Tax Educators' Network, Inc.
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COMPREHENSIVE ANALYSIS, SECURE 1.0/2.0 ACTS AND LATEST RETIREMENT PLAN DEVELOPMENTS

Prof. John J. Connors, J.D., C.P.A., LL.M.
Tax Educators' Network (TEN), Inc.
12403 North Hawks Glen Court
Mequon, WI 53097-2140
TaxesProf@msn.com

Prof. John J. Connors, J.D., C.P.A., LL.M.

As an accounting graduate of La Salle University in Philadelphia, Prof. Connors went on for his law degree at the University of Notre Dame, graduating in 1980. After serving as an instructor in the School of Business Administration, he obtained his Masters of Law in Taxation at the University of Miami Law School in Coral Gables, Florida. He then served on the graduate tax faculty at the University of Wisconsin's School of Business in Milwaukee, WI.

His professional background includes over 48 years of experience in income and estate tax planning, as well as individual, partnership and corporate tax return preparation and research as a senior tax consultant for Price Waterhouse in the Philadelphia and South Bend offices. Prof. Connors also worked on expatriate and corporate tax matters as an international tax consultant for the Chrysler Corporation in London, England.

Prof. Connors currently conducts a national consulting practice designed especially for tax professionals based out of Milwaukee, WI. He also publishes a tax newsletter devoted exclusively to practitioners over the last 30 years entitled the ***Monthly Tax Update***. He has been the outside editor for **CCH's Federal Tax Course**, and has spoken at numerous tax institutes, workshops and conferences around the country. And, his **"Complete Guide to Depreciation, Amortization & Transfers of Property - Issues, Strategies & Answers"** is sold to tax practitioners throughout the U.S., along with annual tax guides entitled **"LLCs Taxed as Partnerships," "Taxation of Real Estate Investments,"** and **"Choice of Entity."**

As a nationally known speaker on a variety of tax topics, Prof. Connors has consistently earned average overall ratings in excess of 4.7 (i.e., on a 5.0 scale) for his knowledge and presentation skills, as well as the quality of his materials. In 2013, he was selected to receive the **Sid Kess Award for Excellence in Continuing Education** by the American Institute of CPAs. And, on any item that he has presented in his materials, he is available for follow-up questions, a factor much-appreciated by those practitioners attending his seminars.

Comprehensive Analysis: 2019 SECURE 1.0 Act and 2022 SECURE 2.0 Act

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2019 SECURE ACT 1.0

Overview of SECURE Act Passed by Congress

On Dec. 19, 2019 the Senate passed (on a 71 to 23 vote) the **Setting Every Community Up for Retirement Enhancement Act (SECURE Act 1.0)** as part of the **Further Consolidated Appropriations Act, 2020 (H.R. 1865)** . The measure was previously passed by the House on Dec. 17, 2019 (on a 297 to 120 vote), and the President signed it on Dec. 20, 2019 into law.

> **Comment:** The final version passed by Congress contained only minor changes from the version passed by the House in the spring of 2019. To properly ascertain the scope and application of these newly passed tax laws and their effect on your client base, you can read the **bills** in their entirely.

> **Comment:** Both **H.R. 1158, Consolidated Appropriations Act**, and **H.R. 1865, Further Consolidated Appropriations Act**, averted a government shutdown that would have commenced on Dec. 21, 2019 without this sweeping $1.4 trillion spending package being passed into law.

The **SECURE Act 1.0** was enacted with the intent of "expanding the opportunities for individuals to increase their savings and make administrative simplifications to the retirement system." Specifically, among its changes, (1) it modifies the requirements for multiple employer plans to make it easier for small businesses to offer such plans to their employees by allowing otherwise completely unrelated employers to join in the same plan; (2) increases the age after which required minimum distributions (RMDs) from certain retirement accounts must begin from 70½ to 72; (3) makes it easier for long-term, part-time employees to participate in elective deferrals; (4) allows consolidated filings of **Forms 5500** for similar plans; and (5) allows penalty-free distributions from qualified retirement plans and IRAs for births and adoptions.

> **Comment:** The bill is intended to address Americans' difficulty in saving and investing for retirement. A 2018 study by Northwestern Mutual found that "one-in-five Americans have no retirement savings at all, while one-in-three of those closest to retirement age have less than $25,000 saved." Given longer life expectancies than previous generations, coupled with the rate of inflation, a minimum balance of $1 million+ is recommended for retirement accounts by the date of retirement.

> **Comment:** Part of the problem has been attributed to the shift away from *defined benefit plans*, in which an employer *guarantees a payout* to employees after they retire, to *defined contribution plans*, in which an employee saves on their own for retirement, often with the employer contributing a pre-set amount to the employee's retirement fund.

> **Comment:** The **SECURE Act 1.0** made it easier for small businesses to set up 401(k) plans by increasing the cap under which they can *automatically* enroll workers in "safe harbor" retirement plans, from 10% of wages to 15% (but only for years after the participant's first "deemed election year" which is capped at 10%). Of course, the employee is allowed to make an affirmative election to *not* be included in this arrangement. It will also provide a maximum tax credit of $500 per year to employers who create a 401(k) or SIMPLE IRA plan with *automatic* enrollment. Plan sponsors will be encouraged to include annuities as an option in workplace plans by reducing their liability if the insurer cannot meet its financial obligations.

Retirement Plan Related Changes:

Non-Tuition Fellowship and Stipend Payments Are Compensation for IRA Purposes: An individual's IRA contributions generally cannot exceed the amount of their compensation that is includible in gross income. Subject to a rule for spouses, an individual who has no “includible compensation income” generally is *not* eligible to make IRA contributions, even if the individual has other income that is includible in gross income. And, under pre-Act law, stipends and non-tuition fellowship payments received by graduate and postdoctoral students were *not* treated as compensation and could *not* be used as the basis for IRA contributions.

New Law: For tax years beginning *after* Dec. 31, 2019, the **SECURE Act 1.0** provides that an amount includible in an individual's income and paid to the individual “to aid the individual in the pursuit of graduate or postdoctoral study” (e.g., a fellowship, stipend, or similar amount) is treated as compensation (i.e., earned income) for purposes of IRA contributions. (**Code §219(f)(1), as amended by SECURE Act 1.0, Sec. 106**)

Repeal of Maximum Age for Traditional IRA Contributions: Under pre-Act law, an individual who had attained age 70½ by the close of a year was *not* permitted to make contributions to a traditional IRA. This restriction, however, did *not* apply to contributions to a Roth IRA.

New Law: For deductible (or, nondeductible, as shown on **Form 8606**) contributions made for tax years beginning *after* Dec. 31, 2019, the **SECURE Act 1.0** repeals the prohibition on contributions to a traditional IRA by an individual who has attained age 70½. (**Code §219(d)(1), as amended by SECURE Act 1.0, Sec. 107**)

> **Comment:** The deadline for making an IRA contribution for the 2019 tax year was April 15, 2020. But, individuals could *not* make a contribution for 2019 if they were already 70½ at some point during 2019. Nevertheless, with this new law change, they could recommence making IRA contributions for the 2020 tax year going forward, given their AGI was *not* above the applicable AGI limits for their filing status (which also varies depending on whether they were already covered by a retirement plan). Of course, if they already begun taking RMDs, they would be putting money into their IRA while simultaneously having to extract a certain amount on an annual basis.
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> **Comment:** This was somewhat of a “common-sense change” since it now matches the rules for 401(k) and 403(b) plans, as well as Roth IRAs. That is, if an individual was *not* a “5% owner,” they could continue to contribute to their retirement plan, while *not* being subject to the RMD rules until they retired. This also opened the door for some planning strategies like additional “back-door Roth IRAs” later in life.
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> **Comment:** This change regarding IRA contributions being allowed even after a taxpayer’s RBD would make more sense if they would also raise the AGI limitations which still remain unchanged. For instance in 2020 with Roth IRA contributions, the phaseout starts at AGIs of $196,000 to $206,000 for MFJ filers and $124,000 to $139,000 for individuals. For traditional IRAs, the AGI phaseout starts $104,000 to $124,000 for couples and $65,000 to $75,000 for single filers. If only one spouse is covered by a plan, the phaseout zone for deducting a contribution for the uncovered spouse started at $196,000 of AGI and ended at $206,000. That continues to be a main reason why only 12% of taxpayers even have an IRA.

Coordination with Qualified Charitable Distribution (QCD) Rules: Under **Code §408(d)(8)(A)**, an annual exclusion from gross income (*not* to exceed $100,000) was available for otherwise taxable IRA distributions that are QCDs. As a result, such distributions were *not* included in gross income, and could *not* be claimed as a charitable deduction on the taxpayer's return, and were *not* subject to the general percentage limitations (i.e., 60% of AGI) that apply for making charitable contributions. In general, a QCD is one that is made:

1. On or after the IRA owner attained age 70½, and

2. Directly by the IRA trustee to a **Code §170(b)(1)(A)** charitable organization (other than a **Code §509(a)(3)** organization or a "donor advised fund" (as defined in **Code §4966(d)(2)**).

Comment: If the intended monies for a charity are initially in a 401(k) or 403(b) plan, they will still have to be moved first into an IRA, and then the QCD can be carried out.

Comment: Some brokerage firms have issued checkbooks for their IRAs whereby a check can simply be written as a donation (i.e., which would count as a QCD) to a eligible charity. In other words, the IRA owner would *not* have to involve the custodian of the account to make this charitable transfer on their behalf in order to qualify as a QCD.

New Law: Under the SECURE Act, effective for distributions made for tax years beginning *after* Dec. 31, 2019, the amount of a taxpayer's QCD that is *not* included in gross income for a tax year is reduced (but *not* below zero) by the excess of:

1. The total amount of IRA deductions allowed to the taxpayer for *all* tax years ending *on or after* the date he or she attains age 70½, over

2. The aggregate amount of such reductions for *all* tax years preceding the current tax year. (**Code §408(d)(8)(A), as amended by SECURE Act 1.0, Sec. 107(b)**)

Comment: This restriction is simply stating that you "can't have it both ways." Namely, you cannot receive a deduction for an IRA contribution, while also seeking an exclusion from gross income for a QCD. In other words, the QCD would have to be reduced by the deduction otherwise allowed for any IRA contributions. As stated in the law provision above, the QCD amount would have to be reduced by *aggregate* amount of IRA deductions taken for tax years on or after the taxpayer had turned 70½, as long as they had *not* previously served to reduce a QCD for a prior tax year.

Example: Jack turned 70½ in 2019. In 2020, he claimed a $7,000 IRA deduction on his return. In addition, he directed his IRA custodian to make a direct contribution to an eligible charity of $20,000. As a result of the change made by the **SECURE Act 1.0**, his QCD is only $13,000. The remaining $7,000 distributed to the charity will be included in his gross income when filing his personal return (and, the coding on the **Form 1099R** should indicate this requirement).

Example: Jack turned 70½ in 2019 and proceeded to make deductible IRA contributions of $7,000 in both 2020 and 2021, while making no QCDs during that time period. Then, in 2022, he made a $20,000 direct contribution from his IRA to an eligible charity (but no IRA contribution). As a result of the change made by the SECURE Act, his QCD is only $6,000. The remaining $14,000 distributed to the charity will be included in his gross income when filing his personal return (and, the coding on the **Form 1099R** should indicate this requirement).

Comment: Assuming that Jack is now 72 in 2021, he will also need to commence making required minimum distributions (RMDs) out of any qualified retirement plans that he might have, as well as any IRAs. Furthermore, in the examples above, *both* types of distributions out of his IRAs (i.e., whether includible in his gross income, or excluded as a QCD) should count toward this RMD requirement.

Comment: Of course, if the full amount of the QCD has to be reduced to the extent of any deductible IRA contributions, with some or all of the QCD being includible in gross income as a result, the taxpayer is still free to take this as a charitable contribution deduction on Schedule A (assuming that they choose to itemize their deductions versus taking the standard deduction).

Bar on Plan Loans through Credit Cards and Similar Arrangements: Employer-sponsored retirement plans are permitted to provide loans to participants. But, unless the loan satisfies certain requirements "in *both* form and operation," the amount of a retirement plan loan is a *deemed distribution* from the retirement plan. And, if an employee stops making payments on a loan before the loan is *fully repaid*, a deemed distribution of the outstanding loan balance generally occurs, which is taxed as though an actual distribution occurred, including being subject to a 10% early distribution tax, if otherwise applicable.

Subject to the limit on the amount of loans (i.e., the lesser of 50% of the participant's account balance or $50,000), which precludes any additional loan that would cause the limit to be exceeded, the rules relating to loans do *not* limit the number of loans an employee may obtain from a plan. In fact, some arrangements have developed under which an employee can access plan loans by using a credit card or similar mechanism.

New Law: For loans made *after* the enactment date (i.e., 12/20/19 which was the day that the **SECURE Act 1.0** was signed into law by President Trump), the **SECURE Act 1.0** provides that plan loans distributed through credit cards (or, similar arrangements) are *not* considered to be meeting the requirements for loan treatment applicable to qualified retirement plans. As a result, such a loan is to be treated as a *deemed distribution* (with a possible 10% early withdrawal penalty being applied as well). (**Code §72(p)(2)(D), as amended by SECURE Act Sec. 108**)

Portability of Lifetime Income Options: Previously, an employer-sponsored retirement plan that allowed employees to direct the investment of their accounts in any product, instrument or investment offered in the market could nevertheless be amended prospectively so as to limit the investments that could be held in the plan. As a result, the employees might have been required to change the investments held within their accounts. And, some investments might have even imposed a fee when the investment was liquidated (e.g., for instance, if the liquidation takes place a short time after acquisition). Furthermore, restrictions on "in-service distributions" (i.e., distributions occurring *before* severance from employment) might have prevented the employee from preserving the investment through a rollover.

New Law: For plan years beginning *after* Dec. 31, 2019, the **SECURE Act 1.0** allows new choices where a "lifetime income investment" is no longer authorized to be held as an investment option by qualified defined contribution plans, Sec. 403(b) plans, or governmental Sec. 457(b) plans. However, such plans may allow:

1. Qualified distributions of a lifetime income investment, or

2. Distributions of a lifetime income investment in the form of a qualified plan distribution annuity contract.

Such a distribution must be made within the 90-day period ending on the date when the "lifetime income investment" is no longer authorized to be held as an investment option under the plan. (**Code §401(a)(37(A)**, **Code §401(k)(2)(B)**, **Code §403(b)(7)**, **Code §403(b)(11), and Code §457(d)(1), as amended by SECURE Act 1.0, Sec. 109**)

A "qualified distribution" is a direct trustee-to-trustee transfer to another employer-sponsored retirement plan or IRA. (**Code §401(a)(38)(B)(I)**)

A "lifetime income investment" is an investment option designed to provide an employee with election rights:

1. That are *not* "uniformly available" with respect to other investment options under the plan, and

2. That are rights to a "lifetime income feature" available through a contract or other arrangement offered under the plan (or under another employer-sponsored retirement plan or IRA through a direct trustee-to-trustee transfer). (**Code §401(a)(38)(B)(ii)**)

A "lifetime income feature" is:

i. A feature that guarantees a minimum level of income annually (or, more frequently) for at least the remainder of the life of the employee or the joint lives of the employee and the employee's designated beneficiary, or

ii. An annuity payable on behalf of the employee under which payments are made in substantially equal periodic payments (but, *not* less frequently than *annually*) over the life of the employee or the joint lives of the employee and the employee's designated beneficiary. (**Code §401(a)(38)(B)(iii)**)

A "qualified plan distribution annuity contract" is an annuity contract purchased for a participant and distributed to the participant by an employer-sponsored retirement plan or an employer-sponsored retirement plan contract. (**Code §401(a)(38)(B)(iv)**)

Long-term Part-time Workers Can Participate in 401(k) Plans: Previously, employers could routinely exclude part-time employees (i.e., employees who work less than 1,000 hours per year) when providing a defined contribution plan to their employees. Also, qualified retirement plans could generally delay participation in the plan based on attainment of age or completion of years of service but *not* beyond the later of completion of one year of service (i.e., a 12-month period with at least 1,000 hours of service) or attainment of age 21.

A plan could provide that an employee was *not* entitled to an allocation of employer nonelective or matching contributions for a plan year unless the employee completed *either* 1,000 hours of service during the plan year or was employed on the last day of the year even if the employee previously completed 1,000 hours of service in a prior year. But, once an employee completed 1,000 hours of service during a plan year, an employee could *not* be precluded from making elective deferrals based on a service requirement.

Qualified retirement plans were, however, subject to requirements as to the "period of service" after which a participant's right to their accrued benefits had to be treated as being nonforfeitable (i.e., "vested"). Generally, a year of vesting service is only required to be credited if an employee completed 1,000 hours of service during the year.

Under a “nondiscrimination requirement” (consisting of a minimum coverage and general nondiscrimination requirement), a qualified retirement plan was prohibited from discriminating in favor of “highly-compensated employees.” In applying these requirements, employees of all members of a controlled group or affiliated service group were treated as employed by a *single* employer. Employees who had *not* satisfied minimum age and service conditions under the plan, certain nonresident aliens, and employees covered by a collective bargaining agreement were generally disregarded. However, a plan that covered employees with less than a year of service or who are under age 21 had to generally include those employees in any nondiscrimination test for the year. Thus, testing could have been done in either of the two ways stated above.

New Law: For plan years beginning *after* Dec. 31, 2020, the **SECURE Act 1.0** requires a Sec. 401(k) plan to allow an employee to make elective deferrals if the employee has worked *at least 500 hours per year* with the employer for *at least three consecutive years*, while also meeting the age requirement (i.e., age 21) by the end of the three-consecutive-year-period. For determining whether the three-consecutive-year period has been met, the 12-month periods beginning *before* Jan. 1, 2021 will *not* be taken into account. Furthermore, this provision does *not* apply in the case of collectively bargained plans.

Once a "long-term part-time employee" has completed this three-year period of service, they cannot be excluded from the plan going forward just because the employee has *not* completed a year of service as defined under the participation requirements (a 12-month period with at least 1,000 hours of service). Once a long-term part-time employee meets the age and service requirements, the employee must be able to commence participation no later than the *earlier* of:

1. The first day of the first plan year beginning *after* the date on which the employee satisfied the age and service requirements, or

2. The date 6 months *after* the date on which the individual satisfied these requirements.

Employers may, but are *not* required to, allow “long-term part-time employees” to participate in the nondiscrimination design based safe harbors (including the “automatic enrollment safe harbor”) for testing the amount of contributions benefits under a qualified retirement plan. If an employer does allow a long-term part-time employee to participate in an automatic enrollment 401(k) plan, that employee would have elective deferrals automatically made at the default rate unless the employee affirmatively elects *not* to make contributions or to make contributions at a different rate.

The **SECURE Act 1.0** does *not*, however, require a “long-term part-time employee” to be otherwise eligible to participate in the plan. As a result, the plan can continue to treat a long-term part-time employee as ineligible under the plan for employer nonelective and matching contributions based on *not* having completed a year of service. Nevertheless, if a plan does provide employer contributions for long-term part-time employees, it must credit, for each year in which the employee worked at least 500 hours, a year of service for purposes of vesting in any employer contributions.

With respect to “long-term part-time employees,” employers would receive “nondiscrimination testing relief” (similar to the present-law rules for plans covering otherwise excludible employees), including permission to exclude these employees from “top-heavy vesting” and “top-heavy benefit requirements.”

