Lowenstein Sandler's Employee Benefits & Executive Compensation Podcast: Just Compensation

Episode 25 -
SECURE 2.0, and How Its Changes May Impact Your Company's Retirement Plans

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JUNE 2023

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Jessica Kriegsfeld: Welcome to the latest episode of Just Compensation. My name is Jessica Kriegsfeld and I'm an associate in the firm's employee benefits and executive compensation group. I'll turn it over to Andy and Megan to introduce themselves.

Andrew Graw: Hi am Andy Graw I chair Lowenstein Sandler's, employee benefits and executive compensation practice group.

Megan Monson: And I'm Megan Monson, a partner in the same practice group as Jessica and Andy. Pleasure to be here today.

Jessica Kriegsfeld: At the end of 2022, President Biden signed into law of the Federal Omnibus spending bill titled to the Consolidations Appropriations Act 2023, which included the SECURE 2.0 Act of 2022, building on the tax legislation improved in 2019 called the Setting Every Community Up for Retirement Enhancement Act of 2019. SECURE 2.0 included a number of provisions that are intended to expand retirement plan coverage and increase retirement savings.

Today we will discuss some of the retirement plan changes in SECURE 2.0 that are effective for 2023 and beyond that sponsors of tax qualified plans should be aware of and some observations about the changes for those affected by the new law. Our discussion will focus on the changes that we think are relevant to most companies that offer qualified plans and the individuals who participate in those plans. As always, this is not intended to be an exhaustive discussion on this topic and is intended to highlight a few key changes. We suggest that you consult with your retirement plan administrator and or advisor for more information on these topics. Megan, what are some of the key changes in SECURE 2.0 that employers and participants should be aware of?

Megan Monson: Thanks, Jessica. One of the biggest changes that SECURE 2.0 puts forth is increasing the age for taking required minimum distributions from tax qualified plans. As it stands today, required minimum distributions are required from tax qualified plans beginning by April 1st of the year following the later of the year in which a participant reaches age 72 or retires. There is a special rule for participants who are greater than 5% owners in a company whereby they are required to begin receiving their required minimum distributions by April one of the year following the attainment of age 72 regardless of whether or not they're retired. Again, as it stands today, owners of IRAs are also required to begin receiving required minimum distributions by April 1st of the year following the year in which they reach age 72. What SECURE 2.0 does is that it defers the age at which point you're required to commence taking required minimum distributions from a tax qualified plan, both for tax qualified plans and IRAs from age 72 to 73 beginning January 1st, of 2023.

It also further increases the age for commencing required minimum distributions from age 73 to age 75 beginning January 1st, 2033. The rationale behind these changes is really kind of at the heart of what SECURE 2.0 is about. It's that not only making additional access to retirement plan savings, but also allowing for people to accumulate additional tax deferred earnings during their retirement. Certainly, folks are continuing to work longer and so by pushing out the ages for commencing required minimum distribution, again, it allows for folks who are working longer and living longer to delay when they're required to start taking distributions and allowing them to earn additional savings under their retirement plans.

So plan sponsors many of whom have recently updated their plans and administrative procedures to increase the required minimum distribution age from 70 and a half to 72 pursuant to SECURE 1.0 are now going to again need to amend their plans and administrative procedures to reflect the SECURE 2.0 changes. One of the other things I'll just briefly touch on with respect to RMDs is that as it previously was in effect there was a 50% penalty for failing to take RMDs to individuals who were required to. That penalty's been reduced to 25% and in some instances to 10%. So again, it's really intended to try to limit the penalties falling on individuals for failing to take the RMDs.

Andrew Graw: That is still a pretty significant penalty tax on individuals who don't receive requirement and distributions on time. It was 50%, as you said. Now it's 25%, but even 25% is a lot and it does fall on the individual even though often is not the individual's fault, it's the plan or plan administrator's fault for not having made the distributions on time.

Megan Monson: And in those situations, you may find a scenario where the individuals seeking to be made whole by the plan administrator. So it's important to have the proper administrative procedures in place to avoid these type of failures. One thing that I'll touch on a little bit later is when amendments that are required for compliance with SECURE 2.0 are required and many of those are not going to be required to actually be adopted until January 1st, 2025. However, for some of these provisions such as the RMD ages that I mentioned, there is a requirement to be operationally compliant and so plan administrators really need to be aware of and make sure they're adopting the proper procedures so that they are making distributions at the appropriate time and when folks reach the right age for commencing those distributions. Another area of SECURE 2.0 that's gaining a lot of attention is with respect to making catch up contributions.

