SECURE 2.0 ACT LEGISLATION INCLUDES SIGNIFICANT CHANGES TO INDIVIDUAL RETIREMENT ACCOUNTS

Date: 31 January 2023

U.S. Corporate Alert

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Late last year, Congress enacted a sweeping set of new retirement savings rules. The SECURE 2.0 Act of 2022 (SECURE 2.0), included as part of the Consolidated Appropriations Act, 2023, builds on the significant retirement savings changes previously enacted by the original SECURE Act of 2019. The changes affect both employer-sponsored retirement savings plans as well as individual retirement accounts (IRAs), including Traditional, Roth, Simplified Employee Pension (SEP) IRAs, and Simple Retirement Accounts (SIMPLE IRAs). While some of the provisions have delayed effective dates, many of the changes are effective immediately.

The IRA-related changes significantly impact IRA administration and documentation for IRA providers, including IRA trustees and custodians. While IRA trust and custodial agreements will not need to be to amended to reflect SECURE 2.0 until 31 December 2025, IRAs must be operated in accordance with SECURE 2.0 changes when and as they become effective. In light of the immediate effective date of many of the changes, IRA trustees and custodians need to immediately update a variety of contribution, distribution, and tax reporting and withholding procedures, as well as their IRA disclosure statements.

The following is a brief summary of the most significant IRA-related provisions of SECURE 2.0 that impact IRA providers.

REQUIRED MINIMUM DISTRIBUTION CHANGES

SECURE 2.0 includes a number of changes that affect IRA-required minimum distributions (RMDs).

Increase in RMD Age (Effective in 2023)

The original SECURE Act generally increased the beginning date for RMDs from retirement plans, including IRAs, from age 70-½ to age 72. SECURE 2.0 increases the beginning date to age 73 in 2023 and to age 75 in 2033. This change does not apply to individuals who were age 72 or older on 31 December 2022.

Reduction in RMD Failure Excise Tax (Effective Immediately)

SECURE 2.0 reduces the excise tax applicable to a failure to timely receive an RMD from an IRA or other retirement account from 50% to 25%. The excise tax is further reduced to 10% if, generally, the failure is corrected by the end of the second taxable year that begins after the end of the taxable year in which the distribution was required to be made. This change became effective on 29 December 2022.

Satisfaction of RMD Requirements With Commercial Annuities (Effective in 2022)

SECURE 2.0 includes more flexible rules for using commercial annuities to satisfy RMD requirements by permitting commercial annuity contracts purchased by an IRA or other retirement plan to provide (i) for annual or more frequent payment increases of up to 5% per year, (ii) accelerated lump-sum payments of all or a portion of the remaining payments due (or payments to be received over a following period of 12 months), (iii) payments of dividends and distributions, and (iv) accelerated death distributions for the undistributed portion of the amount paid for the annuity. These changes are effective for calendar years ending after 29 December 2022.

Expansion of QLAC Exemption (Effective Immediately)

SECURE 2.0 expands the RMD exemption for Qualified Longevity Annuity Contracts (QLACs) by (i) eliminating the requirement that the QLAC premium not exceed 25% of the individual's account or IRA balance, (ii) increasing the QLAC dollar limit from US$125,000 to US$200,000 (indexed to the cost of living beginning in 2024), and (iii) permitting the QLAC to include a provision that allows the individual to rescind the contract within 90 days. These changes became effective on 29 December 2022, and the 90-day “free-look” rescission rule is retroactive to 2 July 2014.

Partial Annuity Rules (Effective Immediately)

SECURE 2.0 allows RMDs for an IRA or other retirement account that has been partially annuitized to be determined under the rules for defined contribution plans rather than the more restrictive defined benefit plan rules. Under the new rule, the value of the annuity contract is treated as part of the account balance and payments from the annuity contract are applied toward the total amount required to be distributed. The overall result should be a reduction in RMDs in most cases. This change became effective on 29 December 2022.

Special Needs Trusts (Effective in 2023)

The original SECURE Act generally requires that distributions following the death of an IRA owner be completed within 10 years unless the designated beneficiary is an “eligible designated beneficiary.” Beneficiaries of certain “special needs” trusts established at least in part for the benefit of a disabled or chronically ill individual can be treated as eligible designated beneficiaries who are exempt from the 10-year limitation if all beneficiaries of the trust otherwise qualify as “designated beneficiaries” for RMD purposes. Charitable organizations do not qualify as “designated beneficiaries.” SECURE 2.0 clarifies that a special needs trust that designates a charitable organization as the remainder beneficiary will not disqualify the special needs trust from the rule permitting the beneficiaries of the trust to be treated as eligible designated beneficiaries. This provision is effective for calendar years beginning after 29 December 2022.

