Understanding the SECURE Act and its implications on planning

The SECURE Act (Setting Every Community Up for Retirement Enhancement Act of 2019) became law on December 20, 2019. With a broad range of provisions governing retirement plans, plan participants, and individual retirement savers, this legislation brings the most significant changes to the retirement industry since the Pension Protection Act (PPA) of 2006. The new law is designed to expand access to retirement accounts, promote participation, and preserve savings. At the same time, it introduces new restrictions on deferring taxes for inherited retirement accounts.

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Summary of the key provisions

Provisions impacting employers and plan sponsors

Provision	Description
Creates "open" multiple employer plans (MEPs)	The act removes barriers for non-related employers to establish a pooled retirement plan. The regulatory burden is reduced by eliminating the "one bad apple" rule: The plan can continue operating even if one employer in the group is out of compliance. MEPs may provide cost-savings and lessen administrative burdens by allowing groups of employers to band together to sponsor a plan. *Effective for plan years beginning after 12/31/20.*
Increases auto-enrollment safe harbor cap on contributions	The cap on qualified auto-escalation programs increases to 15% of compensation from 10%. An auto-escalation feature within the plan automatically increases a participant's plan contribution each year by a certain percentage up to a maximum limit. *Effective for plan years beginning after 12/31/19.*
Increases tax credit for smaller employers (generally 100 or fewer employees) establishing retirement plans	The tax credit for starting a plan increases from a maximum $500 annually for the first three years to a maximum of $5,000. The credit is calculated as the greater of: (1) $500 OR (2) the lesser of (a) $250 for each non-highly compensated employee eligible to participate in the plan or (b) $5,000. *Effective for plan years beginning after 12/31/19.*
Establishes new tax credit for auto-enrollment retirement plans of smaller employers (generally 100 or fewer employees)	This new tax credit of $500 per year for up to three years is for employers to defray costs of plans that include an eligible automatic enrollment arrangement. It can be utilized in addition to the general tax credit for start-up retirement plans and is available to existing plans that add the auto-enrollment feature. *Effective for plan years effective beginning after 12/31/19.*
Expands access to lifetime income options	This provision reduces fiduciary exposure for plan sponsors looking to offer guaranteed, lifetime income options within a retirement plan, by adopting, effective immediately, a fiduciary safe harbor for selecting a lifetime income provider. The plan sponsor must engage in an "objective, thorough, and analytical search" at time of selection. The law also permits portability of lifetime income options through direct trustee-to-trustee transfers to another retirement plan or IRA. *For plan years effective beginning after 12/31/19.*
Requires disclosure of lifetime income	Defined contribution retirement plans must provide an illustration to participants detailing how much their total plan balance would provide in lifetime income based on certain assumptions. The Department of Labor (DOL) is responsible for providing a model disclosure for plan sponsors. *Effective generally one year after rule issuance by DOL.*
Requires long-term, part-time workers be allowed to make 401(k) deferrals	The limit on restricting certain part-time employees from participating in a plan's 401(k) deferral feature is reduced from 1,000 hours annually to 500 hours. Part-time workers who work at least 500 hours for three consecutive years are allowed to participate. These individuals are excepted from nondiscrimination testing and top heavy contribution rules. *Effective for plan years effective beginning after 12/31/20 ; years prior to 2021 are not counted for this purpose.*

Provisions impacting plan participants and IRA owners

Increases the age for required minimum distributions (RMDs)	The age is increased from 70½ to 72. *Effective for those reaching age 70½ after 2019.*
Repeals age limit for traditional IRA contributions	This feature allows individuals who have reached age 70½, or their spouses, to make a traditional IRA contribution, provided they have earned income. Prior to the law change, those over the age of 70½ were limited to contributing to Roth IRAs only. *Effective for contributions made for tax years after 12/31/19.*
Repeals the "stretch" provision on inherited retirement accounts*	Most non-spousal beneficiaries are required to receive distribution of inherited account balances by the end of the 10th year following the year the account owner dies. There is no requirement for annual distributions; the account just has to be fully liquidated by the end of the 10th year. Prior to the new 10-year rule, beneficiaries could opt to "stretch" required distributions based on their remaining life expectancy, allowing remaining amounts to retain tax-deferred status. This change applies to inherited accounts (both traditional and Roth) for deaths occurring after 2019. Exceptions to the new 10-year rule apply to certain account beneficiaries who are still allowed to calculate required distributions based on remaining life expectancy: • Spouses • Beneficiary is disabled or has a chronic illness • Beneficiary is not more than 10 years younger than the deceased account owner • Beneficiary is a minor child of the deceased owner who has not reached the age of majority. In this case, once the age of majority is reached, the 10-year clock begins. *Effective for beneficiaries where the account owner dies after 12/31/19; existing "stretch" distributions from inherited accounts where the account owner dies before 2020, are not impacted until the current beneficiary dies, after which the 10-year rule applies to successor beneficiary(ies).*
Treats taxable, graduate school payments as IRA-eligible compensation	Taxable, non-tuition fellowship and stipend payments are treated as compensation for purposes of making a traditional IRA contribution. *Effective for tax years beginning after 12/31/19.*
Allows penalty-free retirement account distributions for birth or adoption	Account owner avoids the 10% early withdrawal penalty on a distribution for birth of a child or adoption, up to $5,000 per occurrence. To avoid the early withdrawal penalty, the distribution must be taken within one year of the birth or adoption. Account owners will have the option of repaying the distribution back into a retirement plan or an IRA. *Effective for distributions made after 12/31/19.*

