Explainer on New Retirement Plan Law Part 2 - *Choices* Under SECURE 2.0

Client Alert
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Overview

When SECURE 2.0 passed into law at the end of December, it was like a holiday table jam-packed with the favorite foods of every individual person at the party. There is something for virtually everyone within the extraordinary variety of new optional retirement plan changes. In cobbling together the retirement plan provisions that are now known as SECURE 2.0, Congress's goals included strengthening retirement readiness by increasing access to workplace retirement plans and improving opportunities to save for retirement. When reviewing the odd mixture of new provisions included in the final law, however, it's clear that nobody had the goal of making plan administration easier...it won't be!

This Client Alert helps you 1) understand your options, and 2) why you might want to make some of the new optional plan changes. It is Part 2 of a two-part Client Alert. Part 1 of this Client Alert explained the mandatory changes under SECURE 2.0; it can be viewed here.

What optional changes might you want to consider? *("I'll have the trout, with a side of gummy bears, but hold the waffles.")*

SECURE 2.0 included a diverse menu of new retirement plan provisions, each of which is intended to improve benefits for a unique subset of plan participants. Plan sponsors do not have to adopt any of these provisions, but in the battle to attract and retain employees, an employer may want to consider whether their participant population would benefit from the addition of one or more of these options. Most of these would require a plan amendment to effectuate, as well as changes to plan service provider contracts. Virtually all come at the price of an increase

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in the plan's administrative burden.

1. Financial Incentives for Contributing to Plan. Employers may offer a small financial incentive that is not paid from plan assets (e.g., a $10 gift card) to help encourage employee participation in a 401(k) or 403(b) plan. Applies in 2023.

Take away: *These new incentives can help attract and retain employees, increase retirement readiness by increasing plan participation, and can help improve plan participation rates in a plan that has trouble passing annual nondiscrimination testing.*

2. Optional Roth Treatment of Employer Contributions. Employees can elect to pay tax on fully vested employer matching and employer nonelective contributions, so those amounts will be entitled to Roth treatment (no tax on the employer contribution or subsequent earnings upon distribution). Applies for contributions made after December 29, 2022.

Take away: *These new Roth Employer contributions can help participants, since neither the employer contributions nor earnings on those contributions will be subject to taxation upon withdrawal after retirement. Adding the flexibility of this option will benefit all participants without additional employer cost and may make your plan relatively more attractive to employees.*

3. Emergency Personal Expense Distribution. A retirement plan can allow an Emergency Personal Expense Distribution for unforeseeable or immediate financial needs relating to personal or family emergency expenses. The distribution is not subject to the 10% early withdrawal penalty. Only 1 distribution can be permitted per year, up to $1,000 (or the vested account balance, if less). The distribution may be repaid to the plan within 3 years. If repaid in the same year, a second distribution can be made in the second year. If not repaid, a second distribution may be limited. Applies in 2024.

Take away: *This lets the plan function as an emergency fund for lower-income employees and can encourage them to put money into a retirement plan knowing that if times get tight they can get some out, while countering the feeling of "not being able to afford to save" for retirement because they might need that money.*

4. Plan-Linked Emergency Savings Account. Defined contribution plans may offer an emergency savings account to non-highly compensated employees. Only employee Roth deferrals may fund the savings account. The plan may provide for automatic enrollment in the savings account, but participants must have the right to make monthly withdrawals from the account. No fees can apply to the first four withdrawals each year. Employers may auto enroll at a rate of up to 3%, and may contribute on a one-to-one basis, but all contributions are capped at $2,500. If total contributions exceed $2,500 (indexed), or a smaller amount set by the plan, and the participant has a Roth account in the plan, if there is one, those may go to the Roth. Otherwise, capped. Contributions to the savings account must be included when determining the matching contribution due to the participant under the plan. The plan sponsor may remove the savings account feature at any time. If the employee leaves, this money follows as cash or a rollover. Applies in 2024.

> ***Take away:*** *$2,500 sits in the employee's account for any purpose. How it works may be a little hard for an employee to follow, but worth explaining: it basically allows an employee to have an emergency fund but also have it grow tax-free, so it's a real encouragement for employees to contribute to a retirement plan.*

5. Treatment of Student Loan Repayments as Elective Deferrals. Employers sponsoring a 401(k), 403(b), or governmental 457(b) plans have the option to provide a plan matching contribution with respect to "qualified student loan payments" (QSLP). If adopted, these matching contributions must be made available to all match-eligible participants, and at the same rate as match contributions on elective deferrals. QSLP matching contributions are subject to the otherwise applicable vesting provisions under the plan. They may be treated as safe harbor plan contributions. There will be a nondiscrimination test to ensure it doesn't just apply to highly paid employees. The plan can rely on a participant certification of having made a QSLP. Applies in 2024.

