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SECURE 2.0 Act of 2022: The Highlights

A guide to major retirement plan changes

The SECURE 2.0 Act was signed into law on December 29, 2022. The overall goal of the bipartisan legislation is to encourage more Americans to save for retirement while helping ensure those same Americans do not run out of money while in retirement. The major changes affecting retirement plans are summarized here.

Saving for Retirement

Automatic Enrollment. To spur more Americans towards saving for their own retirement, employers with a 401(k) or 403(b) plan will be required to automatically enroll employees in that plan upon the employee becoming eligible, although employees may opt out of coverage. The initial automatic enrollment deferral amount is at least 3% but not more than 10% of the employee's pay. The deferral amount increases by 1% of pay annually until it reaches at least 10% but not more than 15% of pay. Small businesses with 10 or fewer employees are exempt from this provision. This provision is effective for plan years beginning in 2025.

Starter 401(k) Plans. Beginning in 2024, employers who do not have a retirement plan can establish a "starter 401(k)" plan which generally requires all employees be enrolled with a default deferral of between 3% and 15% of the employee's compensation. The deferral amount would be capped at that year's IRA contribution maximum.

Employer Plan Set-up Incentives. To encourage employers to establish retirement plans for their employees, new incentives are created. Starting in 2023, the three-year small business plan startup cost credit is increased from 50% of the administrative cost to 100% for employers with up to 50 employees and is phased out for employers with 51 to 100 employees. The maximum credit is $5,000. There is also a credit for all or a portion of the employer's contributions during the first five years of the plan.

The startup cost credit is also made available to employers who join Multiple Employer Plans (which include Pooled Employer Plans "PEPs"). This is retroactive to 2020.

Catch-up Contributions. Beginning in the year in which a taxpayer reaches age 50, additional amounts can be deferred into or contributed to retirement plans. The legislation makes several changes to these "catch-up contributions."

Theoretically, Americans nearing retirement are in their highest income earning years, providing an opportunity to save more for retirement. For those who attain age 60, 61, 62, or 63 during a given year, that year's catch-up contributions for SIMPLE IRAs, SEP IRAs, and qualified retirement plans such as 401(k)s and 403(b)s will be increased to the greater of $10,000 or 50% more than the regular catch-up contribution amount. The increased amounts are indexed for inflation. These higher amounts are effective for tax years starting in 2025.

The $1,000 catch-up contribution limit for both traditional and Roth IRAs will be indexed for inflation in $100 increments starting in 2024.

Tax legislation almost always requires provisions designed to "pay for" the new tax incentives. Beginning in 2024, catch-up contributions to qualified retirement plans (i.e., not IRAs) are required to be post-tax Roth deferrals. An exception is provided for employees with compensation of $145,000 (indexed) or lower.

The ability to make larger catch-up contributions is generally a positive. However, most taxpayers making those catch-up contributions are in their highest income earning years. Because the catch-up contributions will be Roth contributions, this means potentially more tax is paid during the year of deferral, and the distributions are generally income-tax free during retirement when the individual is typically in a lower income tax bracket. This will be a hidden tax for many people.

Qualifying Longevity Annuity Contracts.

Qualified Longevity Annuity Contracts (QLACs) are deferred annuities designed as a way to hedge against outliving a defined contribution retirement plan or IRA. Previously, funding caps generally prevented QLACs from being utilized by many Americans. To encourage more people to take advantage of QLACs, the 25% of retirement account balance limit for QLACs is repealed. Also, the maximum amount which can go into a QLAC is increased to $200,000 (indexed for inflation). These changes are effective for QLACs purchased or received in an exchange on or after the date of enactment (December 29, 2022). The Treasury Department is required to update QLAC regulations within 18 months to reflect the changes.

Matching Contributions.

Effective immediately, defined contribution plans may offer the option of treating matching contributions as Roth contributions.

Effective in 2024, employees who are not contributing to their employer's qualified plan may receive matching contributions if the employee is making "qualified student loan payments" in lieu of making qualified plan contributions. A "qualified student loan payment" is defined as a payment made by an employee in repayment of a loan incurred solely to pay qualified higher education expenses.

Rollover of Unused 529 Account Balances.

Those saving for their child's education via a 529 plan face unintended taxation if a balance remains in the account after the child obtains a scholarship, finishes schooling, or does not attend college. Beginning in 2024, unused 529 plan balances can be rolled tax- and penalty-free into the 529 plan beneficiary's Roth IRA. The 529 plan must have been open for at least 15 years, the rollover is subject to the annual Roth IRA contribution limit, the rollover has a lifetime cap of $35,000, and the amount rolled into the Roth IRA cannot exceed aggregate contributions (and earnings on those contributions) made at least five years prior to the rollover.

Roth Accounts for SIMPLE and SEP IRAs.

Beginning in 2023, SIMPLE IRAs and SEP IRAs may have a Roth account.

Retirement Plan Distributions

Required Beginning Date.

The original SECURE Act, signed into law in December 2019, changed the date a taxpayer must begin taking qualified plan and IRA distributions. The required beginning date (RBD) for calendar year 2022 is the year in which an individual turned 72. However, as long as it was the first required minimum distribution (RMD), that individual had until April 1 of 2023 to take their 2022 RMD. If the individual waited until 2023 to take the 2022 RMD, they would have two RMDs in this one year, one for 2022 and one for 2023.

