SECURE 2.0 for 401(k) and 403(b) Plans – What's New and When's it Effective?

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Authors:

Amy S. Crotty
Kaitlin E. Hizny
Carl C. Lammers
Caroline N. Renner
Sarah N. Lowe
Megan Vandermeer

While some of us were busy with holiday celebrations and planning for the new year, Congress passed (on December 23, 2022) and President Biden signed into law (on December 29, 2022) the Consolidated Appropriations Act, 2023 to fund the federal government through the end of 2023. The Act is a $1.7 trillion omnibus spending bill that does everything from funding Ukraine to restricting the use of TikTok for government employees. Most important for everyone reading this article is Division T of the spending bill, which is conveniently titled "The SECURE 2.0 Act of 2022" (SECURE 2.0) due to its building upon the Setting Every Community Up for Retirement Enhancement Act of 2019 (SECURE 1.0).

Like SECURE 1.0, SECURE 2.0 aims to help employees be better prepared for retirement by making it easier for employees to participate in retirement plans and for employers to sponsor such plans. SECURE 2.0 has numerous effective dates for its various provisions, some of which are effective immediately, whereas others are not effective until 2027. This article is focused on the most important SECURE 2.0 provisions that relate to 401(k) and 403(b) plans and is organized by effective date, with provisions immediately effective discussed first. Plan amendments to implement SECURE 2.0 must be adopted (like SECURE 1.0) by the end of the 2025 plan year (or the 2027 plan year for governmental and collectively bargained plans). In the meantime, plan sponsors should keep track of any optional provisions they adopt prior to the required amendment date for SECURE 2.0 so the amendment process is easier.

Provisions Effective Immediately

Required Minimum Distributions (Section 107)

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Section 107, which generally applies to all employer-sponsored retirement plans, increases the age when terminated participants must begin required minimum distributions (RMDs), in two steps over the next decade. Previously, the age that would trigger an RMD was age 70 ½. While SECURE 1.0 increased the age to 72, SECURE 2.0 increases the age to 73 for individuals who reach age 72 after December 31, 2022, and before January 1, 2033, and to age 75 for individuals who reach age 74 after December 31, 2032. This is a required change and applies to required distributions after December 31, 2022, for individuals who reach age 72. Even though this is a required change to the RMD rules, plans are not required to allow participants to defer their benefit until their required beginning date.

Recovery of Plan Overpayments (Section 301)

Participants who mistakenly receive more than they are owed under their retirement plans can face unintended hardships when employers eventually seek recoupment of these overpayments with interest, which can be substantial. Section 301 allows plan sponsors to not recoup certain mistaken overpayments to participants and still qualify as a tax-favored plan under the Code. If plan sponsors decide to recoup overpayments, they must follow new limitations and protections that safeguard the financial well-being of the participant, such as not seeking interest on the overpayment, not sending the participant to collections (except for limited circumstances), and a three-year recovery limit. This provision is effective now, with certain retroactive relief for prior good-faith interpretations of existing guidance.

Reduction in Excise Tax for RMDs (Section 302)

Section 302 reduces the excise tax on participants for failure to timely take RMDs from a qualified retirement plan from 50% to 25%. The excise tax is further reduced to 10% for taxpayers who receive a distribution during a "correction window" of the required amount (which triggered the excise tax) and submit a return reflecting such tax. The correction window begins on the date the tax is imposed and ends on the earlier of the date a notice of deficiency is mailed,

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the date the tax is assessed, or the last day of the second taxable year after the end of the year when the tax was imposed.

EPCRS Expansion (Section 305)

Section 305 expands the Employee Plans Compliance Resolution System (EPCRS) to allow any "eligible inadvertent error" to be corrected through its self-correction procedures at any time, regardless of whether the error is significant or insignificant. Errors not eligible include those where the IRS has identified the failure before self-correction begins and those that are not corrected within a "reasonable period" after discovered. A loan error that qualifies as an "eligible inadvertent failure" under this section can be self-corrected under EPCRS, and the Department of Labor (DOL) is required to treat this self-corrected failure as satisfying the DOL's Voluntary Fiduciary Correction Program requirements, although the DOL can impose reporting or other procedural requirements. Moreover, Section 305 directs the Treasury Department to update existing guidance (e.g., under IRS Revenue Procedure 2021-30) or any other guidance within two years after enactment of SECURE 2.0.

