

How New Catch-Up Limits Work for 401(k) Plans

One of the big questions retirement savers have been asking this year is how the new age-50 catch-up contribution limits work.

The rules are fairly straightforward, but there are a few nuances that are important to understand.

Congress added the new catch-up contribution limits to retirement plans out of concern that baby boomers hadn't been saving enough for retirement. These new limits enable savers age 50 and over to increase contributions at a time when retirement draws near.

How They Work

The limit works as follows, assuming you are age 50 or older in 2002: You may make an additional \$1,000 pretax contribution to your 401(k) plan, on top of your regular pretax contribution limit. The catch-up limit will increase \$1,000 a year until reaching \$5,000 in 2006. Starting in 2007, further increases (in \$500 increments) will be indexed to inflation. By the way, the catch-up provision will expire along with the rest of the tax bill in 2011, unless Congress extends it.

Federal 401(k) Contribution Limits		
Year	Regular pretax dollar limit	Catch-up contribution
2002	\$11,000	\$1,000
2003	\$12,000	\$2,000
2004	\$13,000	\$3,000
2005	\$14,000	\$4,000
2006	\$15,000, then annual increases will be indexed to inflation	\$5,000, with further increases indexed to inflation

The nice thing about the catch-up limit is that it is not subject to any other federal or plan contribution limits. Catch-ups are made on top of your current limits. After you contribute the full \$11,000 allowed in 2002, you may make an additional \$1,000 contribution, for a total of \$12,000.

If your plan has restrictions that prevent you from contributing the full \$11,000, such as capping contributions at 15 percent of pay, you can still contribute the \$1,000 on top of your other limit. This even holds true if your contributions are capped because you are considered a highly compensated employee (HCE). Indeed, the IRS is willing to let employers classify excess 401(k) contributions (up to \$1,000) as catch-up contributions. So, if you are an HCE who is 50 or older, and your plan allows catch-up contributions, you should be able to contribute \$1,000 over your HCE limit in 2002 without worrying about a refund.

We've received a number of questions from participants wondering whether they can simply write a check for \$1,000 to their 401(k). The answer is "no." *All 401(k) contributions must be made through payroll deduction.* If you want to make a \$1,000 contribution from a single paycheck, make sure you can afford this reduction in your salary for that pay period.

Availability Troubles

You can't take advantage of the catch-up contribution until your employer amends its plan document to allow them. While many employers did this at beginning of the year, others, for a variety of reasons, don't plan to offer catch-up contributions immediately.

If you are unsure when your plan may offer catch-up contributions, check with your benefits department.

Maximize Your Catch-ups

Understanding how to maximize catch-up contributions is fairly straightforward. A lot depends on whether your employer makes a matching contribution. If it matches your regular contributions, it is not required to match your catch-up contribution, but it is allowed to.

If your employer doesn't provide any matching contribution at all, or if your employer matches both the regular and catch-up contributions, the advice is simple, first you make your full contribution, then you make your catch-up.

If your employer decides to only match regular 401(k) contributions and *not* catch-up contributions, you have to be careful not to miss out on the match for December contributions. That could happen if the following conditions exist:

1. your employer only matches your contributions on a payroll or monthly basis, and
2. your employer only matches your regular 401(k) contributions, not your catch-up contributions, and
3. your employer requires that you first contribute up to the plan limit before making a catch-up contribution.

Here's an example. Suppose you earn \$75,000 a year (\$6,250 a month) and your employer matches your contributions dollar for dollar on the first 5 percent of pay, but only in the pay periods when you contribute.

Further suppose you are one of those conscientious savers who likes to get things done early and make your entire \$11,000 contribution in the first six months of the year. You contribute \$1,833 per month for the first six months of the year. However, only the first \$312.50 (5 percent of \$6,250) of each contribution will be eligible for the company match. While your total contribution by the end of June will be just under \$11,000, your match will be \$1,875.

If you reduce your contributions to \$916.66 a month, by the end of December you will still reach the \$11,000 maximum, but the match you receive will be a much larger \$3,750, because you receive the \$312.50 for 12 months rather than just six.

Catch-up contributions add another variable to the calculation. Suppose you decide to contribute \$1,000 a month for the year (12 months x \$1,000 = \$12,000). Your employer matches only your contributions (not catch-ups), and requires you to make the full contribution before you can make any catch-up and matches only when you contribute. By the end of November, you will have contributed \$11,000, maxing out your contribution. But, the \$1,000 catch up contribution you make in December will not accrue any matching contribution.

A solution? In this case, contribute \$917 per month from January to November. Then in December contribute \$1,913. The \$1,000 is your catch-up while the \$913 is the remaining balance needed to add to your regular contributions to make a full \$11,000 annual contribution. You should receive a matching contribution for the December contribution.