EXCEPTIONS TO THE 10% EARLY DISTRIBUTION EXCISE TAX

Generally, taxable distributions from a retirement plan, including an IRA, before age 59-½ are subject to a 10% excise tax unless an exception applies. SECURE 2.0 revised and added a number of exceptions to that excise tax.

Qualified Birth and Adoption Expenses (Effective Immediately)

The SECURE Act of 2019 added an exception to the 10% early distribution excise tax for distributions from retirement plans, including IRAs, made to individuals who have qualified birth and adoption expenses. That exception provided that qualified birth and adoption expense distributions could be repaid to an IRA or other retirement plan. SECURE 2.0 limits the repayment period for qualified birth and adoption expense distributions to the three-year period beginning on the date of distribution. This limitation is a recognition that it was not generally possible to obtain a refund for taxes on distributions repaid following the lapse of the three-year statute of limitations generally applicable to federal income tax refunds. This change is effective with respect to distributions made after 29 December 2022.

Terminally Ill Individuals (Effective Immediately)

SECURE 2.0 permits terminally ill individuals to receive penalty-free distributions from retirement accounts, including IRAs. The individual must be certified by a physician as having an illness or physical condition that can reasonably be expected to result in death in 84 months or less. Amounts distributed on the basis of terminal illness may be repaid by the individual to an employer-sponsored retirement plan or IRA within three years after the date of distribution. This provision is effective for distributions made after 29 December 2022.

Federally Declared Disasters (Effective Immediately)

From time to time, Congress has exempted retirement account distributions, including IRA distributions, from the 10% early distribution excise tax to the extent made in connection with specific federally declared disasters. SECURE 2.0 provides a permanent, generalized exemption for federally declared disasters. The rules are similar to the rules that have applied to specific exemptions provided in the past: (i) the individual's principal place of abode must be located in a federally declared major disaster area and the individual must have sustained economic loss by reason of the disaster, and (ii) the distribution must be made after the first day of the federally declared “incident period” with respect to the disaster and within 180 days after the first day of the incident period or the date of the disaster declaration (whichever is later). The maximum amount that may be distributed under this exception with respect to any disaster is US$22,000. Any distribution made under this exception may be repaid to an employer-sponsored retirement plan or IRA within three years after the date of the distribution. This provision is retroactively effective with respect to disasters for which the specified incident period begins on or after 26 January 2021.

Repayment Right With Respect to Abandoned First-Time Home Purchases in Qualified Disaster Areas (Effective Immediately)

Distributions from IRAs for qualified first-time home purchase expenses are generally exempt from the 10% early distribution excise tax. SECURE 2.0 expands that exception by permitting those distributions to be repaid to an employer-sponsored retirement plan or IRA if the distribution was to be used to purchase or construct a principal residence in a federally declared disaster area, but it was not so used. The distribution must have been received during the period beginning 180 days before the first day of the federally declared incident period with respect to the disaster and ending 30 days after the last day of that incident period. The distribution must be repaid during the period beginning on the first day of the federally declared incident period with respect to the disaster and ending 180 days after the later of the first day of the incident period or the date of the disaster declaration. The purpose of this provision is to allow individuals who intended to buy or purchase a first-time principal residence, but who were unable to do so by reason of a federally declared disaster, to return the unused funds to a retirement plan. This provision is effective with respect to disasters for which the specified incident period begins on or after 26 January 2021.

Return of Excess Contributions and Earnings (Effective Immediately)

SECURE 2.0 exempts corrective distributions of excess contributions and earnings to an IRA from the 10% early distribution excise tax if the distribution is made before the due date of the IRA owner's federal income tax return for the year of the excess contribution (including extensions). This provision is generally effective on 29 December 2022 without regard to when the excess contribution or distribution occurred.

Emergency Personal Expenses (Effective in 2024)

Under SECURE 2.0, a distribution from a retirement plan, including an IRA, for the purpose of paying emergency personal expenses, up to US$1,000, is exempt from the 10% excise tax. The individual may repay the distribution to an employer retirement plan or an IRA within three years following the date of the distribution. The exemption is only available with respect to one distribution per year, and if an emergency personal expense distribution is made in a year, no other distribution during the immediately following three-calendar-year period may be treated as an emergency personal expense distribution unless the prior distribution is repaid or the individual's annual retirement plan contributions to all plans and IRAs (e.g., the individual's own elective contributions to 401(k) plans and regular IRA contributions) equal or exceed the amount of the prior emergency personal expense distribution. Emergency personal expenses are expenses due to unforeseeable or immediate financial needs relating to personal or family emergencies. This provision is effective for distributions made after 31 December 2023.