SECURE 2.0 changes the RBD to age 73 for year 2023 and thereafter. That means if a person turned 72 in 2022, they still have an RMD for last year and this year. If they were waiting until 2023 to take their first RMD, they still must take both the 2022 and 2023 RMDs this year.

If a person turns 72 in 2023, that individual's RBD is not until next year, 2024.

There is also a provision that changes an individual's RBD to age 75. However, the drafters of the statute made a technical error when drafting, so it isn't clear whether the RBD changes to age 75 in year 2033 or 2034. This will have to be worked out with Technical Corrections.

Annuities in Retirement Plans. Many retirement plan participants and IRA owners use annuities inside their accounts to ensure the plans do not run out of money. Under prior law, all of a taxpayer's IRAs are aggregated to establish a gross balance for purposes of determining required minimum distributions (RMDs), however once an annuity in an IRA is annuitized, the RMD is calculated separately for the IRA annuity and for the other IRAs. The IRA annuity payment could not previously be used to offset the RMD of the other IRAs. Effective immediately, an IRA income annuity's value as of December 31 of the prior year is added to the other IRAs' prior year-end balance to establish a sum. The RMD is determined using that sum. The annuity payment is the first amount to come out for RMD purposes, and the remaining RMD can come from the other IRAs. Unfortunately, the statute does not provide guidance on how to value the IRA annuity. Until regulations are issued, taxpayers may make a reasonable good faith effort in determining the IRA annuity value.

Designated Roth Account Distributions. Under current law, Designated Roth Accounts (often referred to as Roth 401(k)s) have RMDs while Roth IRAs do not. This different treatment was not based on tax policy and was easily worked around by rolling over to a Roth IRA upon retirement or termination of employment. Beginning in 2024, Designated Roth Account RMDs are eliminated.

New Exceptions to 10% Early Distribution Penalty. SECURE 2.0 adds several new exceptions to the 10% penalty for early withdrawals from qualified plans and IRAs. Distributions from non-Roth accounts remain income taxable, the changes impact only the early withdrawal penalty.

- ✓ *Emergency expenses*. Beginning in 2024, a taxpayer may take one annual distribution of up to $1,000 from a retirement account penalty-free for emergency expenses. The emergency expenses must be for "unforeseeable or immediate financial needs relating to necessary personal or family emergency expenses." The taxpayer has the option to repay the distribution within three years. No additional emergency distributions can occur during the three year repayment period unless repayment has occurred.

- ✓ *Domestic abuse*. Beginning in 2024, retirement plans are allowed to permit participants to self-certify that that the participant experienced domestic abuse. Upon certification, the participant may take a penalty-free withdrawal of up to the lesser of $10,000 or 50% of the retirement account balance. The distribution may be repaid within three years. Any income tax paid on the distribution will be refunded if the amount is repaid.

- ✓ *Terminal illness*. Effective immediately, a new exception from the 10% penalty is created for terminally ill individuals. For this purpose, a terminally ill individual is one who has been certified by a physician as having an illness or physical condition which can reasonably be expected to lead to death within 84 months of the date of certification.

- ✓ *Long-term care insurance premiums*. Beginning three years after the date of enactment, taxpayers may take a penalty-free distribution of up to $2,500 (indexed for inflation) to pay premiums on a certified long-term care insurance contract.

- ✓ *Series of substantially equal periodic payments (SOSEPP)*. The legislation clarifies that if a participant is utilizing the SOSEPP exception and (1) the account is either rolled over or (2) an annuity providing the payments is exchanged, the SOSEPP exception continues to apply. This is effective immediately.

Other Provisions

Special Needs Trusts and Inherited Retirement Accounts. The original SECURE Act changed the distribution rules for inherited retirement accounts. As originally drafted, the statute made it difficult to use a special needs trust as a retirement plan beneficiary. SECURE 2.0 clarifies that if a special needs trust for a beneficiary with a disability is the eligible designated beneficiary of an inherited qualified plan or IRA, the special needs trust may provide that the remainder beneficiary of the trust is a charity without losing the ability to stretch the RMDs over the disabled beneficiary's life or life expectancy. This is effective in 2023.

IRA Prohibited Transactions. Beginning in 2023, if an individual with multiple IRAs engages in a prohibited transaction with one of those IRAs, only that IRA is disqualified.

Qualified Charitable Distributions. A taxpayer over age 70½ can make a qualified charitable distribution (QCD), which is a direct distribution from an IRA to a public charity. The QCD qualifies as an RMD, is excluded from the taxpayer's income, and no income tax deduction is allowed. The QCD rules are expanded beginning in 2023 to allow a one-time $50,000 distribution to charity via a charitable gift annuity, charitable remainder unitrust, or charitable remainder annuity trust. The $100,000 annual QCD maximum is also indexed for inflation, effective immediately.

ABLE Accounts. ABLE accounts are tax-advantaged accounts for certain people with disabilities. Distributions from an ABLE account are income-tax free when used for qualified disability expenses of the account's beneficiary. Starting in 2026, the age by which blindness or disability must occur for an individual to be eligible for an ABLE account is raised from 26 to 46.

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