CHIEF INVESTMENT OFFICE

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SECURE 2.0 Provisions Affecting Retirement Plans and IRAs

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INTRODUCTION

On December 29, 2022, President Biden signed into law the $1.7 trillion Consolidated Appropriation Act, 2023. Included in the over 4,000 pages of legislation are various spending and appropriations bills, provisions for additional aid to Ukraine, changes and clarifications to the Electoral College voting procedure, and a long-anticipated retirement saving bill known as SECURE 2.0 Act of 2022. This Tax Alert provides a summary of many of the key changes enacted under SECURE 2.0. In total, SECURE 2.0 includes 92 new or modified retirement provisions. In some respects, this new law is a continuation and amplification of the changes made under the SECURE Act passed in 2019, but also included are many new provisions that attempt to address deficiencies in retirement plan participation and savings among workers.

SECURE 2.0 PROVISIONS AFFECTING EMPLOYER SPONSORED PLANS & IRAS

Increase in Age for Required Beginning Date for Required Minimum Distributions:

Tax deferred retirement plans generally require account owners to begin taking distributions, and pay the corresponding deferred income taxes, during their lifetime. These mandatory distributions are referred to as required minimum distributions (RMDs). The deadline for commencing RMDs is known as the required beginning date (RBD). This deadline is intended to limit the amount of time assets can grow on a tax-deferred basis in the retirement account. However, with many workers choosing to retire later in life, more and more individuals are reaching their RBD while still working.

Recognizing that forcing distributions from retirement accounts while many individuals are still working conflicts with the goal of encouraging saving for retirement, the first SECURE Act extended the RBD to April 1 of the year after the account owner turns 72. Previously the age was 70.5. Under SECURE 2.0, beginning in 2023, that age is increased to 73 (note: those who turned 72 during 2022 are covered by the "old rules"—i.e. since they turned 72 in 2022, their first RMD is due for 2022). SECURE 2.0 also provides that beginning in 2033 the age will ultimately increase to 75. For those born in 1950 or earlier, there is no change. For those born from 1951 to 1959, required minimum distributions commence at age 73; and, for those born 1960 or later, distributions commence at age 75 (there is a drafting error in the legislation which will likely be fixed near term).

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Reduction of Penalties for Failure to take Distributions:

If an individual fails to take their RMD by the annual deadline (April 1 of the year after turning 73 for the first RMD and December 31 for all subsequent RMDs), they are subject to a significant excise tax. Under prior law, this tax was equal to 50% of the amount of the missed RMD. SECURE 2.0 has reduced that tax to 25%.

The new law also provides an opportunity to further reduce the tax to 10%. This requires that the taxpayer take the RMD and file a return reflecting the excise tax during what is referred to as the "correction window". The correction window begins on the date by which the RMD should have been taken and ends at the earlier of: 1) the date of mailing a notice of deficiency for the excise tax due; 2) the date the excise tax imposed is assessed; 3) the last day of the second taxable year after the tax was imposed. This change is effective for all taxable years beginning after December 29, 2022.

Repayment of Qualified Birth or Adoption Distributions (QBADs):

The 2019 SECURE Act permitted individuals to take distributions from a retirement plan of up to $5,000 for qualified birth and adoption expenses without being assessed a 10% early withdrawal penalty. While such distributions are penalty-free, they are subject to any applicable income taxes. However, if such distributions are repaid to the plan, they would be treated as a tax-free rollover, and any taxes previously paid could be refunded to the taxpayer.

While there was no set deadline for repaying these expenses, taxpayers generally have 3 years from the date of filing to amend a tax return and receive a refund. SECURE 2.0 limits the repayment period to 3 years; the maximum number of years that a taxpayer may amend a return and file for a refund of taxes assessed on the QBAD. This new deadline is effective for any QBAD distributions made after December 29, 2022 and retroactively to prior distributions for a 3-year period beginning on the day after the distribution was received.

