RETIREMENT PLAN CONSULTING

Fiduciary Compliance Alert

Gallagher

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IRS Issues Guidance on Miscellaneous SECURE 2.0 Matters

On December 20, 2023, the IRS issued Notice 2024-2 (the "Notice") which contains guidance in question and answer format regarding a host of compliance changes pursuant to the SECURE 2.0 Act of 2022 ("SECURE 2.0"). The Notice is not intended to provide comprehensive guidance but rather is intended to provide direction on discreet issues to assist retirement plans when beginning to implement certain SECURE 2.0 provisions. The Notice states that the IRS will continue to issue further guidance, including regulations, on SECURE 2.0 matters. This paper addresses the significant provisions of the Notice relating to defined contribution plans.

Automatic Enrollment Mandate

SECURE 2.0 requires that all 401(k) or 403(b) plans established after December 29, 2022, have provisions for automatic enrollment and automatic increase, effective starting with the 2025 plan year. Plans established before December 29, 2022, are grandfathered. The automatic enrollment requirement will not apply to those grandfathered plans. Perhaps the most significant questions surrounding this new automatic enrollment mandate involve mergers and spin-offs of plans, particularly in situations where the plan sponsor is involved in a sale or purchase of another company. The Notice provides some helpful insight on those questions.

Specifically, if two plans that were established prior to December 29, 2022, are merged, the merged plan will enjoy grandfathered status, and the SECURE 2.0 automatic enrollment mandate will not apply to the merged plan. If one of the merging plans was established on or after December 29, 2022, then the merged plan will be subject to the automatic enrollment mandate. However, the merged plan will be exempt from the mandate if certain requirements are met, including (1) the plan merger is a result of a stock or asset purchase, (2) the grandfathered plan is the surviving plan and (3) the merger happens within the plan year following the plan year of the corporate level transaction. Also, if a plan is spun off from a grandfathered plan, "the new spun-off plan" generally is also grandfathered and not subject to the automatic enrollment obligation. There are different rules for spin-offs and mergers from multiple employer plans.

Tax Credits for Start-up Plans of Small Employers

SECURE 2.0 expands an existing tax credit for small employers who adopt a retirement plan. The credit is designed to defray expenses associated with starting the new plan. SECURE 2.0 also adds a new tax credit for small employers who make employer contributions to their newly defined contribution plans. Small employers are generally defined as having no more than 100 employees. The Notice clarifies that these two tax credits are separate, and eligible companies can take advantage of both in a single year.

The Notice also addresses questions relating to situations where an employer might have over 100 employees in some years and under 100 employees in other years. If the employer has more than 100 employees in the year the plan is adopted, they are not eligible for the tax credits, even if they fall to less than 100 employees in a later year. Additionally, an employer that has less than 100 employees in the year the plan is adopted but has more than 100 employees in a later year, cannot claim the tax credits in that later year.

De Minimis Financial Incentives

401(k) plans cannot require a participant to defer into the plan in order to receive any other benefit (aside from matching contributions). This provision is commonly referred to as the contingent benefit rule. 403(b) plans are subject to a similar standard under the universal availability rule. SECURE 2.0 provides that a *de minimis* financial incentive (not paid from plan assets) provided to employees who elect to defer into the plan will not violate the contingent benefit rule or the universal availability rule. However, SECURE 2.0 did not specify what would constitute a *de minimis* financial incentive.

The Notice specifies that a financial incentive is *de minimis* only if it does not exceed $250 in value. The *de minimis* financial incentive can be offered only to participants for whom no election to defer is already in effect. The plan could specify a window during which participants must make an election to begin deferring (e.g., the next 90 days). The incentive could also be provided in installments that are contingent upon the participant continuing to defer. For example, the employer may offer a $100 incentive to begin deferring now, and an additional $100 incentive if the participant is still deferring one year from now. The incentive cannot be a contribution to the plan.

The incentive payment is not subject to the rules that apply to employer contributions to the plan. For example, it is not included in nondiscrimination testing and does not count toward the participant's annual accrual limits. The amount generally would be taxable to the employee and is subject to the tax withholding rules. One outstanding question not answered by the Notice is whether or not the employer may require a certain level of deferrals to qualify for the incentive (e.g. deferring at least 3% of pay).

Distributions to Terminally Ill Participants

When a participant elects to take a distribution before age 59½, they will be subject to a 10% additional tax unless an exception applies. SECURE 2.0 added an exception to the additional tax for participants who are terminally ill. A terminally ill individual is someone who has been certified by a physician as having an illness or physical condition which can reasonably be expected to result in death in 84 months or less after the date of the certification.

The Notice clarifies that this rule is available to distributions from qualified retirement plans including 401(k) plans, 403(b) plans and IRAs. Distributions from governmental 457(b) plans are not eligible for this rule. The physician certifying the terminally ill status must be a doctor of medicine or osteopathy who is legally authorized to practice medicine and surgery by their state. The participant must provide the physician certification to the plan administrator. The Notice lists the information that the physician must include in the certification. In general, there is no limit on the amount of distribution that a terminally ill participant can exclude from the 10% additional tax.

