15-Year Catch-up Plan

The sentiment to continue the 15-year catch-up election as a stalwart provision of a 403(b) retirement plan is changing. Why is this the case?

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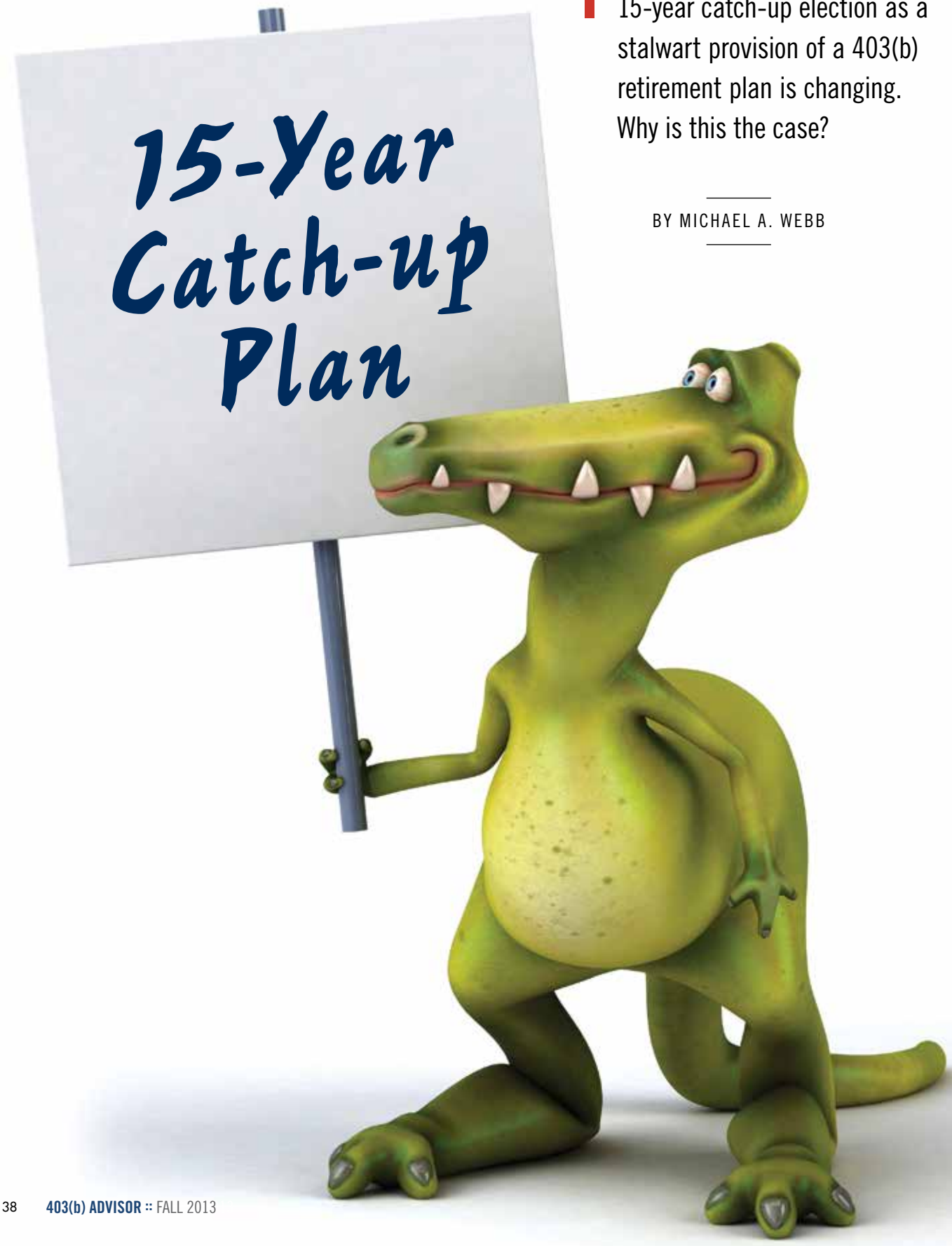

Will the 15-Year Catch-Up Election Become the 'Dinosaur' of 403(b) Plans?

The 15-year catch-up election has been an institution in the 403(b) plan marketplace for many years, having long outlasted many other provisions of the tax code related to 403(b) plan contribution limits. (Remember the "exclusion allowance" calculation?) While it has never been a required provision in retirement plans, it was rare to find an eligible organization (now clarified in the final 403(b) regulations as an educational organization, a hospital, a health and welfare service agency or a church-related organization) that would prevent its employees from utilizing this catch-up election to potentially increase the amount one can defer to a 403(b) plan.

However, the sentiment to continue the 15-year catch-up election as a stalwart provision of a 403(b) retirement plan is changing. In fact, a significant number of plan sponsors either have eliminated the provision since the issuance of the final 403(b) regulations or plan to eliminate it in the near future. Why is this happening? Let's take a look.