Special Needs Trust RMDs:

The original SECURE Act truncated the payout term for certain beneficiaries. Special rules apply in the case of beneficiaries with a disability so payouts can last for a longer period, even if the disabled individual is the beneficiary of a trust. The Act resolves an issue with the original SECURE Act and clarifies that, in the case of a special needs trust established for a beneficiary with a disability, the trust may provide for a charitable organization as the remainder beneficiary without causing a truncated payout period. However, private foundations, donor advised funds, supporting organizations and split-interest trusts will not qualify for the favorable treatment provided under this provision. This change is effective for calendar years beginning after December 29, 2022.

Saver's Credit Now Saver's Match:

Before SECURE 2.0, certain taxpayers who contributed to an IRA, employer plan or ABLE account, were eligible for a tax credit. The tax credit was non-refundable, so many taxpayers who did not have a sufficient tax liability never benefited from the credit. SECURE 2.0 significantly revamps the credit and turns it into a matching contribution from the federal government, which must go into either the taxpayer's IRA or retirement plan. The federal match is 50% of the IRA or retirement plan contribution and capped at $2,000. Only lower income taxpayers are eligible for the government match. For joint filers, a full match is given to those earning up to $41,000 (the match phases out at $71,000). For single filers, a full match is given to those earning up to $20,500 (the match phases out at $35,500). The match cannot be withdrawn by the taxpayer before retirement without incurring penalties, including repayment to the federal government. The new match, which is one of the centerpieces and most costly provisions of SECURE 2.0 ($9 billion), is effective for taxable years beginning after December 31, 2026. It is important to note that IRA providers and defined contribution plan employers are not required to accept these government matching contributions. If a taxpayer does not designate an IRA or plan for their Saver's Match, or the IRA or plan will not accept the match, the amount will be held by the IRS and treated as an overpayment of tax.

Designating an IRA for receipt of a Saver's Match would be similar to designating a bank account to receive a tax refund which is done routinely today. However, with employer plans it may be a bit different as there generally are not specific account and bank routing numbers for individual participant accounts. Since this will not go into effect until 2027, there is time for record keepers to sort out how best to manage receipt of Saver's Match payments to participant accounts for employer plans that choose to accept them.

SECURE 2.0 PROVISIONS AFFECTING EMPLOYER SPONSORED RETIREMENT PLANS

Expanding Automatic Enrollment in Retirement Plans:

One of the key objectives of SECURE 2.0 is to increase worker participation and overall savings in retirement plans. Under the new law, companies with newly established 401(k) and 403(b) plans after the enactment of SECURE 2.0 Act of 2022, will now be required to automatically enroll their employees into the plans, and periodically increase their employees' plan contributions. Workers will continue to have the choice of opting out of contributions, or defining their own contribution percentages.

For the first year of eligibility, the percentage of compensation contributed by the employee must be between 3% and 10% upon being automatically enrolled in the plan. In each subsequent year, the contribution percentage must increase by 1%. These increases must continue until a worker is contributing a minimum of 10% of their eligible compensation and a maximum of 15%. The new law does provide exceptions to automatic enrollment for small companies (those with 10 or fewer employees) and companies that have been in business for fewer than three years. The automatic enrollment provision is effective for plan years that begin after December 31, 2024. It is important to note that plans in existence prior to the enactment of the SECURE 2.0 Act are grandfathered and not affected by these new plan defaults.

Higher Catch-Up Contribution Limit for Certain Workers:

Many employer-sponsored retirement plans permit what are known as "catch-up" contributions for individuals who are age 50 and above. Catch-up contributions simply increase the amount that an individual may add to their retirement plan in a particular year. For 2023, 401(k) and 403(b) plans permit a catch-up contribution of $7,500 in addition to the standard employee contribution limit of $22,500. SIMPLE plans allow for a $3,500 catch-up contribution on top of the $15,500 standard employee contribution limit.

SECURE 2.0 allows for an expanded catch-up contribution for plan participants who are ages 60 through 63. For these workers, the catch-up increases to $10,000 for 401(k) and 403(b) plans and $5,000 for SIMPLE IRAs and SIMPLE 401(k) plans, or 150% of the age 50 catch-up amount, whichever is greater. The $10,000 and $5,000 are subject to an annual cost of living adjustment after 2025. Those over the age of 64 would not be eligible to make the enhanced catch-up contribution: they would be limited to the regular catch-up contribution. These contributions will be permitted for tax years beginning after December 31, 2024.