* Existing annuity contracts that have been annuitized, or where the individual has selected an irrevocable income option to begin at a later date, are not subject to the new 10-year rule. A beneficiary who is not an individual (estate, for example) is still subject to the 5-year rule if the account owner dies before their required beginning date (RBD). If the account owner dies after their RBD, the distributions can continue based on the deceased owner's remaining distribution schedule. Detailed application of the new rule may vary depending on IRS guidance.

What is the impact on charitable distributions from IRAs?

While the law increases the age for required minimum distributions (RMDs) from 70½ to age 72, there is no change in the eligibility age for qualified charitable distributions (QCDs), which remains at 70½.

This provision allows retirees to donate up to $100,000 out of their IRA each year, provided the distribution is sent directly to a qualified charity (private foundations or donor-advised funds are not eligible). Since the distribution is not included in taxable income, taxpayers avoid the negative consequences that IRA withdrawals can create, such as taxation of Social Security benefits or higher Medicare premiums. In addition, this strategy offers the tax benefits of a charitable contribution, without having to itemize deductions on the tax return. Recent tax law changes limiting many popular deductions have resulted in fewer taxpayers itemizing deductions, and more claiming the standard deduction.

The new law includes an “anti-abuse” provision designed to address the situation where an older IRA owner makes a deductible IRA contribution and subsequently requests a QCD. In the event an IRA owner requests a QCD and has made deductible, traditional IRA contributions since reaching age 70½, the amount of the QCD is decreased by the cumulative amount of the deductible IRA contributions.

Consider this example:

- IRA owner contributes and deducts on their tax return $7,000 a year into a traditional IRA at ages 71, 72, and 73, for a total (tax deductible) contribution of $21,000 over the three-year time frame
- The next year, the IRA owner requests a QCD of $50,000 out of the traditional IRA. For that tax year, the amount of the charitable distribution ($50,000) would be reduced by the amount of the deductible IRA contributions ($21,000) for a net, tax-free QCD of $29,000. Consult with a tax professional to determine if the remaining $21,000 directed to the charity could be claimed as an itemized deduction on the tax return.

Other changes related to the law

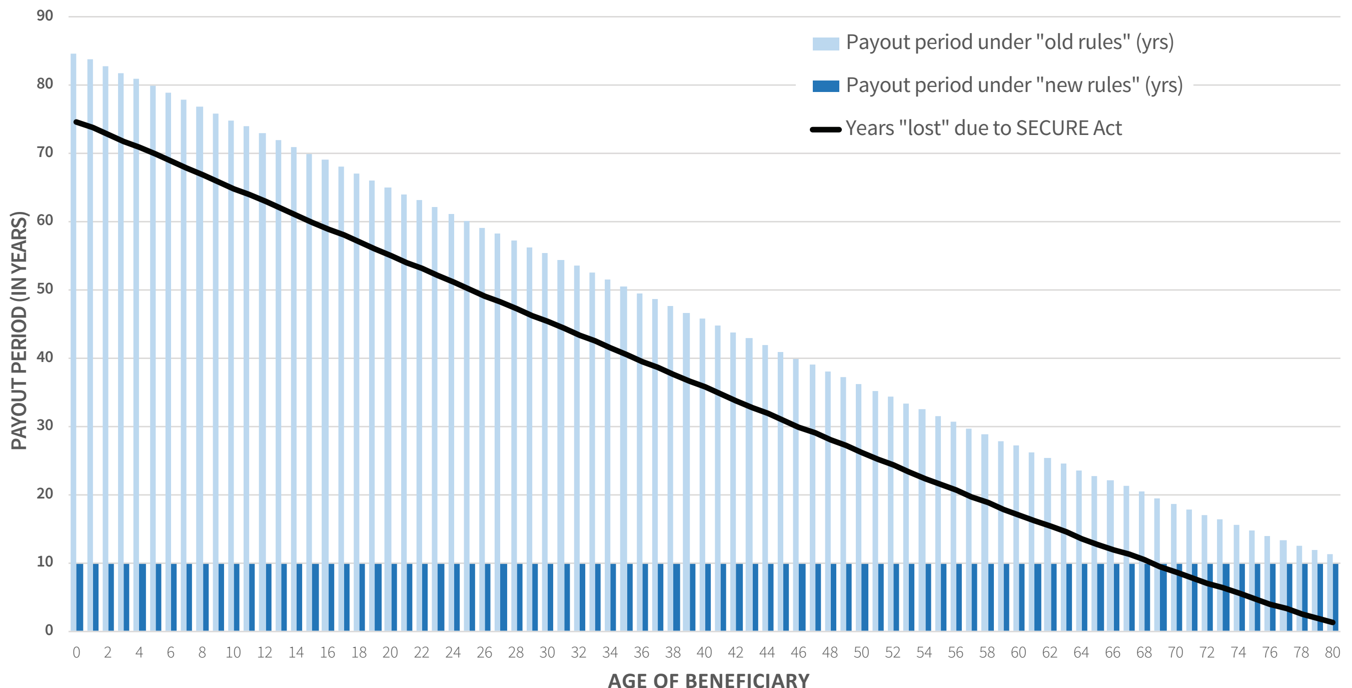
In addition to changes affecting retirement accounts and savings, the law made additional modifications that benefit 529 education savings plans:

- Expenses related to qualified apprenticeship programs are considered qualified expenses for 529 plans
- 529 account distributions, up to $10,000 total (not annually), can be used to repay student loans. This also applies to siblings of 529 account beneficiaries

Here are some other, tax-related provisions enacted by the law or as part of the broader spending appropriations bill that included the SECURE Act legislation:

- The kiddie tax reverts to the version in place prior to the passage of the Tax Cuts and Jobs Act (TCJA) where the child’s unearned income above a threshold (currently $2,300), is generally taxed at the parent’s marginal tax rate. Under the TCJA, unearned income above the kiddie tax threshold was taxed at the same rates as trusts and estates.
- The income floor for deducting qualified medical expenses remains at 7.5% of adjusted gross income (AGI) instead of increasing to 10% of AGI
- Certain taxes enacted by the Affordable Care Act (ACA) are repealed including the medical device tax and the excise tax on high-benefit health plans (referred to as the “Cadillac tax”)

Impact of SECURE Act with new 10-year rule



Based on single life expectancy table under proposed regulations issued in November 2019 and effective beginning in 2022. Assumes an individual beneficiary who does not qualify for an exception to the new 10-year rule.

Planning for the repeal of the “stretch” provision

While many of the provisions will benefit plans and individuals, a significant planning challenge for some retirement account owners and their heirs will be the elimination of the “stretch” provision. This can result in accelerating taxable income and creating “bracket creep” for heirs, some of whom may be in their peak earning years. Also, certain trusts may have been designed to ensure heirs do not withdraw funds too quickly from an inherited account. The repeal of the stretch provision will have a serious impact on this type of planning, as a full distribution of the account in many cases will be required within the 10-year time frame.

Here are some specific planning strategies to consider:

1. Tax-efficient timing of distributions

Heirs will want to plan distributions from inherited retirement accounts in conjunction with their income and other tax variables. For example, some heirs may benefit from pro-rating withdrawals from the retirement account over 10 years. Other heirs may want to withdraw more during years when income is lower or deductions (charitable contributions for example) are higher.

2. Roth conversions may mitigate taxes for heirs

While inherited Roth accounts are also subject to the new 10-year rule, qualified Roth distributions are tax-free for owners and beneficiaries. Converting traditional retirement accounts to a Roth while the account owner is living can avoid potential income tax issues to eventual heirs who no longer have the option of stretching required distributions over their remaining life expectancy, albeit at the cost of accelerating income taxes for the account owner on the converted amount.

3. Careful designation of beneficiaries

- Designate beneficiaries who may be in lower ordinary income tax brackets and leave other assets (such as appreciated stock outside of retirement accounts which benefit from stepped-up cost basis at death) to heirs likely to be taxed at higher ordinary income tax rates.
- Pass the retirement account to more beneficiaries, which will spread the inherited balance among more taxpayers. This may help control bracket creep for heirs by allocating taxable income across more tax returns. While two beneficiaries could spread the inherited retirement income across a maximum of 20 separate tax returns (2 heirs x 10 years), leaving the account to five beneficiaries could spread that income across 50 tax returns (5 heirs x 10 years).
- Leave account balances to spouses who are not subject to the 10-year rule.
- Reconsider leaving a retirement account to much younger beneficiaries (grandchildren, for example) as the tax benefit is vastly devalued since the account has to be fully liquidated within 10 years. For reference, under the old rules, a 25-year-old grandchild beneficiary had roughly 60 years to withdraw the account.