15-Year Catch-Up Election: The Basics

In order to understand one of the primary reasons that the 15-year catch-up election is being revisited by many 403(b) plan sponsors, reviewing the basics of the election is a good place to start.

The 15-year catch-up election increases an individual's 402(g) elective deferral limit ($17,500 in 2013) by the *lowest* of three amounts:

- $3,000
- the *excess* of (a) $15,000, over (b) the total elective deferrals made by the employee of the plan sponsor for prior years
- the *excess* of (a) $5,000 multiplied by the number of years of service of the employee with the plan sponsor, over (b) the total elective deferrals made for the employee at the plan sponsor for prior years

Confused yet? If you are an experienced 403(b) practitioner, probably not — but put yourself in the shoes of the average plan sponsor. Many make the mistake that the first amount ($3,000, increasing the maximum deferral amount) is a guaranteed amount. (The addition in recent years of the age 50 catch-up election, where an additional deferral of $5,500 is guaranteed, only added to the confusion.)

Others believe that the election can only be used for five years (5 times the maximum dollar limitation of $3,000). In fact, if the 402(g) limit is exceeded by less than $3,000 in any given year, the election can continue until $15,000 is used up. I can go on and on regarding plan sponsor (and participant) confusion over the limit, but suffice to say that plan sponsors prefer simplicity in their 403(b) plans, and the 15-year catch-up election is not consistent with this notion.

In addition, as you can see from the definition, the calculation of the limit requires the knowledge of an employee's *entire* contribution history. Historic data collection is not the strength of many nonprofit employers. Vendors often can fill in the gaps, but coordination of data can often be difficult in multiple/legacy vendor situations, especially when participants may have utilized a vendor early on in their working career that has long since been eliminated from the plan.

The Advent of the Age 50 Catch-Up Election and 15-Year Catch-Up Impact

Years ago, the 15-year catch-up election was the *only* method of increasing one's 402(g) elective deferral limit. In addition, other contribution limits greatly restricted what employees could defer into their 403(b) plans. However, over time those contribution limits were either eliminated or greatly relaxed, and the age 50 catch-up election, which permits an increase in the 402(g) elective deferral limit of $5,500 without restriction, was added. Thus it can be argued that the use of a 15-year catch-up election has become less essential.

In addition, the IRS requires coordination between the 15-year and age 50 catch-up elections that can lead to problems. This issue comes into play when an individual is eligible for

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both the age 50 catch-up election *and* the 15-year catch-up election. The IRS has an ordering rule which states that if the basic 402(g) limit on elective deferrals is exceeded, any excess is first attributed to the use of the 15-year catch-up election. Thus, if a participant is eligible for both elections, the 15-year catch-up election *must* be calculated even if the intent of the participant was to use the far less complicated age 50 catch-up election.

Let's use an example to illustrate the complexity of the interaction of these limits. Let's say a participant who is age 50 and otherwise satisfied the requirements of the 15-year catch-up election (that is, he has completed 15 years of service, his average lifetime deferral with the employer does not exceed $5,000 and cumulative excesses under the election do not exceed $15,000). He wishes to utilize the age 50 catch-up to defer $23,000 in 2013 (the $17,500 general limit plus the $5,500 age-50 catch-up).

However, since the participant also qualifies for the 15-year catch-up election, the first $3,000 of the $5,500 excess is considered to be a 15-year catch-up contribution (the maximum amount that can be utilized under the 15-year catch-up election), while the remaining $2,500 is attributable to the age 50 catch-up. Since this $3,000 will count against the $15,000 cumulative limit on excesses under the 15-year-catch up election, it is possible that if the participant defers in similar fashion in future years and later wishes to defer under both the 15-year and age 50 catch-up elections, he may find that the 15-year catch-up limit has been exhausted even though he believes that it had never been used!

More importantly, this interaction requires that the 15-year catch-up calculation — a calculation that we already know is complex and prone to error — must be performed in such situations. In fact, 15-year catch-up election failures are one of the primary defects uncovered in IRS audits of 403(b) plans.

Conclusion

Due to the complexity, lack of historical data, the general relaxing of contribution limits and IRS audit potential, a growing number of 403(b) plan sponsors avoid the calculation entirely by only permitting the age 50 catch-up election and prohibiting the use of the 15-year catch-up election. (We have been told by an IRS senior staffer in the Audit Division that the IRS has noted that many K-12 employers do not offer the 15-plus years of service catch-up — but that many higher education employers do.) Generally, plan sponsors permit existing elections to continue until limits have been exhausted, but do not permit new 15-year catch-up elections. It is probably premature to identify this trend as a permanent one, but it will be interesting to see whether the 15-year catch-up election becomes a "dinosaur" in the next five to 10 years or beyond.

Please note that this article is for general informational purposes only and is not intended to be taken as legal advice or a recommended course of action in any given situation. Readers should consult their own legal advisor before taking any actions suggested in this article.

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