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Significant Expansion of Roth 401(k) and 403(b) Features Under the SECURE 2.0 Act

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****August 2023 UPDATE****

With respect to 401(k), 403(b) and 457(b) plans being required to limit catch-up contributions to Roth instead of pre-tax treatment for certain higher-paid employees (see #2 below), the IRS has effectively delayed implementation for two years. Under Notice 2023-62 released August 25, 2023, the IRS announced an "administrative transition period" until the 2026 tax year. Under this relief:

(1) All catch-up contributions will be treated as meeting the new requirement, even if they are not designated by the employee (or, apparently, treated by the plan) as Roth catch-up contributions.
   – The IRS guidance does not suggest that individual taxpayers will need to make any adjustments on their own individual income tax returns.
   – No statutory authority was provided by the IRS for its ability to offer this optional delay. Given the delay, however, employers would be loath to impose the new requirement early – in which case, the estimated $1B+ annual tax revenue increase predicted by the Joint Tax Committee for 2024 and 2025 from this provision is very unlikely to come to fruition.

(2) A plan without Roth contributions will not be required to add Roth contributions to allow employees to contribute catch-up contributions on a Roth basis.

In addition to this transition relief, the IRS hinted at future guidance on this issue, including that (subject to comments from the public and further consideration from the IRS):

- Employers likely will be permitted, as a matter of plan design, to automatically adjust an employee's catch-up contribution election to provide Roth treatment to the extent necessary to allow the employee to contribute catch-up contributions if the employee's wages were above the $145,000 threshold.

- To determine the $145,000 threshold:
  - Non-FICA wages (such as partner or other self-employment income, railroad employee income, or certain governmental employee income) should not count.
  - Wages from another participating employer in a multiple employer plan should not count. It remains to be seen if the IRS may extend this same concept to apply to other situations such as pre-acquisition wages, or wages from a related employer not participating in the plan.

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The SECURE 2.0 Act of 2022 likely will significantly increase balances in Roth accounts in retirement plans. For the first time, Roth treatment will be mandated for certain plan contributions. Plans not currently offering Roth contributions may decide they need to do so in order to meet this mandate. It is quite possible Congress could enact more Roth mandates in future legislation. Below is a brief discussion of the four key Roth retirement plan-related changes in SECURE 2.0.

Why Roth? *There are various considerations as to why any given participant might prefer Roth contributions in place of pre-tax contributions. From Congress's perspective, expanding Roth contributions is almost always a "revenue raiser" (which can be used to offset tax cuts or spending increases), because Roth contributions will be subject to ordinary income tax when they are made and the "loss" of tax revenue when distributions are made is generally outside the budget period over which Congress evaluates the revenue impact of legislation.*

1. Employees can elect to treat employer contributions as Roth	**Effective immediately** *For 401(k)/profit-sharing, 403(b), and 457(b) plans*

Prior to SECURE 2.0, the only contributions eligible for Roth treatment were employee deferrals. After SECURE 2.0, plans can allow employer matching or non-elective contributions to be designated as Roth contributions. IRS guidance should address key questions about Roth employer contributions including:

- Effective date – This provision was effective for any contributions following enactment. Because SECURE 2.0 was enacted before the end of 2022, this raises the possibility of contributions made in 2023 on account of 2022 (deducted for 2022 and subject to 2022 plan contribution limits) being treated as Roth contributions.

- Taxation to employee and required withholding – Roth employer contributions will be income taxable to employees.

- It is not clear whether employers will be required to withhold taxes from other income payable to the employee. Withholding would raise a number of administrative issues for employers but would generally limit the likelihood of the employee facing a hefty, potentially unexpected tax bill when they file their individual return.
- The income tax timing is also an open question. For example, when employer contributions are made on account of a prior plan year, are they taxable when they are allocated to the participant's account or in the year to which they relate? The latter would be administratively challenging to say the least.

- <u>Employee election and negative consent</u> – The new provision states plainly that employees get to elect Roth treatment. The IRS should address whether plan sponsors can present Roth treatment as the default rule.
    - Assuming plan sponsors are permitted to specify either pre-tax or Roth as the default, agency guidance should also be clear that this is a design decision and that either contribution type is an appropriate default option.

- <u>Optional versus mandatory</u> – Legislative intent and widespread reporting indicate that Roth treatment is optional to participants *and optional for employers*. That said, the legislation text can be read to provide participants the right to make such an election if their plan has a Roth feature. The IRS should confirm that this new feature is entirely optional for plan sponsors.

