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Final RMD regulations reflect SECURE Act and SECURE 2.0

The IRS has released final regulations governing required minimum distributions (RMDs) that reflect the amendments implemented under the SECURE Act and SECURE 2.0, as well as comments to proposed rules issued in 2022. The final regulations largely retain the proposed rules, including the requirement for continued annual distributions following the death of participants after their required beginning dates.

The final rules, which cover qualified defined benefit and defined contribution plans, 403(b) plans, 457(b) plans and IRAs, as well as distributions to surviving spouses and non-spousal beneficiaries and exceptions to applicable excise taxes, will generally apply to the determination of RMDs for calendar years beginning on or after Jan. 1, 2025. Taxpayers will be required to apply prior rules for earlier distributions with a reasonable, good faith interpretation of amendments implemented under the SECURE Act and SECURE 2.0.

General minimum distribution requirements

Treas. Reg. §1.401(a)(9)-1 addresses the application of the effective date of IRC §401(a)(9) amendments, added by SECURE Act Sec. 401, limiting the beneficiaries who may take distributions over their life expectancies.

Generally, under IRC §401(a)(9)(H), as enacted by the SECURE Act, distributions to individuals other than the following eligible designated beneficiaries must generally be distributed by the end

of the 10th calendar year following the year of the employee or IRA owner's death:

- The surviving spouse of the employee (or IRA owner)
- Disabled or chronically ill individuals
- Individuals who are not more than 10 years younger than the employee (or IRA owner)
- Children of the employee (or IRA owner) who have not reached the age of majority

By contrast, distributions to eligible designated beneficiaries may generally extend over the life or life expectancy of the eligible beneficiary.

"By contrast, distributions to eligible designated beneficiaries may generally extend over the life or life expectancy of the eligible beneficiary."

The amended RMD rules, which apply to qualified defined contribution plans, 403(b) plans, 457(b) plans, IRAs and Roth IRAs (but not defined benefit plans), generally apply to distributions with respect to employees who die after Dec. 31, 2019. The final regulations address issues related to the application of the effective date.

Multiple beneficiaries. The final regulations clarify the application of rules when an employee dies before the IRC §401(a)(9)(H) effective date with more than one designated beneficiary. Under the 2022 proposed rules, the application of the SECURE Act Sec. 401 amendments would be dependent on the date of the oldest beneficiary's death. For example, in the event an employee who died before Jan. 1, 2020, named a see-through trust as the sole beneficiary of the employee's interest in the plan, and the trust had three beneficiaries, the SECURE Act Sec. 401 amendments would apply for distributions to the trust upon the death of the oldest trust beneficiary, but only if that beneficiary died on or after the IRC §401(a)(9)(H) effective date for that plan.

The final regulations clarify application of rules to beneficiaries using the separate account alternative, under which the RMD rules are applied separately to the accounts for each beneficiary. The rules provide that, under such circumstances, the application of IRC §401(a)(9) to the separate account for a beneficiary is used to determine whether the amended rules under IRC §401(a)(9)(H) apply to that beneficiary.

Application of RMD rules to qualified annuity contracts. A qualified annuity is exempt from IRC §401(a)(9)(H) if the annuity payment amount under the contract must be irrevocably selected before Dec. 20, 2019. The final rules clarify that the mere ability to pay an additional premium or change the commencement date of benefits under the contract after Dec. 20, 2019, will not cause the contract to lose the exception. However, the IRS cautions, the contract will no longer be exempt if the individual paid an additional premium or changed the commencement date of benefits under the contract after that date.

Distributions commencing during employee's lifetime

Treas. Reg. §1.401(a)(9)-2 provides rules for determining the required beginning date for distributions and whether distributions are treated as having begun during an employee's lifetime. The rules generally reflect the amendments implemented by the SECURE Act (Sec. 114) and SECURE 2.0 (Act Sec. 107).

Uniform required beginning date. The final regulations do not allow a plan to provide a uniform required beginning date of April 1 of the calendar year following the year an employee attains age 70½ that would apply to all employees in the plan regardless of their dates of birth. However, the IRS advises that a plan could require benefits to commence by that date.

Death before required beginning date

Treas. Reg. §1.401(a)(9)-3 provides rules for distributions when an employee dies before the employee's required beginning date. These rules reflect amended IRC §401(a)(9)(H), specifically the limitation to eligible designated beneficiaries of the option to take distributions over their life expectancy.

Roth distributions. The final rules reflect the amendment to IRC §402A(d) (enacted under SECURE 2.0, Act Sec. 325) by providing that if an employee's entire interest under a defined contribution plan is in a designated Roth account, then no distributions are required to be made to the employee during their lifetime. Under such circumstances, the employee would be treated as having died before their required beginning date.