The Notice also clarifies that SECURE 2.0 does not allow 401(k) plans or 403(b) plans to use a terminal illness alone as a separate distributable event. But if a terminally ill participant is eligible for a distribution on a different basis (e.g., a hardship distribution, a disability distribution, or a distribution to a participant who is no longer actively employed), the participant can use the terminally ill rule to avoid the 10% early withdrawal penalty. Plans that do not have a cash or deferred arrangement (e.g., profit sharing plans or money purchase plans) seemingly may offer distributions on the basis of the participant's terminal illness. But the Notice makes clear that adding this type of distribution trigger is optional for plan sponsors, not mandatory.

Correcting Elective Deferral Errors in Automatic Enrollment Plans

To encourage the adoption of automatic enrollment provisions, the IRS has generally allowed auto-enroll plans to use a special correction rule when newly eligible participants are not automatically enrolled, or an affirmative deferral election is not properly implemented. If correct deferrals begin within 9½ months of the plan year following the year in which the error began (and certain other requirements are met including a notice to impacted participants), the plan could correct the error without making a corrective contribution for the missed deferrals. If the employee notifies the plan sponsor of the error, correct deferrals must begin by the end of the month following the month in which the notification was made. The current Employee Plans Compliance Resolution System sunsets this correction rule at the end of 2023. However, SECURE 2.0 permanently codified this correction rule for eligible automatic enrollment plans.

The Notice clarifies when this statutory relief becomes effective. Specifically, if the 9½-month deadline falls after December 31, 2023, the plan may rely on the statutory correction method. In an example given in the Notice, a plan fails to automatically enroll an eligible employee on January 1, 2023. The employer has until the first payment of compensation made on or after October 15, 2024 (the last day of the 9½-month period after the end of the 2023 plan year) to begin correct elective deferrals for the employee. Because that mid-October 2024 deadline is after January 1, 2023, the employer can rely on the statutory correction rule.

Current IRS guidance would require terminated employees to receive a corrective contribution equal to 50% of the missed deferral. However, the Notice is very clear that the special correction method can be used for terminated employees.

Additionally, the plan sponsor must still make a contribution for any missed match based on the full matching amount the participant would have received had the correct deferral been taken. The Notice clarifies that the corrective matching contribution must be made within a reasonable period, based on all the facts and circumstances. However, if the corrective match is made by the last day of the sixth month following the month in which correct elective deferrals begin (or would have begun for terminated employees), the match will have been contributed within a reasonable period.

Contributing Employer Contributions on a Roth Basis

Prior to SECURE 2.0, plans could allow participants to make elective deferrals on a pre-tax basis, or a post-tax Roth basis. If certain requirements are met, Roth contributions can be distributed entirely tax-free to the participant. However, plans could not allow participants to have employer contributions go into the plan on a Roth basis. Employer contributions could be made on a pre-tax basis only. SECURE 2.0 allows, but does not require, plans to offer employees the choice of receiving any employer contributions on a pre-tax basis or post-tax Roth basis.

The Notice clarifies that any general rule applying to Roth deferrals will also apply to employer contributions made on a Roth basis. For example, any Roth election by the participant is irrevocable and contributions are included in the participant's taxable income. Roth contributions must be segregated from pre-tax funds. If the plan elects to allow participants this option, employees must have an effective opportunity to make (or change) their designation at least once during each plan year.

A contribution source must be fully vested before a participant could choose to have future employer contributions made on a Roth basis. If the participant is only partially vested in the contribution source, no Roth election can be made for any part of a contribution to that source. Roth contributions to a 401(k) or 403(b) plan are not subject to FICA or FUTA taxes. Roth contributions made to a governmental 457(b) plan are not subject to FUTA taxes, but will be subject to FICA taxes to the extent that the governmental employee is required to pay FICA taxes.

Amendment Deadlines

SECURE 2.0 imposed a deadline to amend plan documents for any SECURE 2.0 changes. The deadline generally was the end of the 2025 plan year. For governmental plans and collectively bargained plans, the amendment deadline was the end of the 2027 plan year. This amendment deadline applied both to mandatory SECURE 2.0 changes as well as to optional changes that a plan sponsor chooses to implement prior to the deadline. The deadline coincided with the amendment deadline for changes under the Setting Every Community Up for Retirement Enhancement Act of 2019 ("SECURE 1.0") and the Coronavirus Aid, Relief, and Economic Security Act (the "CARES Act").

The Notice moves the document amendment deadline for SECURE 1.0, SECURE 2.0, and the CARES Act. Generally, plans will now be required to amend their documents by the end of the 2026 plan year. Collectively bargained plans must be amended by the end of the 2028 plan year. Governmental plans generally must be amended by the end of the 2029 plan year.

Gallagher Insight

These clarifications around numerous SECURE 2.0 matters are welcome. In particular, the Notice answers some of the most common questions raised relating to when the automatic enrollment mandate applies and what financial incentives are considered *de minimis*. However, the Notice acknowledges that significant additional guidance is needed from the IRS on many SECURE 2.0 changes. Plan sponsors and plan administrators must remain vigilant in the coming years for additional IRS direction.

In particular, plan sponsors should consider whether *de minimis* financial incentives to encourage participants to defer might be effective in increasing plan participation. Careful thought should be given to an employer's unique workforce in thinking about how to structure any financial incentives to have the greatest impact on participation rates. For example, plan sponsors must consider the amount of the incentive, whether the incentive should be paid over a certain period, and what window of time participants will have to make an initial deferral election.