> ***Take away:*** *Just like an employer can match contributions to a 401(k) and similar plans, student loan payments can be matched—a big draw for an employer relying on recent-college grads.*

6. Terminal Illness Exception from Early Withdrawal Penalty Tax. The 10% early distribution penalty will not apply for a participant distribution during a terminal illness, regardless of age, starting in 2023.

> ***Take away:*** *Although this is a change to the tax law, plans will need to be amended in order to allow participants to take advantage of this new tax break, and additional governmental guidance is needed.*

7. Increase in Catch-Up Contribution Limit. The "age 50" catch-up limit is increased to the greater of $10,000 or 150% of the regular catch-up in 2025, for participants who will attain at least age 60, but not age 64, by the end of the current tax year. Applies in 2025.

> ***Take away:*** *This will be especially beneficial for employees who didn't save enough for retirement while younger—now, these employees may enjoy the benefit of excluding more wages from tax, while squeezing in more savings towards the end of a career. Operationally, administering a special rule that applies during only a 4-year window will require extra attention to avoid mistakes.*

8. Qualified Longevity Annuity Contracts. A longevity annuity is a deferred annuity contract that begins payments at the end of a participant's life expectancy (typically at age 85) to hedge the participant's risk of outliving her or his savings. A qualified longevity annuity contract (QLAC) is a special deferred income annuity that allows individuals to reduce their Required Minimum Distributions (RMDs) for several years. The QLACs is funded through insurance premiums that are thereby removed from the RMD calculation. Up to $200,000 can now be placed in a QLAC. The death benefit from a QLAC can either be lump sum or a life annuity equal to the payments that the deceased participant would have received. A free-look period of up to 90 days to revoke the contract is also permitted. Generally effective for QLACs purchased on or after December 29, 2022.

> ***Take away:*** *Most employees vastly underestimate their longevity—devoting a portion of savings to a delayed annuity hedges the risk of outliving one's retirement savings, and this provision makes this option more attractive to consider.*

9. Increase of Mandatory Cash-out Limit. A retirement plan can now distribute and rollover into an Individual Retirement Annuity any small account balances of former employees up to $7,000 without the need for a participant benefit election or a spousal waiver. Previously the mandatory distribution limit was $5,000. Applies for distributions in 2024.

> ***Take away:*** *Eliminating small account balances can be beneficial from the standpoint of streamlining plan administration and avoiding "lost participants," but can also affect the cost of the plan for better (due to reduced headcount) or for worse (due to the reduction in plan assets affecting the availability of lower-cost share classes for investments.)*

10. Hardship Withdrawals. A Plan Administrator may rely on an employee certification that he or she meets the deemed hardship distribution requirements. Applies in 2023.

> ***Take away:*** *A retirement plan may, but is not required to, permit hardship distributions. This provision makes it easier for an employee to withdraw money for a qualifying immediate and heavy financial need. Since the money cannot generally be repaid to the plan, hardship distributions can adversely affect retirement readiness.*

11. Long-Term Care Insurance Premiums. The 10% early distribution excise tax will no longer apply to a plan distribution of up to $2,500 per year for the payment of premiums for certain specified long-term care insurance contracts. Applies for distributions after December 29, 2025.

> ***Take away:*** *Long-term care insurance is expensive, and premium increases can cause people to drop a policy that they have paid into for many years. This provision helps make long-term care insurance more affordable for those lacking financial resources.*

12. Life Annuities. The RMD rules have required that payments must generally be in the form of non-increasing annuities, which made the use of an annuity contract unattractive to participants in individual account plans because certain accelerated (increased) payment features like single sum distributions and death benefits were not permitted. The RMD actuarial tests now permit these features in a plan-provided lifetime annuity. Applies in 2023.