	2022	2023	2024	2025
Age for Required Min. Distributions	72	73	73	73
401k Regular Contribution	$20,500	$22,500	$22,500*	$22,500*
401k Catch-up	$6,500	$ 7,500*	$7,500*#	$7,500*#
401k Expanded Catch-up (for those age 60-63)	—	—	—	$10,000**#

* amounts annually adjusted for inflation.
** amounts annually adjusted for inflation and will be greater of $10,000 or 150% of normal (inflation-adjusted) catch-up contribution.
# for taxpayers earning $145,000 or less, the catch-up and expanded catch-up contributions can be contributed to a Roth or regular deferred account. For those earning more, such contributions must be made on an after-tax basis to a Roth account.

All catch up contributions after age 50 must be after-tax Roth contributions:

Prior to SECURE 2.0, employees aged 50 and above who made catch-up contributions were permitted to designate that this additional contribution be made either on a tax deferred basis, or to a Roth account on a post-tax basis. SECURE 2.0 now requires that all catch-up contributions be made on an after-tax basis to a Roth retirement account. As a result, the catch-up contribution will not be excluded from the employee's income, but will grow tax-free and can be withdrawn tax-free in the future. There is an exception for employees with compensation of $145,000 or less, adjusted annually for inflation. The $145,000 limit is based on the prior year's wages paid by the employer sponsoring the plan. Plans that do not currently permit Roth contributions will need to add a Roth contribution option if they are to continue to permit catch up contributions. This change, which is the largest revenue raising provision within SECURE 2.0 (nearly $17 billion), is effective for tax years beginning after December 31, 2023.

Employer matching contributions may be made as Roth contributions:

Before the enactment of SECURE 2.0, all employer contributions were made on a pre-tax basis to employee accounts. This was the case even for matching contributions for employees contributing to a Roth account; the employee's contributions would go to the Roth account and the match would be made in a pre-tax account. Under the new law, plans may now give employees the option of designating that the matching contribution be made as a Roth contribution. Matching contributions made to a Roth by the employer would be considered taxable income to the employee. This change is effective December 29, 2022.

Roth Plan RMD Rules:

Unlike traditional IRAs, and most other retirement plans, Roth IRAs do not require owners to take RMDs during their lifetime. This can be a significant benefit, as it extends the amount of time that assets may remain in the Roth IRA and grow tax-free. However, previously for employer Roth accounts within 401(k) and 403(b) plans, there was not a similar exception to the RMD rules. For employer plan participants with Roth accounts, assets would have to be rolled out of the plan and into a Roth IRA to avoid being subject to RMDs.

SECURE 2.0 has eliminated RMDs for Roth employer accounts during the lifetime of the owner. This will be effective for taxable years beginning after December 31, 2023. However, it will not apply to distributions required for years prior to 2024 that are permitted to be taken after January 1, 2024.

SIMPLE and SEP Roth IRAs:

Since 2006, employers who provide 401(k), 403(b) and 457(b) plans have had the option to offer their employees both traditional accounts funded with pre-tax dollars, and Roth accounts funded with after-tax dollars. For smaller employers who opt to establish SIMPLE or SEP IRAs for their employees, there has not been a Roth option.

SECURE 2.0 now allows for contributions to be made to a SIMPLE Roth IRA account on an after-tax basis. Additionally, for SEP IRAs, which are funded only with employer contributions, employers may allow employees to treat SEP contributions as Roth IRA contributions. This change is effective for taxable years beginning after December 31, 2022.

Matching Contributions for Student Loan Payments:

Recent graduates often join the workforce with significant student loan obligations. In many instances, these individuals will have to prioritize making student loan payments over contributing to their workplace retirement plans. This means that they're missing out on any matching retirement plan contributions that an employer would otherwise make on their behalf. Under SECURE 2.0, employers are permitted to make matching contributions to 401(k), 403(b), 457(b), and SIMPLE IRA plans for any qualified student loan payments made by an employee. To calculate the match, an employer may consider all student loan payments, up to the amount of the employee's maximum allowable contributions to the retirement plan for the year. An employer may rely on an employee's certification that a qualifying student loan payment was made. This provision is effective for years beginning after December 31, 2023.

