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SECURE 2.0 Act Carries Significant Impact for Governmental Plans

On December 29, 2022, President Biden signed the SECURE 2.0 Act of 2022 (SECURE 2.0) into law.

The statute is the final compilation of several bills: (1) the Securing a Strong Retirement Act, which passed the House of Representatives 414-5 in March of 2022; (2) the Retirement Improvement and Savings Enhancement to Supplement Healthy Investments for the Nest Egg Act (RISE & SHINE), which passed unanimously through the Senate's Health, Education, Labor & Pensions Committee; and (3) the Enhancing American Retirement Now Act (EARN) which passed unanimously through the Senate Finance Committee.

SECURE 2.0 contains a wide array of mandatory and optional changes for governmental retirement plans under the Internal Revenue Code (the Code). However, some of the more notable provisions of the legislation will not apply. For example, governmental plans are exempt from the requirement that all new start up elective deferral plans contain a provision for automatic enrollment. While the provisions of SECURE 2.0 would become effective operationally at different points, governmental plan sponsors would not have to amend their plan documents to comply with the new SECURE 2.0 rules until December 31, 2029. This paper highlights the provisions of SECURE 2.0 that significantly impact governmental retirement plans and plan participants.

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From the perspective of retirement plan sponsors and administrators, SECURE 2.0 is not perfect but offers plenty of exciting **mandatory** and **optional** changes. It contains some provisions that impose additional requirements and mandates with which we must comply. However, the statute overall makes many significant adjustments to the compliance rules that improve retirement plan policy for both governmental plan sponsors/administrators and participants. SECURE 2.0 largely enjoyed broad support from both political parties.

Plan administrators must be extremely aware of when the different rules under SECURE 2.0 become applicable. Gallagher will continue to give you the most up to date information on what steps must (or may) be taken and when. Additionally, we expect in the coming years, a significant amount of regulatory activity interpreting the many provisions of the new legislation. Your Gallagher consultant will make sure that you have the current status on all new developments as they happen. If you have any questions about the terms of SECURE 2.0 and how it impacts your plan, please reach out to your Gallagher consultant.

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SECURE 2.0 Provisions

The key provisions below are organized into four sections: Plan Design Changes, Required Minimum Distribution and Life Annuity Changes, Plan Distribution Changes and Miscellaneous

Section 1: Design Changes

I. Permit Matching Contributions on Student Loan Payments – **Optional**:
SECURE 2.0 would permit a plan sponsor to make matching contributions to a governmental 457(b) or 403(b) plan based on the participant's repayment of student debt. The vesting schedule for matching contributions made on student loan repayments must be identical to the vesting schedule for matching contributions made on elective deferrals. The plan sponsor can rely on employee certification regarding the student debt repayments. This type of benefit would not assist the employee in repaying their student loans. But, it would increase their retirement security by allowing them to receive matching contributions at a time when they might not otherwise be saving for retirement. This provision became effective for plan years beginning in 2024.

II. Higher Catch-up Contribution for Participants at Age 60 – **Optional**:
Participants who have attained age 50 may make catch-up contributions to their retirement plan above the general Code Section 402(g) cap. The limit on catch-up contributions for 2024 is $7,500. SECURE 2.0 would increase that limit for participants during the taxable years in which they turn 60, 61, 62 and 63. The increased catch-up limit would not apply in the years the participant turns age 64 or older. For those eligible participants in governmental 457(b) or 403(b) plans, SECURE 2.0 increases the catch-up to the greater of $10,000 or 150% of the standard catch-up limit. The higher catch-up limits will be adjusted for inflation. This provision becomes effective for plan years beginning in 2025.

III. Provisions for Emergency Savings – Optional:
SECURE 2.0 has two optional provisions allowing participants to use their governmental 457(b) or 403(b) plan for covering emergency expenses.

a. First, the statute adds a new optional distribution trigger for emergencies, along with an exception to the 10% early distribution tax. Only one distribution is permissible each calendar year of up to $1,000 (as adjusted annually for inflation). An emergency expense is any "unforeseeable or immediate financial need relating to necessary personal or family emergency expenses." Plan administrators can rely upon the participant's written certification that they meet that emergency standard.