Repayment of QBADs (Section 311)

SECURE 1.0 added a new in-service distribution opportunity for qualified birth and adoption distributions (QBADs) for eligible retirement plans, with respect to which the 10% early distribution penalty did not apply. The amount of a QBAD could be repaid to a plan at any time and qualify as a rollover distribution. Section 311 limits the repayment of a QBAD to a three-year period in order for the distribution to qualify as a rollover contribution from an eligible retirement plan. This change is intended to true up the repayment period with the other tax rules so that a taxpayer who repays a QBAD can amend his or her tax return to obtain a refund. This change applies to distributions made after December 29, 2022, and also has some retroactive application.

Employee Certification of Hardships (Section 312)

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Section 312 allows a plan administrator to rely on an employee's self-certification of both (i) a safe harbor hardship event, and (ii) that the distribution is not in excess of the amount required to satisfy the financial need and the employee has no alternative means of satisfying the need, when approving a hardship distribution from a 401(k) or 403(b) plan.

Distribution Penalty Exception for Terminal Illness (Section 326)

Section 326 provides an exception to the 10% penalty on early distributions from a qualified retirement plan for individuals with a terminal illness. The terminal illness must be substantiated by a physician, with death expected within seven years. The amount distributed may be repaid within three years, in which case the distribution will be treated as an eligible rollover distribution.

Federal Disaster Distributions (Section 331)

Section 331 creates another exception from the 10% early withdrawal tax penalty for any "qualified disaster recovery distribution," which is a distribution to an individual whose principal place of abode is in the qualified disaster area and who has sustained an economic loss due to the qualified disaster within 180 days of the first incident period of the qualified disaster, as specified by the Federal Emergency Management Agency.

An individual may not receive more than $22,000 in all taxable years with respect to any qualified disaster. A qualified disaster recovery distribution may be repaid at any time during the three-year period after the distribution was received. The amount may be included in the individual's gross income ratably over the three-year period. This exception applies to qualified disasters that occurred on or after January 26, 2021.

Roth Employer Contributions (Section 604)

Section 604 allows certain qualified retirement plans to permit participants to designate employer-matching or nonelective contributions as Roth contributions. Furthermore, employer-matching contributions for student loan payments may also be

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designated as Roth contributions. These contributions are includible in employee income and must be 100% vested when made.

Effective January 1, 2024

Student Loan Payments as Deferrals (Section 110)

Section 110 expands the definition of employer-matching contributions to include those made by employers on behalf of employees making "qualified student loan payments," so long as certain requirements are met. Employers can rely on employee certification that student loan payments were made. Significantly, plans utilizing this feature are permitted to perform ADP testing separately for employees that receive matching contributions due to qualified student loan payments, thereby allaying employer concerns that allowing these matching contributions could skew the results of nondiscrimination testing. Moreover, for safe harbor 401(k) plans, automatic enrollment safe harbor 401(k) plans, or Section 401(m) safe harbor plans, these qualified student loan payments can be treated as elective deferrals or elective contributions, as applicable.

Emergency Withdrawals (Section 115)

Section 115 permits emergency personal expense distributions that are not subject to the 10% penalty for early distribution. Participants are entitled to take one distribution per calendar year up to the lesser of $1,000 or the individual's total vested benefit under the plan. In this context, "emergency personal expense distribution" refers to a distribution for the purposes of meeting unforeseeable or immediate financial needs relating to necessary personal or family emergency expenses. Fortunately, plan administrators can rely on a participant's written certification that the distribution constitutes an emergency personal expense distribution. If a participant takes a penalty-free emergency personal expense distribution, the participant cannot take another one for the next three calendar years unless the participant fully repays the distribution or his or her total employee contributions equal or

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exceed the amount of the distribution.

Emergency Savings Accounts (Section 127)

Section 127 allows plans to offer emergency savings accounts (ESAs) for non-highly compensated employees. An ESA is a short-term savings account established and maintained as part of an individual account plan that accepts designated Roth contributions. An ESA can be designed to be elective or to use automatic enrollment and requires 30 to 90 days' explanatory notice prior to the first contribution. An automatic contribution ESA may have a contribution rate of up to 3% of the eligible participant's compensation unless the participant affirmatively elects to make contributions at a different rate or opts out.

