Employee Benefits and Executive Compensation: Getting Ready for 2024 - Qualified Plans
Hosts: Lynne Wakefield, Constance Brewster, and Brianna Hourihan
Recorded 11/01/23

Lynne Wakefield:

Hi, everyone. You're tuned in to Troutman Pepper's Employee Benefits and Executive Compensation podcast miniseries, your compass for navigating the complex world of benefits and compensation as we closeout 2023 and head into 2024. I'm Lynne Wakefield and I'm here with my co-hosts, Constance Brewster and Brianna Hourihan. Constance and I are both partners in the employee benefits and executive compensation practice at Troutman Pepper, and Bri is one of our associates.

Constance Brewster:

Thank you for the introduction, Lynne. I'm Constance, and today, we'll discuss some pressing issues and recent legislative developments in the qualified retirement plan space as we prepare for 2024. These include key provisions of SECURE 2.0 that are effective in 2024, proposed regulations on the use of forfeitures, the expansion of the Employee Plans Compliance Resolution System, which we refer to as EPCRS, and recent litigation trends. We'll conclude this episode with a reminder of year-end administrative tasks.

Brianna Hourihan:

Thanks so much for outlining that, Constance. It really is astonishing how quickly 2023 has passed and even more so how much has transpired in the qualified retirement plan space over the year. From a legislative perspective, I think one of the most significant developments has to be the enactment of SECURE 2.0 at the end of 2022.

Constance Brewster:

Agreed. If you joined our webinar last year, you know that the Secure Act enacted on December 20, 2019 made a number of changes to qualified plans, including new participation requirements for part-time long-term employees, and increased required minimum distribution age, just to name a few. Three years later on December 29, 2022, SECURE 2.0 was signed into law building on the Secure Act and introducing substantial changes to the law's governing retirement plans. These changes include modification to rules governing plan participation, automatic enrollment, catch up contributions, required minimum distributions and more. SECURE 2.0 also includes a number of optional provisions such as the treatment of student loan payments as elective deferrals for purposes of matching contributions and additional in-service withdrawal opportunities. While some of these changes are effective, new others are not effective until 2024, 2025 or beyond.

Brianna Hourihan:

Yes, there is so much to unpack here. I don't even know where we start.

Lynne Wakefield:

I think it makes sense to start with some of the mandatory provisions of SECURE 2.0. I know one significant change relates to the eligibility of long-term part-time employees, like Constance mentioned. Before, Secure and SECURE 2.0, a plan sponsor generally could exclude part-time and other employees who did not complete a year of service, which is generally defined as the completion of a thousand hours of service in a 12-month period, from 401k plan participation. The Secure Act changed that rule beginning in the 2024 plan year requiring that 401k plans allow part-time employees who work more than 500 hours per year during three consecutive years to participate for purposes of making elective deferrals. Then in 2025, we have SECURE 2.0, which reduces the 500-hour lookback requirement from three to two consecutive years.

Constance Brewster:

So this sounds like 401k plan sponsors that exclude part-time, temporary or seasonal workers will need to work with their third-party administrators or their internal HR teams to track hours. For the 2024 plan year, any such excluded employees who worked more than 500 hours in 2021, '22, and ‘23 must be allowed to make elective deferrals beginning in '24, and then for '25, the two-year lookback period applies. But plan sponsors are not required to make matching contributions or non-elective contributions for this population, right?

Lynne Wakefield:

Yeah, that's right, but this one has a lot of tentacles that may not be readily apparent at first blush. So for example, the part-time employees and their deferrals can be disregarded when completing non-discrimination testing and applying the top-heavy rules, but there aren't special provisions for the matching or non-elective contributions, so excluding part-time employees from those contribution types could have non-discrimination testing impacts. And although you don't have to make the matching or non-elective contributions for this population, if they later become eligible for these contributions in the normal course, you have to give them credit for their part-time years for vesting purposes. I mean, honestly, if it's not cost prohibitive, it definitely seems like it would be simpler for plan sponsors to amend their plans to provide for immediate eligibility of part-time employees, so they don't have to track hours for these purposes or deal with these other nuances.

