PALLAS
CAPITAL ADVISORS

The "R" in IRS Stands for "Revenue" (and they want to see it)

WHAT'S NEW

Earning over $145,000 from your employer in 2023? Be prepared to lose another tax deduction next year. Starting in 2024, a change in tax rules will affect "high-earning" Americans making catch-up contributions to their 401(k) retirement accounts. Currently, those aged 50 and older can make extra contributions to their 401(k)s using pre-tax money, with a limit of $7,500 extra (up to $30,000 total) for 2023. However, under the new rule, beginning in 2024 participants earning over $145,000 in wages from their plan sponsor in the preceding year must make these catch-up contributions in the form of Roth contributions, which are made with after-tax money. (The changes don't apply to IRAs, which allow a catch-up contribution in 2023 of $1,000 for savers 50 and over on top of the $6,500 annual limit.)

> **Example:** Elizabeth, age 51, and James, age 54, work for Axiom Enterprises, Inc., which offers a 401(k) plan. Elizabeth, who was paid $250,000 in wages from the company in 2023, must make any catch-up contributions for 2024 to the plan as Roth contributions. James, who received $140,000 in wages in 2023, is not required to make his catch-up contributions as Roth contributions but can choose to do so (if the plan allows).

The change was introduced as part of a set of new rules (commonly called SECURE 2.0) passed by Congress in December, 2022. This has significant implications for retirement planning, as it means that high-earning individuals will have to pay taxes on their catch-up contributions upfront during their higher-earning years, rather than deferring those taxes until retirement when they might be in a lower tax bracket. This change could reshape retirement savings strategies and estate planning.

CHANGE CAN BE GOOD

It's not entirely bad news. While some individuals might end up paying more in taxes due to this change, there can be a benefit to increasing contributions to Roth accounts, where money grows tax-free and can be withdrawn tax-free in retirement. Because Roths grow tax-free, they are better options for big savers than taxable brokerage accounts, which require owners to pay taxes annually on dividends, interest, and realized capital gains. Roths also benefit heirs, who receive distributions from the account income-tax-free. It is important to remember that both Roth and traditional accounts must be liquidated over 10 years by most non-spouse beneficiaries.

CONFUSION REQUIRES CLARIFICATION

However, there are several uncertainties and complexities related to the implementation of the new rule. Congress did not address certain questions, including this basic one – "What happens if a plan doesn't already allow Roth contributions?"

The new rules also say that prior-year wages must be with the employer sponsoring the plan. This look-back requirement apparently means that new employees—no matter how well paid—will get a free pass from the mandatory Roth requirement in their first year of employment (because those employees have no wages the previous year from the new company).

Employers are requesting a delay in the effective date of the rule due to logistical challenges in implementing the changes in their systems. Many are seeking more time to adjust payroll and other systems to ensure compliance.

There is also an ongoing push for clarification and guidance from regulators, including whether employers must seek permission from high earners to put their catch-up contributions into a Roth or if this can be done automatically. The Treasury Department plans to issue guidance but has not commented on the request for a delay.

Overall, the change in tax rules for catch-up contributions is expected to have a significant impact on retirement planning for high-earning Americans.