Full distribution of employee's entire interest following death of eligible beneficiary. The final rules clarify that, following the death of an eligible designated beneficiary, the requirement to take an annual distribution will apply for all subsequent calendar years until the employee's interest is fully distributed. Thus, an RMD is due for the calendar year of the eligible designated beneficiary's death, and that amount must be distributed during that calendar year to any beneficiary of the deceased eligible designated beneficiary to the extent it has not already been distributed to the eligible designated beneficiary.

Default rule. The proposed rules allowed plans to permit an employee or designated beneficiary to elect between the applicable 5-year or 10-year rule and the life expectancy rule if the plan specified the default that would apply when the employee or designated beneficiary has not made an election. The final regulations state that the requirement to specify a default applies only if the plan is intended to use a default that differs from what would apply under the regulations if the employee or designated beneficiary did not make an affirmative election. ■

Supreme Court decision warrants review of buy-sell agreements

In *T. Connelly, Exr.*, the Supreme Court held in a unanimous decision that, where a closely held corporation had a contractual obligation to redeem a deceased shareholder's shares at fair market value, the obligation is not necessarily a liability that reduces the corporation's value for federal estate tax purposes (*T. Connelly, Exr.*, 2024-1 USTC ¶60,740, *aff'g*, CA-8, 2023-1 USTC ¶60,737).

Facts

Two brothers were the sole shareholders of a closely held corporation, with M owning about 75% and T owning about 25%. The brothers had entered into a buy-sell agreement providing that each brother had the right to purchase the other brother's shares upon their death. If the surviving brother decided not to purchase the shares, the corporation had a contractual obligation to redeem either brother's shares at fair market value, based on an appraisal. The corporation had purchased life insurance policies on the two brothers to cover the redemption cost.

When M died, T decided not to purchase the shares. The corporation fulfilled its redemption obligation by using proceeds from a $3.5 million policy on M to redeem M's shares that the estate valued at $3 million, with the corporation valued at $4 million. There was no independent appraisal of the corporation's fair market value.

The IRS determined that the $3.5 million value of the life insurance proceeds should be included in the overall valuation of the corporation, raising its value to around $7 million and M's interest to $5.3 million. The estate argued that the obligation to redeem the shares offset the value of the life insurance used to fund the redemption.

Supreme Court decision

The Supreme Court agreed with the IRS and the circuit court. The Court found that the redemption had no economic impact on the shareholders, because the value of the shareholders' interests before and after the redemption was the same. Therefore, a contractual obligation to redeem shares at fair market value would not, on its own, reduce the value of those shares. The Court stated that the brothers had chosen the structure for the agreement and could have pursued other options that would have kept the life insurance proceeds out of the valuation, such as a cross-purchase agreement.

> "The Supreme Court agreed with the IRS and the circuit court."

The decision increased the valuation of the corporation by $3 million, increased M's estate tax liability by about $1 million and reduced the amount received by M's heirs by about $1 million.

Planning

Many buy-sell agreements have been structured in a manner similar to the one in *Connelly*, relying on an Eleventh Circuit Court decision in *G. Blount Est.* In *Blount*, the Eleventh Circuit, reversing the Tax Court, held that the life insurance proceeds received by the company upon the death of the decedent were offset by the company's obligation to redeem the decedent's shares under the buy-sell agreement (*G. Blount* Est., CA-11, 2005-2 USTC ¶60,509, 428 F3d 1338). After *Connelly,* this reliance is now misplaced. It did not seem to matter to the Court in *Connelly* whether the shareholders were related.

> "The Supreme Court in *Connelly* suggested a cross-purchase agreement as an alternative."

The Supreme Court in *Connelly* suggested a cross-purchase agreement as an alternative. The shareholders (or trusts for the shareholders' benefit) purchase insurance on each other rather than have the corporation purchase the insurance, permitting the insurance proceeds to purchase the shares of a deceased shareholder without inflating estate tax values.

If the decedent owned their own insurance, and the insurance was obtained by the surviving shareholder to purchase the decedent's stock, the insurance proceeds would be included in the decedent's gross estate.

There is also authority that the insurance is not includible in the decedent's gross estate if it is purchased by the corporation but passed to the surviving shareholder for purchase of the decedent's stock rather than being used to redeem the shares directly.

Although not apparently a focus of the Court in *Connelly*, it is probably a good idea to get an independent appraisal of the corporation. It appears from the facts that an appraisal was required in the buy-sell agreement between the brothers. However, an independent appraisal was not obtained.