In general, there's limits in terms of the amount of elective deferrals that a participant can contribute to a tax qualified plan. For individuals who are over the age of 50, they're permitted to make larger contributions to their retirement plan known as catch-up contributions. Under existing law, catch-up contributions can be made as regular pre-tax contributions or if a plan permits as a Roth contribution. Roth contributions are made to a plan on an after-tax basis and if deferred until a qualified distribution occurs, neither the Roth contributions nor their earnings are taxable. What SECURE 2.0 does here is that effective January 1st, 2024 for any participant whose wages for the prior calendar year exceed $145,000 annually adjusted for inflation. Any catch-up contributions they make to a 401K or 457(b) plan are going to be treated as a Roth contribution and this is an important change that really both participants and employers should be aware of.

On the employer side in particular, if you have a plan that does not already permit Roth contributions, that certain administrative procedures will need to be established to avoid having a participant's catch-up contribution, basically having to be reclassified as a Roth contribution. And for the participants in the plan, any employee who's earning more than that statutory limit could be unaware and think that they're making these catch-up contributions on a pre-tax basis. And that may have an impact on the amount they want to contribute to the plan.

Andrew Graw: I think it's really important, this could be an area of surprise for people. This particular provision takes effect after 2024, and so employers ought to be planning to include an open enrollment material for 2024, clear communications about this change so that people aren't unwittingly making catch-up contributions, believing that they would be on a pretext basis when in fact they have to be on an after tax basis. That leads to the next E change under SECURE 2.0 that has to do with matching and non-elective Roth's contributions. So starting in this year, 2023, employers may but are not required to allow participants to designate some or all of their fully vested matching contributions or non-elective profit sharing contributions as Roth contributions.

Megan Monson: Another important change as a result of SECURE 2.0 is the increased catch-up contribution limit. For 2023, the catch-up contribution limit for 401K and 457(b) plans for those age 50 or older is 7,500. IRAs currently have a $1,000 catch up limit and that is not indexed annually for inflation, but what SECURE 2.0 does is it increases the catch-up contribution limit for individuals who attained ages 60, 61, 62 and 63 to the greater of $10,000 or 50% more than the regular catch-up amount in 2024. And this change is effective January 1st, 2025.

Really the goal behind this increased catch-up contribution is to allow individuals who are getting closer to retirement age to increase and add to their retirement plan savings, which is again similar to what a lot of the rationale behind the SECURE 2.0 changes relate to. I'll also add that the new law allows for the IRA catch-up contributions be adjusted annually for inflation beginning January 1st, 2024. So again, these are important limits to be aware of as we approach the various deadlines in terms of providing information to participants in your plan and in terms of the open enrollment making elective deferral decisions for the next plan year.

Andrew Graw: And on that one Megan, I think it's important to note that although the catch-up limit for individuals in that age range, 60 to 63 is increasing significantly because of the other rule we talked about, if they make more than $145,000 index for inflation, then those additional catch-up contributions have to be made on a Roth contribution basis.

Megan Monson: Yeah, that's a great point, Andy. And so I think this really goes back to the importance of providing information and educational material to the participants in your plan so that they can make educated decisions about what makes sense for their retirement plan savings and their deferral elections for the next plan year.

Andrew Graw: Another change under SECURE 2.0 has to do with the ability of plans to make distributions of relatively small amounts. Right now, under current law, if an individual is due an amount that's under $1,000, a plan can just pay that out without the individual's consent. If it's between $1,000 and $5,000, the plan CAN still has to get the individual's consent, but the plan can automatically roll over that amount to an IRA created on the individual's behalf. SECURE 2.0 increases that limit slightly from $5,000 to $7,000. That's effective for distributions made after 2023. That's a good change. It will help employers eliminate some relatively small balances. It probably won't be that significant because it's only going from $5,000 to $7,000, but I expect most employers will modify their plans in order to take advantage of that increased limit.

Megan Monson: And I'll just echo Andy said. So while this is an optional change, it's something that would be beneficial to many companies and if they do desire to modify the plan for this, a plan amendment will be needed to implement this change.

Andrew Graw: One other thing I'll add, Megan, is that that particular change, it applies to all plans across the board, whether they're 401K or defined benefit plans. A lot of the changes that we've been talking about and we'll talk about are geared toward 401K plans, but this increase cash out limit is effective for pension plans as well.

