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Voices SECURE Act offers possible retirement strategies for accountants to discuss with clients

By Henry Montag, Brett Goldstein
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In a landslide vote of 417 to 3 on May 23, the House overwhelmingly voted to approve the SECURE (Setting Every Community Up for Retirement Enhancement) Act and send it to the Senate. This bipartisan bill has been in the news because it puts an end to "stretch IRAs" as we know them. However, what very few people have mentioned is the significant impact this bill would have on profit-sharing plans. Not only would stretch IRAs be dead if the legislation were to pass in the Senate, but your clients' profit-sharing plans could be next based on the new part-time participation requirements under the bill. The Senate has its own version of the bill known as the Retirement Enhancement and Savings Act (RESA), with some significant differences from the SECURE Act.

If you have an IRA, chances are the beneficiary is your spouse. However, if you have an IRA that you don't plan to use, then your beneficiary might be your youngest grandchild. The IRS requires that you withdraw a certain amount every year once you turn 70 ½, also known as a required minimum distribution, or RMD. The stretch IRA works because younger beneficiaries have smaller RMDs and thus they incur smaller taxes, allowing for a longer accumulation period and a larger sum of money going to the beneficiaries. The effective date for IRAs and the RMDs is 2020, and the effective date for retirement plans and RMDs is 2022.

The House version of the bill changes the stretch period to a maximum of 10 years. The Senate version allows a stretch on the first $400,000 of aggregated IRAs and the exceeding balance must be distributed within five years. Under current rules, if a 25 year old inherited a $1 million IRA, they would take a distribution over their life expectancy of 57.2 years. Their distribution would be approximately $17,482. The federal tax, assuming a 24 percent bracket, would be about $4,195. Under the SECURE Act, the beneficiary would have to withdraw all the money within 10 years. Thus, they could withdraw $100,000 per year and pay $24,000 in taxes each year, assuming the same 24 percent tax bracket and $40,000 in taxes if the beneficiary is a trust.

IRA trusts that were only used in estate planning or asset protection may become more popular as children under the age of 18 can't open an account in most states or name a beneficiary. There are minor children who may have thousands of dollars in taxable income under the SECURE Act. If the Senate version is signed by the president, non-spouse minor beneficiaries would have to withdraw $200,000 per year and pay a lot of taxes.

This affects not just children but those with conduit trusts. In a conduit trust, the RMDs pass through directly and immediately to a beneficiary. This rule allows for the smallest RMD to be paid. Under the SECURE Act, the beneficiary would have to take a lump sum distribution by the tenth year and pay the hefty taxes. Conduit trusts should be converted to accumulation trusts to avoid the lump sum payout in the tenth year.

Life insurance will become a more important planning tool as people may need a way for minor children to pay the income taxes without further eroding their inheritance. For those who can't get life insurance due to medical issues, Roth IRAs and Roth 401(k)s may also provide a great way to pass wealth tax-free to the younger generation.

However, before your clients contribute to a Roth 401(k), if they are self-employed or own their own business, they may want to think twice about contributing. The reason being that your clients' 401(k)s and profit-sharing plans will also be affected by the SECURE Act, by creating a new class of employee called a long-term part-time employee. It's similar in the Senate version, the RESA Act.

For years, all part-time employees who worked under 1,000 hours could be excluded from 401(k) and profit-sharing Plans. If passed, the SECURE Act would allow employees who work at least nine and a half hours per week and have been with the employer for at least three consecutive years (under the Senate version, it's two years) to contribute to a 401(k) and receive a safe harbor match under the new long-term part-time rule.

Both bills state that long-term part-time employees could continue to be excluded from the profit-sharing and top-heavy contributions. The problem is that profit-sharing plans also have to pass non-discrimination testing. RESA would provide that these long-term part-time employees would be excluded from the non-discrimination testing. The SECURE act makes no reference to whether these part-time

employees would be excluded from non-discrimination testing. We will have to see which version is ultimately agreed upon. Hopefully the provisions in the Senate version will prevail and these part-timers will be excluded from the non-discrimination testing. Otherwise part-time employees working nine and a half hours per week will be mandated to receive employer-matching and profit-sharing contributions, which we feel will result in many employers deciding to terminate these plans.

Let's say an employer has 10 part-time employees earning $10,000 per year that have been excluded from the 401(k). Under a safe harbor 401(k) profit-sharing plan, these 10 part-time employees may now be required to receive anywhere from 3 to 9 percent of their salary in matching and profit-sharing deposits. If employers will be required to contribute to part-time employees in the form of matching and profit-sharing deposits in order to satisfy non-discrimination testing, then how long will it be before they start terminating these plans?

However, there is a light at the end of this tunnel. The SECURE Act and RESA only makes changes to 401(k) and profit-sharing plans. Under the current proposals, there are no changes being proposed to defined benefit plans. Thus, to eliminate part-time employees from a retirement plan, employers may need to consider a defined benefit plan instead of a profit-sharing plan. There are significant advantages to a defined benefit plan, including higher contribution limits, and the ability to make tax-free distribution for medical expenses, assuming the defined benefit plan has a 401(k) component (see Stop deducting medical expenses. Here's what to do instead).

These areas, while not the sole intent of the bill, constitute significant changes that accountants will need to consider in order to determine whether it still makes sense for a client to maintain a 401(k), and whether a non-spouse beneficiary is in compliance and has taken their RMD within the required five or 10 years.

There's more to come on each of these and other topics once it becomes clear how the chairman of the House Ways and Means Committee, Richard Neal, D-Mass., and the top Republican on the committee, Rep. Kevin Brady, R-Texas, will work out the details as to which version will be adopted and sent to the president for his signature. Some believe this could happen as early as this summer or fall.

Henry Montag

Brett Goldstein