Congress projects that employer Roth contributions will be popular (and result in large tax revenues to the US Treasury). That said, plans already can have in-plan Roth conversions. These allow participants to convert employer contributions to Roth treatment including immediately after contributions are made (if vested). Plan sponsors may well conclude that in-plan Roth conversions are sufficient for employees to achieve their desired Roth balances.

2. Mandatory Roth treatment of catch-up contributions for individuals who earned $145,000 in the prior year	**Effective beginning with the 2024 calendar year** *For 401(k), 403(b), and 457(b) plans*

SECURE 2.0 is the first time Congress has mandated Roth treatment of retirement plan contributions. In particular, beginning in 2024, for employees who earned at least $145,000 of wages from the employer in the prior year (with such limit indexed for inflation), any catch-up contributions must be made on a Roth basis. This requirement raises a number of issues for which IRS guidance will be helpful:

- Plans currently without Roth contributions – The requirement that catch-up contributions be made on a Roth basis is not limited to plans that currently offer Roth contributions. Accordingly, plans not currently offering Roth contributions are likely to begin offering them. Unless the IRS provides other relief, the only other viable choice would be to eliminate catch-up contributions. For large employers, elimination is complicated by the fact that an employer offering catch-up contributions in one plan must offer them to all participants in all plans within the controlled group.

- Separate catch-up elections – Some plans allow employees to make catch-up contributions at the same time they make regular contributions but through a separate election. Other plans are designed so that catch-up contributions kick in only after an employee reaches a plan contribution limit such as the 402(g) limit ($22,500 in 2023). For the latter design, the IRS should address whether the contributions can be fungible as to pre-tax and Roth status. For example, assume an employee contributes $10,000 of Roth and then switches to pre-tax. Does the plan need to switch the employee back to Roth upon reaching the 402(g) limit, or can the initial Roth contributions be recharacterized as the catch-up portion?

- Coordination with non-discrimination testing – A 401(k) plan currently can reduce the need for distributing excess contributions by highly compensated employees (HCEs) in connection with failed Actual Deferral Percentage (ADP) testing by recharacterizing contributions by HCEs as catch-up contributions, if the individual did not maximize their catch-up contributions for that year. The IRS should address whether or not that recharacterization requires a recharacterization of the amount as Roth.

- Pay tracking – The $145,000 limit is different from the limit for determining HCE status. Instead, it looks to W-2 pay from the employer. The IRS will need to identify what aggregation rules apply for determining pay from the employer, or whether this can be determined on an EIN-by-EIN basis.

3. Elimination of pre-death required minimum distributions (RMDs) for Roth 401(k) accounts	**Effective beginning with the 2024 calendar year** *For 401(k)/profit-sharing, 403(b), and 457(b) plans*

Required minimum distribution rules do not apply to Roth IRAs during the lifetime of the IRA holder. Roth 401(k) and 403(b) accounts, however, are counted for purposes of determining RMDs. SECURE 2.0 provides that, effective in 2024, Roth 401(k) and 403(b) accounts are not subject to the RMD rules during the life of the participant.

- Reduce rollovers from plans – Policy makers anticipate that this change will allow more Roth accounts to be retained in retirement plans, whereas participants might currently be inclined to take plan distributions to move Roth funds to an IRA to avoid RMDs.

- Effective date – This change is effective beginning for tax years in 2024. It appears to apply to all participants, whether or not they have reached their required beginning date before 2024. However, it explicitly does not apply to a distribution made in 2024 on account of an individual reaching their required beginning date in 2023.

4. Roth treatment for SEP IRA and SIMPLE IRA contributions	**Effective beginning with the 2023 calendar year**

Prior to SECURE 2.0, SIMPLE IRAs (which allow employee and employer contributions and generally can be sponsored by employers with up to 100 employees) did not allow for Roth treatment of contributions. Accordingly, smaller businesses could not sponsor these more streamlined plans and allow Roth contributions.

Simplified Employee Pension Plan (SEP) IRAs (which allow employer contributions only) similarly did not have the option of Roth treatment.

With the changes provided by SECURE 2.0, these arrangements are now permitted to have Roth contributions.

If you have any questions about this alert or the SECURE 2.0 Act, we would be glad to hear from you. Contact any member of our Benefits and Compensation practice.