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Distributions taken due to an emergency can be repaid into the plan within three years. When a participant takes an emergency expense distribution, they cannot take another one during the following three calendar years unless the original distribution is repaid into the plan. This provision became effective in 2024.

b. SECURE 2.0 also creates optional "pension-linked emergency savings accounts" for defined contribution plans, including governmental 457(b) and 403(b) plans. These accounts may only be established on a Roth basis, and are only available to non-highly compensated employees. The plan can be structured to allow participants to elect deferrals into the account, or as an automatic enrollment feature with a maximum default deferral rate of 3%. These accounts do not have a minimum contribution, but contributions must stop at $2,500 (as adjusted annually for inflation). Distributions from the account are allowed at least once per month "at the discretion of the participant," and are exempt from the 10% penalty for early distributions. The first four withdrawals from the account each plan year may not be subject to any withdrawal fees. Plans that add pension-linked emergency savings accounts must provide an annual participant notice regarding the feature. This provision became effective beginning with the 2024 plan year.

IV. Increase in Cash Out Limit – Optional:

Currently, the Code requires participant consent to any distribution from a governmental 457(b) or 403(b) plan if the account balance exceeds $5,000. If a terminated employee's account holds $5,000 or less, the plan administrator can force a distribution of the account without the participant's consent. Accounts between $1,000 and $5,000 must be rolled into an IRA rather than forced out in a taxable distribution. Effective in 2024, SECURE 2.0 increased the cash out limit from $5,000 to $7,000. This provision will allow plans to sweep out more small accounts.

V. Roth Contributions for Catch-up Deferrals – Mandatory, if applicable:

Under SECURE 2.0, any governmental 457(b) or 403(b) plan that permits participants to make catch-up contributions must require such contributions to be designated Roth contributions, starting in 2026. This restriction will only apply to participants whose compensation during the prior year exceeds $145,000 (as adjusted annually for inflation). Participants who earned $145,000 or less in the prior year can still defer catch-up contributions on a pre-tax basis. Participants who are over age 50 and earn more than $145,000 could not elect to make their catch-up contributions on a pre-tax basis. This provision may increase the number of retirement plans adopting a Roth feature.

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VI. Roth Option for Employer Matching or Nonelective Contributions – Optional:
Under current rules, any employer matching and nonelective contributions made to a governmental 457(b) or 403(b) plan can only be made on a pre-tax basis. Neither the participant nor the plan sponsor can elect to have employer contributions made on a Roth basis. Under SECURE 2.0, plans may elect to permit an employee to designate some or all of their matching or nonelective contributions as designated Roth contributions. As with any Roth contribution, participants must include an employer contribution that is a designated Roth contribution in their taxable gross income. Participants can elect to treat employer funds as a Roth contribution only if the amount is fully vested. This rule can be applied to any contributions made after the enactment of SECURE 2.0.

Section 2: Required Minimum Distribution and Life Annuity Changes

I. Increase in Required Distribution Beginning Date Age:
SECURE 1.0 increased the required beginning date for plan distributions from age 70½ to age 72. Under SECURE 2.0, the required beginning date would increase to age 73 in 2023, and to age 75 in 2033.

II. Changes to the Required Minimum Distributions (RMDs) Rules:
The Code imposes an excise tax on any missed RMDs equal to 50% of the amount that should have been distributed. The Code imposes the excise tax on the participant, not the plan or the plan sponsor. SECURE 2.0 would reduce the penalty for failure to take RMDs from 50 to 25 percent. SECURE 2.0 further reduces the excise tax from 25 percent to 10 percent, if the error is corrected timely. This provision became effective for taxable years beginning in 2023.

Additionally, the Code does not currently require RMDs from Roth IRAs. Roth accounts in governmental 457(b) and 403(b) plans are subject to the RMD rules. SECURE 2.0 eliminates the pre-death distribution requirement for Roth accounts in employer plans, including governmental 457(b) and 403(b) plans. This provision became effective for taxable years beginning in 2024.

Finally, RMD rules currently require that any annuity in a defined contribution plan account be treated separately from the rest of the account, resulting in higher RMDs. SECURE 2.0 permits the plan to aggregate distributions from both portions of the account for purposes of determining minimum distributions, potentially allowing for lower RMDs.

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III. Removing Certain Barriers for Life Annuities:
Treasury regulations relating to RMDs contain a rule precluding annuity products from providing payments that start out small and increase over time. The rule can prohibit provisions that provide only modest benefit increases under life annuities. For example, the rule can prevent guaranteed annual increases of only 1 or 2%; return of premium death benefits and period certain guarantees. SECURE 2.0 would eliminate this restriction, allowing for more flexibility in annuities paid from qualified retirement plans. This provision is effective for calendar years starting in 2022.

IV. Increases in Permissible Qualifying Longevity Annuity Contract Limits:
Qualifying longevity annuity contracts (QLACs) are deferred annuities that begin payment well after retirement. QLACs are a way for retirees to hedge against the risk of outliving their retirement savings. SECURE 2.0 contains provisions making the use of QLACs more practical. The treasury regulations exempt QLACs from the RMD rules until payments commence. However, the regulations imposed certain limits on the exemption. SECURE 2.0 repeals the limit that the QLAC premium cannot exceed 25% of the participant's account balance, and increases the overall QLAC limit from $125,000 to $200,000 (as adjusted annually for inflation). The statute also would allow for QLACs with spousal survival rights.