But, this relief ceases to apply to any employee who becomes a "full-time employee" (as of the first plan year beginning *after* the plan year in which the employee completes a 12-month period with at least 1,000 hours of service). (**Code §401(k)(2)(D), Code §401(k)(15), as amended by SECURE Act 1.0, Sec. 112**)

Penalty-free Plan Withdrawals for Births or Adoptions: Previously, a distribution from a qualified retirement plan, a Sec. 403(b) tax-sheltered annuity plan, an eligible Sec. 457(b) deferred compensation plan of a State or local government employer, or an IRA, is generally included in income for the year distributed. Unless an exception applies, a distribution *before* age 59½ is also subject to a 10% additional tax (i.e., "early withdrawal penalty") on the amount includible in income.

New Law: For distributions made *after* Dec. 31, 2019, the **SECURE Act 1.0** provides for penalty-free withdrawals from retirement plans for a "qualified birth or adoption distribution." This would generally include a distribution to an individual if made during the one-year period beginning on the date on which a child of the individual is born or on which the legal adoption by the individual of an "eligible adoptee" is finalized. An "eligible adoptee" means any individual (other than a child of the taxpayer's spouse) who has *not* attained age 18 or is physically or mentally incapable of self-support (i.e., regardless of age). The maximum aggregate amount of a qualified birth or adoption distribution by any individual with respect to any birth or adoption is $5,000, applied on an individual basis (i.e., so each spouse separately may receive a $5,000 of qualified birth or adoption distributions). Taxpayers must include the name, age, and taxpayer identification number (TIN) of the child or eligible adoptee on their tax return. In addition, such qualified birth or adoption distributions may be subsequently recontributed to an individual's applicable eligible retirement plans, subject to certain requirements. (**Code §72(t)(H), as amended by SECURE Act 1.0, Sec. 113**)

> **Comment:** This provision only applies to the possible imposition of the **Code §72(t)** "10% early withdrawal penalty." It does *not* impact the requirement that such distributions be included in the taxpayer's gross income. Therefore, the **Code §23** "adoption credit" ($14,080 per qualifying child for 2019) would still be available, given the AGI thresholds were *not* exceeded and certain other requirements were met.

Increase in Age for Beginning Date of RMDs: Employer-provided qualified retirement plans (e.g., 401(k), 403(b) or 457(b) plans), traditional IRAs, and individual retirement annuities are subject to "required minimum distribution (RMD) rules," which require benefits to be distributed or commence being distributed by the required beginning date (RBD).

> **Comment:** Keep in mind there is no RMD requirement for Roth IRAs (although beneficiaries inheriting Roth IRAs do have to starting "draining" them over no more than 10 years now, even though such income would continue to be nontaxable). In other words, if you inherit a Roth IRA, calculate your RMDs as though the account owner had died *before* their RBD (i.e., required beginning date), regardless of the actual date of death.

Under pre-Act law, the RBD for IRAs was April 1st following the calendar year in which the IRA owner attains age 70½. For employer-sponsored retirement plans, for non-5% company owners, the RBD is April 1st following the *later* of the calendar year in which the employee attains age 70½ or retires (at least for that *particular employer's* retirement plan). For an employee who is a 5% owner, the RBD is the *same* as for IRAs even if the employee continues to work past age 70½.

A number of payout choices were available where an IRA or retirement plan account owner died *before* the RBD and the spouse was the account's beneficiary. Under pre-Act law, one of these choices allowed the spouse to delay distributions from the decedent's account until Dec. 31st of the year in which the decedent would have attained age 70½. Or, roll over the deceased spouse's account into the surviving spouse's IRA which meant RMDs could be delayed on these co-mingled funds until the surviving spouse turned 70½.

New Law: Under the **SECURE Act 1.0**, the RBD for IRAs will now be April 1st following the calendar year in which the IRA owner attains age 72. For employer-sponsored retirement plans, for non-5% company owners, the RBD will be April 1st following the *later* of the calendar year in which the employee attains age 72 or retires from that particular employer's qualified plan. For an employee who is a 5% owner, the RBD is the *same* as for IRAs even if the employee continues to work past age 72. (**Code §401(a)(9)(C)(i)(I), and Code §401(a)(9)(C)(ii)(I), as amended by SECURE Act 1.0, Sec. 114**)

In a "conforming change," where an IRA or retirement plan account owner dies *before* the RBD and the spouse is the account's beneficiary, the spouse will be able to delay distributions from the decedent's account until Dec. 31st of the year in which the decedent would have attained age 72. Another age-72 conforming change is made to the **Code §408(b)** definition of "endowment contracts." (**Code §401(a)(9)(B)(iv)(I), and Code §408(b), as amended by Act Sec. 114**)

Effective Date: The above "required-beginning-date changes" are effective for distributions required to be made *after* Dec. 31, 2019, with respect to individuals who attain age 70½ *after* that date.

Comment: In other words, if the taxpayer was already 70½ before 1/1/2020, the **SECURE Act 1.0** changes do *not* apply to them and they would continue to make their RMDs as they did before this new law was passed.

Example: John turns age 72 on Aug. 12, 2025. Under the changes made by the SECURE Act, he does *not* need to commence RMDs until April 1st of 2026 with regard to his SIMPLE IRA plan. Under prior law, he would have commenced making RMDs by April 1st of 2024 (i.e., the year after he turned 70½).

Example: Sam turned 70½ during 2019 (i.e., *before* 1/1/2020). Therefore, he is required to start his RMDs by April 1st of 2020 and is unaffected by the changes made the **SECURE Act 1.0**.

Comment: The IRS has issued proposed regulations **(REG-132210-18)** that would update the life expectancy and distribution tables used to calculate Required Minimum Distributions (RMDs) from qualified retirement plans, individual retirement accounts and annuities, and certain other tax-favored employer-provided retirement arrangements. Subject to a transition rule, the new life expectancy tables in the proposed regulations would apply to distribution calendar years (i.e., years when an individual must take an RMD) beginning *on or after* 1/1/21. Supposedly, this updating of the mortality tables will still take place and is unaffected by the **SECURE Act 1.0** changes. The combination of these two things will result in *not* only a delay, but also a reduction of the RMD amounts going forward.

ALERT: WHEN THE SECURE ACT 1.0 PASSED, RETIREMENT PLAN PROFESSIONALS UNANIMOUSLY CONCLUDED THAT DISTRIBUTIONS FROM AN IRA OR QUALIFIED PLAN INHERITED BY A NONSPOUSAL BENEFICIARY COULD BE DELAYED UNTIL THE END OF THE 10TH YEAR, REGARDLESS OF WHETHER THE DECEDENT HAD REACHED THEIR "REQUIRED BEGINNING DATE" (RBD) AS OF THEIR DATE OF DEATH.

NEVERTHELESS, PROPOSED REGS ISSUED OVER TWO YEARS LATER (I.E., IN FEB. 2022) INDICATE THAT DISTRIBUTIONS WHEN THE DECEDENT HAD REACHED THEIR RBD BEFORE DEATH HAD TO BE TAKEN OUT THROUGHOUT THE 10-YEAR PERIOD USING THE LIFE EXPECTANCY TABLES FOR YEARS 1 TO 9, WITH ANY REMAINING BALANCE BEING EXTRACTED BY THE END OF THE 10TH YEAR.

THE IRS SUBSEQUENTLY STATED THAT THE 50% PENALTY FOR FAILURE TO TAKE THESE DISTRIBUTIONS BASED ON THE PROPOSED REGS WOULD NOT BE IMPOSED FOR THE 2021 TAX YEAR. BUT SUCH DISTRIBUTIONS WOULD HAVE TO BE MADE FOR YEARS 2 THROUGH 9 (I.E., 2022 THROUGH 2029) WITH THE BALANCE OF THE IRA OR QUALIFIED PLAN BEING TAKEN OUT BY THE END OF THE 10TH YEAR (I.E., 2030).

Comment: The analysis below starts with the SECURE Act 1.0 explanation and then a summary of the proposed regs follows.

"Stretch Option" Now Limited to 10 Years: Under pre-Act law, a *nonspousal* beneficiary of a retirement plan, tax-deferred annuity or IRA could choose to spread the RMDs over their **remaining life expectancy** with the payouts starting in the year *immediately after* the decedent's death.

Comment: Depending on the amount inherited and given enough time, the beneficiary may *not* ever have to put another dime into their own retirement account(s) because of the compounding growth from the inherited IRA. For instance, if you leave a $500,000 Roth IRA to a 40-year-old heir (i.e., nonspousal beneficiary), by their 65th birthday, the inherited IRA would have grown to approximately $1 million tax-free given a 6% rate of return per year, even *after* taking annual distributions (i.e., RMDs) for this initial 25-year period.

Example: "Stretch Option" for Nonspousal Inherited IRA and Retirement Plans: This change is expected to provide a huge tax revenue increase for the federal government by removing beneficiaries' ability to string out distributions. In fact, this provision is the *single biggest revenue raiser* in the **SECURE Act 1.0** ($15.9 billion over the next decade). The reasoning behind the change is that the government wanted these accounts to be retirement accounts and *not* "tax shelters for multi-generational planning."

Example: "50-Year Old Nonspousal Heir"
Assume that the value of all inherited accounts (i.e., both retirement plans and IRAs) is $100,000 and this nonspousal beneficiary is 50 years old. Furthermore, assume a conservative 3% rate of return on these assets. Comparing pre-Act law where the beneficiary could "stretch out" the RMDs over their remaining life expectancy v. the maximum 10-year period which now must be used, we have the following respective RMD amounts (with the balance left in the account(s) after the RMD):

Year	Pre-SECURE Act	Post-SECURE Act
1	$ 3,968.25	$10,000
	98,912.70	92,700
2	$ 4,087.30	$10,300
	97,670.16	84,872
3	$ 4,209.92	$10,609
	96,264.05	76,490.89

4	$ 4,336.22 94,685.66	$10,927.27 67,530.53
5	$ 4,466.30 92,925.94	$11,255.09 57,963.70
6	$ 4,600.29 90,975.42	$11,592.74 47,762.09
7	$ 4,738.30 88,824.23	$11,940.52 36,896.22
8	$ 4,880.45 86,462.09	$12,298.74 25,335.40
9	$ 5,026.87 83,878.28	$12,667.70 13,047.73
10	$ 5,177.67 81,061.63	$13,047.73 -0-

	Pre-SECURE Act	**Post-SECURE Act**
RMDs	**$45,491.57**	**$114,638.79**

RMD Increase under SECURE Act = +$69,147.22

ALERT: UNDER THE PROPOSED REGS ISSUED BY THE IRS IN FEB. 2022, THE "POST-SECURE ACT 1.0" APPROACH ABOVE IS REQUIRED IF THE DECEDENT HAD REACH THEIR REQUIRED BEGINNING DATE (RBD) (I.E., 72 YEARS OLD IN 2020, 2021 OR 2022) BY THE DATE OF THEIR DEATH.

IF THE DECEDENT HAD NOT REACHED THEIR RBD BY THE TIME THAT THEY DIED, THEN NO RMDs WOULD BE REQUIRED UNTIL THE END OF THE 10TH YEAR WHEN ALL OF THE FUNDS IN THE IRA OR QUALIFIED PLAN WOULD HAVE TO BE EXTRACTED BY THE NONSPOUSAL BENEFICIARY.

Comment: As you can see from the above example, this nonspousal 50-year old taxpayer who inherits an IRA or retirement account would still have **$81,061.63 remaining out of the original $100,000** value of the account, despite taking out RMDs over this initial 10-year period. And, if there was an assumed higher rate of return, the entire $100,000 balance (and, possibly more) would still be there after 10 years of RMDs had the SECURE Act *not* been passed.

Comment: As an alternative to taking an RMD each of the first 9 years under the SECURE Act, the taxpayer could instead just take a lump-sum by the **end of the tenth year** (i.e., $100,000 with a 10-year investment return at an annual compounding rate of return) which most probably put the taxpayer in a *significantly higher marginal rate* for that final year.

Comment: An excellent article by **Jamie P. Hopkins** entitled **"Pros, Cons and Possible Disasters after SECURE Act"** provides a good overview of this planning issue.

"Stretch Option" Still Available in Certain Cases: Binding annuity contracts that were in effect at the time of the enactment of the **SECURE Act 1.0** are exempt. And, there are special rules for beneficiaries of defined benefit pension plans. The other major exception is for "eligible designated beneficiaries" (a status that you must meet as of the date of the account owner's death). Those meeting the "eligible designated beneficiary" status will be exempt from the 10-year RMD distribution rule. These include surviving spouses, nonspousal heirs that are *less than 10 years* younger than the decedent, chronically ill individuals, disabled individuals, and minors. Minors will age out of the exclusion once they hit the age of majority in their state, typically 18 to 21. At that time, the 10-year required minimum distribution period would become applicable.

Comment: Ed Slott, in his tax article syndicated by USA Today entitled **"Some Retirees Feeling Less Secure About Tax Rule Changes in SECURE Act"** has indicated that only "children" and *not* "grandchildren" can be "eligible designated beneficiaries. But, "children who remain in school" can wait to start the "10-year stretch period" until they are 26. However, "qualified charitable distributions (QCDs)" can still be made once a taxpayer has turned 70½, even though the "requirement beginning date (RBD)" has now been increased to age 72 for making "required minimum distributions (RMDs)."

Comment: The elimination of the "stretch option" is directed at *nonspousal* beneficiaries and would, therefore, *not* affect spouses who stand to inherit their deceased spouse's IRAs or retirement accounts. For an excellent article on this topic, **Kiplinger** has an article entitled **"How Heirs Can Maximize an Inherited IRA,"** especially the section that deals with *spousal* beneficiaries.

Example: "Eligible Designated Beneficiary"
Claude dies in 2020 and leaves his IRA to his sister Marian who is 8 years younger. Since she would be an "eligible designated beneficiary," the balance in this inherited IRA could be paid out over her remaining life expectancy. But, if Marian dies before the account balance is exhausted, any remaining balance going to a *nonspousal* beneficiary (assuming they were *not* an "eligible designated beneficiary") would have to be paid out within 10 years of Marian's death.

Example: "Younger Spousal Beneficiary"
Harold who is 85 years old leaves his $1 million IRA to his younger spouse Miriam who is 55 (and, an "eligible designated beneficiary"). She would be able to keep this account separate so as to take distributions free of any "10% early withdrawal penalty" until age 59½. Then, it could be rolled over into her IRA account with no RMDs until April 1st of the year after she turns 72.

☞**Required Minimum Distributions for Non-Spousal Beneficiaries for 2021 and 2022 (Notice 2022-53)**

The IRS intends to provide relief to those taxpayers subject to the "10-year rule" (i.e., for non-spousal beneficiaries) who did *not* take Required Minimum Distributions (RMDs) in 2021 *and/or* 2022 but now realize that the IRS has stated that they were required to do so under **proposed regulations** (i.e., that were originally issued in Feb. 2022). The **Setting Every Community Up for Retirement Enhancement (SECURE) Act of 2019** added the requirement that, for most taxpayers, any funds in an inherited retirement plan must be paid out on or before December 31st of the *tenth calendar year* following the original holder's death. These payments (at least according to the proposed regs) must begin in the *first calendar year* following the year of the IRA owner/plan participant's death based on the life expectancy of the *designated beneficiary* with a final distribution in year 10. The IRS has now announced plans to issue final regulations under **Code §401(a)(9)** that will apply "no earlier than the 2023 distribution calendar year." As a result, the 50% penalty under **Code §4974** would *not* apply for failure to take RMDs subject to these rules for either of these tax years.

> **Comment:** The confusion stems from the fact that the "old rule" stated that a non-spousal beneficiary had to take RMDs "by the end of the 5-year period" beginning after the year in which the decedent died, or over their remaining life expectancy.

> **Comment:** The changes made by the **SECURE Act** were originally intended to apply to distributions with respect to an employee who died after 2019.

Code §401(a)(9) Rules: Specifically, **Code §401(a)(9)(A)(ii)** provides that the entire interest of an employee in a "qualified plan" must be distributed, beginning *not* later than the employee's "required beginning date," in accordance with regulations, over the life of the employee or over the lives of the employee and a *designated beneficiary* (or, over a period *not* extending beyond the life expectancy of the employee *and* a designated beneficiary).

More importantly, **Code §401(a)(9)(B)(i)** provides that, if the employee dies *after* distributions have begun, the employee's remaining interest must be distributed **"at least as rapidly as under the distribution method used by the employee as of the date of the employee's death."**

> **Comment:** So, if a non-spousal beneficiary (e.g., a child of the decedent) inherited the funds in a qualified plan (or, IRA) after the "required beginning date" (RBD) of the decedent, then the life expectancy of that child could *not* be used for the ensuing 10-year period and, instead, the "at least as rapidly" requirement mentioned above would result in the continued use of what had been the RMDs that the decedent had been taking.

> **Comment:** The rules of section **Code §401(a)(9)** are incorporated by reference in **Code §408(a)(6)** and **(b)(3)** for individual retirement accounts and individual retirement annuities, **Code §408A(c)(5)** for Roth IRAs, **Code §403(b)(10)** for annuity contracts, custodial accounts, and retirement income accounts described in **Code §403(b)** (i.e., Sec. 403(b) plans), and **Code §457(d)** for eligible deferred compensation plans.

Changes Made by SECURE Act: Now, pursuant to **Code §401(a)(9)(H)(i)**, if an employee in a defined contribution plan has a designated beneficiary, the 5-year period under the former "5-year rule" is lengthened to 10 years (i.e., "10-year rule") and the new 10-year rule applies regardless of whether the employee dies *before* the required beginning date. In addition, pursuant to **Code §401(a)(9)(H)(ii)**, the **Code §401(a)(9)(B)(iii)** exception to the 10-year rule (i.e., under which the 10-year rule is treated as satisfied if distributions are paid over the designated beneficiary's lifetime or life expectancy) applies only if the designated beneficiary is an "eligible designated beneficiary" (i.e., a spouse or minor beneficiary under the age of 18).

Refunds of 50% RMD Penalty: The Service stated that if a taxpayer has already paid an excise tax (i.e., the 50% penalty under **Code §4974**) for a missed RMD in 2021 that constitutes a "specified RMD," that taxpayer may request a refund of that excise tax. A "specified RMD" is any distribution that, under the interpretation included in the proposed regulations, would be required to be made pursuant to **Code §401(a)(9)** in 2021 or 2022 under a defined contribution plan or IRA that is subject to the rules of **Code §401(a)(9)(H)**. **(Code §401; RMDs)**

☞**IRS Releases Updated Life Expectancy Tables for RMDs (TD 9930)**

These new life expectancy tables, which will now be used for required minimum distributions, were last updated in 2002 and account for more-current individual mortality rates. In other words, the revised tables will result in distributions being spread out over more years since life expectancies are now projected to be about one to two years longer than those listed in the existing tables. For example, a 72-year-old IRA owner currently uses a distribution period of 25.6 years to calculate RMDs. Under the new tables, a 72-year-old would use a longer period of 27.4 years. By basing RMDs on longer life expectancies, plan participants and IRA owners will be able to take out *smaller* annual payouts while providing for longer tax-deferral of assets held in these accounts. The updated tables apply to computing withdrawals for 2022 and beyond, even for those people who have been using a shorter life expectancy in prior years. **(Code §401(a)(9); RMDs)**

> **Comment:** Besides updating these "mortality tables," the RBD has been moved to age 72 (and, will probably be increased again).

2022 SECURE ACT 2.0

Introduction

With the signing into law of the omnibus spending bill that included **SECURE Act 2.0 of 2022** on Dec. 29, 2022, businesses and their employees can now capitalize on added incentives related to their retirement plans.