ESAs cannot have a minimum contribution account balance but are subject to a maximum account balance of $2,500 (adjusted for inflation) or such lesser amount determined by the plan sponsor. Monthly withdrawals by participants of all or a part of their ESA account balance must be permitted. The first four withdrawals per year must be free (i.e., not be subject to fees solely on account of the withdrawal), but any additional withdrawals may be subject to reasonable fees. If a plan that includes an ESA has matching contributions, amounts contributed under the ESA must be eligible for matching contributions.

Increase of Involuntary Cash-Out Limit (Section 304)

Section 304 increases the involuntary cash-out limit and the related limit for the automatic rollover rules from $5,000 to $7,000. Previously, plans could automatically distribute accounts with $5,000 or less without participant consent so long as any such amounts distributed in excess of $1,000 were automatically rolled over to an IRA, unless the participant elected otherwise.

Pre-Death RMD Exception for Roth Accounts (Section 325)

Under Section 325, designated Roth accounts are excluded from the RMD rules prior to the participant's death. Previously, only Roth IRA accounts were excluded from the RMD rules prior to death. This

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change applies to taxable years beginning after December 31, 2023. It does not apply to distributions required prior to January 1, 2024, that are permitted to be paid on or after such date.

Surviving Spouse Treated as Employee for RMDs (Section 327)

Section 327 allows a designated beneficiary who is the surviving spouse of an employee to elect to be treated as if he or she were the employee for RMD purposes. If the surviving spouse elects to be treated as the employee, RMDs will begin no earlier than when the employee would have attained the applicable age. If the surviving spouse dies before distributions begin, the surviving spouse is treated as the employee. This election requires timely notice to the plan administrator and generally cannot be revoked once made.

Safe Harbor Elective Deferral Correction (Section 350)

Under current law, employers that adopt retirement plans with automatic enrollment or automatic escalation features can be subject to penalties for failing to properly implement those provisions, even if inadvertent. The IRS has previously issued guidance on correcting these failures, which is set to expire on December 31, 2023. Section 350 establishes a grace period to correct reasonable errors in administering the automatic enrollment and automatic escalation features. To correct failures under this new safe harbor, (i) the error must be corrected within 9.5 months of the end of the plan year in which the error occurred (or the date on which the employee notified the plan sponsor of the error, if earlier); (ii) the error must be resolved favorably toward the participant and without discriminating against other similarly situated participants; and (iii) notice of the error must be provided to the affected participant(s) within 45 days of the date on which corrective deferrals commence. Although this new safe harbor does not require plan sponsors to make corrective contributions for missed deferrals, the plan sponsor is still responsible for contributing any missed matching contributions, plus earnings.

403(b) Hardships (Section 602)

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Section 602 conforms the hardship distribution rules for Section 403(b) plans to those currently in place for Section 401(k) plans. So, 403(b) plans can distribute qualified nonelective contributions (QNECs), qualified matching contribution, as well as earnings on any of these contributions.

Roth Catch-Up Contributions (Section 603)

Section 603 provides generally that all catch-up contributions to qualified retirement plans are subject to Roth tax treatment. An exception to this general rule is carved out for participants with compensation of $145,000 or less, indexed for inflation. This provision is a revenue-generating provision and may present implementation challenges for payroll arrangements that are not currently set up for Roth contributions.

Effective January 1, 2025

Expansion of Automatic Enrollment (Section 101)

Section 101 requires automatic enrollment and automatic escalation in new retirement plans. New 401(k) and 403(b) plans established after December 31, 2024, must satisfy the "eligible automatic contribution arrangement" (EACA) requirements. Among these requirements are automatic enrollment at a default rate of between 3-10% with the ability to withdraw contributions within the first 30-90 days, as well as an automatic escalation of 1% per year up to a maximum of at least 10% (but capped at 15%). Certain exemptions apply, including for governmental, church, new, and small employers.

Increased Catch-Up Limit (Section 109)

Section 109 boosts the catch-up contributions limit for individuals aged 60 through 63 to the greater of (i) $10,000 or (ii) 150% of the regular catch-up amount for 2024, indexed for inflation. Implementation of this new requirement will be challenging given that recordkeepers will now need to track three separate age groups for catch-up contributions alone: participants ages 55-59, 60-63, and 64 and older.