4. Existing trust beneficiary designations must be reviewed

Account owners who wished to control distributions to heirs following their death may have opted to assign a trust as the beneficiary of an IRA. This can occur for a variety of reasons such as where there are spendthrift concerns. These trusts, often referred to as "look through" or "see through" trusts, had to meet certain requirements to ensure required distributions could be stretched based on the remaining life expectancy of the trust beneficiary. These trusts fall into two categories: conduit and accumulation (or discretionary) trusts. Conduit trusts generally require that distributions are paid out to trust beneficiaries. Accumulation trusts provide the trustee discretion to determine the amount of funds distributed, if any, to beneficiaries. Distributions from the IRA may be retained inside of the trust.

The new law creates potential issues for both types of trusts, assuming an exception to the new 10-year rule doesn't apply (the beneficiary has a disability or chronic illness, for example). This also assumes that the IRS will continue to treat individual beneficiaries of appropriately designed conduit and accumulation trusts as individuals. For conduit trusts, the requirement to distribute all of the IRA funds within 10 years conflicts with the objective of establishing the trust in the first place for many IRA owners, i.e., being able to control the amount of funds the beneficiary receives. In this case, the IRA owner should consult with an attorney on what options exist, if any, to modify the trust arrangement. In some instances, the conduit trust may be modified to an accumulation trust (if the account owner is still living), which can exert some control over payments from the trust to beneficiaries.

While accumulation trusts offer the flexibility to control payments to trust beneficiaries and retain income inside of the trust, the IRA must still be liquidated within 10 years after the year the owner dies. This can mean acceleration of taxable IRA income retained inside the trust, which is taxed at less favorable trust tax rates (e.g., the highest marginal tax rate on trust income applies on taxable income exceeding $13,450 for 2022). Trust law is complex, so it is critical for account owners or beneficiaries to consult with an attorney.

5. Charitable trusts may be an alternative
A charitable remainder trust (CRT) may be an option to provide an income stream to non-spouse heirs over a longer time period than 10 years. The account owner designates the CRT as the beneficiary. Upon death, the IRA is transferred tax free to the charitable trust, which can provide income for heirs based on lifetime payments or a 20-year term, with the remainder interest retained by the charity. Beneficiaries of a CRT would generally report taxable income as distributions from the trust are received.

6. Utilize QCDs to spend down IRAs while living
Since the tax deferral benefit of retirement accounts for non-spouse heirs is lessened under the new law, this makes these accounts a less beneficial asset, on a relative basis, to leave to the next generation. For this reason, it may make sense for account owners (and spousal beneficiaries) to spend down a greater portion of funds while living, and designate other assets to pass to heirs. One tax-effective strategy for spending down an IRA is the QCD, which allows an account owner age 70½ or older to distribute up to $100,000 annually, tax free, to a qualified charity.

7. Fund permanent life insurance
Some retirement account owners may see a benefit from funding life insurance premiums with retirement account distributions while living, as a means to create a legacy for the next generation. If the life insurance is properly structured within an irrevocable, life insurance trust (ILIT), it can pass assets to heirs free of income and estate taxes at death.

A retirement savings opportunity for those over age 70½

The repeal of the age limit for making traditional IRA contributions means that older individuals who are still working can benefit from tax-deductible IRA contributions. In addition, taxpayers who are over the income limit to contribute to a Roth IRA* may want to consider funding a non-deductible (i.e., after tax) IRA contribution and subsequently converting that amount to a Roth IRA. This is sometimes referred to as the "back-door Roth IRA strategy," as there are no income restrictions on Roth IRA conversions. However, adverse tax consequences, referred to as the "pro rata" rule, may apply if the individual owns other pretax IRAs (including a SEP-IRA or SIMPLE-IRA). Before considering this strategy, taxpayers should consult with their tax professional.

* For 2022, modified adjusted gross income (MAGI) must be less than $129,000 ($204,000 if married filing a joint return) to make a full Roth IRA contribution.

The role of advice

With significant changes across retirement accounts, individual investors as well as business owners may consider the importance of seeking professional advice from their financial advisor or tax professional. Most of the provisions of the SECURE Act take effect in 2020 and careful planning, where possible, will be needed. Investors will want to review existing retirement and estate plans with an advisor to ensure that they are on track to meet their goals under the new law. For example, the repeal of the "stretch IRA" strategy has implications for estate planning. With the introduction of "open" multiple employer plans (MEPs) and expanded tax credits, smaller businesses have new considerations for establishing workplace retirement savings plans for their employees.

Consult a qualified tax or legal professional and your financial advisor to discuss these types of strategies. Personal circumstances vary widely so it is critical to work with a professional who has knowledge of your specific goals and situation.

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Many aspects of the SECURE Act are subject to guidance from the IRS, and that guidance may ultimately differ from current interpretations, including this material. This material has been prepared using available information, but there is no guarantee that final guidance will not introduce additional considerations or interpretations of the Act.

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