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SECURE 2.0 Act and Its Impact on Defined Contribution Plans

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In our prior alert, we introduced the SECURE 2.0 Act of 2022 (SECURE 2.0 or the Act), a portion of the Consolidated Appropriations Act of 2023. There we discussed key provisions applicable to all qualified retirement plans. This alert, part of our ongoing series covering the retirement plan changes in SECURE 2.0, summarizes provisions applicable only to defined contribution plans.

Provisions Impacting 401(k) and 403(b) Plans

Higher Catch-Up Limit to Apply for Ages 60-63. Individuals age 50 and over are permitted to make catch-up contributions under a retirement plan in excess of the otherwise applicable limits. The Act further increases these limits for participants who have attained age 60, but have not attained age 64, to the greater of $10,000 or 150 percent of the regular catch-up amount for 2024, indexed for inflation. These changes become effective January 1, 2025.

Treatment of Student Loan Payments as Elective Deferrals for Purposes of Matching Contributions. SECURE 2.0 permits sponsors of defined contribution plans to treat "qualified student loan payments" as elective deferrals for matching contribution purposes. A qualified student loan payment is broadly defined as any indebtedness incurred by the participant solely to pay the participant's cost of attending an institution providing post-secondary education. Eligible participants are required to annually certify the amount and timeliness of any loan payments made. This provision is effective for plan years beginning after December 31, 2023.

Expanding Automatic Enrollment. Effective on the first day of the plan year beginning after December 31, 2024, SECURE 2.0 requires all 401(k) and 403(b) plans to include an eligible automatic contribution arrangement (EACA) unless an exception applies. An EACA requires individuals to become automatically enrolled at a default rate between 3 percent and 10 percent and an automatic enrollment amount escalation of 1 percent per year up to at least 10 percent but no more than 15 percent.

The Act contains exceptions for all defined contribution plans that include a 401(k) feature prior to the effective date, all 403(b) plans established prior to the effective date, small businesses, new businesses, church plans and government plans.

Surprisingly, SECURE 2.0 does not exclude multiemployer plans from the automatic enrollment requirement. Sponsors of multiemployer-defined contribution plans that do not permit elective deferrals should carefully consider how administration may be impacted if a 401(k) feature is added after the effective date of this provision.

Improving Coverage for Part-Time Workers. The SECURE Act required employers to allow long-term, part-time workers to make elective deferrals to defined contribution plans following completion of three consecutive years with at least 500 hours of service. The Act reduces the three-year rule to a two-year rule, effective for plan years beginning after December 21, 2024. Consistent with the SECURE Act, the Act disregards all pre-2021 service for purposes of determining vesting service. Additionally, SECURE 2.0 excludes all pre-2023 service for purposes of determining long-term, part-time status under the new standard.

Withdrawals for Certain Emergency Expenses. SECURE 2.0 permits in-service distributions from 401(k) and 403(b) plans under the following circumstances:

- *Payment of Emergency Expenses.* These distributions may not exceed $1,000, and a participant may not take more than one distribution in a calendar year. Additionally, if the distribution is not repaid, a participant is not permitted to take an additional emergency expense distribution during the three calendar years following the year of the distribution. This provision is effective for plan years beginning on or after January 1, 2024.
- *Domestic Violence Survivors.* Survivors of domestic violence can receive distributions equal to the lesser of $10,000 (indexed for inflation) or 50 percent of the participant's vested account balance. This provision is effective for plan years beginning on or after January 1, 2024.
- *Qualified Federally Declared Disasters.* Individuals whose primary place of residence is located in the geographic area determined to be impacted by a federally declared disaster may receive distributions of up to $20,000. Taxation of the distribution can be spread over the three-year period following the distribution. This provision is effective for disasters declared after January 26, 2021.

Plan sponsors are permitted to rely on a participant's certification of eligibility. Repayment of these distributions is generally permitted within three years of the distribution. Qualifying distributions are also exempt from the 10 percent early withdrawal penalty.

Employers May Rely on Employee Certification for Hardship Distributions. The Act allows a plan administrator to rely on a participant's self-certification of the occurrence of a hardship event that satisfies the IRS "safe harbor" circumstances and qualification for a hardship withdrawal. This provision is effective for plan years beginning December 29, 2022.

Repayment of Qualified Birth or Adoption Distribution. Under the SECURE Act, plan sponsors were permitted to add an in-service distribution option following the birth or adoption of a child. The SECURE Act permitted repayment of the distribution. SECURE 2.0 clarifies that a participant is permitted to repay the distribution only during the three-year period following the distribution. This requirement is effective for distributions made after December 29, 2022. Distributions made prior to the effective date may only be repaid prior to December 31, 2025.

Roth Plan Distribution Rules. Historically, Roth IRAs have been exempt from pre-death required minimum distribution rules. The Act expands this exemption to Roth subaccounts held in an employer retirement plan, effective for taxable years beginning after December 31, 2023. This provision does not apply to distributions required before January 1, 2024.

Long-Term Care Contract Purchased with Retirement Plan Distributions. The Act permits retirement plans to provide in-service distributions for the purpose of purchasing long-term care insurance. The distribution may not exceed the lesser of: (1) the employee's costs; (2) 10 percent of the employee's vested account balance; or (3) $2,500 per year. These distributions may also be exempt from the 10 percent early withdrawal tax if certain requirements are satisfied. This change is effective for distributions beginning December 29, 2025.