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Long-Term Part-Time Employees (Section 125)

SECURE 1.0 required plans to allow "long-term part-time" employees to participate for purposes of making elective deferrals, starting January 1, 2024. A long-term part-time employee was defined as an employee who worked 500 hours of service for three consecutive years. SECURE 2.0 changes the definition of long-term part-time employee so that an employee is only required to work 500 hours of service for two consecutive years. Section 125 clarifies that only service during and after 2023 is counted for eligibility and vesting of any employer contributions. Furthermore, Section 125 clarifies that pre-2021 service is disregarded for purposes of the SECURE 1.0 vesting rules. Section 125 also extends this rule to 403(b) plans.

Consolidation of Defined Contribution Plan Notices (Section 341)

Within two years, the Secretaries of Treasury and Labor are directed to amend regulations to permit consolidation of required notices for defined contribution plans. The regulations will allow, but not require, consolidation of two or more notices which are required under ERISA and the Internal Revenue Code into a single notice as long as the combined notice: (1) includes the required content; (2) clearly identifies the issues addressed therein; (3) is furnished at the time and with the frequency required for each such notices; and (4) is presented in a manner that is reasonably calculated to be understood by the average plan participant and that does not obscure or fail to highlight the primary information required for each notice.

Effective January 1, 2026

Long-Term Care Contracts (Section 334)

Under Section 334, qualified retirement plans can allow qualified long-term care distributions for participants to purchase long-term care insurance with such distributions exempt from the 10% tax on early withdrawals. The distribution must be for a qualified long-term care insurance contract covering long-term care services. The

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distribution for the taxable year cannot exceed the lesser of (i) the amount paid by an employee for long-term care insurance for the employee, spouse, or other qualifying family members, (ii) an amount equal to 10% of the participant's vested accrued benefit, or (iii) $2,500. The participant must file a long-term care premium statement with the plan that includes a statement provided by the issuer of the long-term care coverage.

Requirement to Provide Paper Statements (Section 338)

Under the new rules for defined contribution plans, a paper benefit statement must be provided to participants at least once annually unless a participant elects otherwise. Participants can opt out of the paper statements under procedures that follow the 2002 safe harbor for opting into electronic delivery.

Miscellaneous

Performance Benchmarks for Asset Allocation Funds (Section 318)

The DOL's participant disclosure regulations require that each designated investment alternative's historical performance be compared to an appropriate broad-based securities market index. Section 318 of SECURE 2.0 directs the Secretary of Labor to update those regulations within two years so that an investment that uses a mix of asset classes, like a target date fund, ***may*** be benchmarked against a blend of broad-based securities market indices. Although the plan administrator is not required to use a blend of broad-based securities for its comparison, three rules must be met if it chooses to do so: (1) the index blend must reasonably match the fund's asset allocation over time; (2) the index blend is reset at least once a year; and (3) the underlying indices must be appropriate for the investment's component asset classes and otherwise meet the rule's conditions for index benchmarks.

Reporting and Disclosure Report to Congress (Section 319)

Section 319 directs the Treasury Department, DOL, and Pension Benefit Guaranty Corporation to review and make

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recommendations on the reporting and disclosure requirements for retirement plans. The recommendations made to Congress should consolidate, simplify, standardize, and improve these requirements no later than three years after the date of enactment.

Treasury Guidance on Rollovers (Section 324)

In an effort to simplify and standardize the rollover process to and from retirement plans and IRAs, Section 324 tasks the Treasury Secretary with creating sample forms for rollovers of eligible rollover distributions which may be used by both the incoming and outgoing retirement plan or IRA. These sample forms must be completed no later than January 1, 2025.

Report to Congress on Section 402(f) Notices (Section 336)

Section 402(f) notices are given by employer retirement plans when a distribution to a participant is eligible for rollover. The notice also describes distribution options and tax consequences. SECURE 2.0 directs the Government Accountability Office to analyze the effectiveness of these notices and make recommendations that would allow for a better understanding by recipients of different distribution options and corresponding tax consequences, including spousal rights. The Government Accountability Office must issue this report within 18 months after the date of enactment.

Fee Disclosure Improvements (Section 340)

The Secretary of Labor is tasked with reviewing regulations relating to fiduciary requirements for disclosure in participant-directed individual account plans and exploring how to improve the design of the disclosures described so that participants' understanding of fees and expenses related to defined contribution plans may be enhanced. A report on the findings must be given to Congress within three years and include recommendations for legislative changes.

For more information on SECURE 2.0 or other employee benefits issues, contact the author of this article or any member of Frost Brown Todd's Employee Benefits & ERISA Team.

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