Originally, the **Securing a Strong Retirement Act of 2022 (SECURE Act 2.0)** was passed in March 2022 with an overwhelming bipartisan vote of 414-5 by the U.S. House of Representatives while two separate bills on retirement were debated by the Senate. Components of each bill eventually were folded into the omnibus bill by the lame duck Congress.

SECURE Act 2.0 follows the initial phase by Congress to address the retirement crisis in the United States. As mentioned above, **Setting Every Community Up for Retirement Enhancement (SECURE 1.0) Act** was signed into law Dec. 27, 2019.

SECURE 2.0 is an attempt to build on the initiatives already started to help a wide range of Americans achieve retirement security and financial well-being and the two Acts should be viewed as an integrated unit when planning for our clients.

SECURE 2.0 is comprehensive legislation intended to expand and increase retirement savings, especially for low-income and part-time employees, and to simplify and clarify many complex and confusing existing retirement plan rules.

Title I: Expanding Coverage and Increasing Retirement Savings

Sec. 101 - Expanding Automatic Enrollment in Retirement Plans

Background: According to the Congressional report, one of the main reasons many Americans reach retirement age with little or no savings is that too few workers are offered an opportunity to save for retirement through their employers. However, even for those employees who are offered a retirement plan at work, many do *not* participate. But automatic enrollment in 401(k) plans (i.e., providing for people to participate in the plan unless they take the initiative to opt out) significantly increases participation.

Since first defined and approved by the Treasury Department in 1998, automatic enrollment has boosted participation by eligible employees generally, and particularly for Black, Latinx, and lower-wage employees. An early study found that adoption of automatic enrollment increased participation in a 401(k) plan by short-tenure Latinx employees from 19 percent to 75 percent. An Ariel/Aon-Hewitt study found that, in plans using automatic enrollment, "[t]he most dramatic increases in enrollment rates are among younger, lower-paid employees, and the racial gap in participation rates is nearly eliminated among employees subject to auto-enrollment."

Automatic Enrollment: Sec. 101 of the **SECURE Act 2.0** requires 401(k) and 403(b) plans to automatically enroll participants in the respective plans upon becoming eligible (although employees may opt out of coverage). The initial automatic enrollment amount is at least 3 percent but not more than 10 percent. Each year thereafter that amount is increased by 1 percent until it reaches at least 10 percent, but not more than 15 percent.

<u>Current Plans Grandfathered</u>: All current 401(k) and 403(b) plans are grandfathered (i.e., they can continue without the requirement for "automatic enrollment").

<u>Exception for Certain Plans</u>: There is an exception for small businesses with 10 or fewer employees, as well as new businesses (i.e., those that have been in business for less than 3 years), church plans, and governmental plans.

<u>Effective Date</u>: Sec. 101 is effective for plan years beginning *after* December 31, 2024.

Sec. 102 - Modification of Credit for Small Employer Pension Plan Startup Costs

<u>Background</u>: The current 3-year "small business startup credit" is 50 percent of administrative costs involved with the setting up of a qualified retirement plan, limited to an annual cap of $5,000.

<u>Increased 100% Credit</u>: Sec. 102 of the **SECURE Act 2.0** makes changes to the credit by increasing the startup credit from 50 percent to 100 percent of administrative costs for employers with *up to 50 employees*. Except in the case of defined benefit plans, an "additional credit" is provided. The amount of the additional credit generally will be a percentage of the amount contributed by the employer on behalf of employees, up to a per-employee cap of $1,000. This full additional credit is limited to employers with *50 or fewer* employees and phased out for employers with between 51 and 100 employees. The applicable percentage is 100 percent in the *first and second years*, 75 percent in the third year, 50 percent in the fourth year, 25 percent in the fifth year – and no credit for tax years thereafter.

<u>Effective Date</u>: Sec. 102 is effective for taxable years beginning *after* December 31, 2022.

Sec. 103 - Saver's Match

<u>Background</u>: Current law provides for a nonrefundable credit for certain individuals who make contributions to individual retirement accounts (IRAs), employer retirement plans (e.g., 401(k) and 403(b) plans), and ABLE accounts.

<u>Credit Replaced with Federal Matching Contribution</u>: Sec. 103 of the **SECURE Act 2.0** repeals and replaces the credit with respect to IRA and retirement plan contributions, changing it from a credit paid in cash (i.e., as part of a tax refund) into a "federal matching contribution" that must be deposited into a taxpayer's IRA or retirement plan. The match is 50 percent of IRA or retirement plan contributions up to $2,000 per individual (i.e., the first $4,000 contributed matched with $2,000 federal contribution). The match phases out between $41,000 and $71,000 in the case of taxpayers filing a joint return ($20,500 to $35,500 for single taxpayers and married filing separate; $30,750 to $53,250 for head of household filers).

<u>Effective Date</u>: Sec. 103 is effective for taxable years beginning *after* December 31, 2026.

Sec. 105 - Pooled Employer Plan Modification

<u>Background</u>: Sec. 105 of the **SECURE Act 2.0** clarifies that a pooled employer plan ("PEP") may designate a named fiduciary (other than an employer in the plan) to collect contributions to the plan. Such fiduciary would be required to implement written contribution collection procedures that are "reasonable, diligent, and systematic."

Effective Date: Sec. 105 is effective for plan years beginning *after* December 31, 2022.

Sec. 106 - Multiple Employer 403(b) Plans

Background: Multiple employer plans ("MEPs") provide an opportunity for small employers to band together to obtain more favorable retirement plan investment results and more efficient and less expensive management services.

Incentives Added: Sec. 106 of the **SECURE Act 2.0** makes MEPs "more attractive by eliminating outdated barriers to the use of MEPs and improving the quality of MEP service providers." Sec. 106 allows 403(b) plans, which are generally sponsored by charities, educational institutions, and non-profits, to participate in MEPs and PEPs, including relief from the "one bad apple rule" so that the violations of one employer do *not* affect the tax treatment of employees of compliant employers.

Effective Date: Sec. 106 is effective for plan years beginning *after* December 31, 2022.

Sec. 107 - Increase in Age for RMDs

Background: Under current law (i.e., **SECURE Act 1.0**), participants are generally required to begin taking distributions from their retirement plans at age 72. The policy behind this rule is to ensure that individuals spend their retirement savings during their lifetime and *not* use their retirement plans for estate planning purposes to transfer wealth to beneficiaries.

New Age 73 for RMDs in 2023: The **SECURE Act 1.0** increased the required minimum distribution age from 70½ to 72. Sec. 107 of the **SECURE Act 2.0** further increases the required minimum distribution age to 73 starting on January 1, 2023. Furthermore, the RMD age will again increase to 75 starting on January 1, 2033.

> **Comment:** The original proposal in the **SECURE Act 2.0** was to gradually raise the RMD age from 72 to 73, and then in a few years to 74, and finally, to age 75 starting in 2030 but this version of the proposed law did *not* it pass the Senate. Nevertheless, this change recognizes the fact that more senior citizens are working longer.

Sec. 108, Indexing IRA Catch-up Limit

Background: Under current law, the limit on IRA contributions is increased by $1,000 (but *not* indexed for inflation) for individuals who have attained age 50.

IRA Catch-up Contributions Indexed for Inflation: Sec. 108 of the **SECURE Act 2.0** indexes this limit.

Effective Date: Sec. 108 is effective for taxable years beginning *after* December 31, 2023.

Sec. 109 - Higher Catch-up Limit for Ages 60, 61, 62, and 63

<u>Background</u>: Under current law, employees who have attained age 50 are permitted to make catch-up contributions under a retirement plan in excess of the otherwise applicable limits. The limit on catch-up contributions for 2022 is $6,500, except in the case of SIMPLE plans for which the limit is $3,000. Sec. 109 of the **SECURE Act 2.0** increases these limits to the *greater* of $10,000 or 50 percent more than whatever the regular catch-up amount is in 2025 (i.e., for those taxpayers age 50 or older) for individuals who have attained ages 60, 61, 62 and 63. In addition, the increased amounts are indexed for inflation after 2025.

<u>Effective Date</u>: Sec. 109 is effective for taxable years beginning *after* December 31, 2024.

Sec. 110 - Student Loan Payments Treated as Elective Deferrals for Matching Contribution Purposes

<u>Background</u>: Sec. 110 is intended to assist employees who may *not* be able to save for retirement because they are overwhelmed with student debt. As a result, these employees are missing out on available matching contributions for retirement plans.

> **<u>Comment</u>:** Student loan debt, according to the Federal Reserve in 2021, impacts 45 million Americans whose combined debt for student loans is $1.75 trillion. Employers will now be able to make matching contributions to an employee's 401(k) per their plan provisions when an employee makes a student loan repayment, thus enabling the employee to pay off their student loan and save for retirement at the same time.

<u>Employers Matching Student Loan Repayments</u>: Sec. 110 allows such employees to receive those matching contributions as they repay their student loans. Sec. 110 permits an employer to make matching contributions under a 401(k) plan, 403(b) plan, or SIMPLE IRA with respect to "qualified student loan payments." A qualified student loan payment is broadly defined as any indebtedness incurred by the employee solely to pay qualified higher education expenses of the employee. Governmental employers are also permitted to make matching contributions in a section 457(b) plan or another plan with respect to such repayments.

<u>Discrimination Testing</u>: For purposes of the nondiscrimination test applicable to elective contributions, Sec. 110 allows a plan to test separately the employees who receive matching contributions on student loan repayments.

<u>Effective Date</u>: Sec. 110 is effective for contributions made for plan years beginning *after* December 31, 2023.

Sec. 111 - Credit for Small Employer Plan Start-up Costs When Joining MEPs

<u>Background</u>: The **SECURE Act 2.0** provides a tax credit for "small employers" and the start-up costs associated with joining an existing "multiple employer plan" (MEP). Sec. 111 ensures the start-up tax credit is available for 3 years for employers joining a MEP, regardless of how long the MEP has been in existence. Under both pre- and post-SECURE Act law, the start-up tax credit only applies for the first 3 years that a plan is in existence. In other words, if a "small business" joins a MEP that has already been in existence for 3 years, the start-up credit is *not* available. If, for example, the MEP has been existence for 1 or 2 years when a small business joins, the small business may be able to claim the credit for 1 or 2 years, respectively. Sec. 111 fixes this issue so that employers joining a MEP (which includes PEPs) are eligible for the credit for *all* 3 years.

Effective Date: Sec. 111 is effective *retroactively* for taxable years beginning *after* December 31, 2019.

Sec. 113 - Financial Incentives for Employer Matching Contributions

Background: Under current law, employers may provide matching contributions as a long-term incentive for employees to contribute to a 401(k) plan. However, immediate financial incentives (e.g., gift cards in small amounts) are prohibited even though individuals “may be especially motivated by them to join their employers’ retirement plans.”

De Minimis Financial Incentives: Sec. 113 of the **SECURE Act 2.0** enables employers to offer “de minimis financial incentives,” *not* paid for with plan assets, such as low-dollar gift cards, “to boost employee participation” in workplace retirement plans by exempting de minimis financial incentives from **Code §401(k)(4)(A)** and from the corresponding rule under **Code §403(b)**.

Effective Date: Sec. 113 is effective for plan years beginning *after* the date of enactment of this Act (i.e., after 12/29/22).

Sec. 114 - Tax Deferral for Sales of Employer Stock to S Corp ESOPs

Background: Sec. 114 of the **SECURE Act 2.0** provides for a deferral of tax for certain sales of employer stock to employee stock ownership plans sponsored by S corporations. Under **Code §1042**, an individual owner of stock in a non-publicly traded C corporation that sponsors an employee stock ownership plan (“ESOP”) may elect to defer the recognition of gain from the sale of such stock to the ESOP if the seller reinvests the sales proceeds into “qualified replacement property,” such as stock or other securities issued by a U.S. operating corporation. After the sale, the ESOP must own at least 30 percent of the employer corporation’s stock.

New Tax Deferral for S Corporations: Sec. 114 now expands the gain deferral provisions under **Code §1042** with a 10 percent limit on the deferral to sales of employer stock to S corporation ESOPs.

Effective Date: Sec. 114 is effective for sales made *after* December 31, 2027.

Sec. 115 - Withdrawals for Certain Emergency Expenses

Background: Generally, an additional 10 percent tax under **Code §72(t)** applies to early distributions from tax-preferred retirement accounts, such as 401(k) plans and IRAs, unless an exception applies.

New Exception for “Emergency Distributions:” Sec. 115 of the **SECURE Act 2.0** provides an exception for certain distributions used for emergency expenses, which are “unforeseeable or immediate financial needs relating to personal or family emergency expenses.” Only *one* distribution is permissible annually of up to $1,000. In addition, a taxpayer has the option to repay the distribution within 3 years. But no further emergency distributions are permissible during the “3 year repayment period” unless repayment actually occurs.

Effective Date: Sec. 115 is effective for distributions made December 31, 2023.

Sec. 116 - Additional Nonelective Contributions to SIMPLE IRA Plans

Background: Current law requires employers with SIMPLE IRA plans to make employer contributions to employees of either 2 percent of compensation or 3 percent of employee elective deferral contributions.

Additional Employer Contributions Allowed: Sec. 116 of the **SECURE Act 2.0** will permit an employer to make additional contributions to each employee of a SIMPLE IRA plan in a "uniform manner," provided that the contribution may *not* exceed the *lesser* of up to 10 percent of compensation or $5,000 (which will be indexed for inflation).

Effective Date: Sec. 116 is effective for taxable years beginning *after* December 31, 2023.

Sec. 117 - Contribution Limit for SIMPLE IRA Plans

Background: Under current law, the annual contribution limit for employee elective deferral contributions to a SIMPLE IRA plan is $14,000 ($15,500 in 2023) and the catch-up contribution limit beginning at age 50 is $3,000 (3,500 for 2023). A SIMPLE IRA plan may only be sponsored by a small employer (100 or fewer employees), and the employer is required to either make matching contributions on the first 3 percent of compensation deferred or an employer contribution of 2 percent of compensation (regardless of whether the employee elects to make contributions).

Increased Contribution Limits: Sec. 117 of the **SECURE Act 2.0** increases the annual deferral limit, as well as the catch-up contribution at age 50 by 10 percent, as compared to the limit that would otherwise apply in the first year this change is effective, in the case of an employer with no more than 25 employees. An employer with 26 to 100 employees would be permitted to provide higher deferral limits, but only if the employer either provides a 4 percent matching contribution or a 3 percent employer contribution. Sec. 117 makes similar changes to the contribution limits for SIMPLE 401(k) plans.

Effective Date: Sec. 117 is effective for taxable years beginning *after* December 31, 2023.

Comment: The Secretary of Treasury is also required to report to Congress on data related to SIMPLE IRAs by December 31, 2024, and annually thereafter.

Sec. 118 - Tax Treatment of Certain SEP Contributions

Background: Sec. 118 of the **SECURE Act 2.0** will now permit employers of domestic employees (e.g., nannies) to provide retirement benefits for such employees under a Simplified Employee Pension ("SEP").

Effective Date: Sec. 118 is effective for taxable years beginning *after* date of enactment of this Act (which was signed into law on 12/29/22).

Sec. 120 - Exemption for Automatic Portability Transactions

Background: Under current law, an employer is permitted to distribute a participant's account balance without participant consent if the balance is under $5,000 and the balance is immediately distributable (e.g., after a termination of employment). Current law also requires an employer to roll over this distribution into a default IRA if the account balance is at least $1,000 and the participant does *not* affirmatively elect otherwise.

Automatic Portability Services: Sec. 120 of the **SECURE Act 2.0** will now permit a retirement plan service provider to provide employer plans with "automatic portability services." Such services involve the automatic transfer of a participant's default IRA (established in connection with a distribution from a former employer's plan) into the participant's new employer's retirement plan, unless the participant affirmatively elects otherwise.

Effective Date: Sec. 120 is effective for transactions occurring *on or after* the date which is 12 months after the date of enactment of this Act (which was 12/29/22).

Sec. 121 - "Starter 401(k) Plans" for Employers with No Retirement Plan

Background: Sec. 121 of the **SECURE Act 2.0** will now permit an employer that does *not* sponsor a retirement plan to offer a "starter 401(k) plan" (or, a "safe harbor 403(b) plan"). A starter 401(k) plan (or, a "safe harbor 403(b) plan") would generally require that *all* employees be default enrolled in the plan at a 3 to 15 percent of compensation deferral rate. The limit on annual deferrals would be the *same* as the IRA contribution limit, which for 2022 is $6,000 ($6,500 for 2023) with an additional $1,000 ($1,000 for 2023 as well) in catch-up contributions beginning at age 50.

Effective Date: Sec. 121 is effective for plan years beginning *after* December 31, 2023.

Sec. 124 - Modification of Age Requirement for Qualified ABLE Programs

Background: Current law allows states to create "qualified ABLE programs," which are tax-advantaged savings programs for certain people with disabilities. Distributions from an ABLE account are tax-free if used for "qualified disability expenses" of the account's designated beneficiary.

Increased Age Requirement: Sec. 124 of the **SECURE Act 2.0** increases the age by which blindness or disability must occur for an individual to be an "eligible individual" by reason of such blindness or disability for an ABLE program.

Effective Date: Sec. 124 is effective for taxable years beginning *after* December 31, 2025.

Sec. 125 - Improving Coverage for Part-time Workers

Background: The **SECURE Act 2.0** builds on the earlier provisions in the **SECURE Act 1.0** and now will require employers to allow even more "long-term, part-time workers" to participate in the employers' 401(k) plans. The **SECURE Act 1.0** provision stipulated that (except in the case of collectively bargained plans) employers maintaining a 401(k) plan must have a "dual eligibility requirement" under which an employee must complete either 1 year of service (with the 1,000-hour rule) or 3 consecutive years of service (where the employee completes at least 500 hours of service).

More Part-time Employees Eligible: Sec. 125 of the **SECURE Act 2.0** reduces the 3 year rule to just 2 years, effective for plan years beginning *after* December 31, 2024. Sec. 125 also provides that pre-2021 service is disregarded for vesting purposes, just as such service is disregarded for eligibility purposes under current law, effective as if included in the SECURE Act to which the amendment relates. This provision also extends the "long-term part-time coverage" rules to 403(b) plans that are subject to ERISA.

Effective Date: These "long-term part-time coverage" rules effective for plan years beginning *after* December 31, 2024.

Sec. 126 - Special Rules for Distributions from Sec. 529 Plans to Roth IRAs

Background: Sec. 126 of the **SECURE Act 2.0** amends the current law to allow for tax and penalty-free rollovers from long-term qualified tuition programs (i.e., 529 plans) to Roth IRAs, under certain conditions.

New Sec. 529 Rollover Provision: Beneficiaries of Sec. 529 college savings accounts would be permitted to rollover up to $35,000 over the course of their lifetime from any 529 account in their name to their Roth IRA. But these rollovers will also be subject to Roth IRA annual contribution limits, and the Sec. 529 account must have been open for more than 15 years.

> **Comment:** According to the Senate Finance Report, families and students have concerns about leftover funds being trapped in Sec. 529 accounts unless they take a non-qualified withdrawal and assume a penalty (at least on the earnings portion of the account). This has led to hesitating, delaying, or declining to fund Sec. 529 plans to levels needed to pay for the rising costs of education. Sec. 126 of the **SECURE Act 2.0** is meant to eliminate this concern by providing families and students with the option to avoid the penalty, resulting in families putting more into their Sec. 529 plans. Families who sacrifice and save in Sec. 529 accounts should *not* be punished with tax and penalty years later if the beneficiary has found an alternative way to pay for their education. They should be able to retain their savings and begin their retirement account on a positive note.

> **Comment:** According to **savingforcollege.com**, money can be kept in a 529 plan *indefinitely*. 529 plans can be used for graduate school, not just undergraduate school, and can be passed on to one's children. There is also no age limit on contributions to a 529 plan.