Catch-Up Contributions Made on a Roth Basis. Under prior law, catch-up contributions were permitted to be made on a pre-tax or Roth basis. Pursuant to SECURE 2.0 and effective January 1, 2024, if a plan permits Roth contributions, then catch-up contributions must be made on a Roth basis. The Act includes an exception for participants whose prior-year compensation did not exceed $145,000, indexed for inflation.

Optional Treatment of Employer Matching or Nonelective Contributions as Roth Contributions. The Act allows plan sponsors to permit participants to designate employer matching or nonelective contributions as Roth contributions. Student loan matching contributions may also be designated as Roth contributions. Matching and nonelective contributions designated as Roth contributions are not excludable from the employee's income and must be 100 percent vested when made. This provision is effective for contributions made after December 29, 2022.

Creation of Safe Harbor for Correction of Employee Elective Deferral Failures. The Act creates a specific safe harbor correction method for mistakes made related to automatic enrollment, affirmative enrollment and automatic escalation features within a retirement plan. Specifically, employers are not required to make a qualified nonelective contribution related to these errors, provided the error is discovered within 9-1/2 months following the close of the plan year in which the error occurred. Plan sponsors must continue to make corrective contributions equal to any missed matching contributions. This provision may be used to correct errors occurring after December 31, 2023.

Provisions Impacting 403(b) Plans

Multiple Employer 403(b) Plans. SECURE 2.0 permits the creation of Pooled Employer 403(b) Plans. The Act also directs the Treasury to issue regulations providing these plans relief from the "one bad apple rule" and to issue model plan language. This provision is effective for plan years beginning after December 31, 2022.

Enhancement of 403(b) Plans. Under previous law, 403(b) plan investments were generally limited to annuity contracts and publicly traded mutual funds. The Act permits 403(b) custodial accounts to participate in group trusts with other tax-preferred savings plans and IRAs. This revision is effective after the date of enactment, December 29, 2022.

Unification of Hardship Withdrawal Rules for 401(k) and 403(b) Plans. The Bipartisan Budget Act of 2018 created differences in the hardship rules for 401(k) plans and 403(b) plans primarily allowing 401(k) plans to make hardship distributions from more contribution sources. The Act conforms the hardship distribution rules for 401(k) and 403(b) plans so that 403(b) plans may now make hardship distributions from the same contribution sources as 401(k) plans. Further, distributions from 403(b) plans are no longer treated as failing to be made upon hardship solely because the employee does not take available loans. These changes are effective for plan years beginning after December 31, 2023.

Provisions Impacting Employee Stock Ownership Plans (ESOPs)

Deferral of Tax for Certain Sales of Employer Stock to ESOPs sponsored by S

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Corporations. The Act expands the gain deferral provisions available to owners of C Corporations sponsoring an ESOP to also apply to owners of S Corporations sponsoring an ESOP. The deferral available to owners of S Corporations is limited to 10 percent. This expansion is effective for sales of stock after December 31, 2027.

Certain Securities Treated as Publicly Traded in Case of ESOPs. The Act allows for certain non-exchange traded securities to qualify as "publicly traded employer securities" for purposes of required diversification rules related to plan qualification. These employer securities (1) must be subject to priced quotations by at least four dealers on a SEC-regulated interdealer quotation system; (2) not be a penny stock and not issued by a shell company; and (3) have a public float of at least 10 percent of outstanding shares. There are additional requirements as well, depending upon whether the stock was issued by a domestic or foreign entity. These changes are effective for plan years beginning after December 31, 2027.

Provisions Impacting Multiple Employer Plans

Modification of Pooled Employer Plans. The SECURE Act created Pooled Employer Plans (PEPs) that allow unrelated employers to join together to participate in one plan without any commonality requirement. To qualify as a PEP, the plan must satisfy a variety of requirements, including specific fiduciary designations and acknowledgments. The Act clarifies the rules to allow the plan to designate any named fiduciary, other than a participating employer, as the entity responsible for contribution collections. Such fiduciary is required to implement written reasonable, diligent and system contribution collection procedures. This change applies for plan years beginning after December 31, 2022.

Provisions Impacting Administration of Defined Contribution Plans

Financial Incentives Permitted to Encourage Plan Contributions. The Act allows plan sponsors to offer de minimis financial incentives (not paid for with plan assets), such as low-dollar gift cards, for participants who contribute to a 401(k) or 403(b) plan. These de minimis financial incentives will be exempt from the contingent benefit rule and relief is provided from the Code and ERISA prohibited transaction rules. This provision is effective for plan years beginning after the date of enactment, December 29, 2022.

Application of Top-Heavy Rules to Defined Contribution Plans Covering Excludable Employees. Employers may now perform the top-heavy test separately for excludable employees and non-excludable employees. This change is effective for plan years beginning after December 31, 2023.

As a reminder, excludable employees are individuals who have not earned one year of service or attained age 21.

If you have any questions about SECURE 2.0 or the Consolidated Appropriations Act of 2023 and the potential impact these legal changes could have on your benefit plans, please contact your Reinhart benefits attorney.