Megan Monson: So another key point that I just want to briefly touch on with respect to SECURE 2.0 is related to automatic enrollment. As it stands today, employers can but are not required to include an automatic enrollment feature in their 401k plan. So that is essentially a provision that automatically enrolls as the name suggests, eligible employees in the plan at a particular percentage of their compensation unless the employee affirmatively opts out. And employers who offer this may also but are not required to allow auto enrolled participants to basically withdraw within 90 days after enrolling in the plan and withdraw their contributions. So what SECURE 2.0 does with respect to auto enrollment is it makes it mandatory, although the number of plans impacted by this provision is a relatively small group. It's not going to apply to any plans that are established before December 29th, 2022. It doesn't apply to any plan maintained by an employer that's been in existence for less than three years.

It does not apply to small employers that have less than 10 employees, and it does not apply to simple plans, governmental plans or certain other plans. So really you kind of think about this requirement is that it's going to apply to new plans for relatively larger employers that have been around for a longer period of time. And the goal behind this provision is that again, it's intended to help increase retirement plan savings and increase the number of people participating in 401K plans. So there's a couple aspects of SECURE 2.0 that are required for 401K plans with respect to the automatic enrollment.

The first is enrolling new participants into the plan. So then these new participants will need to be automatically enrolled at a contribution rate of no less than 3%, but no more than 10%. The new law also requires that participants who are automatically enrolled in the plan have 90 days after they've been automatically enrolled to withdraw from the plan and also to withdraw the contributions that they have made. Separately SECURE 2.0 also requires automatic increase feature, so that means the contributions that each participant makes to the plan increases by 1% each year at least until the participant's contribution equal 10% of their compensation but can continue until the participants contributing up to 15% of their compensation into the plan.

Andrew Graw: I think that's, even though it's only applicable for new plans, I think that that structure will end up becoming a standard for employers because now employers know with certainty that they can have say an automatic increase of 1% per year up to 10 to 15%. They also know with some certainty, right, that they can have an automatic enrollment with anywhere from three to 10% as the starting automatic contribution rate. I think over time I think these features will creep into existing employers plans even though they're not required to include them.

Megan Monson: Yeah, that's a really good point, Andy, and I'll also add that if an employer does want to include these features, again, that's something that would require an amendment to the plan just to have that kind of at the forefront in thinking through the practical implications.

Jessica Kriegsfeld: Other than some of the key changes to SECURE 2.0 we just briefly talked about Andy, are there other noteworthy elements of Secure 2.0 worth highlighting?

Andrew Graw: Sure. There are a number of other elements to SECURE 2.0. It's actually quite a long list. We'll just touch on a few of them. And I kind of view these as tangential changes that could be used by employers to either improve administration or to make plans more accessible to participants. So for example, one of the provisions of 2.0 allows employers to make matching contributions off of student loan repayments that participants may make. The idea here was that if participants are using available funds that they have to pay off student loans and that prevents them from having enough money to make contributions to a 401K plan to get the company match. This would allow companies to treat those student loan repayments as though they were contributions to the 401K plan by participants. It actually builds on a ruling by the IRS from a few years ago.

Frankly, I've not seen a lot of employers act on that ruling, but maybe now that it's codified into law, there'll be greater interest in it and we'll see employers start to use this particular provision. Now, the new law allows non highly compensated employees to defer on a post-tax basis, not pre-tax up to the lesser of 3% of their compensation or $2,500 to an emergency savings account, which they can subsequently draw down on as needed in order to meet emergencies that may arise. We're awaiting guidance from the IRS to determine what kind of emergencies would qualify for use of those funds, but presumably they will be lenient and allow employees to access those funds when they need to for emergency withdrawals. Importantly, when an employee takes a withdrawal from one of those accounts, well it would be normally subject to a 10% penalty tax if under 59 and a half, SECURE 2.0 waives the 10% penalty tax for those kinds of withdrawal. And since it was post-tax money to begin with, essentially those withdrawals can come out virtually tax-free.

Another change under SECURE 2.0 eliminates the 10% early withdrawal penalty charge or withdrawals for emergencies, certain emergencies as well as withdrawals needed by domestic abuse victims. Normally any withdrawal prior to age 59 and a half is subject to a 10% penalty tax. That 10% penalty tax is waived, although it would be subject to income tax. Perhaps it was always unfair or a 10% penalty tax to apply when somebody really needs to access their funds for such an emergency. And lastly, the one that I'll mention is that SECURE 2.0 allows employers to use de-minimize financial incentives in order to induce employees to join the 401K plan.