In planning for corporate succession, it is always a good idea to consult with estate planning experts to make sure that the latest authorities are being utilized in estate tax planning. While the *Connelly* brothers may have been using the latest authorities under *Blount*, their case was used to change that authority. ■

IRS guidance on employer plan matching contributions for student loan payments

The IRS has issued interim guidance in the form of questions and answers for 401(k) and similar retirement plans that provide or wish to provide matching contributions based on eligible qualified student loan payments (QSLPs) made by their participating employees.

Section 110 of the SECURE 2.0 Act of 2022 permits employers with 401(k), 403(b), governmental 457(b) or SIMPLE IRA plans to provide matching contributions based on student loan payments, rather than only on elective contributions, in plan years beginning after Dec. 31, 2023.

The IRS addresses a variety of plan administration issues related to this provision. Among other issues, the guidance addresses:

- General definitions of a QSLP and student loan matching contribution eligibility rules (including dollar and timing limitations)
- What is required for employee certification that student loan matching contribution requirements have been met
- Reasonable student loan matching contribution procedures a plan may adopt
- Special nondiscrimination testing relief for 401(k) plans that include student loan matching contributions

Applicability date

This guidance applies for plan years beginning after Dec. 31, 2024. For plan years beginning before Jan. 1, 2025, a plan sponsor may rely on a good faith, reasonable interpretation of section 110 of SECURE 2.0. According to the IRS, the guidance in this notice is an example of a good faith, reasonable interpretation of section 110 of SECURE 2.0. (See IRS News Release IR-2024-217, IRS Notice 2024-63.) ■

Allocation of discretionary employer retirement contributions for health and student loan expenses

The IRS has issued a private letter ruling authorizing an innovative plan design that allows employees to make an annual irrevocable election to allocate discretionary employer contributions to the employer's 401(k) plan, the employee's Health Savings Account (HSA), a retiree health reimbursement arrangement (HRA) or the employer's educational assistance program for the reimbursement of student loan payments (but not other education expenses). Under the terms of the private letter ruling, which may be relied on only by the taxpayer who requested it and has no precedential value, employer contributions would be subject to the generally applicable HSA and student loan reimbursement (SLR) dollar limits and the restrictions governing retiree HRAs.

It is important to note that under the approved design, employees would not have the right to receive the employer contribution in cash or as any other taxable benefit. Thus, the employer contribution to the 401(k) plan would not be treated as cash or deferred election and would not be subject to the generally applicable IRC §402(g) annual deferral limits on elective deferrals.

The ruling effectively shields the amounts allocated by an employee election from inclusion in income under the constructive receipt rules, removing what has been a central concern preventing adoption of such options.

401(k) and profit-sharing plan

The employer maintains a 401(k) plan that authorizes elective employee deferrals (pretax or post-tax (Roth) contributions). In addition, the plan provides for two types of employer contributions: a safe harbor non-elective contribution and a discretionary employer contribution equal to a specified percentage of annual eligible compensation per pay period.

Employees generally do not have the ability to direct the investment of the discretionary contribution. Additionally, the contributions are subject to a six-year graded vesting schedule.

Proposed amendments

The employer proposed amending the 401(k) plan, the retiree HRA and the educational assistance program and modifying the allocation of employer contributions to employee HSAs to allow eligible employees the choice to allocate the employer contribution of a specified percentage of compensation among the programs.

Generally, the employer proposed providing employees with a choice to make an annual irrevocable election to allocate an additional employer contribution equal to a specified percentage of compensation (subject to an annual dollar limit) among the 401(k) plan, the retiree HRA (for employees age 55 or older with 10 years of service at the time of the employee's election), the educational assistance program (solely for the purpose of student loan payments under IRC §127(c)(1)(B)) or an employee's HSA.

"The employer proposed to finance the allocations by reducing the existing discretionary contribution to the 401(k) plan."

Reduction in existing discretionary contributions. The employer proposed to finance the allocations by reducing the existing discretionary contribution to the 401(k) plan. Thus, the amendment would not necessitate additional employer contributions and could be implemented on a relatively cost-neutral basis.

Employees may not elect cash or taxable benefits. Employees would not be permitted to receive the employer contribution in the form of cash or as a taxable benefit.

Avoiding excess contributions. Employees who elect to have the employer contribution allocated to the educational assistance program or as an HSA contribution would not be eligible to receive other benefits from the educational assistance program or make pretax payroll contributions to the HSA until after March 15 of the following year.