Effective Date: Sec. 126 is effective with respect to such rollover distributions *after* December 31, 2023.

Sec. 127 - Emergency Savings Accounts Linked to Pension Plans

Background: Though individuals can save on their own, far too many fail to do so. According to a report by the Federal Reserve, almost half of Americans would struggle to cover an unexpected $400 expense. As a result, many are forced to tap into their retirement savings. A recent study found that, in the past year, almost 60 percent of retirement account participants who lack emergency savings tapped into their long term retirement savings, compared to only 9 percent of those who had at least a month of emergency savings on hand. Separating emergency savings from one's retirement savings account will provide participants a better understanding that one account is for short-term emergency needs and the other is for long-term retirement savings, thus empowering employees to handle unexpected financial shocks without jeopardizing their long-term financial security in retirement through emergency hardship withdrawals.

New Emergency Savings Accounts: Sec. 127 of the **SECURE Act 2.0** provides employers the option to offer to their non-highly compensated employees pension-linked emergency savings accounts. Employers may automatically opt employees into these accounts at no more than 3 percent of their salary, and the portion of an account attributable to the employee's contribution is capped at $2,500 (or lower as set by the employer). Once the cap is reached, the additional contributions can be directed to the employee's Roth defined contribution plan (if the employee has one) or stopped until the balance attributable to contributions falls below the cap. Contributions are made on a Roth-like (i.e., post-tax) basis and are treated as elective deferrals for purposes of retirement matching contributions with an annual matching cap set at the maximum account balance (i.e., $2,500 or lower as set by the plan sponsor). The first four withdrawals from the account each plan year may *not* be subject to any fees or charges solely on the basis of such withdrawals. At separation from service, employees may take their emergency savings accounts as cash or roll it into their Roth defined contribution plan (if they have one) or IRA.

> **Comment:** No specific "effective date" was mentioned for this provision in the Senate Finance Report. Presumably, employers could commence offering this option to their employees for plan years starting in 2023.

Sec. 128 - Enhancement of 403(b) Plans

Background: Under current law, 403(b) plan investments are generally limited to annuity contracts and publicly traded mutual funds. This limitation prevents 403(b) plan participants (i.e., generally, employees of charities and public schools, colleges, and universities) from access to "collective investment trusts," which are often used by 401(a) plans to expand investment options for plan participants at a lower overall cost.

Expanded Investment Options for 403(b) Plans: Sec. 128 of the **SECURE Act 2.0** would permit 403(b) custodial accounts to participate in "group trusts" with other tax-preferred savings plans and IRAs, and would be effective after date of enactment (i.e., 12/29/22).

Title II – Preservation of Income

Sec. 201 - Remove RMD Barriers for Life Annuities

Background: Sec. 201 of the **SECURE Act 2.0** eliminates certain barriers to the availability of life annuities in qualified plans and IRAs that come into play under current law due to an actuarial test in the required minimum distribution regulations. The test is intended to limit tax deferral by precluding commercial annuities from providing payments that start out small and increase excessively over time. In operation, however, the test commonly prohibits many important guarantees that provide only modest benefit increases under life annuities. For example, guaranteed annual increases of only 1 or 2 percent, return of premium death benefits, and period certain guarantees for participating annuities are commonly prohibited by this test. But without these types of guarantees, many individuals are unwilling to elect a life annuity under a defined contribution plan or IRA.

Effective Date: Sec. 201 is effective for calendar years ending *after* the date of enactment of this Act (i.e., so calendar year plans ending on 12/31/22 would be impacted by this change).

Sec. 202 - Qualifying Longevity Annuity Contracts

Background: In 2014, the Treasury Department published final regulations on "qualifying longevity annuity contracts" (QLACs). QLACs are generally deferred annuities that begin payment at the end of an individual's life expectancy. Because payments start so late, QLACs are an inexpensive way for retirees to hedge the risk of outliving their savings in defined contribution plans and IRAs. But the required minimum distribution rules were an impediment to the growth of QLACs in defined contribution plans and IRAs because those rules generally require payments to commence at age 72, before QLACs begin payments. The 2014 regulations generally exempted QLACs from the minimum distribution rules until payments actually commenced. However, due to a lack of statutory authority to provide a full exemption, the regulations imposed certain limits on the exemption that have prevented QLACs from achieving their intended purpose in providing longevity protection.

QLAC Barriers Removed: Sec. 202 of the **SECURE Act 2.0** addresses these limitations by repealing the 25 percent limit and allowing up to $200,000 (indexed for inflation) to be used from an account balance to purchase a QLAC. Sec. 202 also facilitates the sales of QLACs with spousal survival rights, while also clarifying that "free-look periods" are permitted up to 90 days with respect to contracts purchased or received in an exchange *on or after* July 2, 2014.

Effective Date: Sec. 202 is effective for contracts purchased or received in an exchange on the date of enactment of this Act (i.e., 12/29/22), with the Treasury Secretary being required to update the relevant regulations within 18 months of the 12/29/22 date of enactment of this Act.

Sec. 204 - Eliminating a penalty on partial annuitization

Background: If a tax-preferred retirement account also holds an annuity, current law requires that the account be bifurcated between the portion of the account holding the annuity and the rest of the account for purposes of applying the required minimum distribution rules. This treatment may result in higher minimum distributions than would have been required if the account did *not* hold an annuity.

Special Aggregation Rules for RMDs: Sec. 204 of the **SECURE Act 2.0** will allow the account owner to elect to aggregate distributions from *both* portions of the account for purposes of determining required minimum distributions.

Effective Date: Sec. 204 is effective on the date of enactment of this Act (i.e., 12/29/22). Also, the Treasury Secretary is instructed to update the relevant regulations accordingly.

Title III – Simplification and Clarification of Retirement Plan Rules

Sec. 301 - Recovery of Retirement Plan Overpayments

Background: Sometimes retirees mistakenly receive more money than they are owed under their retirement plans. These mistakes cause problems when they occur over time, and plan fiduciaries later seek to recover the overpayments from unsuspecting retirees. When an overpayment has lasted for years, plans often compel retirees to repay the amount of the overpayment, plus interest, which can be substantial. Even small overpayment amounts can create a hardship for a retiree living on a fixed income.

Discretion with Recoupments: Sec. 301 of the **SECURE Act 2.0** will permit retirement plan fiduciaries the latitude to decide *not* to recoup overpayments that were mistakenly made to retirees. But if plan fiduciaries do choose to recoup overpayments, limitations and protections apply to safeguard innocent retirees. This change is intended to protect both the benefits of future retirees, as well as the benefits of current retirees. Rollovers of the overpayments also remain valid.

Effective Date: Sec. 301 is effective on the date of enactment of this Act (i.e., 12/29/22), and further outlines how plan fiduciaries may proceed with respect to determinations made prior to the date of enactment of this Act to seek or *not* to seek recovery of overpayments.

Sec. 302 - Reduction in Excise Tax on Plan Accumulations

RMD Penalty Reduced: Sec. 302 of the **SECURE Act 2.0** reduces the penalty for failure to take required minimum distributions from 50 to 25 percent. Furthermore, if a failure to take a required minimum distribution from an IRA is corrected "in a timely manner" (i.e., as defined under this Act), the excise tax on the failure is further reduced from 25 percent to 10 percent.

Effective Date: Sec. 302 is effective for taxable years beginning *after* the date of enactment of this Act (i.e., 12/29/22).

Sec. 303 - Retirement Savings Lost and Found

Background: Every year, thousands of people approach retirement but are unable to find and receive the benefits that they earned often because the company they worked for moved, changed its name, or merged with a different company. Similarly, every year there are employers around the country ready to pay benefits to retirees, but they are unable to find the retirees because the former employees changed their names or addresses.

National On-line Database: Sec. 303 of the **SECURE Act 2.0** creates a national online searchable "lost and found database" for Americans' retirement plans at the Department of Labor ("DOL"). The database will enable retirement savers, who might have lost track of their pension or 401(k) plan, to search for the contact information of their plan administrator.

Effective Date: Sec. 303 directs that the database be created and functional no later than 2 years after the date of enactment of this Act (i.e., 12/29/22).

Sec. 304 - Updating Dollar Limit for Mandatory Plan Distributions from Employers

Background: Under current law, employers are permitted to transfer former employees' retirement accounts from a workplace retirement plan into an IRA if their balances are between $1,000 and $5,000.

Increased Threshold for Mandatory Distributions: Sec. 307 of the **SECURE Act 2.0** increases the limit from $5,000 to $7,000.

Effective Date: This higher threshold will apply effective for distributions made *after* December 31, 2023.

Sec. 305 - Expansion of Employee Plans Compliance Resolution System

Background: Because of the ever growing complexity of retirement plan administration, Sec. 305 expands the **Employee Plans Compliance Resolution System** **("EPCRS")** to (1) allow more types of errors to be corrected internally through self-correction, (2) apply to inadvertent IRA errors, and (3) exempt certain failures to make required minimum distributions from the otherwise applicable excise tax. For example, Sec. 305 allows for correction of many plan loan errors through self-correction, which are a frequent area of error and can be burdensome to correct a single loan error through the IRS.

Effective Date: Sec. 305 is effective on the date of enactment of this Act (i.e., 12/29/22).

Comment: Any guidance or revision of guidance required by Sec. 305 shall be promulgated no later than 2 years after the date of enactment of this Act. And **Rev. Proc. 2021–30** (or, any successor guidance) shall be updated to take into account the provisions of this section no later than 2 years after the date of enactment of this Act.

Sec. 306 - "First Day of the Month" Requirement for 457(b) Plans Eliminated

Background: Under current law, 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. This rule, however, does *not* apply to other defined contribution plans.

Flexibility with Plan Deferral Rates: Sec. 306 of the **SECURE Act 2.0** allows such elections to be made at *any* time prior to the date that the compensation being deferred is available.

Effective Date: Sec. 306 is effective for taxable years beginning after the date of enactment of this Act (i.e., 12/29/22).

Sec. 307 - One-time Election for QCDs to Split-interest Entities/Increased QCD Limit

New Election for QCDs: Sec. 307 of the **SECURE Act 2.0** expands the IRA qualified charitable distribution (QCD) provision to allow for a *one-time*, $50,000 distribution to charities through charitable gift annuities, charitable remainder unitrusts (CRUTs), and charitable remainder annuity trusts (CRATs).

Effective Date - New Election: This one-time provision is effective for such distributions made in taxable years beginning *after* the date of enactment of this Act (12/29/22).

Inflation Adjustment for QCD Limit: Sec. 307 of the **SECURE Act 2.0** also indexes for inflation the annual IRA charitable distribution limit of $100,000.

Effective Date - Inflation Adjustment: This indexing for inflation provision is effective for qualified charitable distributions (QCDs) made in taxable years ending *after* the date of enactment of this Act (i.e., 12/29/22).

Sec. 308 - Distribution to Firefighters

Background: Under current law, if an employee terminates employment after age 55 and takes a distribution from a retirement plan, the 10 percent early withdrawal penalty under **Code §72(t)** does *not* apply. However, there is a special rule for "qualified public safety employees" in governmental plans, under which age 50 is substituted for age 55 for purposes of this exception from the 10 percent tax. This exemption applies to *public* sector firefighters, but *not private* sector firefighters.

New Exemption for Volunteer Firefighters: Sec. 308 of the **SECURE Act 2.0** extends the age 50 rule to private sector (e.g., volunteer) firefighters, who merit the same treatment for distributions.

Effective Date: Sec. 308 is effective for distributions made after the date of enactment of this Act (i.e., 12/29/22).

Sec. 309 - Exclusion of Disability-related First Responder Payments

Disability Payments Excluded: Sec. 309 of the **SECURE Act 2.0** permits first responders to exclude service-connected disability pension payments from gross income *after* reaching retirement age.

Effective Date: Sec. 309 is effective for amounts received in taxable years beginning *after* December 31, 2026.

Sec. 310 - Separate Top-heavy Tests for Plans Covering Excludible Employees

Background: Under current law, qualified retirement plans must satisfy the "top-heavy test," in addition to other nondiscrimination tests. Plans that are deemed "top-heavy" are required to provide employees with a minimum of a 3 percent of nonelective pay contribution, which can be a significant cost to small businesses. Other nondiscrimination tests that apply to 401(k) plans allow an employer to test otherwise excludible employees (e.g., those who are under age 21 and have less than 1 year of service) separately. This was intended to encourage plan sponsors to permit employees to defer earlier than the minimum age and service conditions permitted under the law because it reduces the situations where plans would fail the nondiscrimination tests if these employees were included when performing the test. However, this *separate* testing is *not* allowed for the "top-heavy test."

Top-heavy Trap for Small Businesses: Small business retirement plans often do *not* cover excludible employees because, if the plan is or becomes top-heavy, the employer may be required to contribute a top-heavy employer contribution for *all* employees who are eligible to participate in the plan, which could strain the budget for these small businesses.

Separate Top-heavy Test: Sec. 310 of the **SECURE Act 2.0** allows an employer to perform the top-heavy test *separately* on the non-excludible and excludable employees. This is intended to remove the financial incentive to exclude employees from the 401(k) plan and increase retirement plan coverage to more workers.

Effective Date: Sec. 310 is effective for plan years beginning *after* December 31, 2023.

Sec. 311 - 3-Year Limit on Repayment of Qualified Birth or Adoption Distributions

Background: The **SECURE Act 1.0** included a provision that allows individuals to receive distributions from their retirement plan in the case of birth or adoption (i.e., "qualified birth or adoption distribution," or QBAD) without paying the 10 percent early withdrawal penalty tax under **Code §72(t)**. These distributions can be recontributed to a retirement plan at *any* time and are treated as rollovers. The problem with current law, however, is the allowance of recontributions "at any time." **Code §6511** prevents a refund from being provided to a taxpayer after the statute of limitations for the return has closed, which is generally a 3 year period. As a result, there would *not* be a mechanism under the Code allowing someone who took a birth/adoption distribution to recontribute the distribution more than 3 years later and amend their return to receive a refund for the taxes that were paid in the year of the withdrawal.

Time Limit on Recontributions: Sec. 311 of the **SECURE Act 2.0** amends the QBAD provision to restrict the recontribution period to just 3 years.

Effective Date: Sec. 311 is effective to distributions made after the date of the enactment of this Act (i.e., 12/29/22) and *retroactively* to the 3 year period beginning on the day after the date on which such distribution was received.

Sec. 312 - Employer Reliance on Employee Self-certification for Hardship Distributions

Employee Self-certification: Given that certain conditions are met, Sec. 312 of the **SECURE Act 2.0** provides that employees are permitted to self-certify that they have had an event that constitutes a hardship for purposes of taking a "hardship withdrawal." This is considered "a logical step" in light of the success of the coronavirus related distribution self-certification rules and the current hardship regulations that already permit employees to self-certify that they do *not* have other funds available to address a hardship.

Effective Date: Sec. 312 is effective for plan years beginning *after* the date of enactment of this Act (i.e., 12/29/22).

Sec. 313 - SOL for Excise Tax on Excess Contributions and Accumulations

Background: Under current law, the statute of limitations (SOL) for excise taxes imposed on excess contributions, or required minimum distribution failures start running as of the date that a specific excise tax return (i.e., **Form 5329**) is filed for the violation. But individuals are often *not* aware of the requirement to file **Form 5329**. As a result, this can lead to an *indefinite* period of limitations that can cause hardship for taxpayers due to the accumulation of interest and penalties (Cf. ***Paschall v. Commr.,* 137 T.C. 8 (7/52011)**).

3-Year Statue of Limitations: In order to provide finality for taxpayers in the administration of these excise taxes, Sec. 313 of the **SECURE Act 2.0** provides that a 3-year statute of limitations begins when the taxpayer files an individual tax return (i.e., **Form 1040**) for the year of the violation. In the case of excess contributions, however, the statute of limitations will instead run 6 years (i.e., as opposed to just 3 years) from the date that **Form 1040** is filed. There is also a further exception from this 6-year rule for taxes that result from of a bargain sale to the IRA.

Comment: In general, these changes are intended to ensure that there is a reasonable statute of limitations for violations of which taxpayers were *not* aware and therefore did *not* file an excise tax return (i.e., **Form 5329**), while *retaining* existing law in fact scenarios that involve a "bargain sale."

Effective Date: Sec. 313 is effective on the date of enactment of this Act (12/29/22).

Sec. 314 - Penalty-free Withdrawals by Domestic Abuse Victims

Background: A domestic abuse survivor may need to access the money in their retirement account for various reasons, such as escaping an unsafe situation.

Self-certification by Victim: Sec. 314 of the **SECURE Act 2.0** allows retirement plans to permit participants that self-certify that they experienced domestic abuse to withdraw a small amount of money (the lesser of $10,000, indexed for inflation, or 50 percent of the participant's account balance). Although such distribution made under Sec. 314 will have to be included in gross income, they will not be subject to the 10 percent penalty on early withdrawals. Furthermore, such participants will have the opportunity to repay the withdrawn money from the retirement plan over 3 years and will be refunded for income taxes on money that is repaid.

Effective Date: Sec. 318 is effective for distributions made *after* December 31, 2023.

Sec. 315 - Reformation of Family Attribution Rule

Background: Under the Code, certain related businesses are required to be aggregated when performing the "coverage and nondiscrimination tests." The aggregation rules are generally based on the degree of common ownership of the businesses. In determining the level of ownership in a business, the tax laws have certain attribution rules whereby an individual is deemed to own stock held by other individuals or entities.

Attribution Rules Updated: Sec. 315 of the **SECURE Act 2.0** updates two stock attribution rules. The first update addresses inequities where spouses with *separate* businesses reside in a *community* property state when compared to spouses who reside in common law states. The second update modifies the attribution of stock between parents and minor children.

Effective Date: Sec. 315 is effective for plan years beginning *after* December 31, 2023.

Sec. 316 - Benefit Accruals Allowed until Employer Tax Return Due Date

Background: The **SECURE Act 1.0** permits an employer to adopt a *new* retirement plan by the due date of the employer's tax return for the fiscal year in which the plan is effective. Current law, however, provides that plan amendments to an existing plan must generally be adopted by the last day of the plan year in which the amendment is effective. This precludes an employer from adding plan provisions that may be beneficial to participants.

<u>Plan Amendments Allowed until Return Due Date</u>: Sec. 316 of the **SECURE Act 2.0** amends these provisions to allow discretionary amendments that increase participants' benefits to be adopted by the due date of the employer's tax return.

<u>Effective Date</u>: Sec. 316 is effective for plan years beginning *after* December 31, 2023.

Sec. 317 - Retroactive First Year Elective Deferrals for Sole Proprietors

<u>Background</u>: Under the **SECURE Act 1.0**, an employer may establish a new 401(k) plan after the end of the taxable year, but before the employer's tax filing date and treat the plan as having been established on the last day of the prior taxable year. Such plans may also be funded by employer contributions up to the employer's tax filing due date.

<u>Elective Deferrals for Sole Proprietors</u>: Sec. 317 of the **SECURE Act 2.0** will permit these plans, when they are sponsored by sole proprietors or single-member LLCs, to receive employee contributions up to the date of the employee's tax return filing due date for the initial year.

<u>Effective Date</u>: Sec. 317 is effective for plan years beginning *after* the date of enactment of this Act (i.e., 12/29/22).

Sec. 320 - Eliminating Unnecessary Plan Notices for Unenrolled Participants

<u>Background</u>: Under current law, employees eligible to participate in a retirement plan are required to receive numerous notices that are intended to inform them of their various options and rights under the plan. In the case of eligible employees who have elected to *not* participate in the plan (i.e., unenrolled participants), these notices (e.g., such as notices regarding the different investment options available under the plan) are generally unnecessary, and can even have adverse effects on savings and coverage.