This has actually come up from time to time for us. We've had clients that have wanted to use small discounts on their own goods, if they're a manufacturer or other ways of inducing or incentivizing participants to increase their contributions to the 401K plan or to start contributions. This particular provision of SECURE 2.0 refers to using these incentives to induce employees who are not contributing to the 401K plan to do so. It's unclear whether it would be in regulations, whether they will also enable these financial incentives to be used to induce participants to increase their already existing 401k contributions. The kinds of minimal financial incentives that we're talking about are like $50 gift cards, but there are other incentives that are of the same nature that could be used as well.

Megan Monson: Another change in the bucket that Andy mentioned in terms of trying to help promote access to retirement plans for a wider group of people is something that builds upon a rule put forth by SECURE 1.0 in terms of trying to promote long-term part-time employees becoming eligible to participate in a 401K plan. What SECURE 1.0 put forth is that an individual that qualifies as a long-term part-time employee if he or she has at least either 1000 hours of service in a 12-month period or 500 hours of service in a three-year consecutive period. In effect, those rules would go into effect for plan years beginning in 2024 because they disregard service prior to 2021. But what

SECURE 2.0 changes and builds on from that rule is it reduces the three-year consecutive period for counting the 500 hours per year to two years. So in effect, with the hope of sweeping in a larger group of people to be considered long-term part-time employees who are now going to be eligible to participate in 401K plan. This rule's going to go into effect for plan years beginning after December 31st, 2024.

And so employers who are impacted by this who have long-term part-time employees only to assess internally and take stock of one, the additional changes, and two, the additional folks that may become eligible for their plans effective January 1st, 2025. Two other items I'll briefly touch on that are intended to help ease the administration side of retirement plans are the EPCRS expansion and the missing participant database. EPCRS or the Employee Plans Compliance Resolution Systems sets forth certain procedures for self-correcting failures of tax qualified plans, as well as procedures for submitting through the Department of Labor or IRS Correction Program. But what SECURE 2.0 does is it made a number of changes that promote the ability to self-correct failures, basically anything that's considered an eligible inadvertent failure, which is known as a failure that occurs despite the existence of practices and procedures that are intended to promote compliance. And it also removes a specific deadline for self-correcting failures.

Historically, the EPCRS had a bifurcation of whether a failure is significant or insignificant, and that would depend on whether or not it was eligible for self-correction depending upon how long that issue has been in play. And so again, really the goal behind this is to ease the administration and allow for a larger number of items to be self-corrected under the procedures of the new EPCRS. The other piece that I mentioned is creation of the missing participant database. So employers are required to locate quote, missing participants if they're terminating a plan, if they're making distributions under the plan. And what SECURE 2.0 does is it creates a national online database to help employers with meeting their obligations under this. Dealing with unclaimed pension benefits in particular always requires the employer to make reasonable attempts to locate missing participants, and so the goal behind this new online database, hopefully it'll be a helpful tool in kind of achieving that effort.

Jessica Kriegsfeld: Thanks, Megan. What do plan sponsors need to consider now related to the SECURE 2.0?

Megan Monson: So as I mentioned earlier, there's no actual amendments required for 2023. The amendments themselves for any of these changes are going to be due by the last day of the first plan year beginning after January 1st, 2025. That said, if there are changes that are either required, such as the required minimum distribution ones that I mentioned, or some of these other optional changes that they want to take advantage of, they're required to have operational compliance. And so that may be not only being aware of these changes, but making sure that they have administrative procedures in place to ensure that they are compliant.

Jessica Kriegsfeld: Is there anything else related to SECURE 2.0 that either of you want to highlight?

Andrew Graw: Well, like we've said before, there were a number of provisions in SECURE 2.0 that affect a wide variety of plans. We've really tried to highlight the ones that affect 401K plans and to some extent IRAs, but there are others in the law that affect IRAs predominantly. Some affect pension plans, some affect employee stock ownership plans. So employers should really go through the law with their benefits advisors or council and determine what they can do with SECURE 2.0. How can they improve their benefits programs, how can they make them more accessible or advantageous for their employees and ultimately get the most out of what's there.

Jessica Kriegsfeld: Thanks, Andy. We hope that you found today's discussion related to SECURE 2.0, informative and provided you some food for thought regarding the impact on tax qualified plans and retirement planning. Please consider checking out a client alert that we previously published on this topic, which will be links to this episode. Thanks very much for joining us today. We look forward to having you back for our next episode of Just Compensation.

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