Deferral of tax for Sales of S-Corp Stock to ESOP:

Section 1042 of the Internal Revenue Code provides that if several requirements are met, an owner of stock in a privately held C corporation may sell their stock to an employee stock ownership plan (ESOP) without recognizing a capital gain on the sale. This gain deferral will continue as long as certain rules are followed for the reinvestment of the proceeds. For more information see our Wealth Strategy Report: Section 1042 Rollover of ESOP Sale Proceeds.

SECURE 2.0 extends Section 1042 deferral treatment to sales of S corporation stock, but with a significant limitation. Deferral of gain for S corporation stock sales is limited to 10% of the gross proceeds realized from the sale to the ESOP. This has the effect of dropping the top federal capital gains rate from 20% to 18%. This change will be effective for sales occurring after December 31, 2027.

Retroactive First Year Elective Deferrals for Sole Proprietors:

The original SECURE Act included a change allowing an employer to establish a new retirement plan after year-end, but before the due date of employer's tax return, and treat the plan as if it were created on the last day of the prior year. This change allows employers to make prior year contributions to the new plan, even though the plan was established after the new year, if the contributions are made before the employer's tax-filing deadline. Prior to the SECURE Act this would not have been permitted. However, this did not change the requirement that employee elective contributions to 401(k) plans must be made before year-end to qualify as a contribution for that year.

SECURE 2.0 now allows an individual who owns an entire interest in an unincorporated business, and is its only employee, to make employee elective contributions to a new solo 401(k) up to the individual's tax filing deadline (without extensions) and treat the contributions as prior year contributions. This extension of time to make an elective contribution is only available for the first year of the plan. This provision is effective for plan years beginning after December 29, 2022.

Long-term Care Contracts and Retirement Plan Distributions:

SECURE 2.0 loosens the distribution rules and would permit retirement plans to distribute up to $2,500 per year (adjusted for inflation beginning in 2025) for the payment of premiums for certain specified (high quality coverage) long term care insurance contracts for the participant (or their spouse or certain other family members). Distributions to pay such premiums would be exempt from the 10% tax on early distributions, but generally would still be taxable income. This provision will be effective December 29, 2025 (3 years after date of enactment).

Small Immediate Financial Incentives for Contributions:

Employers generally may not provide benefits conditioned on an employee contributing to a 401(k) or 403(b) plan, except for matching contributions. Prior to SECURE 2.0, this would prohibit employers from providing small gifts (e.g. gift cards) as a financial incentive for their employees to contribute to a retirement plan. SECURE 2.0 provides an exemption for a "de minimis financial incentive" from the contingent benefit and prohibited transaction rules that otherwise would prohibit such gifts. This change applies for years beginning after December 29, 2022.

SEP Contributions for Domestic Employees:

Employers of domestic employees, such as nannies or housekeepers, can create a SEP retirement plan for such employees under SECURE 2.0 even though the employer is not operating a business. This change is effective for taxable years beginning after December 29, 2022.

SECURE 2.0 PROVISIONS AFFECTING IRAS

Inflation Indexing IRA Catch-Up Limit:

Like employer sponsored plans, IRAs also permit an additional "catch-up" contribution for those aged 50 and above. For IRAs, the catch-up contribution limit was set at a static $1,000. SECURE 2.0 provides that the catch-up contribution will now be indexed for inflation in increments of $100 beginning in 2024. If the annually indexed amount is not divisible by $100 the catch-up contribution for the year is rounded down to the nearest $100. This adjustment will be effective for years beginning after December 31, 2023.

Excess Accumulations in 529 College Savings Plans: Rollover to Roth IRA:

Despite the rising costs of higher education, there are occasions when there are excess funds in a 529 College Savings Plan. This could be due to excess contributions, robust investment performance, grants or scholarships or a variety of other reasons. It has always been the case that excess funds could be transferred into another family member's college savings account or distributed to the plan beneficiary (a distribution to a beneficiary—a so-called non-qualified withdrawal—would trigger income on any earnings within the plan and would also trigger a 10% penalty).