Domestic Abuse Victims (Effective in 2024)

SECURE 2.0 allows victims of domestic abuse to take penalty free withdrawals from retirement plans, including IRAs, in an amount equal to the lesser of $10,000 or 50% of the individual's account balance during the one-year period beginning on any date on which the individual is a victim of domestic abuse (which is defined to include not only abuse of the individual IRA owner but also abuse of the individual's child or a member of the individual's household). The distribution is not eligible for rollover and may be repaid to an employer-sponsored retirement plan or an IRA during the three-year period beginning on the date of the distribution. The $10,000 limit is indexed to the cost of living for calendar years after 2024. This provision is effective for distributions made after December 31, 2023.

SEP AND SIMPLE IRAS

Roth SEP SIMPLE IRA Contributions (Effective in 2023)

Effective for taxable years beginning after 31 December 2022, employer and employee SEP and SIMPLE IRA contributions may, at the employee's election, be made on a Roth basis.

SEP IRAs for Domestic Employees (Effective in 2023)

Effective for taxable years beginning after 29 December 2022, an employer may make deductible SEP contributions for domestic employees (e.g., nannies).

Student Loan SIMPLE IRA Matching Contributions (Effective in 2024)

For purposes of required SIMPLE IRA matching contributions, an employer may elect to treat student loan repayments as if they were employee elective deferral contributions to the SIMPLE IRA. The provision applies to qualified higher education loans, and the employee is required to certify payments on the loan to the employer. This provision does not change any of the limits otherwise applicable to SIMPLE IRA employee or employer matching contributions—the loan repayments are subject to the annual limit on employee SIMPLE IRA elective deferral contributions (US$15,500 for 2023, plus catch-up contributions) and are subject to the employer SIMPLE

IRA matching contribution requirement. An employer can match student loan repayments under this provision only if it does so for all eligible employees. This provision is effective for contributions for plan years beginning after 31 December 2023.

SIMPLE IRA Nonelective Contributions (Effective in 2024)

Prior to SECURE 2.0, no employer contributions other than the required nonelective contribution (2% of compensation) or matching contribution (generally, 100% of employee contributions equal to the first 3% of compensation) were permitted. SECURE 2.0 permits the employer to make, in addition to the required nonelective or matching contribution, a voluntary nonelective contribution with respect to each eligible employee who earns at least US$5,000. The additional nonelective contribution may not exceed 10% of the employee's compensation (up to a maximum contribution of US$5,000; the $US5,000 figure is indexed to the cost of living for years beginning after 31 December 2024), and the contribution percentage must be uniform for all eligible employees. This provision is effective for taxable years beginning after 31 December 2023.

Increase in SIMPLE IRA Employee Elective Deferral Contribution Limits (Effective in 2024)

SECURE 2.0 will increase the limit on annual employee elective deferral contributions to SIMPLE IRAs (currently US$15,500, plus an additional US$3,500 catch-up contribution for individuals age 50 or older). For employers with less than 26 employees who received at least US$5,000 of compensation in the prior year, the contribution limits, including catch-up contributions for employees who are age 50 or older, will be increased by 10% above and beyond any normal cost-of-living increase. The limits will increase for employees of other eligible employers only if they provide a 4% employer matching contribution or a 3% nonelective contribution to all eligible employees. The limits for employees of other employers (i.e., employers who employ more than 25 employees who received at least US$5,000 of compensation in the prior year and who do not elect to make the higher 4% matching contribution or 3% nonelective contribution) will not change (i.e., they will be eligible only for regular cost-of-living increases). This provision is effective for tax years beginning after 31 December 2023.

Mid-Year Termination of SIMPLE IRA (Effective in 2024)

Under current law, an eligible employer generally may not terminate a SIMPLE IRA plan mid-year. SECURE 2.0 permits an eligible employer to terminate a SIMPLE IRA plan mid-year if the employer replaces the SIMPLE IRA plan with a SIMPLE 401(k) plan, a safe harbor 401(k) plan, a 401(k) plan with a qualified automatic contribution arrangement, or a “starter” 401(k) plan.[1] (Note that these requirements may prevent the mid-year termination of a SIMPLE IRA plan when it is often most desired—in connection with a merger or acquisition where an employer acquires a target with a SIMPLE IRA plan.) The SIMPLE IRA and replacement 401(k) plan are subject to a combined annual contribution limit for the year of the transition based upon the pro-rated annual limits for each arrangement during the period in which each arrangement was maintained. This provision is effective for plan years beginning after 31 December 2023.

