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Postponing 401(k) Catch-Up Changes Makes Time to Clarify Rules

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The IRS created an opportunity last week to provide much-needed clarity on retirement savings when it delayed its enforcement of a new law requiring workers earning more than $145,000 a year to make catch-up contributions only on a Roth (after-tax) basis.

The enforcement delay, to 2026, came after lobbying efforts by the benefits community and retirement plan sponsors, urging the IRS for more time to prepare for the changes under the SECURE 2.0 Act.

The requirement applies to 401(k) plans, tax-deferred annuities under Section 403(b), and governmental plans described in Section 457(b).

Prior to SECURE 2.0, plan sponsors weren't required to put either Roth contributions or catch-up contributions into their plans, though most did.

The Act's Section 603 for the first time added a mandatory tax code requirement that applies to all plans permitting catch-up contributions.

Because there was no precedent for the new requirement, questions abounded about how to implement it.

They included whether it covers self-employed individuals who don't pay federal payroll taxes, how best to apply the provisions in plans covering unrelated employers, what elections are required of affected participants, and whether plan sponsors could require that all catch-up contributions be made on a Roth basis.

The IRS also has yet to answer whether all participants can be required to make catch-up contributions only on a Roth basis, and whether a plan may implement Roth provisions only for catch-ups.

To further complicate matters, inadvertent changes to Section 603 appeared to eliminate catch-up contributions, leading retirement plan sponsors to consider dropping catch-up contributions entirely.

Given that the changes were to take effect Jan. 1, 2024, the IRS heeded calls for a delay and created a two-year "administrative transition period."

This means that before Jan. 1, 2026, plans without Roth options can continue allowing catch-up contributions, and plans with current Roth provisions can keep Roth catch-ups optional.

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The IRS also previewed guidance it will likely issue on some threshold compliance matters and, in doing so, answered some of the questions about how catch-up contributions will work starting in 2026. Most likely:

- The Roth requirement won't apply to partners and other self-employed individuals, or to state and local government employees not covered by Social Security, as defined by Section 3121(b)(7).
- Administrators may treat a nonspecific catch-up contribution election as an election to make Roth catch-up contributions.
- Participants in plans covering more than one employer (such as open multiple employer plans) won't have compensation from different unrelated employers aggregated to determine whether they're subject to the Roth catch-up requirement.
- Contributions made by participants to all plans, including plans of unrelated employers, will continue to be aggregated to determine whether the dollar limits on annual catch-up contributions have been exceeded, as they are now.

The IRS has requested comments specifically on whether catch-up contributions can be limited to participants whose prior year federally taxed wages didn't exceed $145,000.

The deadline for submitting comments is Oct. 24, 2023. Besides giving plan sponsors and administrators breathing room to comply, the transition period gives the IRS and Congress time to reevaluate Section 603 and provide clear statutory authority for the positions taken in the guidance.

However, it's unclear whether the IRS has the authority to issue guidance that appears to conflict with statutory language. Some might believe that a statutory amendment is necessary to change the intended effective date of Section 603 or to reinstate catch-up contributions. Congressional action as part of a technical corrections bill would eliminate any doubt.

Additional time also gives Congress a chance to simplify compliance with Section 603 and to make it more uniform. For example, plans don't currently need to keep track of whether an employee's prior year compensation exceeds $145,000, but they do need to track highly compensated employees, as defined in Section 414(q).

Applying the Roth catch-up requirement to highly compensated employees would make it unnecessary to track a new compensation limit.

There's also no policy reason to exempt self-employed individuals from the Roth requirements—including them would equalize the treatment of employees and the self-employed for catch-up contribution purposes.

Congress or Treasury also could permit automatic recharacterization of pre-tax contributions made by good faith errors in determining prior year compensation, rather than requiring more burdensome corrective distributions.

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