> ***Take away:*** *New flexibility permits a greater range of annuity options to satisfy the RMD rules. This essentially allows for variable rate annuities that capture/lock-in market increases.*

13. Automatic Portability Services. When a participant fails to direct where a mandatory distribution should be sent, the plan can set up a "default" IRA for the individual. A retirement plan can now obtain automatic portability services that will transfer a former plan participant's default IRA into the individual's new employer-sponsored retirement plan without an election. The individual must be provided a notice before and after the transfer. The portability service provider must acknowledge its fiduciary status. They may receive fees for their service. Applies as of December 29, 2023.

> ***Take away:*** *Employers can help keep former employees in contact with their retirement money, by avoiding having "missing participants" leave money in a default IRA.*

14. Savers Match. The current refundable income tax credit for low income individuals who contribute to an employer retirement plan or IRA will change. The individual's contribution will be matched up to 50%, but not to exceed $2,000 per individual. The individual must deposit that portion of their tax refund into the retirement plan or IRA. The tax credit phases out above incomes of $20,500 for single taxpayers and $41,000 for married taxpayers. Applies in 2027.

> ***Take away:*** *The current credit was ineffective because when an employee owed no tax, they didn't get the credit. The new credit may invite trouble for lower-income employees, however, if they fail to follow through with depositing the credit into their retirement account.*

15. Governmental 457(b) Plans. Participants no longer must make an election to contribute to a governmental 457(b) plan before the "first day of the month" to which the election will apply. Not applicable to nongovernmental 457(b) plans. Applies in 2023.

> ***Take away:*** *This provision eliminates the gap period between when a new employee is hired and when they begin contributing to their employer's 457(b) plan, which can cause a failure to contribute to the plan as a result of inertia or forgetfulness.*

16. Cash Balance Plan Variable-Rate Crediting Rate. A Cash Balance/hybrid plan that uses a variable interest crediting rate can use the interest crediting rate in effect as the projected interest crediting rate for purposes of meeting the accrual rules, if it is not in excess of 6%. Applies starting in 2023.

> ***Take away: "****Backloading" is when the plan structures pay credits so that older and longer-serving employees enjoy significantly higher benefits than shorter-term employees. Capping the interest rate at 6% prevents companies from masking backloading with high interest rates.*

17. Retiree Health Benefits. A defined benefit pension plan that is at least 110% funded can transfer up to 1.75% of plan assets to certain retiree health accounts. This can be done until December 31, 2032 but does not apply to collectively bargained plans. Applies for transfers made after December 29, 2022.

> ***Take away:*** *This provision makes it easier for an employer with an overfunded pension plan to use assets to pay for retiree health care, at least through 2032.*

18. Qualified Birth or Adoption Distributions (QBADs). A retirement plan may, but is not required to, provide for QBADs, i.e., a distribution from the participant's account of up to $5,000 when a child is first born or adopted. While penalty free, a QBAD is subject to income tax, unless repaid to the plan in which case the taxes can be refunded. The repayment period for a QBAD was formerly unlimited. Now the time period for repayment is generally three years, in order to be eligible to receive a refund of the taxes previously paid.

> ***Take away:*** *Children are expensive. Adding the option of obtaining a QBAD distribution may encourage younger employees to contribute to the retirement plan because they know they will be able to access their money if they expand their family.*

Conclusion

The complete smorgasbord of permitted new plan features can--at first glance—be overwhelming. Part 1 of this Client Alert described mandatory provisions in SECURE 2.0. This Part 2 describes the optional changes.

Working with legal counsel, plan sponsors should sort through the full panoply of permitted plan changes to determine which are best suited to their particular plan participant population. For example, a participant base that is low paid may benefit more from a feature such as the Emergency Personal Expense Distributions or the Roth-form of Employer contributions. A participant base that has a high number of young professionals may benefit from features such as the treatment of Student Loan Payments as Elective Deferrals. And, a participant base with older, higher paid participants may benefit from adding QLACs, and increased Catch-Up contributions.

Some of these permitted plan changes may ease plan administration or reduce costs. Examples of these types of changes might include allowing participant self-certification of hardship distribution eligibility, or the increase of the Mandatory Cash-Out Limit. But most of these changes will add complexity to plan administration. As with all optional plan design decisions, the trade-offs should be carefully considered before moving ahead.

You may not be able to implement most of these options until your retirement plan's Recordkeeper or Third-Party Administrator is ready to handle the new plan feature. And, as mentioned previously, amendments to your plan document will be required.

Please contact your Butzel attorney, or the authors of this Client Alert, if you have any questions or would like more information.

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