Brianna Hourihan:

Speaking of tricky mandatory changes, another one is the SECURE 2.0 requirement that catch up contributions be made on a Roth basis for participants whose prior year FICO wages exceeded $145,000. Under the new rules, if a plan does not provide for Roth contributions, then all participants regardless of compensation will be prohibited from making catch-up contributions. What this really means is that if participants earning $145,000 or more cannot make catch-up contributions, then no one can.

Constance Brewster:

This is the one plan sponsors were most focused on earlier this year, given that the required Roth catch-up rules are effective beginning in 2024. Thankfully, the IRS recently announced a much welcomed two-year administrative transition period for implementing Roth catch up contribution requirements. During this two-year delay, all participants aged 50 or older during a plan year can make catch up contributions on a pre-tax basis regardless of income, provided that the plan permits pre-tax catch-up contributions.

There are a number of questions still out there and the IRS has indicated that additional guidance is forthcoming. In our client base, we're seeing a number of third-party administrators and record keepers halt implementation of the mandatory Roth catch-up contribution requirements for 2024 in light of this two-year delay.

Brianna Hourihan:

Agreed. Given the two-year transition, I really can't think of any plan sponsors or record keepers who are taking steps to implement these requirements in 2024. Another highly anticipated but optional SECURE 2.0 provision that doesn't seem to have a high take-up rate among plan sponsors at this point is the ability to provide matching contributions on qualified student loan payments. This provision allows employees to simultaneously repay their student loans while also building their retirement savings. While it seems like there is definitely interest in this type of provision from plan sponsors, it seems that many are taking the wait and see approach for 2024 given that additional guidance is still forthcoming.

Lynne Wakefield:

Yeah, it seems like the IRS is definitely going to be busy with all of this guidance to be issued. I feel like we could focus this whole podcast and probably a number of others on just the SECURE 2.0 developments, but let's just cover quickly a few more before we switch gears. I guess the first one I would mention is the increase in the involuntary cash-out limit from 5,000 to 7,000. In light of the costs associated with maintaining participants with small balances in the plan as well as the difficulty associated with trying to find missing participants down the road, this is one I'm seeing a lot of plan sponsors deciding to go ahead and implement. For plan sponsors who are currently at 5,000, this is a pretty simple change without a significant amount of additional legwork. I guess for plan sponsors who are currently at a thousand, if they wanted to go up to the $7,000 limit, there are some additional considerations in play like negotiating an automatic rollover agreement with an IRA provider for involuntary distributions of a thousand dollars or greater.

Constance Brewster:

Another one I'd mention is the availability of a number of new penalty-free in-service withdrawals, including withdrawals for emergency expenses, domestic abuse and terminal illness. I've seen some interest in these provisions from plan sponsors, but some seem to view this expansion of in-service distributions as a departure from the true purpose of the plan, which is to save for retirement.

Brianna Hourihan:

Well, if we're picking final SECURE 2.0 highlights, the one I'd mentioned is the ability to rely on a participant's self-certification of eligibility for a hardship withdrawal rather than requiring documentation to substantiate the withdrawal. This is one I definitely recommend touching base with the third-party administrator on to see if they're allowing this in 2024. If they are and the plan is individually designed, the plan should be amended accordingly.

Lynne Wakefield:

Yeah, and that raises a good point, Bri. We're talking about all of these amendments and whether they're mandatory amendments or optional amendments, something that's likely on the minds of a number of plan sponsors at this time of year as plan amendments. So what should plan sponsors be doing with plan documents and amendments in light of all these changes?

Constance Brewster:

Well, the technical deadline for plan amendments is the last day of the first plan year beginning on or after January 1, 2025, as long as the plan operates in accordance with such amendments as of the effective date of the requirement or implementation. Some plan sponsors who are implementing changes now that they want to communicate to their participants are simultaneously amending their plans, and I've seen this for changes like the increased RMD age and the increase in involuntary cash-out limit. For some of the more technical changes, we're generally seeing clients wait for additional IRS guidance, regulations and model language that is hopefully on the horizon.

Lynne Wakefield:

Yep. There's that concept again. The IRS needs to get us some guidance, so fingers crossed for that and definitely some bonus points for model language. Let's go ahead and switch gears now away from SECURE 2.0 and talk about the recent expansion of EPCRS, which is the IRS correction program.

Constance Brewster:

Just as we thought we were moving away from SECURE 2.0.