<u>Unnecessary Notices Eliminated</u>: Sec. 320 of the **SECURE Act 2.0** no longer requires employers provide certain intermittent ERISA or Code notices to unenrolled participants who have elected to *not* participate in a workplace retirement plan. Nevertheless, to further encourage participation of unenrolled participants, the plan is still required to send (1) an annual reminder notice of the participant's eligibility to participate in the plan and any applicable election deadlines, and (2) any otherwise required document requested at any time by the participant. This rule applies only with respect to an unenrolled participant who received the summary plan description, in connection with initial eligibility under the plan, and any other notices related to eligibility under the plan required to be furnished.

<u>Effective Date</u>: Sec. 320 is effective for plan years beginning *after* December 31, 2022.

Sec. 322 - Tax Ramifications of IRA Involved in Prohibited Transaction

<u>Background</u>: When an individual engages in a prohibited transaction with respect to their IRA, the IRA is disqualified and treated as completely distributed to the individual, irrespective of the size of the prohibited transaction.

<u>Only Violating IRA Impacted</u>: Sec. 322 of the **SECURE Act 2.0** clarifies that if an individual has multiple IRAs, only the IRA with respect to which the prohibited transaction occurred will be disqualified.

Effective Date: Sec. 322 is effective for taxable years beginning after the date of enactment of this Act (i.e., 12/29/22).

Sec. 323 - Clarification of Substantially Equal Periodic Payment Rule

Background: Current law imposes a 10 percent early withdrawal penalty on early distributions from tax-preferred retirement accounts. However, an exception applies to "substantially equal periodic payments" that are made based on the account owner's life expectancy (i.e., per IRS mortality tables).

Exception for Annuity Payments: Sec. 323 of the **SECURE Act 2.0** provides that the exception continues to apply in the case of a rollover of the account, an exchange of an annuity providing the payments, or an annuity that satisfies the required minimum distribution rules.

Effective Date: Sec. 323 is effective for transfers, rollovers, exchanges *after* December 31, 2023 and effective for annuity distributions *on or after* the date of enactment of this Act (i.e., 12/29/22).

Sec. 325 - Roth IRA Distribution Rules

Background: Under current law, required minimum distributions do *not* need to be made prior to the death of the owner of a Roth IRA. However, pre-death distributions are required in the case of the owner of a Roth designated account in an employer retirement plan (e.g., 401(k) plan).

Pre-death Roth Payouts for Qualified Plans Eliminated: Sec. 325 of the **SECURE Act 2.0** eliminates the pre-death distribution requirement for Roth accounts held in an employer's qualified retirement plan (e.g., 401(k) and 403(b) plans).

Effective Date: This provision is effective for taxable years beginning *after* December 31, 2023. But Sec. 325 does *not* apply to distributions which are required with respect to years beginning *before* January 1, 2024, but are permitted to be paid *on or after* such date.

Sec. 326 - Distributions on Account of Terminal Illness

Background: Under current law, an additional 10 percent early withdrawal penalty under **Code §72(t)** is imposed in situations where a terminally ill individual receives distributions before age 59½ if no other exception applied.

Individual with Terminal Illness: Sec. 326 of the **SECURE Act 2.0** will now provide an exception to the 10 percent early withdrawal penalty in the case of a distribution to a terminally ill individual.

Effective Date: Sec. 326 is effective for such distributions made *after* the date of enactment of this Act (i.e., 12/29/22).

Sec. 327 - Surviving Spouse Election to Be Treated as Employee

Special Election for Surviving Spouses: Sec. 327 of the **SECURE Act 2.0** will now permit a surviving spouse to elect to be treated as the deceased employee for purposes of the required minimum distribution rules with regard to the qualified plan inherited.

Effective Date: Sec. 327 is effective for calendar years beginning *after* December 31, 2023.

Sec. 328 - Repeal of Direct Payment Requirement by Sec. 457 Plans for Health and L/T Care Insurance

Background: Current law provides an exclusion from gross income ($3,000) for distributions from a governmental retirement plans to public safety officers in order to pay for their health insurance premiums. This exclusion requires that the plan directly pay the insurance premiums.

Direct Payment Exclusion Eliminated: Sec. 328 of the **SECURE Act 2.0** repeals the direct payment requirement. As a result, distributions can now be made from the plan to such individuals which are then used to pay these premiums.

Effective Date: and is effective for distributions made after the date of enactment of this Act.

Sec. 329 - Modification of Eligible Age for Exemption from Early Withdrawal Penalty

Background: Under current law, the 10 percent early withdrawal penalty on distributions from tax preferred retirement savings plans does *not* apply to a distribution from a governmental plan to a public safety officer who is at least age 50.

Exception for 25 Years of Service: Sec. 329 of the **SECURE Act 2.0** extends this exception to public safety officers with at least 25 years of service with the employer sponsoring the plan.

Effective Date: This provision is effective for distributions made after the date of enactment of this Act (12/29/22).

Sec. 331 - Use of Retirement Funds for PDDAs

Exception for Distributions Used for PDDAs: Sec. 331 of the **SECURE Act 2.0** provides permanent rules relating to the use of retirement funds in the case of a federally declared disaster area. This permanent rules will allow up to $22,000 to be distributed from employer retirement plans or IRAs for affected individuals. Furthermore, such distributions will *not* be subject to the 10 percent early withdrawal penalty under **Code §72(t)** and can be included in gross income over a 3-year period. At the option of the taxpayer, these distributions can be repaid to a tax preferred retirement account. In addition, for amounts distributed *prior* to the disaster to purchase a home can be recontributed, and an employer is permitted to provide for a larger amount to be borrowed from a plan by affected individuals and for additional time for repayment of plan loans owed by affected individuals.

Effective Date: Sec. 331 is effective for disasters occurring *on or after* January 26, 2021.

Sec. 332 - SIMPLE IRAs Replaced with 401(k) Plans

SIMPLE IRA Replaced with 401(k) Plan: Sec. 332 of the **SECURE Act 2.0** allows an employer to replace a SIMPLE IRA plan with a SIMPLE 401(k) plan or other 401(k) plan that requires mandatory employer contributions during a plan year.

Effective Date: This provision is effective for plan years beginning *after* December 31, 2023.

Sec. 333 - Additional Tax on Corrective Distributions of Excess Contributions Eliminated

Background: Current law requires excess contributions to an IRA to be distributed out of the account. This "corrective distribution" includes the excessive contribution and any earnings allocable to that contribution.

No Penalty on Excess Contributions: Sec. 333 of the **SECURE Act 2.0** will now exempt the excess contribution and earnings allocable to the excess contribution from the 10 percent early withdrawal penalty.

Effective Date: This provision is effective for any determination of, or affecting, liability for taxes, interest, or penalties which is made on or after the date of enactment of this Act (i.e., 12/29/22), without regard to whether the act (or failure to act) upon which the determination is based occurred *before* such date of enactment.

Sec. 334 - L/T Care Contracts Purchased with Retirement Plan Distributions

Distributions Used to Buy L/T Care Insurance: Sec. 334 of the **SECURE Act 2.0** permits retirement plans to distribute up to $2,500 per year for the payment of premiums for "certain specified long term care insurance contracts." Distributions from plans to pay such premiums are exempt from the additional 10 percent tax on early distributions. Only a policy that provides for "high quality coverage" is eligible for early distribution and waiver of the 10 percent penalty.

Effective Date: Sec. 334 is effective 3 years after date of enactment of this Act (i.e., 12/29/25).

Sec. 336 - Report to Congress on Section 402(f) Notices

Background: Sec. 402(f) notices are given by employer retirement plans in the case of a distribution to a participant that is eligible for rollover to another tax preferred retirement account and describes distribution options and tax consequences.

Effectiveness of 402(f) Notices: Sec. 336 of the **SECURE Act 2.0** requires the Government Accountability Office to issue a report to Congress on the effectiveness of section 402(f) notices.

Effective Date: GAO compliance is to occur within 18 months *after* the date of enactment of this Act (i.e., 6/29/24).

Sec. 337 - Modification of RMD Rules for Special Needs Trusts

Background: The **SECURE Act 1.0** placed limits on the ability of beneficiaries of defined contribution retirement plans and IRAs to receive lifetime distributions after the account owner's death.

Special rules apply in the case of certain beneficiaries, such as those with a disability.

RMD Rules Special Needs Trusts: Sec. 337 of the **SECURE Act 2.0** clarifies that, in the case of a special needs trust established for a beneficiary with a disability, the trust may provide for a charitable organization to be the remainder beneficiary.

Effective Date: Sec. 337 is effective for calendar years beginning *after* the date of enactment of this Act (i.e., 12/29/22).

Sec. 338 - Paper Statements Required in Certain Cases

Annual Paper Statements Required: Sec. 338 of the **SECURE Act 2.0** amends ERISA to generally provide that, with respect to *defined contribution* plans, unless a participant elects otherwise (i.e., elects to receive electronic paperless statements), the plan is required to provide a paper benefit statement at least once annually. Meanwhile, the other three quarterly statements required under ERISA are *not* subject to this rule (i.e., they can be provided electronically). For *defined benefit* plans, unless a participant elects otherwise, the statement that must be provided once every 3 years under ERISA must be a paper statement.

Effective Date: The Labor Secretary is required to update the relevant sections of their regulations and corresponding guidance by December 31, 2024, and the annual paper statement is effective for plan years beginning *after* December 31, 2025.

Sec. 345 - Annual Audits for Group of Plans

Background: Under current law, generally, a **Form 5500** for a defined contribution plan must contain an opinion from an independent qualified public accountant as to whether the plan's financial statements and schedules are fairly presented. However, no such opinion is required with respect to a plan covering fewer than 100 participants.

Required Audits: Sec. 345 of the **SECURE Act 2.0** clarifies that plans filing under a Group of Plans need only to submit an audit opinion if they have 100 participants or more. In other words, DOL and Treasury would continue to receive full audit information on at least the number of plans as under current law.

Effective Date: Sec. 345 is effective on the date of enactment of this Act (12/29/22).

Sec. 350 - Safe Harbor for Corrections of Employee Elective Deferral Failures

Background: Under current law, employers that adopt a retirement plan with automatic enrollment and automatic escalation features could be subject to significant penalties if "even honest mistakes are made." The IRS has issued guidance on the correction of failures relating to default enrollment of employees into retirement plans. This guidance includes a safe harbor, which expires on December 31, 2023, that permits correction if notice is given to the affected employee, correct deferrals commence within certain specified time periods, and the employer provides the employee with any matching contributions that would have been made if the failure had not occurred. Employers are concerned about the lapse of the safe harbor at the end of 2023.

Correction Period Extended: Sec. 350 of the **SECURE Act 2.0** eases these concerns by allowing for a grace period to correct, without penalty, "reasonable errors" in administering these automatic enrollment and automatic escalation features. However, errors must be corrected prior to 9 ½ months after the end of the plan year in which the mistakes were made.

Effective Date: Sec. 350 is effective to errors *after* December 31, 2023.

Title VI – Revenue Provisions

Sec. 601 - SIMPLE and SEP Roth IRAs

Background: Generally, all plans that allow pre-tax employee contributions are permitted to accept Roth contributions with just one exception – SIMPLE IRAs. 401(k), 403(b), and governmental 457(b) plans are all allowed to accept Roth employee contributions.

After-tax Contributions to SIMPLE IRAs Allowed: Sec. 601 of the **SECURE Act 2.0** allows SIMPLE IRAs to now accept Roth contributions too. In addition, aside from grandfathered salaried reduction simplified employee pension plans, under current law, simplified employee pension plans (SEPs) can only accept employer money and *not* on a Roth basis.

After-tax Contributions to SEPs Allowed: Sec. 601 of the **SECURE Act 2.0** will now allow employers to offer employees the ability to treat employee and employer SEP contributions as Roth (i.e., after-tax contributions, in whole or in part).

Effective Date: The provisions in Sec. 601 are effective for taxable years beginning *after* December 31, 2022.

Sec. 602 - Hardship Withdrawal Rules for 403(b) Plans

Background: Under current law, the distribution rules for 401(k) and 403(b) are different in certain ways that are "historical anomalies" for several different reasons. For example, for 401(k) plans, all amounts are available for a "hardship distribution." For 403(b) plans, in some cases, only employee contributions (without earnings) are available for "hardship distributions."

403(b) Hardship Distribution Rule Revised: Sec. 602 of the **SECURE Act 2.0** will now conform the 403(b) rules to the 401(k) rules.

Effective Date: This provision is effective for plan years beginning *after* December 31, 2023.

Sec. 603 - Elective Deferrals Limited to Regular Contribution Limit

Background: Under current law, catch-up contributions to a qualified retirement plan can be made on a pre-tax or Roth basis (if permitted by the plan sponsor).

Roth Catch-up Contributions: Sec. 603 of the **SECURE Act 2.0** will now provide that *all* catch-up contributions to qualified retirement plans are subject to Roth (i.e., after-tax) treatment.

Exception for Employees Paid Less than $145,000: An exception is provided for employees with compensation of $145,000 or less (indexed for inflation).

Effective Date: This provision is effective for taxable years beginning after December 31, 2023.

Sec. 604 - Optional Roth treatment of employer matching Contributions

Background: Under current law, plan sponsors are *not* permitted to provide employer matching contributions in their 401(k), 403(b), and governmental 457(b) plans on a Roth (i.e., after-tax) basis. In other words, matching contributions must be on a pre-tax basis only.

Optional Roth Treatment for Employer Matches: Sec. 604 of the **SECURE Act 2.0** will now allow defined contribution plans to provide participants with the option of receiving matching contributions on a Roth (i.e., after-tax) basis.

Effective Date: This provision is effective on the date of enactment of this Act (i.e., 12/29/22).

Sec. 605 - Charitable Conservation Easements

Background: The tax deduction for charitable contributions of conservation easements has long played a crucial role in incentivizing the preservation of critical habitat, open spaces, and historically important areas and structures. However, since 2016 the IRS has identified certain syndicated conservation easement transactions involving pass-through entities as "listed transactions" carrying a high potential for abusive tax avoidance.

Deductions for Conservation Easements Limited: Sec. 605 of the **SECURE Act 2.0** will now disallow a charitable contribution deduction for a "qualified conservation contribution" if the deduction claimed exceeds two and one half times the sum of each partner's relevant basis in the contributing partnership, unless: (1) the contribution meets a 3 year holding period test; (2) substantially all of the contributing partnership is owned by members of a family; or (3) the contribution relates to the preservation of a certified historic structure. In the case of a contribution for the preservation of a certified historic structure, however, a new reporting requirement applies.

Deed Corrections Allowed: Sec. 605 also provides taxpayers the opportunity to correct certain defects in an easement deed (excluding easements involved in "abusive transactions") and makes certain changes to statute of limitations and penalty provisions.

Effective Date: Sec. 605 is generally effective for contributions made *after* the date of enactment of this Act (i.e., 12/29/22).

Sec. 606 - Enhancing Retiree Health Benefits in Pension Plans

Background: Under current law, an employer may use assets from an over funded pension plan to pay retiree health and life insurance benefits. These rules, however, sunset at the end of 2025.

Benefit Extension: Sec. 606 extends the sunset date to the end of 2032 and would also permit transfers to pay retiree health and life insurance benefits provided the transfer is no more than 1.75 percent of plan assets and the plan is at least 110 percent funded.

Effective Date: Section 606 is effective for transfers made on or after the date of enactment of this Act.

Key IRA & Qualified Plan Developments

Miscellaneous:

☞**2023 Inflation-Adjusted Increases Impacting Retirement Plans** (**Notice 2022-55**)
The following are the 2023 inflation-adjusted increases with regard to retirement plans:

- Defined benefit plan maximum benefit going from $245,000 to $265,000

- Defined contribution plan maximum deposit going from $61,000 to $66,000

- 50-and-over catch-up contribution going from $6,500 to $7,500

- 401(k)/403(b)/457 plan maximum deferral going from $20,000 to $22,500

Example: "Solo 401(k) Defined Contribution Plan Deferral"
John is the sole owner and employee of his S corporation and is over 50 years of age. For 2023, he will be able to set aside $30,000 (i.e., $22,500 + $7,500 catch-up) for his 401(k) plan. Even though *employment* taxes of $4,590 (i.e., 2 x 7.65% x $30,000) will have to be paid, no current *income* taxes would be due. Subtracting this $30,000 from the $66,000 defined contribution plan maximum deferral cap, this leaves $36,000 which can still be deferred by way of employer contributions to his 401(k) plan. The employer contribution cap is 25% x John's salary. So, dividing $36,000 remaining under the overall $66,000 deferral cap would allow up 25% of $144,000 of his salary to be subject to this employer matching contribution. Of course, factoring the employer's and employee's share of employment tax, this would be at a potential cost of $22,032 in employment taxes (i.e., 15.3% x $144,000, since the FICA cap for 2023 is going up to $160,200).

Comment: The obvious question is whether it is better to pay the additional salary to John in the example above at the 15.3% cost of additional employment taxes as opposed to having some of the S corporation's profits being paid out as K-1 distributions (thus, saving the current 15.3% employment tax cost, but subjecting it to John's 22% marginal federal income tax rate, plus 5% for state income tax. The increased K-1 amount would also be eligible for the Sec. 199A 20% deduction whereas any additional salary would *not* qualify. So, this 27% marginal income tax rate, in reality, is equivalent to 21.6%. But, any contribution to the 401(k) plan would benefit from tax-deferred accumulation, whereas additional salary would probably have to go into a taxable investment account (unless there was another pre-tax deferral opportunity available such as putting the additional salary amount into health savings account).

Comment: With the annual 401(k) contribution limit rising, some individuals might feel pressure to put more money into retirement savings. However, most people are *not* contributing up to the 401(k) limit anyway. A recent Vanguard report found that only 14% of people with Vanguard 401(k) accounts were contributing the maximum amount allowed. This was in spite of the fact that the majority (58%) of those people were making more than $150,000 annually.

- SIMPLE IRA going from $14,000 to $15,500

- SIMPLE IRA catch-up going from $3,000 to $3,500

Example: "Maximum Deferral with SIMPLE IRA"
John is the sole owner and employee of his S corporation and is over 50 years of age. But instead of a "Solo 401(k)" he decides to set up a SIMPLE IRA. As opposed to a maximum deferral cap of $66,000, he is now faced with the maximum that he can contribute to the SIMPLE IRA being capped at just $19,000 (which is not even close to the $30,000 that a non-owner employee could put away in a 401(k) plan). Furthermore, the maximum employer match is capped at just 3% (v. 25% for the "Solo 401(k) plan").

- IRA contribution limit going from $6,000 to $6,500

Comment: The IRA limit was stuck at $6,000 since 2019, but the steep inflation that we have experienced lately finally gave it a boost. Nevertheless, the additional IRA "catch-up" contribution for people 50 and over is *not* subject to an annual cost-of-living adjustment and stays at $1,000 for 2023 (for a total 2023 contribution limit of $7,500 if you are at least 50 years old).

☞**Retirement Plan Tax Numbers/Thresholds for 2022**
Many key dollar limits on retirement plans and IRAs are going to increase for the 2022 tax year. The maximum 401(k) plan contribution is $20,500. Taxpayers born before 1973 can contribute an extra $6,500 (i.e., for a total of $27,000). These limits also apply to 403(b) and 457 plans. The cap on SIMPLE IRAs increases to $14,000 with taxpayers 50 and older being able to put in $3,000 more. The 2022 contribution limit for traditional IRAs and Roth IRAs remains $6,000, plus $1,000 as an additional catch-up contribution for individuals 50 and older.