V. Exchange-Traded Funds for Annuity Products:
Exchange-traded funds (ETFs) are pooled investment funds. Unlike mutual funds, their shares are traded on stock exchanges, and can be traded throughout the day, rather than having to wait until after the market closes. ETFs are used in some qualified retirement plans and IRAs. However, Treasury regulations prevent ETFs from being available through annuities. SECURE 2.0 directs the Treasury department to update the regulations to facilitate the creation of a new type of ETF that is "insurance-dedicated," allowing annuity products to invest.

Section 3: Plan Distribution Changes

I. Unforeseeable Emergency Distributions Streamlined:
Under the current rules, a plan administrator cannot rely simply on the participant's representation that an unforeseeable emergency has occurred. SECURE 2.0 allows 401(k) and 403(b) plan administrators to rely on a written certification from the participant that they have a financial need due to an unforeseeable emergency, that the requested amount is not more than what they need to meet the emergency and that the participant has no alternative means to satisfy the need. The statue says that the

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IRS "may" adopt regulations disallowing the administrator's reliance if they have actual knowledge that the participant's representation is not correct. This provision became effective for plan years starting in 2023.

II. Health Insurance Distributions For Public Safety Officers – Optional:
Currently, governmental retirement plans can allow eligible retired public safety officers to take a distribution to pay for health insurance premiums. The distributions are tax-free to the participant, up to $3,000. But the premiums must be paid directly from the plan to the insurer. SECURE 2.0 allows the distribution to be made directly to the participant. When filing their tax return, the participant must certify that the amount excluded from taxable income did not exceed the amount made for the premiums. This provision became effective for distributions after the enactment of SECURE 2.0.

III. Distributions to Victims of Domestic Abuse – Optional:
As a rule, participants who take distributions from retirement plans before turning age 59½ must pay a 10% excise tax on the distribution amount, unless a specific exception applies. SECURE 2.0 adds a new optional distribution trigger for victims of domestic abuse, along with an exception to the 10% early distribution tax. The distribution can equal 50% of the participant's vested account up to $10,000 (as adjusted annually for inflation). The new exception applies to anyone who has in the prior 1-year period experienced "physical, psychological, sexual, emotional, or economic abuse, including efforts to control, isolate, humiliate, or intimidate the victim, or to undermine the victim's ability to reason independently, including by means of abuse of the victim's child or another family member living in the household." Distributions taken due to domestic violence can be repaid into the plan within three years. This provision became effective in 2024.

IV. Distributions After Separating from Service:
Generally, the 10% tax on early distributions does not apply to participants who have terminated employment in or after the year they turn age 55. For qualified public safety employees taking a distribution from a governmental plan, that age is reduced to 50. SECURE 2.0 provides that the exemption from the 10% tax for public safety employees is now the earlier of age 50 or 25 years of service under the plan. The legislation also expands the definition of qualified public safety employee to include corrections officers and forensic security employees. These provisions became effective for distributions after the enactment of SECURE 2.0.

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V. Distributions to Terminally Ill Participants:
SECURE 2.0 also exempts from the 10% tax any distribution to a participant who is terminally ill. However, the statute does not create a specific distribution trigger for terminally ill participants. 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. Distributions to a terminally ill participant can be repaid into the plan within three years. This provision became effective immediately upon the enactment of SECURE 2.0.

VI. Disaster Relief Distributions – Optional:
In prior years, Congress has frequently passed retirement plan relief for participants who are impacted by a specific federally declared disaster. SECURE 2.0 creates a permanent set of rules designed to provide that relief. It allows participants in governmental 457(b) and 403(b) plans to take "qualified disaster recovery distributions" for participants that (1) live within a federally declared disaster area and (2) have sustained an economic loss due to the declared disaster. The distribution cannot exceed $22,000 with respect to any specific disaster. The participant need not pay the 10% extra tax on early distributions, and can repay the amount within three years. Additionally, the participant can include the distribution in their taxable income ratably over the course of three years.

Governmental 457(b) and 403(b) plans can also offer special participant loan rules to participants who meet the requirements for a disaster distribution. Specifically, the plan can increase the maximum loan amount to $100,000, up to the full amount of the participant's vested account. The plan can also allow a delay in the beginning of loan repayments, including an extension of the five-year deadline for completely repaying the loan.