Lynne Wakefield:

Right. Well, can't ever get enough of that, right? This one's a little bit different though in the sense that it's not a required or optional plan design change, but really instead, an expansion of EPCRS that allows any eligible inadvertent failure, which is a term of art, whether it's significant or insignificant to be self-corrected at any time under certain conditions. So this really, I think, builds on the IRS's efforts to liberalize EPCRS over the last several years.

Constance Brewster:

Agreed. This one was a bit surprising given that plan correction issues have typically been addressed by the IRS through administrative guidance rather than through legislation, but it's not entirely surprising that Congress put its hat in the ring on this topic given the increasing complexity of the legal framework in plan administration.

Lynne Wakefield:

Yeah, but we're still waiting for some additional guidance on this one too. We've seen a notice to date and it's anticipated that the IRS is going to issue a new iteration of EPCRS in the not too distant future, but at the end of the day, I think this change is definitely good news for plan sponsors because it will expand the circumstances under which routine operational errors can be corrected without an IRS VCP filing, regardless of whether it's a significant or an insignificant operational failure and regardless of how far back it goes.

Brianna Hourihan:

Yeah, Lynne, I agree. This is definitely a positive development for plan sponsors. It really seems that it is becoming easier and less costly to fix operational errors. I would also put the new overpayment correction rules that are addressed in the same portion of SECURE 2.0 within this bucket. Plan sponsors have always grappled with the requirement to recover overpayments from participants and beneficiaries, and SECURE 2.0 provides plan fiduciaries with the discretion not to recover these overpayments, as well as guardrails for those situations in which plan fiduciaries do seek to recover.

Lynne Wakefield:

Okay. It's been almost 10 minutes and we're still talking about SECURE 2.0. I know we've only scratched the surface, but ultimately, plan sponsors need to take proactive steps to determine how SECURE 2.0 affects their plans and whether they wish to adopt any optional provisions. They'll also need to coordinate with their payroll vendors and their 401k plan record keepers to decide which of these optional changes can be implemented. Let's talk about something equally exciting, which is the recently issued guidance related to the use of forfeitures and qualified retirement plans. Bri, can you give us a quick overview of the proposed regulations?

Brianna Hourihan:

Yes, sure thing. For defined contribution plans, the proposed regulations clarify that forfeitures may be used to pay plan administrator expenses, reduce employer contributions under the plan, or increase benefits in other participants' accounts, all in accordance with plan terms. The proposed regulations also require that forfeitures be utilized within 12 months after the close of the plan year in which the forfeitures are incurred. From a defined benefit plan perspective, the proposed regulations remove outdated guidance and eliminate requirements that forfeitures be used as soon as possible to reduce employer contributions, which is inconsistent with the new minimum funding rules.

Instead, the proposed regulations require that the use of reasonable actuarial assumptions be used to determine the effect of expected forfeitures and future contributions. The proposed regulations also reflect current law prohibiting the use of forfeitures to increase the benefits any employee would otherwise receive under the plan at any time prior to the termination of the plan, or the complete discontinuance of employer contributions. The regulations are proposed to apply to plan years beginning on or after January 1, 2024. However, plans are permitted to rely on the language and the proposed regulations immediately.

Lynne Wakefield:

Thanks, Bri. This seems like a really straightforward change, but I think it's one that's really important. There are a few key takeaways from the proposed regulations that I think are worth highlighting. The first I would mention is that the manner in which forfeitures are to be used should be specified in the plan document, so it's important to check that. And the second is the timing of the use of forfeitures. This concept has been around for a while, but it's not necessarily something that's always implemented in practice.

Forfeitures should not just sit in the forfeiture account and accrue. They need to be used and quickly. The proposed regulations do provide for some transition relief so that defined contribution plan forfeitures that occurred during plan years beginning before January 1, 2024 will be deemed to have occurred in 2024. So that means that plan sponsors that have accumulated forfeitures over a number of plan years basically have a pass to utilize the forfeitures by the end of 2025 for calendar year plans. All of this is to say it's worth looking at forfeiture account balances and plan documents for permitted uses and considering fiduciary duties when determining how to apply the forfeitures.