The income ceilings on Roth IRA pay-ins will be increasing as well. Contributions phase out at AGIs of $204,000 to $214,000 for couples and $129,000 to $144,000 for unmarried taxpayers. But, deduction phaseouts for traditional IRAs start at lower levels, from AGIs of $109,000 to $129,000 for couples and $68,000 to $78,000 for single filers. If only one spouse is covered by a retirement plan, however, the phaseout for deducting a contribution for the uncovered spouse starts at $204,000 of AGI and ends at $214,000.

Finally, new life expectancy tables for calculating RMDs will apply for 2022 and future tax years. The revised tables allow distributions to be spread out over more years because they account for more-current individual mortality rates than the past tables. **(Misc.; 2022 Key Tax Amounts)**

☞**Retirement Funds Not Always Exempt from Creditors in Bankruptcy (*Lerbakken*, No. 18-6018, Bankruptcy App. Panel (8th Cir., 10/16/2018))**
Pursuant to a divorce decree, the taxpayer was awarded his ex-wife's interest in her entire IRA, along with half of her 401(k) plan. He later was forced to file for bankruptcy and attempted to shield these assets from his creditors. But, since these retirement plan assets were acquired in a divorce, the exemption normally accorded such assets was *not* available. The bankruptcy court agreed, stating that the exemption for retirement plan assets is only applicable to the person that created and funded the accounts. **(Misc.; Bankruptcy)**

Comment: A state bankruptcy exemption also does *not* prevent a federal tax lien from being executed. In a recent district court decision, the Service wanted to foreclose on a couple's home to enforce a tax lien, but the couple insisted that their home was protected by a state's (here, MA) homestead exemption. But, the court agreed with the IRS that the state bankruptcy exemption had no effect on the federal tax lien. There was also no bankruptcy stay in place to halt the foreclosure process. **(*Seeley*, No. 16-cv-10935-ADB (DC, MA; 11/8/18))**

Code §61 - Gross Income:

☞**IRS Matching Form 1099-R to Reported Distributions on Form 1040 (*Larochelle*, TC Summ. Op. 2022-12 (7/12/2022))**

The Service is getting tougher on taxpayer failures to report large IRA distributions on their personal returns. Its automated underreporting program matches data on information returns, such as **Form 1099-R**, with income amounts actually reported on individual tax returns. If there is a significant mismatch, the agency will contact the taxpayer to the issue by sending out a computer-generated **CP2000** notice. In this instance, a couple failed to report $238,000 in IRA distributions shown on **Form 1099-R**. The Service examined the couple's 2017 joint federal income tax return. It then issued a notice of deficiency dated January 6, 2020, and determined a deficiency of $72,177 and a **Code §6662** accuracy-related penalty of $9,075 for 2017. Petitioners timely filed a Petition for redetermination pursuant to **Code §6213(a)**. Eventually, they conceded in Tax Court that they did indeed owe the additional taxes and penalties. **(Code §61; Form 1099-R)**

> **Comment:** Not receiving **Form 1099-R** does *not* serve to negate an accuracy-related penalty. The couple in this case may have conceded the tax, but insisted that they should not owe the 20% fine imposed by the IRS for substantial understatement of income. Their position was that they did *not* remember ever receiving the **Form 1099-R** from the IRA custodian. Even though certain tax information forms are not received, it does *not* abrogate the couple's duty to report income and pay tax on the IRA payout.

Code §72(t) - Early Withdrawal Penalty:

☞**"Early Withdrawal Penalty" in Reality Constitutes a Tax (*Grajales*, Docket No. 21-1420 (2nd Cir., 8/24/2022))**

The 10% additional tax on early withdrawals is in fact a tax, an appeals court rules. This 2nd Circuit decision *affirms* a 2021 Tax Court decision. In that case, a 42-year-old woman who took a distribution from her retirement plan insisted that the 10% levy was a "penalty or other amount" which would have required prior written IRS supervisory approval. The appeals court rejected her claim, agreeing with the Service that the levy is a "tax and *not* a penalty, addition to tax or an additional amount." As a result, prior written supervisory approval is unnecessary. **(Code §72(t); 10% Early Withdrawal Tax)**

☞**Exception to 10% Early Withdrawal Penalty to Pay Medical Expenses (*Salter*, TC Memo. 2022-29 (4/5/2022))**

There is some confusion about the exception to the 10% penalty for pre-age-59½ distributions where you are otherwise using funds from a retirement account to pay medical costs. To qualify as penalty-free, (1) the money must be used for medical costs of the taxpayer, spouse or dependent; (2) the funds must cover expenses *actually paid* in the year of the withdrawal; and (3) only the amount of medicals that exceeds the 7.5% of AGI threshold qualifies. This penalty relief, however, applies regardless of whether a taxpayer itemizes their deductions or chooses instead to take the standard deduction. In this recent case, an individual who took an early distribution from his qualified retirement plan (i.e., 401(k) or 403(b) plan, or an IRA) to allegedly help pay for his medical costs. But it did *not* qualify for the 10% penalty exception because his total medical expenses did *not* exceed the 7.5% AGI floor. **(Code §72(t); Early Withdrawal Penalty)**

> **Comment:** Remember to distinguish situations where the taxpayer is instead using a "health savings account" (HSA) to cover medical. There, such costs *not* only include those actually

incurred in the year the HSA distribution occurs, but *any* such costs since the tax year that the HSA was first set up. And, there is no rule that only the amount that exceeds the 7.5% of AGI threshold qualifies.

☞**Retirement Funds Must Be Paid to Ex-Spouse Directly Pursuant to QDRO (*Rosenberg*, TC Memo. 2019-124 (9/19/2019))**

When retirement funds are involved in a divorce property settlement, the rules can be complex, resulting in unwanted taxes and a possible penalty to the recipient ex-spouse. The family court will draw up a "qualified domestic relations order" (QDRO) and have the clerk of the court forward to the administrator handling the transfer of the funds. At this point, there are two distinct choices that the recipient ex-spouse has to decide upon, especially if they are *not* yet age 59½. If they received the funds directly, the monies will be taxable but they will *not* be subject the **Code §72(t)(2)** "10% penalty for early withdrawals" (since they are being paid pursuant to a property settlement in a divorce proceeding). On the other hand, if they direct the monies to be transferred to an IRA (either existing, or a newly-created account), then any subsequent withdrawals will be subject to the penalty unless a specific exception exist (e.g., first-time home purchase, extraordinary medical expenses, etc.).

Here, the ex-husband thought he had to set up a new IRA account at Merrill Lynch where his ex-wife had her IRA in order to receive these monies being paid out pursuant to the property settlement order (i.e., QDRO). But, he had no intention of retaining this account and promptly withdrew the monies within one week and closed the account. The brokerage firm then issued him a **Form 1099-R** for the withdrawal, but he failed to include this amount in his gross income, along with subjecting it to the 10% penalty. **(Code §72(t); Early Withdrawal Penalty)**

Comment: The same result can occur upon the death of a spouse who was married to a "younger" person (i.e., someone *not* yet age 59½). If the surviving spouse intends to withdraw any of the funds received, they should be held in a separate account and *not* co-mingled with an IRA, for instance, that they already have in place. Otherwise, not only would these withdrawn monies be taxed, but absent an exception under **Code §72(t)(2)**, they will also be subject to the 10% early withdrawal penalty.

☞**401(K) Distribution for First-time Home Purchase Subject to "10% Early Withdrawal Penalty" (*Soltani-Amadi*, TC Summary Opinion 2019-19 (8/8/2019))**

A 401(k) distribution used for a "first-time home purchase" was subject to a 10% early withdrawal penalty because the exception to the additional tax for first-time home purchases only applies to distributions from IRAs (and *not* qualified retirement plans).

Comment: This is also true when making QCDs if the monies to be used are in a qualified retirement plan. If that was the case, the funds should first be transferred out of the plan and into an IRA before they are disbursed to the charity.

Background: Distributions from qualified retirement plans are subject to a 10% "early withdrawal penalty," unless an exception applies. (**Code §72(t)(1)**) And, 401(k) (or, 403(b)) plans are "qualified retirement plans." (**Code §4974(c)**) Meanwhile, **Code §7701(a)(37)** defines an "individual retirement plan" as an individual retirement account or annuity (commonly referred to as IRAs). The Tax Court agreed that, for **Code §72(t)** purposes, a 401(k) plan is *not* an individual retirement plan. (***Uscinski*, TC Memo 2005-124 (5/25/2005)**) as opposed to distributions from individual retirement plans used for a first-time home purchase which are *not* subject to the 10% additional tax. (**Code §72(t)(2)(F); Early Withdrawal Penalty**)

Comment: If the taxpayer could have rolled over the necessary funds from their qualified plan (401(k) or 403(b)) first into an IRA, and then distributed them out for the "first-time home purchase," the 10% penalty tax would *not* have applied.

☞**Threat of IRS Levy No Exception for 10% Penalty for Early Retirement Plan Withdrawals (Thompson, Case No. 18-cv-01675-JCS (DC CA, 8/30/2018))**

The district court confirmed that the mere threat of the IRS imposing a levy on one's retirement plan in order to satisfy outstanding tax liabilities does *not* provide an exception to the **Code §72(t)** 10% early withdrawal penalty. In this instance, a married couple who were under age 59½ withdrew over $1 million in order to pay their tax debts. After the IRS assessed the penalty, they countered that an exception existed because the IRS had threatened to levy the funds to pay several years of back taxes. However, because there was no actual levy in place, the couple owed over $100,000 because of the penalty. **(Code §72(t); Early Withdrawal Penalty)**

Comment: The IRS has a helpful **chart** listing withdrawals that escape the 10% penalty, such as a series of substantially equal payments that last for the longer of five years or until age 59½, and withdrawals that are made to cover "extraordinary medical expenses" (i.e., those which exceed the current 7.5% of AGI threshold). The chart also notes which exceptions apply to 401(k)s and other qualified plans; those only for IRAs, SIMPLEs and SARSEPs; and which ones apply to all plans.

☞**Husband's Transfer to Ex-Wife of IRA Funds Resulted in 10% Early Withdrawal Penalty (*Summers* , TC Memo 2017-125 (6/27/2017))**

A husband and wife decided to get divorced without involving lawyers. During the settlement process, the husband believed that his IRA should be split 50-50 with his wife. As a result, he took an early distribution from his IRA and gave half of it to his wife before the divorce was finalized. The IRS issued a notice of deficiency to the husband for the 10% early distribution penalty, and he argued that his ex-wife was liable for the penalty on the portion of the IRA proceeds received by her. The Tax Court disagreed, holding that the husband was liable for the entire amount of the penalty. The exception under **Code §72(t)(2)(C)** was *not* available because the distribution was *not* made "pursuant to a qualified domestic relations order." **(Code §72; Early Withdrawal Penalty)**

Comment: He would also be liable for the income taxes involved with the distribution since the funds came to him first (and, he would be the one issued a **Form 1099-R**).

☞**Higher Educational Expenses Must Be Paid in Same Year as IRA Distribution to Avoid 10% Penalty on Early Withdrawals (*Duronio*, TC Memo. 2007-90)**

In yet another decision on this issue, qualified higher educational expenses paid in a year other than the year of an early IRA distribution meant that the entire amount was subject to the 10% penalty on early withdrawals. The case demonstrates how this rule continues to trap many parents of college students.

Comment: Unlike IRA contributions that can be made for a tax year up until the filing of a return, there is no "grace period" for the same-year rule for IRA withdrawals and tuition payments. Numerous taxpayers are getting caught in this trap, meaning that besides the income tax bite being taken out of their distributed IRA monies, they are getting hit with an additional 10% penalty tax. Here, the mother who was trying to help out her son with his tuition bill for college had to pay an extra $2,000 in taxes.

Code §105 - Health Reimbursement Arrangements:

☞**Regs for Health Reimbursement Arrangements Finalized** (**TD 9867**)

The IRS, along with the Departments of Labor (DOL) and Health and Human Services (HHS), has issued final rules that allow integrating health reimbursement arrangements (HRAs) and other account-based group health plans with individual health insurance coverage or Medicare, if certain conditions are satisfied (i.e., individual coverage HRA). The final rules also set forth conditions under which certain HRAs and other account-based group health plans will be recognized as "limited excepted benefits."

Comment: Although we might be experts in general tax law areas, we might not work intensely in the fringe benefit or retirement plan area on a day-to-day basis. Nevertheless, there is no reason why we cannot have some awareness when important changes are made and at least know to seek out additional input for our clients' planning needs.

Comment: These regs apply to tax years beginning after 12/31/19.

Background - Health Reimbursement Arrangements (HRAs): An "account-based group health plan" is an employer-provided group health plan that provides for reimbursement of expenses for medical care, subject to a maximum fixed-dollar amount of reimbursements for a period (e.g., a calendar year). An HRA is a type of account-based group health plan funded solely by employer contributions (i.e., with no salary reduction contributions or other contributions by employees) that reimburses an employee solely for medical care expenses incurred by the employee, or the employee's spouse, dependents, and children who, as of the end of the tax year, have *not* attained age 27, up to a maximum dollar amount for a coverage period. The reimbursements under these types of arrangements are excludible from the employee's income and wages for Federal income tax and employment tax purposes. And, amounts that remain in the HRA at the end of the year often may be used to reimburse medical care expenses incurred in later years, depending on the terms of the HRA. Account-based group health plans also include other arrangements, for example, health flexible spending arrangements (health FSAs).

Background - Affordable Care Act (ACA): The **Affordable Care Act** added **Code §9815(a)(1)** to incorporate the provisions of **Part A of Title XXVII of the Public Health Service Act (PHSA)** into ERISA and the Code, and make them applicable to group health plans and to health insurance issuers providing health insurance coverage in connection with group health plans. Under **Code §4980D**, an excise tax is imposed on failures to meet these requirements.

Among the ACA provisions applicable to group health plans are the "annual dollar limit prohibition" (i.e., annual limit), which prohibits a group health plan (or, a health insurance issuer offering group health insurance coverage) from establishing *any* annual limit on the dollar amount of benefits for *any* individual. (**PHSA §2711**) Also applicable are "preventative services requirements," which require non-grandfathered group health plans (or, health insurance issuers offering group health plans) to provide certain preventative services without imposing any cost-sharing requirements for the services. (**PHSA §2713**)

Under the ACA, the **Health Insurance Portability and Accountability Act**, and other statutes, both the Code and ERISA subject group health plans to a variety of requirements. However, these requirements generally do *not* apply to "excepted benefits," including limited excepted benefits that:

a. Are provided under a separate policy, certificate, or contract of insurance, or

b. Are otherwise *not* an integral part of the plan. (**Code §9831(c)(1)**)

Specifically, the benefits offered separately from a group health plan that may be "excepted" are:

1. Limited scope vision and dental benefits (**Code §9832(c)(2)(A)**);

2. Benefits for long-term care, nursing home care, home health care, or community-based care, or any combination of those benefits (**Code §9832(c)(2)(B)**); and

3. Other similar, limited benefits as specified in the regs. (**Code §9832(c)(2)(C)**)

2018 Proposed Regs: The Departments issued proposed regs that would allow an individual coverage HRA to be integrated with individual health insurance coverage or Medicare. The combined coverage would allow the HRA to satisfy the annual limit and preventative service requirements, under certain circumstances. The proposed regs also proposed expanding the definition of "limited excepted benefits" under **Code §9832(c)(2)**, to recognize certain excepted benefit HRAs. (**Prop. Reg. §54.9831-1**)

In addition, the proposed regs included rules on premium tax credit (PTC) eligibility for individuals covered under an individual coverage HRA integrated with individual health insurance coverage. An individual is eligible for the PTC for a month if the individual meets various requirements (i.e., a "coverage month"). Among other things, under **Code §36B(c)(2)**, a month is *not* considered to be a "coverage month" for an individual if either:

1. The individual is eligible coverage under an eligible employer-sponsored plan and the coverage is "affordable and provides minimum value" (MV); or

2. The individual is enrolled in an "eligible employer-sponsored plan," even if the coverage is *not* affordable or does *not* provide MV.

An "eligible employer-sponsored plan" includes coverage under an insured or self-insured group health plan and is "minimum essential coverage" (MEC) unless it consists solely of "excepted benefits."

The proposed regs provided that an employee who is offered, but opts out of, an HRA integrated with individual health insurance coverage, and an individual who is offered such an HRA because of a relationship to the employee (i.e., a "related HRA individual"), are eligible for MEC under an "eligible employer sponsored plan" for any month the HRA is "affordable and provides MV." As a result, these individuals would *not* be eligible for the PTC for their Exchange coverage for months the HRA is affordable and provides MV. (**Prop. Reg. §1.36B-2**)

The proposed regs also addressed the circumstances in which an HRA is considered to provide MV and would clarify the ways in which the generally applicable employer-sponsored coverage PTC eligibility rules apply to HRAs integrated with individual health insurance coverage.

In addition, the DOL proposed a clarification to provide plan sponsors with assurance that the individual health insurance coverage premiums reimbursed by an HRA and other account-based health plans or a qualified small employer health reimbursement arrangement (QSEHRA) does *not* become part of an ERISA plan, provided certain conditions are met.

HHS proposed regs that provided a special enrollment period in the individual market for individuals who gain access to an HRA and other account-based group health plans integrated with individual health insurance coverage or who are provided a QSEHRA.

2019 Final Regs: The various Departments mentioned above have now finalized the proposed regs. The final regs largely adopt the proposed regs with some modifications. Like the proposed regs, the final regs allow integration of individual HRAs with individual health insurance coverage and Medicare. (**Reg. §54.9802-4**) As a result, an employer that does *not* provide group health insurance to its employees may offer an individual HRA that will satisfy the requirements for MEC as long as certain conditions are met.

Generally, an HRA must require the participant (and, any dependents) to be enrolled in individual health insurance that is subject to, and complies with, the prohibition on annual payout limits and required preventative services rules. (**Reg. §54.9802-4(c)(i)**) In addition, the HRA must provide that it will *not* reimburse medical expenses incurred by the participant *after* the individual health coverage ceases. (**Reg. §54.9802-4(c)(ii)**) The HRA plan sponsor must verify the participant's individual health insurance coverage with each request for reimbursement and can rely on substantiation provided by the participant (**Reg. §54.9802-4(c)(5)**)

Furthermore, a plan sponsor may *not* offer a choice between an individual coverage HRA and a traditional group health plan to any participant (or, dependent). (**Reg. §54.9802-4(c)(2)**) Also, an individual coverage HRA must be offered on the *same* terms to *all* participants in the *same* class. The final regs add "restriction class size" but allow additional class types. (**Reg. §54.9802-4(c)(3)**) However, there may be a variation in the terms due to the number of participant's dependents covered (**Reg. §54.9802-4(c)(3)(A)**) or the participant's age. (**Reg. §54.9802-4(c)(3)(B)**)

Under the final regs, a participant must be allowed to opt out of coverage *before* the beginning of the plan year. (**Reg. §54.9802-4(c)(4)**)

The final regs retain the proposed rule that an employee and a related HRA individual are *not* eligible for the PTC any month the employee is offered an individual coverage HRA that is affordable and offers MV, even if the employee opts out of the arrangement. (**Reg. §1.36B-2**)

The final regs also define "essential health benefits" and how HRAs can be used once they are integrated with individual health insurance. (**Reg. §54.9815-2711**)

> **Comment:** The IRS has also released **Notice 2019-45** expands upon previous guidance (**Notice 2004-23**, **Notice 2004-50** and **Notice 2013-57**) by providing an appendix with a limited list of additional "preventive care services" and items for certain "chronic conditions" that may be treated as preventive care for purposes of **Code § 223(c)(2)(C)**. These additional services and items are treated as "preventive" only when prescribed to treat an individual "diagnosed with the specified chronic condition," and only when prescribed "for the purpose of preventing the exacerbation of the chronic condition or the development of a secondary condition."