The restriction is designed to prevent contributions from exceeding the applicable limits under IRC §127(a)(2) and IRC §223(b).

IRS issues reminder about SECURE 2.0 impact on Form W-2

The IRS has reminded businesses that, starting in tax year 2023, changes under the SECURE 2.0 Act of 2022 may affect the amounts they need to report on their Forms W-2.

The SECURE 2.0 provisions potentially affecting Forms W-2 are:

- *De minimis* financial incentives (Section 113 of SECURE 2.0)
- Roth SIMPLE and Roth SEP IRAs (Section 601 of SECURE 2.0)
- Optional treatment of employer non-elective or matching contributions as Roth contributions (Section 604 of SECURE 2.0)

The changes made by SECURE 2.0 were intended to encourage the use of the various employer retirement plans.

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De minimis financial incentives

The IRS noted that SECURE 2.0 made changes that allow employers to offer small financial incentives to employees who choose to participate in 401(k) or 403(b) plans. If an employer offers an incentive, it is considered part of the employee's income and is subject to regular tax withholding unless there is a specific exemption.

Roth SIMPLE and Roth SEP IRAs

Salary reduction contributions to a Roth SEP or Roth SIMPLE IRA are subject to federal income tax withholding, the Federal Insurance Contributions Act (FICA) taxes and the Federal Unemployment Tax Act (FUTA) taxes. These contributions should be included in boxes 1, 3 and 5 of Form W-2. They also must be reported in box 12 with code F (for a SEP) or code S (for a SIMPLE IRA).

However, employer matching and non-elective contributions to a Roth SEP or Roth SIMPLE IRA are not subject to withholding for federal income tax, FICA taxes or FUTA taxes. The IRS explained that these contributions must be reported on Form 1099-R for the year in which the contributions are made to the employee's Roth IRA. The total amounts are listed in boxes 1 and 2a of Form 1099-R with code 2 or 7 in box 7, and the IRA/SEP/SIMPLE checkbox is checked.

Designated Roth non-elective contributions and designated Roth matching contributions

Under SECURE 2.0, plans can allow employees to designate as Roth contributions certain matching and non-elective contributions made after Dec. 29, 2022. The IRS stated that these contributions are not subject to withholding for federal income tax. In addition, these contributions generally are not subject to withholding for Social Security or Medicare tax.

Unlike regular Roth contributions, designated Roth non-elective and matching contributions must be reported on Form 1099-R for the year in which they are allocated to an individual's account. They are reported in boxes 1 and 2a of Form 1099-R, and code G is used in box 7.

The IRS cautioned that if a business filed 2023 Forms W-2 without following these new guidelines, they may need to file Form W-2c to correct any errors. (See *IRS Newswire*, Issue No. FS-2024-29.)

IRS guidance on long-term, part-time employees in 403(b) plans

The IRS has provided guidance addressing long-term, part-time employee eligibility requirements under the nondiscrimination rules of IRC 403(b)(12)(D), which apply to certain 403(b) plans beginning in 2025. The IRS has also announced a delayed applicability date for related final regulations under IRC 401(k).

Application of 403(b)(12)

The IRS has provided questions and answers on the requirement that 403(b) plans allow certain long-term, part-time employees to participate. The IRS clarified that the long-term, part-time employee eligibility rules only apply to 403(b) plans that are subject to Title I of ERISA. Thus, a governmental plan under ERISA §3(32), 29 U.S.C. §1002, is not subject to the long-term, part-time employee eligibility rules because it is not subject to Title I pursuant to ERISA §4(b), 29 U.S.C. §1003.

The guidance also provides that 403(b) plans can continue to exclude student employees regardless of whether the individual qualifies under long-term, part-time employee eligibility rules. The IRS explains that the student employee exclusion in 403(b)(12)(A) is a statutory exclusion based on a classification rather than on service.

Future Guidance

The guidance for 403(b) plans applies for plan years beginning after Dec. 31, 2024. The IRS anticipates issuing proposed regulations applicable to 403(b) plans that are generally similar to proposed regulations applicable to 401(k) plans.

"The guidance for 403(b) plans applies for plan years beginning after Dec. 31, 2024."

Applicability date for 401(k) regs

The IRS also addressed the applicability date of rules for 401(k) plans. Final regulations related to long-term, part-time employee eligibility rules will apply no earlier than plan years beginning on or after Jan. 1, 2026.

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Building a team of professionals to help provide solutions for our clients

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We want to work together as a team and offer value for your practice and clients. Using complementary skills and philosophies, we can help save time, money and resources while assisting mutual clients in planning for today's financial and tax challenges.

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