A new and favorable penalty-free option is now available to remove excess funds and use them to fund retirement savings. 529 funds can now be rolled directly into a Roth IRA (via a trustee-to-trustee transfer) if certain conditions are met. No more than $35,000 can be rolled over from a 529 Plan to a Roth IRA over the lifetime of the 529 beneficiary and no more than $6,500 in any one year (this annual amount is capped at the Roth IRA annual contribution limit, less the amount contributed to an IRA or Roth IRA). To avoid back-end stuffing of a 529 Plan, no rollover is allowed unless the 529 has been open for more than 15 years and no rollover can consist of any funds contributed within 5 years prior to the rollover. This change is effective with respect to distributions from 529 Plans after December 31, 2023.

Inflation Adjustment for Qualified Charitable Distribution (QCD) limitation:

Individuals over the age of 70 ½ are permitted to direct that up to $100,000 per year be distributed to charity from their IRA. This is known as a qualified charitable distribution (QCD). The $100,000 limit has been in place since this provision was first enacted in 2006. SECURE 2.0 provides that the $100,000 annual QCD limit will be indexed for inflation annually, rounded to the nearest multiple of $1,000. This is effective for taxable years beginning after December 29, 2022, and the first inflation adjustment calculation will be calculated for 2024.

Qualified Charitable Distribution to Split Interest Entity:

SECURE 2.0 has also expanded upon the existing QCDs rules to allow for charitable distributions from IRAs to various types of charitable split-interest trusts, including Charitable Remainder Trusts (CRUTs and CRATs) and Charitable Gift Annuities. However, the impact of this change appears to be extremely limited since a taxpayer may only elect to do this once, and the maximum dollar amount of a split-interest QCD is $50,000. For any of these split-interest entities, the income interest may be held by the IRA owner and/or the owner's spouse, and all income paid to the lifetime beneficiary will be taxable as ordinary income. This will be effective for taxable years beginning after December 29, 2022.

IRAs and Prohibited Transactions:

Taxpayers cannot invest their IRAs in certain investments or simply in any manner they determine. Certain investments or activities can result in a so-called prohibited transaction. If that is the case, the IRA is considered "disqualified" and treated as fully distributed to the individual, irrespective of the size of the prohibited transaction. SECURE 2.0 modifies this severe consequence. Effective for taxable years beginning after December 29, 2022, if an individual has multiple IRAs, only the IRA with respect to which the prohibited transaction occurred will be disqualified. Taxpayers entering into certain high-risk transactions in their IRA, such as the acquisition of residential real estate, may want to consider bifurcating their IRA to avoid the risk of disqualifying the full IRA rather than the portion that acquires the particular investment.

OTHER PROVISIONS

There are numerous other provisions of SECURE 2.0 designed to encourage retirement savings; here are but a few:

- Improving coverage for part-time workers—certain long-term part-time employees would be required to be part of an employer's 401(k) plan.
- Employers without a current 401(k) plan could offer a "starter 401(k) plan" with lower contribution caps and simplified rules.
- Withdrawals for emergency purposes of up to $1,000 per year are exempt from the 10% early withdrawal penalty, and the taxpayer has the option to repay the distribution within 3 years.
- Liberalize rules for permitting life annuities in IRA and 401(k) plans, including qualified longevity annuity contracts (QLACs).

CONCLUSION

SECURE 2.0 modernizes and encourages employers to establish retirement plans and nudges, and even incentivizes, employees to participate in retirement plans. Many of its provisions do not immediately take effect, and some changes do not take effect for several years. However, the change in the mandatory distribution age to 73 will generally take effect in 2023, so those who were expecting to commence retirement distributions should contact their plan administrator or custodian and plan accordingly. Higher income taxpayers age 50 and older will feel the tax cost of SECURE 2.0 beginning in 2024, when their catch-up contributions can no longer be excluded from their annual income. In the long run, those taxpayers will be able to accumulate those funds on a tax-free basis and will not be required to withdraw them even after retirement.

— National Wealth Strategies, Chief Investment Office

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