text{All Prior “15 years of service” Catch-up Contributions}$   
 $(\$1,000 \text{ in } 2002 + \$2,000 \text{ in } 2003 + \$3,000 \text{ in } 2004 + \$3,000^* \text{ in } 2005 + \$3,000^* \text{ in } 2006 + \$3,000^* \text{ in } 2007 \text{ for a total of } \$15,000)$
- Example:**  $15,000 - 15,000 = 0$  **FAIL**

**The three part test requires that your limit is the LESSER of the three amounts. In our example, the least is zero (0) under Test 3.**

\* Although Employee A elected \$4,000 in catch-up contributions in 2005, and \$5,000 in 2006 and 2007, under Test 1 above for 2005 and 2006, and under Tests 1 and 3 for 2007, only \$3,000 are attributable to the “15 year catch-up” contribution. The remaining amounts (\$1,000 in 2005, and \$2,000 in both 2006 and 2007) are “age 50” catch-up contributions.

Based on IRS and independent audit experience, § 402(g) excess amounts are the most common transactional failure under review. Many times employers are not tracking prior contribution history for proper testing and investment providers are not always considering prior catch-up contributions when testing. Additionally, if multiple investment providers are utilized by the employee, there is typically no data sharing

between vendors and therefore no coverage for the employer under standard hold harmless agreements.

In order for employees to maximize their retirement plan contributions, they should be informed of the consequences of utilizing the “age 50” catch-up prior to utilizing the “15 years of service” catch-up as it may reduce the total amounts they are able to contribute to the 403(b) plan.

Added controls should be initiated by employers to recognize cumulative contributions both in total and amounts considered as catch-up contributions. These ordering rules for catch-up contributions are currently effective. Employers should consider reviewing plan contributions for the 2003 calendar year so excesses can be addressed prior to April 15, 2004.

Your questions and comments are welcome. This article was written by Tamara M. Vaughn, QPA, Vice President and Director of Employee Benefits for Citizens Bank & Trust. Tamara has been performing plan administration and audits for retirement plans for over 20 years. She is a featured speaker at national and state association meetings and has been working with the IRS’s awareness programs since 1999.

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