VII. Deadline for Repaying Qualified Birth or Adoption Distributions (QBADs) – Optional:
SECURE 1.0 added QBADs, an optional distribution trigger for participants with new children through birth or adoption. SECURE 1.0 allowed participants to re-contribute the QBAD back into the plan, but did not specify a deadline for re-contributing the amount. SECURE 2.0 clarifies the rule to give parents up to three years to return the QBAD back to the plan. This provision became effective with respect to any QBAD made after the enactment of SECURE 2.0. The deadline for recontributing QBADs taken prior to the statute's enactment is January 1, 2026.

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VIII. Distributions for Long-Term Care Contracts – Optional:
SECURE 2.0 allows governmental 457(b) and 403(b) plans to permit distributions for the purposes of allowing the participant to pay the premium on a long-term care contract. The distribution cannot exceed the lower of 10% of the participant's vested account balance or $2,500 (as adjusted annually for inflation). The participant must file the long-term care contract with the plan. The 10% extra tax on early distributions will not apply to long term care distributions. This provision becomes effective three years after the enactment of SECURE 2.0.

See also, *Provisions for Emergency Savings – Optional* above

Section 4: Miscellaneous

I. Eliminating the "First Day of the Month" Requirement:
Unlike 401(k) plans or 403(b) plans, participants in a governmental 457(b) plan must request changes in their deferral rate prior to the beginning of the month in which the deferral will be made. SECURE 2.0 allows such elections in governmental 457(b) plans to be made at any time prior to the date that the compensation being deferred is made available to the participant. This provision became effective for taxable years beginning in 2023.

II. 403(b) Plan Investments:
The Code generally limits 403(b) plan investments to annuity contracts and mutual funds. 403(b) plan participants have no access to collective investment trusts, which 401(a) plans use frequently due to their lower fees. SECURE 2.0 amends the Code to permit 403(b) plans funded through custodial accounts to invest in collective investment trusts. However, Security Exchange Commission rules would require certain exemptions to make this rule operative. SECURE 2.0 does not address securities laws that may continue to prevent such investments. Congress would need to make some additional adjustments to fully implement this change.

III. Revisions to the Employee Plans Compliance Resolution System:
The Employee Plans Compliance Resolution System (EPCRS) is the IRS' program for fixing qualification errors in retirement plans. SECURE 2.0 expands the EPCRS to allow plans to self-correct virtually any operational error, regardless of how long ago the error occurred. Plans still have to establish reasonable practices and procedures to be eligible for self-correcting errors, and the self-correction will need to be completed within a reasonable period after the error is found. Self-correction continues to be

unavailable for egregious errors or the diversion or misuse of plan assets. SECURE 2.0 also expands the self-correction possibility for plan loan errors. Additionally, the statute allows plans to correct overpayments to plan participants without attempting to make the participant repay the excess amounts. Any rollover of an overpayment would not be invalidated if certain requirements are met.

Finally, SECURE 2.0 provides relief to Eligible Automatic Contribution Arrangement (EACA) plans when participants are not properly enrolled (or increased), or when a participant's affirmative deferral election is not properly implemented. If corrected generally within 9½ months after the plan year end of when the error occurred, no corrective contribution is required for the missed deferral. The plan sponsor must provide any missed matching contributions (adjusted for earnings), as well as a notice to the impacted participants. The current EPCRS has the same rule, although it sunsets at the close of 2023. This change makes the correction method permanent. SECURE 2.0 also makes clear that this correction method can be used for terminated participants, which is not allowed under current EPCRS rules.

IV. Retirement Savings Lost and Found:

SECURE 2.0 would create a national, online searchable lost and found program for Americans' retirement accounts, run by the Department of Labor (DOL). The intent is to assist people who are unable to find and receive the benefits that they earned because the company they worked for moved, changed its name or merged with a different company. The program would also assist plans that are unable to find participants because the former employees changed their names or addresses. The statute directs the creation of the database within two years following the enactment date.

V. Saver's Match:

Currently, the Saver's Credit provides certain lower-income taxpayers with a tax credit for retirement contributions up to $2,000. SECURE 2.0 changes the tax credit to into a federal pre-tax matching contribution that must be deposited into a taxpayer's IRA or retirement plan. (Retirement plans are not required to accept the contribution.) The match equals 50 percent of IRA or retirement plan contributions up to $2,000 per individual. The match phases out between $41,000 and $71,000 in the case of married taxpayers filing a joint return. The match is not available to taxpayers who are (1) under the age of 18, (2) claimed as a dependent on someone else's tax return or (3) a student. The match is reduced by any distribution taken during the taxable year or the prior 2 years. This provision becomes effective for taxable years beginning in 2027.

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