Constance Brewster:

This is particularly noteworthy given that the latest trend in qualified plan litigation seems to be related to the use of plan forfeitures and whether plan fiduciaries are using such forfeitures in a manner that is consistent with fiduciary rules. As a reminder, litigation in the qualified plan space has proliferated in recent years with over 200 401k plan class actions filed in federal courts since 2020. Initially, these suits were targeted at larger plans with billions in plan assets, but more recently, they've also targeted smaller plans. These suits oftentimes involve cookie cutter complaints making allegations against plan fiduciaries for excessive recordkeeping fees and excessive expense ratios, failure to remove poorly performing funds, and then using active instead of passive investment strategies, et cetera.

Brianna Hourihan:

It kind of seems to me that the forfeiture related allegations are just the latest attempt by plaintiffs to throw something at the wall to see if it'll stick.

Lynne Wakefield:

It very well could be, but regardless, plan sponsors need to be cognizant of the allegations that are being made so that they can try to mitigate any risk of suit. Over the last few months, the 401k plans of several large companies have been the target of suits alleging that the use of forfeitures to reduce employer contributions, rather than to pay administrative expenses that inevitably are borne by participants constitutes a breach of fiduciary duty. And the legal theory posed by these cases is that an employer violates ERISA when it exercises discretion over the use of forfeitures to benefit itself over plan participants.

Constance Brewster:

It seems a shakeup given that the IRS has sanctioned the use of forfeitures to pay plan expenses and reduce employer contributions in the past and in its recently proposed forfeiture regulations. Although remember, the Department of Labor which enforces ERISA fiduciary duties is not bound by the IRS. However, the fiduciary concern seems to be where the employer has discretion in determining the use, and plaintiffs are essentially arguing that this exercise of discretion is a fiduciary decision. The outcome may very well hinge on the plan's terms. Each of the plans at issue in these cases by their terms permitted discretion in how the employer used the forfeitures. A better approach may be to remove the discretion and/or provide for an ordering in the use of forfeitures in the actual plan document terms, but this could also make it challenging to defend if forfeitures are not utilized in accordance with the plan's terms.

Brianna Hourihan:

Unfortunately, the suits containing these claims are still fairly early on in the litigation process, so we'll just have to keep an eye on how these allegations pan out and whether plaintiffs have a viable claim with respect to the use of plan forfeitures.

Lynne Wakefield:

Yeah, I agree, Bri, but for now, I think that at a minimum, plan sponsors should ensure that potential uses of forfeitures are expressly provided for in their plan documents and ensure that their administration is consistent with plan language. And when we're looking at amending plans to comply with the forfeiture regulations anyway, it seems like a good opportunity to do that. I think plaintiffs are more likely to have a viable claim if forfeitures are not being used in accordance with plan terms.

Brianna Hourihan:

Speaking of plan sponsor to-dos, this does seem like a good time to transition to our final topic, to highlight year-end administrative reminders for calendar year plans.

Lynne Wakefield:

Great segue, Bri. We know that the end of quarter four gets extremely busy for plan sponsors. I think despite the craziness of the fourth quarter, it's imperative that plan sponsors don't lose sight of the annual year-end administrative tasks related to 401k plans. To name a few, for calendar year plans, December one is the deadline to distribute Safe Harbor Plan notices, annual automatic enrollment notices and annual qualified default investment alternative notices. That's generally 30 days before the first day of the plan year. December 15th is the extended deadline for distributing summary annual reports for those plans that obtained an extension to file their Form 5500, and December 31 is the deadline for current year required minimum distributions, other than the first RMD, which was due April 1st, and to amend the plan for any discretionary changes that became effective during 2023.

So as you guys have been listening, I'm sure you can see that there is a lot going on in this space. There's a lot to talk about, and I think there will continue to be as we move into 2024. I think that this is the perfect point to end our episode. We know that was a lot of information, but we hope that it's been helpful in thinking about recent developments and year-end to dos and that we didn't lose any of our listeners along the way. If you have any questions or need further clarification on any of the topics we talked about today, please don't hesitate to reach out to any of us directly.

Brianna Hourihan:

As a reminder, this episode is part of an ongoing miniseries and we've got more exciting content coming your way, so stay tuned for the next installment.

Lynne Wakefield:

In closing, we are excited to announce that we are hosting our annual webinar in September of 2024 where we'll explore these topics and more, providing a comprehensive look at the future landscape of employee benefits and executive compensation. Thank you for listening.