Effective Dates: The regs are effective on August 19, 2019. They generally apply for plan years beginning *on or after* January 1, 2020. However, the final rules under **Code §36B** apply for taxable years beginning *on or after* January 1, 2020, and the final rules providing a new special enrollment period in the individual market apply January 1, 2020. **(Code §105; HRAs)**

Code §401 - Required Minimum Distributions:

☞**Contributions for SEP-IRA Must Come from S/E Income (*Doberstein*, TC Bench Opinion**

10557-21S (5/26/2022))

The Tax Court has confirmed that in order to contribute to a SEP-IRA, you must have earnings from self-employment. In this instance, a self-employed engineer whose income from his business was minimal, was forced to take a full-time employee position with the government. Then, despite having no earnings from self-employment, he still contributed $5,500 to his SEP-IRA for the tax year in question. As a result, he was *not* allowed to deduct the contribution. **(Code §401; SEP-IRA)**

> **Comment:** Self-employeds have until Oct. 17, 2022 to set up and fund a SEP-IRA for 2021. Up to 20% of net self-employment earnings (i.e., gross amount of S/E earnings less one-half of the SECA tax liability). The overall cap is 20% on net self-employment earnings of $290,000 for 2021 and $305,000 for 2022.

☞**401(k) Contributions Not Subject to Creditor Claims in Bankruptcy (*In Re Davis*, No. 19-3117 (6th Cir., 6-1-2020))**

General creditors in a bankruptcy case were *not* entitled to seize a woman's post-bankruptcy 401(k) contributions, provided she also regularly made such pay-ins prior to filing bankruptcy, according to the Appeals Court. Her pre-tax 401(k) contributions that her employer withheld from her monthly wages are excluded from "disposable income" for bankruptcy purposes, so the money was *not* available for any of her unsecured creditors. **(Code §401(k); Bankruptcy)**

☞**Summary of Current Rules for RMDs**

Generally, taxpayers who were at least 70½ years old by 12/31/2019 (or, age 72 by the end of 2020 or 2021) and have a retirement account (i.e., qualified retirement plan or IRA), are required to withdraw minimum amounts annually. There are a few waivers and other rule changes that have resulted from legislation over the past two years.

Taxpayers Still Working: For taxpayers with retirement plans provided by an employer, RMDs can be delayed for that particular plan if the account holder continues working and is *not* at least a 5% owner of that employer. But, again, this would only apply for that specific qualified plan sponsored by that particular employer. However, for taxpayers who do meet the applicable age criteria, they are nevertheless required to make annual withdrawals from traditional IRAs as well as from simplified employee pension plans (SEPs), savings incentive match plans for employees (SIMPLE) and salary reduction simplified employee pension (SARSEP) plans, even if they continue working.

> **Comment:** Keep in mind that for this "5% ownership rule," the attribution rules will apply so that, for example, if the taxpayer's children take over the business, their ownership stake, if any, will be attributed back to their parents.

> **Comment:** Under none of the various rules being discussed here will a taxpayer be required to withdraw any funds from a Roth IRA. But, should their account be inherited by other family members (except their surviving spouse) they would have to commence RMDs (even though the amounts received from the Roth IRA would continue to be tax-free).

RMD Changes - CARES Act: Along with the **SECURE Act**, these changes included an RMD waiver for the 2020 tax year for holders of workplace retirement plan accounts, as well as IRAs. This moratorium included individuals who turned age 70½ in 2019 and had their first and second RMDs due in 2020, or had their first RMD due on April 1, 2021, for the 2020 tax year. But, this one-time waiver only applied to 2020. So, even though there is no requirement to "double up" for RMDs for the 2021 tax year, taxpayers will have to resume RMD payouts. For taxpayers who turned 70½ in 2019, RMDs due in 2020 were waived. But these taxpayers must take a 2021 RMD by December 31, 2021, with the amount of the

RMD being based on their account balance as of December 31, 2020. Meanwhile, for those taxpayers who turned 72 in 2021, but had *not* reached 70½ in 2019, their 2021 RMD must be taken by April 1, 2022. And, again, the RMD amount is based on account balances as of December 31, 2020. These taxpayers' 2022 RMD will be due by December 31, 2022, based on account balances as of December 31, 2021.

Comment: The other changes made by the above Tax Acts mandated that non-spousal beneficiaries of IRAs or qualified retirement plans such as 401(k)s and 403(b)s withdraw all such funds within 10 years. These RMDs, however, need *not* be evenly spread out over the 10-year period with the result that the *entire* balance can be withdrawn on the *last* day of the tenth year. Exceptions exist for beneficiaries *not* more than ten years younger than the decedent from whom they inherited the accounts, and for minors.

☞**10-Year "Clean-out Rule" for Inherited Retirement Plan Monies Varies Based on Decedent's RBD**

Practitioners have questioned the mechanics of the 10-year rule that became law as part of the **TCJA** and is effective for decedents dying after 2018. The key issue is whether amounts need to be paid out each year? Or, can the beneficiary wait until year 10 to drain the entire balance in the inherited retirement account or IRA? The answer is that "it depends."

Comment: This observation came from the **Kiplinger Tax Letter**. Upon further research, however, it does *not* seem as though that law requires this distinction.

If the deceased IRA owner died *before* their required beginning date (RBD) for taking required minimum distributions (RMDs), then distributions need *not* be distributed *evenly* over a 10-year period. Instead, beneficiaries can wait until year 10 to pull out the entire balance in the account, take annual payouts, or even skip some years, so long as the inherited retirement account or IRA is depleted within 10 years. On the other hand, if the deceased IRA owner died *after* their RMD beginning date, then annual RMDs must be paid to the beneficiary in years 1 through 9 (i.e., based on the IRS "mortality tables"), with the remaining balance in the account depleted by the end of the 10th year. **(Misc.; RMDs)**

☞**Avoiding 10% Early Withdrawal Penalty on Pre-59½ Plan Distributions (Notice 2022-6)**

Absent a few limited exceptions, an early withdrawal penalty normally applies to pre-59½ distributions out of IRAs or qualified plans such as 401(k) or 403(b) plans. One of the exceptions is to extract "substantially equal periodic payments" from the IRA or retirement plan. Such distributions must extend until the *later* of 5 years or until age 59/½ is reached. Withdrawals must be based on the owner's life expectancy or the joint life expectancy of the owner and the designated beneficiary. However, if the distributions vary substantially from year to year, all distributions to-date will be subject to the 10% penalty. **(Code §72(t); 10% Early Withdrawal Penalty)**

Comment: "Vary substantially" could include situations where a required payment was missed during this period of "must extend until the *later* of 5 years or until age 59/½ is reached."

Notice 2022-6: This IRS notice provides detailed information on the three distinct methods then extracting the funds in order to avoid any penalty as follows:

1. **Required Minimum Distribution Method:** The balance in the account should be divided by the number of years taken from the IRS "**life expectancy table**."

2. **Fixed Amortization Method:** Similar to the payment schedule for a mortgage, the required annual distribution is determined by amortizing the account balance over a specific number of years using the "life expectancy tables" and applicable interest rates.

3. Fixed Annuitization Method: The account balance is divided by an annuity factor and interest rate.

> **Comment:** For the most up-to-date life expectancy tables to be used to determine required minimum distributions, to **Appendix B** of **IRS Pub. 590-B**.

> **Comment: Notice 2022-6** replaces the guidance in **Rev. Rul. 2002-62** and **Notice 2004-15** for any series of payment beginning *on or after* 1/1/23. The guidance may also be used for a series of payments beginning in 2022.

☞**Retirement Plan Cannot Be Forced to Offer Loans to Participants (Info. Ltr. 2019-0004)**

The IRS has advised that while the Code imposes certain requirements on qualified employer plans that offer loans to participants, such plans do *not* have to offer loans at all. And, even if they do, they may restrict them to certain situations. As a result, the IRS cannot force a plan to offer loans or stop a plan from imposing certain restrictions on loans.

Background: The laws relating to qualified employer plans impose various limitations on the permissibility of loans and distributions from those plans. For example, **Code §401(k)(2)(B)(i)** provides that in the case of a **Code §401(k)** plan that is part of a profit-sharing or stock bonus plan, elective deferrals may be distributed only in certain situations, one of which is on account of hardship.

In order to make a loan or distribution (including a hardship distribution), a plan must contain language authorizing the loan or distribution. A loan from a qualified employer plan to a participant or beneficiary is treated as a plan distribution unless: **(CARES Act increases these limits to ≥ $100,000 or 100% of vested benefits under the plan, but only for loans taken out in 2020)**

1. The loan amount does *not* exceed the lesser of:

   i. $50,000, or

   ii. One-half of the present value of the employee's nonforfeitable accrued benefit under the plan.

However, a loan up to $10,000 is allowed, even if it's more than half the employee's accrued benefit. (**Code §72(p)(2)(A)**)

2. The loan is required to be repaid within five years, (**Code §72(p)(2)(B)(i)**) except that a longer repayment can be used for a "principal residence plan loan" (i.e., a loan used to acquire any dwelling unit which, "within a reasonable time," is to be used as the participant's *principal* residence; (**Code §72(p)(2)(B)(ii)**)

3. Except as provided in the regs, the plan loan is amortized in "substantially level payments," made *not* less frequently than quarterly; and (**Code §72(p)(2)(C)**)

4. The loan is evidenced by a legally enforceable agreement. (**Reg. §1.72(p)-1, Q&A 3**)

> **Comment: Corona virus distributions which allow up to $100,000 in plan loans only applies until 12/31/20.**

Early (generally, pre-age 59½) withdrawals from a qualified retirement plan result in an additional tax (i.e., penalty) equal to 10% of the amounts withdrawn that are includible in gross income. (**Code §72(t)(1)**) The additional tax applies unless the taxpayer qualifies for one of several specific exceptions.

(**Code §72(t)(2)**, **Code §72(t)(3)**) There is no exception for "hardship withdrawals." A similar rule applies to distributions from an IRA.

Plan provisions and regs under certain Code sections establish verification procedures that a plan must follow before loans or distributions can be made from the plan. For example, the regs under **Code §401(k)** set forth certain criteria an employee must meet in order to receive a "hardship distribution." A plan may contain procedures designed to confirm that the criteria have been satisfied.

IRS Ruling: In this Information Letter, which was a response to an question concerning obtaining a loan from the taxpayer's **Code §401(k)** plan, the IRS advised that it could *not* force a plan to offer loans or stop a plan from imposing certain restrictions on loans. The IRS noted it that it was *not* necessarily the Code that prevented the taxpayer from getting a "hardship loan" from the plan. However, the IRS explained that plans do *not* have to offer loans to participants. And even if they do, they may restrict them to certain situations, such as where a "hardship" is involved.
Examples of this would be in cases such as medical expenses or student loans for plan owner or their dependents. But, again, it was up to the plan whether to include such features. Finally, the IRS advised that the taxpayer might want to contact the plan administrator to see if "hardship distributions" were available (even if "loans" generally were not). **(Code §401; Pension Plan Loans)**

☞**Proposed Regs Issued on Hardship Distributions from 401(k) Plans (REG-107813-18)**

The IRS has issued proposed regulations on hardship distributions from 401(k) plans that take into account changes from the **Bipartisan Budget Act of 2018**, the **Tax Cuts and Jobs Act**, as well as other recent tax acts. Among other things, the proposed regs eliminate any requirement that an employee be prohibited from making elective contributions after receiving a hardship distribution, or that an employee must first take plan loans before receiving a hardship distribution. The proposed regs also eliminate the "facts and circumstances determination" of whether a distribution is "necessary to satisfy a financial need" and provide for a new "general standard" under which a hardship distribution may *not* exceed the amount of "an employee's need, and the employee must represent having insufficient cash or other liquid assets to satisfy the need." Special rules apply to plan amendments, applicability dates and reliance. **(Code §401; Hardship Distributions)**

Comment: Keep in mind the special rules if a distribution is made due to factors stemming from the COVID pandemic (it is not treated as a "hardship distribution").

☞**Tax Options Where Nonspouse Roth IRA Beneficiary's Fails to Begin Taking RMDs (Info. Ltr. 2016-0071)**

Normally the required minimum distribution rules of under **Code §401(a)(9)(A)** do *not* apply to Roth IRAs during the owner's lifetime. Nevertheless, post-death distributions must be made according to the RMD rules as if the Roth IRA owner died *before* their required beginning date. This IRS memo addresses whether a nonspousal beneficiary's failure to begin RMDs *within one year* of the Roth IRA owner's death made the "life expectancy rule" inapplicable and, as a result, required that distributions be made under the alternative "five-year rule." The IRS explained that RMDs must be made according to the "life expectancy rule" unless the plan (1) requires distributions to be made under the five-year rule or (2) allows the beneficiary to elect the five-year rule, and the beneficiary timely makes the election. The bottom line is that the "applicable distribution period" is based on these specific rules and *not* on whether distributions were timely received. **(Code §401; RMDs)**

Comment: Although the Roth IRA distributions continue to be tax-free to a non-spousal beneficiary, the funds in the account are subject to the RMD rules.

☞**Required Minimum Distributions for Qualified Plans Cannot Be Satisfied With IRA Withdrawals (PLR 201406023)**

Even though a SEP withdrawal can be used to meet the required minimum distribution from an IRA, such a withdrawal cannot be used to meet the RMD from a qualified retirement plan. In this instance, the taxpayer was told by his financial adviser that he could tap his SEP for the *total* mandatory withdrawal from the SEP, his IRA and the balance in his qualified plan and he subsequently took that advice. Then, more than 60 days after he made the SEP withdrawal, he found out that the advice was wrong when the retirement plan administrator made him take the required annual payout from the plan. And, the trustee of the SEP refused to allow him to reverse the excess distribution. Nevertheless, the IRS came to the rescue and allowed the owner of the SEP do a late rollover back into that IRA account of the excess payout. In this private letter ruling, the Service waived the 60-day rule because the taxpayer had relied on the erroneous advice of a financial professional. The bottom line is that he did *not* owe any tax on the amount of the excess withdrawal from the SEP. **(Code §408(d)(3); RMD)**

Code §402 - Taxation of Beneficiary of Employee's Trust:

☞**Proposed Regs Govern Qualified Plan Loan Rollovers (REG-116475-19)**

These regs address the amendments to **Code §401(c)** by **Sec. 13613** of the **Tax Cuts and Jobs Act**, which provides an "extended rollover period" for a "qualified plan loan offset." **Code §72(p)(1)** provides that if, during any tax year, a participant or beneficiary receives (directly or indirectly) any amount as a loan from a qualified employer plan (defined under **Code §72(p)(4)(A)** which would include *both* defined contribution plans such as 401(k)s and 403(b)s, or a defined benefit plan), that amount will be treated as having been received by the individual as a distribution from the plan. For certain plan loans, **Code §72(p)(2)** provides an exception to the general treatment of loans as "distributions." But, for this exception to apply, the loan generally must satisfy three requirements:

- The loan's terms must satisfy the limits on loan amounts, under **Code §72(p)(2)(A)** (i.e., $50,000, except for Corona virus related loans which allow for higher limits under the **CARES Act**);

- The loan must be repayable within five years (six years for Corona virus related loans) ; and

- The loan must require substantially level amortization over the loan term (three years for Corona virus related loans).

The **TCJA** amended **Code §402(c)(3)** to provide an "extended rollover deadline" (i.e., as opposed to the normal 60-day rollover period) for qualified plan loan offset (QPLO) amounts. Any portion of a QPLO amount (up to the *entire* amount) may be rolled over into an eligible retirement plan by the individual's tax filing due date (including extensions) for the tax year in which the offset occurs.

Prop. Regs. §1.402(c)-3 takes into account these changes to the QPLO rollover rules. For instance, they state that a QPLO is a type of "plan loan offset." As a result, most of the general rules relating to plan loan offset amounts apply to QPLO amounts. In addition, the rules in **Regs. §1.401(a)(31)-1, Q&A-16** (which explains the offering of a direct rollover of a plan loan offset amount), and **Regs. §31.3405(c)-1, Q&A-11** (which contains special withholding rules for plan loan offset amounts), that apply to plan loan offset amounts in general also apply to QPLO amounts. The proposed regulations provide examples to illustrate the interaction of the special rules for QPLOs with the general rules for plan loan offsets.

Consistent with the **Code §402(c)(3)(C)** amendments, the proposed regs provide that a distribution of a plan loan offset amount that is an "eligible rollover distribution" and a QPLO amount may be rolled over by the employee (or spousal distributee) to an eligible retirement plan through the period ending on the individual's tax filing due date (including extensions) for the tax year in which the offset is treated as distributed from a qualified employer plan.

The proposed regs also contain definitions of "plan loan offset amount," "QPLO amount," and "qualified employer plan" and special rules for QPLO determinations when a severance from employment has occurred.

Effective Date: The rules will be effective when they are final, but taxpayers may rely on them with respect to plan loan offset amounts, including QPLO amounts, treated as distributed *on or after* Aug. 20, 2020, until the final regulations are issued. **(Code §402; QPLOs)**

Code §403 - Taxation of Employee Annuities:

☞IRS Provides Relief from "Once-in-always-in" Condition of 403(b) Plan Part-time Exclusion (Notice 2018-95)

The IRS has provided transition relief from the "once-in-always-in" (OIAI) condition for excluding part-time employees under **Reg. §1.403(b)-5(b)(4)(iii)(B)** from the "universal availability requirements" applicable to **Code §403(b)** plans. Under the "OIAI exclusion condition," for a **Code §403(b)** plan that excludes part-time employees from making elective deferrals, once an employee is eligible to make elective deferrals, the employee may *not* again be excluded from making elective deferrals in *any* later exclusion year on the basis that the employee is a part-time employee. **(Code §403(b); Sec. 403(b) Plans)**

> **Comment: Code §403(b)(12)(A)** provides that certain categories of employees may be excluded from making elective deferrals despite the "universal availability requirement," including part-time employees who normally work less than 20 hours per week (part-time exclusion), or 1,000 hours/year. **But keep in mind the new provision created by the SECURE Act where "long-term, part-time employees" can be eligible for their employer's retirement plan.**

Code §408 - Individual Retirement Accounts:

☞9th Circuit Reverses; Taxpayer Allowed to Use FSC to Bypass Roth IRA Contribution Limit (*Mazzei*, 127 AFTR 2d 2021-748 (9th Cir., 6/2/2021))

The 9th Circuit, *reversing* the Tax Court, held that the IRS cannot assert the "substance over form doctrine" to prevent a taxpayer from using a transaction involving a foreign sales corporation (FSC) to contribute more to a Roth IRA than the annual contribution limit would otherwise allow. The Court found that "Congress's statutory FSC language negated the IRS's use of the doctrine."

Background: Under the now-repealed provisions of **Code §§921-927** (i.e., the FSC statute), a corporation with foreign trade income (i.e., an "export corporation") was allowed to establish a "related FSC" as a shell corporation and then effectively cycle a portion of that income through the FSC where it would be taxed at lower rates. As a result, the Tax Court initially concluded that the FSC's taxable income was generated through "related-party transactions that lacked meaningful economic substance." In other words, the FSC taxation rules "thus reflected a departure from the normal principle that taxation is based on economic substance rather than on legal form."