TAX CREDITS FOR SMALL EMPLOYERS

Small Employer Retirement Plan Startup Cost Tax Credit (Effective in 2022)

SECURE 2.0 expands the annual tax credit available to employers with up to 100 employees for the first three years of a new retirement plan, including a SEP or SIMPLE IRA plan. Under prior law, the credit was generally limited to 50% of startup costs up to US$5,000. SECURE 2.0 increases the percentage limitation for employers with no more than 50 employees to 100% of startup costs and provides an additional credit for all eligible employers equal to a percentage of contributions made by the employer up to a maximum of US$1,000 per employee for the first five years of a new plan. The percentage declines from 100% in the first and second years to 75% in the third year, 50% in the fourth year, and 25% in the fifth year. The additional credit is phased out for employers with more than 50 employees (2% per employee in excess of 50). No contribution credit is allowed with respect to any employee whose compensation for the year of the contribution exceeds US$100,000 (indexed to the cost of living for years after 2023). The additional credit is available only with respect to contributions to defined contribution plans and is not available with respect to defined benefit plan contributions. This change is effective for tax years beginning after 31 December 2022.

Military Spouse Tax Credit (Effective in 2022)

SECURE 2.0 implements a new tax credit available to small employers with respect to contributions to defined contribution retirement plans (including SEP and SIMPLE IRAs) for employees who are married to members of the uniformed military services. A tax credit of up to US$500 is available—US$200 per military spouse, plus 100% of employer contributions for the benefit of the military spouse up to US$300 each year for up to three years beginning with the year in which the military spouse first becomes eligible to participate in the plan. The tax credit is available only to employers who have no more than 100 employees who received at least US$5,000 of compensation from the employer in the prior year, and no credit is available with respect to a military spouse who is a highly compensated employee (generally meaning any 5% owner in the current or prior year or any employee earning more than the compensation limit in the prior year (US$150,000 for 2023)). In addition, in order to qualify for the credit, the employer's plan must permit military spouses to participate in the plan within two months after their hire date. Military spouses must be entitled to receive contributions equal to the contributions that nonmilitary spouses are entitled to receive after two years of service, and all employer contributions for military spouses must be 100% immediately vested. This provision is effective for tax years beginning after 29 December 2022.

OTHER PROVISIONS

SECURE 2.0 includes a number of other IRA-related provisions.

Statute of Limitations for Excess IRA Contributions and Required Minimum Distribution Failures (Effective Immediately)

The statute of limitations applicable to the excise tax payable with respect to specified retirement plan failures, including an excess contribution to an IRA or a failure to take a RMD from a retirement plan, including an IRA, has historically commenced only upon filing of a Form 5329, which is the form used to declare and pay such excise taxes. In many cases, where the individual was not aware of the error, this meant that the statute of limitations never lapsed because a Form 5329 was never filed. SECURE 2.0 provides that the statute of limitations period for these errors commences when the individual files his or her Form 1040 federal income tax return for the year the error occurred. It further provides that the statute of limitations is, generally, three years, but six years for the excess IRA contributions excise tax. These changes became effective immediately on 29 December 2022.

Default IRA Transfers (Effective in 2023)

SECURE 2.0 establishes a new exemption from the prohibited transaction rules under the Internal Revenue Code and the Employee Retirement Income Security Act of 1974 that would permit an IRA provider to receive compensation in connection with the transfer amounts from a default IRA established by the IRA provider pursuant to an automatic rollover from an employer-sponsored retirement plan to a retirement plan sponsored by a successor employer of the individual for whom the default IRA was established. The exemption requires IRA providers who wish to utilize the exemption to conduct monthly searches for retirement plans sponsored by successor employers of individuals for whom the IRA provider maintains default IRAs and to transfer the default IRA to the successor employer's retirement plan unless the IRA owner affirmatively opts out following advance notice. The exemption is conditioned upon (i) the IRA provider's acknowledgment of fiduciary status with respect to the default IRA, (ii) reasonable fees and compensation, (iii) disclosure of such fees and compensation to an independent fiduciary of the successor retirement plan, (iv) offering default IRA transfer services to all successor employer retirement plans on the same terms and conditions, (v) pre- and post-transaction notices to the individual owner of the default IRA, and (vi) the IRA provider not exercising discretion over the amount or timing of default IRA transfers. The exemption includes a six-year record retention requirement and annual audit requirement and obligates the IRA provider to maintain a website that lists the record-keepers for each successor employer retirement plan with respect to which the IRA provider carries out automatic portability transactions. The exemption is available with respect to default IRA transfers to successor employer retirement plans occurring on or after 29 December 2023.

Expansion of Tax-Free IRA Charitable Distribution Rule (Effective in 2023)

SECURE 2.0 permits a one-time tax-free charitable distribution of up to US$50,000 to charitable remainder annuity trusts, charitable remainder unitrusts, and charitable gift annuities. This is in addition the preexisting rule that permits tax-free charitable distributions of up to an annual maximum of US$100,000. This new provision is effective for tax years beginning after 29 December 2022. In addition, the US$50,000 and US$100,000 limits are indexed to inflation for tax years beginning after 2023. (The US$100,000 limitation was not previously indexed.)

Indexing Catch-Up Contributions (Effective in 2024)

Historically, annual IRA catch-up contributions for individuals age 50 or older have been limited to US$1,000, and, unlike catch-up contributions to qualified retirement plans, that limit has not been indexed to the cost of living. The US$1,000 IRA annual catch-up contribution limit will be indexed to the cost of living for tax years beginning after 31 December 2023.

529 Plan Account Transfers to Roth IRAs (Effective in 2024)

SECURE 2.0 permits direct transfers from 529 plan accounts to a Roth IRA established for the beneficiary of the 529 plan account. The 529 plan account must have been established at least 15 years prior to the date of the rollover. The transfer is subject to a US$35,000 lifetime maximum and an annual maximum rollover equal to the annual Roth IRA contribution limit reduced by contributions actually made to the Roth IRA. The transfer may not exceed the aggregate amount of contributions and earnings to the 529 plan prior to the five-year period ending on the date of the transfer. This provision is effective for transfers after 31 December 2023.

Expansion of Retirement Plan Correction Programs to IRAs (Effective before 2025)

SECURE 2.0 directs the Internal Revenue Service to expand its retirement plan correction program—known as the Employee Plans Compliance Resolution System (EPCRS)—to IRAs by 29 December 2024. For many years, the EPCRS program has allowed employers that sponsor tax-favored retirement plans to correct failures to administer those plans in a manner consistent with the Internal Revenue Code with reduced or no penalty cost. This expansion of the EPCRS program will allow IRA owners to take advantage of similar rules for eligible inadvertent compliance failures, for example, by providing for waivers of the RMD excise tax and correcting nonspouse-inherited IRA rollovers due to IRA provider inadvertent error.

Saver's Credit Replaced by Contribution to IRA/Plan (Effective in 2027)

SECURE 2.0 replaces the former “saver's tax credit” with a federal contribution to the taxpayer's IRA or retirement plan. The saver's tax credit allowed a low-income taxpayer to take an annual tax credit of up to US$1,000 of annual retirement plan (including IRA) contributions. The credit was phased out based upon adjusted gross income up to US$36,500 (US$73,000 for married filing jointly) for 2023. Under SECURE 2.0, the tax credit is replaced with a contribution by the federal government to the taxpayer's Traditional IRA or other non-Roth retirement plan in an amount equal to 50% of the taxpayer's annual retirement plan contributions, up to a maximum of US$2,000 per individual. The matching contribution phases out based upon adjusted gross income between US$20,500 to US$35,500 (US$41,000 to US$71,000 for married filing jointly, and US$30,750 to US$53,250 for head of household). These limits are indexed to the cost of living for years after 2027. The contribution is reduced by the amount of regular retirement plan distributions received by the individual (or the individual's spouse if married and filing jointly) during the three-year period ending in the year of the contribution. The contribution is not subject to limitations on the amount of annual contributions, including, if made to an IRA, the IRA annual contribution limit (US$6,500 for 2023, plus catch-up contributions). The matching contribution is not generally available to any taxpayer under age 18 or who is a tax dependent of another person, a full-time student, or a nonresident alien. This change is effective for years beginning after 31 December 2026.

FOOTNOTES

[1] A “starter” 401(k) plan is a new type of 401(k) plan enacted as part of SECURE 2.0 under which an employer that does not otherwise sponsor a tax-qualified retirement plan may adopt a deferral-only 401(k) plan with automatic enrollment and lower contribution limits. A starter 401(k) plan is exempt from annual employee contribution nondiscrimination testing.

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