Facts: Two members of the taxpayer's family established an FSC. They then each established a Roth IRA made their Roth IRAs shareholders of the FSC. The family's export corporation then paid commissions into the FSC, and the FSC distributed its after-tax income (which was greater than the Roth IRA contribution limit) as dividends to its shareholders (i.e., the Roth IRAs) rather than to their export corporation.

IRS Position: The IRS asserted that this scheme (i.e., having the Roth IRAs as shareholders rather than the taxpayers themselves), "lacked any economic substance," and sought to have the Tax Court to recharacterize the entire scheme under the "doctrine of substance over form" (as the court stated, one "should look at the economic realities of a transaction, *not* legal abstractions").

Tax Court Decision: The Tax Court determined that, under "substance-over-form principles," the taxpayers (and, *not* the Roth IRAs) should be treated as the real owners of the FSC. Therefore, the taxpayers should be deemed to have personally received the dividends, which meant that their contributions to the Roth IRAs exceeded the limits for such contributions. As a result, the Tax Court agreed with the IRS that the taxpayers were consequently liable for excise taxes on the excess contributions. (***Mazzei*, 150 TC 138 (3/5/2018)**)

9th Circuit Decision: The 9th Circuit decision that having Roth IRAs as FSC shareholders, which effectively allowed contributions to the Roth IRAs in excess of the contribution limit, did *not* violate the FSC rules or the Roth IRA contribution rules. The Court reiterated that, "It is a 'black-letter principle' that, in construing and applying the tax laws, courts generally follow substance over form." Nevertheless, "like any background maxim that informs the construction and application of a statute, the doctrine of substance over form can be negated by Congress in express statutory language." And, here, the Court concluded that, "this is such a case."

The Court's position was that repealed **Code §925(a)** provided that "the taxable income of an FSC and (i.e., a commonly-controlled entity) shall be based upon a transfer price which would allow such FSC to derive taxable income attributable to such sale (regardless of the sales price actually charged) in an amount which does *not* exceed (a statutory provided formula)." The Court said the parenthetical phrase "regardless of the sales price actually charged" showed that Congress had expressly decreed that FSCs can engage in transactions, with commonly-controlled entities, that lack any economic substance and that are assigned hypothetical values determined according to statutory formulas that bear no relationship to any underlying real-world valuation.

Since the taxpayers otherwise complied with the FSC rules when they made their Roth IRAs shareholders of the FSC, and since the FSC rules "expressly allow for transactions that lack economic substance," the IRS could *not* invoke the substance-over-form doctrine to say that the contributions to the Roths should instead be treated as dividends to the taxpayers.

Finally, the 9th Circuit noted that it was joining with the 1st, 2nd, and 6th Circuits **(*Benenson*, 121 AFTR 2d 2018-1350 (1st Cir., 2018); *Benenson*, 122 AFTR 2d 2018-6897 (2nd Cir., 2018); and *Summa Holdings*, 119 AFTR 2d 2017-787 (6th Cir., 2017))** in concluding that, when Congress expressly departs from "substance-over-form principles," the IRS "may *not* invoke those principles in a way that would directly reverse that congressional judgment." **(Code §408; Roth IRA)**

☞Special IRS Audit Focus on Large Unreported IRA Payouts (*Ball*, TC Memo. 2020-152 (11/10/2020))

In this instance, a SEP-IRA owner requested that the IRA custodian deposit a $210,000 distribution into the account of his SMLLC. The SMLLC immediately loaned the funds to another company, which repaid the debt to the LLC in the following year. The SMLLC then deposited the money back into the SEP-IRA.

The taxpayer tried to report the payout as nontaxable on his return. When he was audited by the IRS, he claimed that he "was acting as a conduit or agent for the IRA custodian," which the Tax Court rejected. The IRA custodian had no knowledge of the transaction other than the distribution and reported it as such on **Form 1099-R**. The Tax Court agreed that the SEP-IRA owner "had unfettered control of the funds distributed to him, and therefore the distribution had to be included in his gross income. **(Code §408; IRA Distributions)**

> **Comment:** The Service is also using data from **Form 1099-K** to generate audit leads. Third-party payment networks such as PayPal must send the 1099-K to payees who have over 200 transactions and were paid more than $20,000 during the year. Then, IRS's computers flag mismatches with receipts reported on **Schedule C** of **Form 1040**.

☞60-Day IRA Rollover Rule Strictly Enforced (PLR 2020033088)

Taxpayers need to be careful if they are considering taking a withdrawal from their IRA for short-term cashflow needs. The extracted funds have to be returned within 60 days or the distribution will be taxed, and possibly subject to the **Code §72(t)** 10% early withdrawal payout penalty if the taxpayer has *not* yet reached age 59½ (and, one of the exceptions does *not* otherwise applied). As shown by this private letter ruling, the IRS can be very reluctant in waiving (or, extending) the 60-day period. In this instance, it refused to grant additional time to an individual who used some of his IRA balance to help make a cash offer on the purchase of a new home. He had intended to replace the funds in his IRA with the proceeds from the sale of his current residence, but that property failed to sell until more than 60 days after the IRA withdrawal. **(Code §408; IRA Withdrawals)**

> **Comment:** While **Code §408(d)(3)(I)** does grant the IRS the authority to waive a late rollover "where the failure to waive such requirement would be against equity or good conscience," the Service has stated clearly that returning a "loan" late will *not* meet that criteria. While the "borrowing" noted above is permitted since nothing in the IRC bars it, that was *not* the purpose of the rollover provision. Instead, that provision was meant to allow taxpayers to move funds from one account to another and, at least according to the IRS, it is *not* against "equity or good conscience" to deny relief when a taxpayer was using the provision for other purposes.

> **Comment:** Unlike a 401(k) or 403(b) qualified retirement plan, the Code does *not* impose a requirement on an IRA custodian to inform individuals of the 60-day rollover rule, and the failure of a financial institution to provide this information (as was the situation in this case) does *not* rise to the level of "financial institution error."

☞IRS Allows Waiver of 60-Day IRA Rollover Requirement (PLR 202029006)

The Service granted a taxpayer's request to waive the 60-day rollover requirement (thereby allowing an IRA distribution to be rolled over to another IRA within 60 days so the distribution was *not* taxable or otherwise subject to the **Code §72(t)** 10% "early withdrawal penalty") because the taxpayer had relied on her ex-spouse for financial and tax issues and the distributing financial institution did *not* inform the taxpayer that the check it sent was an IRA distribution. **(Code §408; IRA Rollovers)**

☞IRA Owner Allowed Additional Time to Roll Over Account (PLR 2020_____)

Because of extenuating circumstances beyond the control of the taxpayer, the IRS granted relief with regard to a "late IRA rollover." Here, the taxpayer had moved and never received notification that his IRA custodian resigned and had transferred the assets in the IRA to him. He only found out about the mix-up upon hearing from IRS, when he then transferred the assets to a new IRA. Although it took applying for a private letter ruling, the Service granted him the extra time needed to complete the rollover. **(Code §408; IRA Rollovers)**

Comment: Keep in mind that in a lot of instances a taxpayer does *not* need apply for an IRS ruling for missed time limits regarding an IRA rollover. Instead, they can "self-certify" that they qualify for a waiver of the 60-day rule, provided they meet certain conditions (Cf. **Rev. Proc. 2016-47**). The late rollover must be for one of 11 reasons, such as bank error, death or serious illness of the account owner or family member, misplaced check or severe damage to one's home. And the rollover must be completed within 30 days after the reason for failing to timely do it in the first place ceases.

☞**Spousal Rollover Allowed Even Though Decedent's IRA Failed to Designate a Beneficiary (PLR 201931006)**

Generally, a surviving spouse may make a tax-free "spousal rollover" from a deceased spouse's IRA only if that surviving spouse is designated as the IRA's beneficiary. However, in this private letter ruling, the IRS stated this general rule did *not* apply (and, a tax-free spousal rollover was allowed) where the decedent failed to designate an IRA beneficiary, died without a will, and the surviving spouse was the administrator and sole heir to the decedent's estate. **(Code §408; Rollover IRA)**

☞**IRS Provides New Self-Certification Procedure for Late Retirement Plan Rollovers (Rev. Proc. 2016-47)**

The IRS has provided a new "self-certification procedure" designed to help recipients of retirement plan distributions who, due to one or more specified reasons, inadvertently miss the 60-day time limit for properly rolling these amounts into another retirement plan or IRA. The new self-certification procedure allows these taxpayers to claim eligibility for a waiver of the 60-day rollover requirement that can be relied upon by a plan administrator or IRA trustee in accepting and reporting receipt of the rollover contribution.

Comment: **Rev. Proc. 2020-46** modifies and updates **Rev. Proc. 2016-47**, which provides a list of permissible reasons for a taxpayer to self-certify eligibility for a waiver of the 60-day rollover requirement under certain eligible retirement plans. This Revenue Procedure *modifies* that list by adding a new reason: a distribution was made to a state unclaimed property fund.

New Self-Certification Option: A taxpayer may make a written certification to a plan administrator or an IRA trustee, custodian, or issuer by using the "model letter" provided in **Rev. Proc. 2016-47** (or, by using a letter that is substantially similar in all material respects). A copy of the certification should be kept in the taxpayer's files and be available if requested on audit. The certification must state that a contribution satisfies the following conditions:

- The IRS must *not* have previously denied a waiver request with respect to a rollover of all or part of the distribution to which the contribution relates;

- The taxpayer must have missed the 60-day deadline because of the taxpayer's inability to complete a rollover due to one or more reasons set out in **Rev. Proc. 2016-47, §3.02(2)**, including error by the financial institution, postal error, and a death in the taxpayer's family;

- The contribution must be made to the plan or IRA "as soon as practicable after the applicable reason(s) no longer prevent the taxpayer from making the contribution." This requirement is deemed to be satisfied if the contribution is made within 30 days after that time.

The IRS intends to modify the instructions to **Form 5498, IRA Contribution Information**, to require that an IRA trustee that accepts a rollover contribution *after* the 60-day deadline report that the contribution under those circumstances. (**Rev. Proc. 2016-47, §3.03**)

A plan administrator or IRA trustee may, absent actual knowledge to the contrary, rely on a taxpayer's self-certification solely for purposes of determining whether the taxpayer has satisfied the conditions for a waiver of the 60-day rollover requirement. (**Rev. Proc. 2016-47, §3.04(1)**)

The IRS cautioned that this self-certification process is *not* technically a waiver of the 60-day requirement. Nevertheless, a taxpayer may report the contribution as a valid rollover unless later informed otherwise by the IRS. But, if IRS in the course of an examination determines that the requirements for a waiver were *not* actually met, the taxpayer may be subject to additions to income and penalties, such as the penalty for failure to pay the proper amount of tax under **Code §6651**. (**Rev. Proc. 2016-47, §3.04(2)**)

The modification of **Rev. Proc. 2016-47** also *modifies* **Rev. Proc. 2003-16**, by providing that, in addition to automatic waivers and those granted via application for a letter ruling, the IRS may grant a waiver during an examination of the taxpayer's income tax return. (**Rev. Proc. 2016-47, §4**)

Effective Date: Rev. Proc. 2016-47 is effective on Aug. 24, 2016. (**Rev. Proc. 2016-47, §5**) **(Code §408; IRA Rollovers)**

☞**IRA Trustee-to-Trustee Transfers Not Counted for One-per-Year Limit on Rollovers (Info. Ltr. 2015-0035)**

The IRS has confirmed that trustee-to-trustee transfers avoid the one-rollover-every-12-months rule. Taxpayers with multiple IRAs have a limit of one rollover every 12 months which applies on an aggregate basis to all of the IRAs, and *not* on an IRA-by-IRA basis. As a result, someone who takes a distribution from their IRA and timely rolls the money back (i.e., within 60 days) is *not* permitted to withdraw funds from any other IRA during the following 12 months and do another tax-free rollover. Nevertheless, IRA owners can continue to make unlimited trustee-to-trustee transfers between IRAs because such direct transfers of IRA funds are *not* considered to be "rollovers." Also, the IRA owner can be given a check payable to the new IRA for their benefit. **(Code §408; IRA)**

Code §408A - Roth IRAs:

☞**Surviving Spouse Allowed Rollover of Roth IRA (PLR 202136004)**

A surviving spouse requested a ruling on the proposed rollover of a Roth IRA distribution into one or more Roth IRAs in her sole name after the death of her spouse. At the time of his death, the decedent maintained a Roth IRA with a trust as the sole beneficiary and the surviving spouse was the sole beneficiary of that trust. The IRS determined that the surviving spouse is eligible to roll over the Roth IRA distribution into one or more Roth IRAs established and maintained in her own name. Provided that the rollover is timely, the surviving spouse will *not* be required to include the distribution in gross income for federal income tax purposes. Also, in the year following the year of the rollover the surviving spouse will *not* be required to take required minimum distributions from her Roth IRA during her lifetime. **(Code §408A; Roth IRAs)**

☞**Use of DISC Allows Taxpayers to Avoid Roth IRA Contribution Limits (*Benenson*, 121 AFTR 2d 2018-XXXX (1st Cir., 4/6/2018))**

In 2002, two brothers each established a Roth IRA by contributing $3,500. The next day, a transaction was completed that resulted in each IRA owning 50% of a newly-formed C corporation holding company that owned 100% of a DISC. By 2008, the Roth IRAs were each worth more than $3 million. In **Notice 2004-8**, the IRS announced that it would challenge transactions that involved corporations owned by Roth IRAs that shifted value to a Roth IRA in excess of annual contribution limits. The DISC rules (which are covered under **Code §§991- 997**) allow dividends to be paid from commissions without being taxed as corporate income. The IRS attempted to recast the payments as dividends followed by Roth IRA contributions. In this instance, the 1st Circuit upheld the transaction *reversing* the Tax Court. Dividends paid on stock held by a Roth IRA are considered earnings of the Roth IRA rather than contributions, and as a result, do *not* count towards the contribution limits. **(Code §408A; Roth IRAs)**

> **Note: Congress has been looking to shut down this planning strategy. Therefore, pay close attention to the tax proposals being considered to see if this maneuver is being prohibited.**

Code §414 - Definitions and Special Rules:

☞**Workers' Prior Service Counted for Retirement Plan Eligibility and Vesting Purposes (CCA 202019018)**

The IRS has determined that leased workers' period of service that occurred before they were hired as regular employees should be taken into account when calculating years of service for purposes of retirement plan eligibility and vesting. Pursuant to **Code §414(n)(4)(B)**, the four-month period of work under a leasing arrangement must be counted for purposes of minimum participation and vesting under the qualified retirement plan of a company that used a staffing agency to hire workers through a leasing arrangement who ultimately became full-time employees, despite the fact that now-common law employees never satisfied requirements to be leased employees. **(Code §414; Retirement Plans)**

Code §3405 - Special Rules for Pensions, Annuities, and Certain Other Deferred Income:

☞**Final Regs Released on Income Tax Withholding on Certain Periodic Retirement and Annuity Payments (IR-2020-223)**

The IRS has issued final regulations (TD 9920) updating the federal income tax withholding rules for certain periodic retirement and annuity payments made *after* 12/31/20. The regulations specify that the IRS will provide the rules and procedures for determining the default withholding rate on periodic payments in applicable forms, instructions, publications, and other guidance. In July 2020, the IRS released a draft of a redesigned **Form W-4P (Withholding Certificate for Pension or Annuity Payments)** for 2021. However, based on comments from stakeholders, the IRS has decided to postpone issuance of the redesigned form. Instead, the 2021 **Form W-4P** "will be similar to the 2020 version." The IRS also intends to provide in the instructions to the 2021 **Form W-4P** that the default withholding rate will continue to be determined by treating the taxpayer as a married individual claiming three withholding allowances. **(Code §3405; Withholding Tax)**

Code §4975 - Tax on Prohibited Transactions:

> **Note: Once again, pay attention to the tax proposals that Congress is considering with regard to IRA and any additional restrictions that might be passed in this area.**

☞**Prohibited Transactions Caused Loss of Bankruptcy Protection for IRA (*Yerian*, No. 18-10944 (6/26/2019))**

Because the taxpayer engaged in some **prohibited transactions**, the normal protection from third-party creditors with regard to IRA fund was lost. The taxpayer, in anticipation of filing bankruptcy, purchased a condo and two cars with their IRA funds. As a result, this protection was lost and creditors were allowed to attached the retirement plan funds. (**Code §4975**; **Prohibited Transactions)**

☞**Previous Prohibited Transactions Distributions Retroactively Disqualified IRA (*Marks*, TC Memo 2018-49 (11th Cir., 4/10/2018))**

A distribution received by a taxpayer from an account that was no longer treated as a taxable IRA was nontaxable because the account had engaged in a "prohibited transaction" years before and, as a result, the account was no longer an IRA. More importantly, the statute of limitations had passed with regard to the disqualification of the IRA.

Comment: Since the account was no longer an IRA, and because the statute of limitations had run, the the taxpayer did *not* have to include $98,000 in distributions of two promissory notes ($40,000 on a loan to her father and $60,000 on a loan to her friend were the "prohibited transactions" made previously) from this former IRA in her gross income. In addition, she was *not* liable for the **Code §72(t)** 10% early withdrawal penalty, or the **Code §6662** penalty for failure to pay tax. (**Code §4975**; **Prohibited Transactions)**

Code §6502 - IRS Assessments:

☞**Being Forced to Tap Retirement Assets to Satisfy Back Taxes (*Lowery*, TC Memo. 2019-151 (11/18/2019))**

A couple who owed $640,000 in back taxes offered to pay $6,341 a month pursuant to a six-year installment plan. The Service countered that they were capable of paying much more, but agreed to the offer if the couple also liquidated and paid over a retirement account belonging to the 60-year-old husband. The couple objected, claiming that he was "too close to retirement, and liquidating the account would be a hardship." The Tax Court remanded the case back to IRS's appeals office to examine whether circumstances such as the husband's age should restrict tapping the account to pay the outstanding taxes. (**Code §6502**; **IRS Assessments)**

Code §6751 - IRS Penalties:

☞**Sec. 72(t) 10% Early Distribution Amount Is Tax, Not Penalty (*Grajales*, 156 TC No 3 (1/25/2021))**

The Tax Court has concluded that the **Code §72(t)(1)** 10% early distribution exaction is a tax, *not* a penalty. As a result, the **Code §6751(b)** requirement for written supervisory approval of penalties does *not* apply to it.

Background: Code §6751(b) provides that no penalty under the Code can be assessed unless the initial determination of such assessment "is personally approved (i.e., in writing) by the immediate supervisor of the individual making such determination or such higher level official as the Secretary may designate."

Meanwhile, the term "penalty" includes any addition to tax or any additional amount. (**Code §6751(c)**) **Code §72(t)(1)**, which is labeled as a "10-percent additional tax on early distributions from qualified retirement plans" and sub-captioned "Imposition of additional tax," provides that "[i]f any taxpayer receives any amount from a qualified retirement plan (as defined in **Code §4974(c)**), the taxpayer's tax" shall be increased by 10% (unless an exception applies).

Tax Court Decision: In this instance, a taxpayer took an early distribution from her IRA. No exceptions applied, and the IRS determined that the **Code §72(t)(1)** 10% penalty tax applied. The taxpayer argued that the 10% exaction was a "penalty" and that therefore the IRS needed to comply with **Code §6751(b)** *before* assessing it. But the Tax Court held that the **Code §72(t)(1)** 10% exaction is a "tax," *not* a penalty, addition to tax or, an additional amount. Therefore, it is *not* subject to the written supervisory approval requirement of **Code §6751(b)**. **(Code §6751; IRS Penalties)**