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Planning Alternatives & Considerations as a Result of The SECURE Act

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Your client's retirement nest egg should feel more secure now that the president has signed the Setting Each Community Up for Retirement Enhancement (SECURE) Act.[1] However, depending on how much money is in their retirement nest egg, they may not be SECURE at all.

AN OVERVIEW

In May of 2019, the SECURE Act passed the House of Representatives by a practically unanimous margin of 417 yeas to three nays. In the Senate, a few Senators objected as the SECURE Act didn't permit workers to use 529 college savings accounts to pay tuition for K-12 schools. Thus, the SECURE Act stalled in the Senate for the next six months.

The U.S. Congress then crafted a bipartisan 2020 budget bill that would avoid a government shutdown and provide a combined $1.4 trillion for the fiscal year 2020 across military and civilian departments. Looking to get the SECURE Act passed, Congress added the SECURE Act to the 2020 budget bill, and it was signed into law by the president on December 20, 2019.

ONE CHANGE TO AFFECT MANY

One change that will affect virtually all your clients is the change to the Required Minimum Distribution

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[1] Enacted under the Further Consolidated Appropriations Act, 2020, Pub. L. No. 116-94.

(RMD) rules. Before the SECURE Act, Americans needed to take a required minimum amount from their IRA in the year starting at age 70½. Under the new law, the age is increased to 72.[2]

The SECURE Act also eliminated the maximum age for someone to make a traditional IRA contribution. Under the old law, once someone reached age 70½ they were no longer allowed to make an IRA contribution. Under the SECURE Act, an individual over age 70½ can now make an IRA contribution of up to $7,000 as long as they have that much earned income.

There is a caveat to this new law. Anyone who turned 70½ years old in 2019 will still need to withdraw their required minimum distributions this year. Failure to do so results in a 50% penalty of their RMD. Americans who are expected to turn 70½ years old in 2020 will not be required to withdraw RMDs until they are 72. This rule grandfathers all participants that were already taking their 'Stretch IRAs' prior to December 31, 2019.

THE BAD NEWS

Some of the good news concerning the SECURE Act is largely overshadowed by the bad news. The SECURE Act has disrupted any previous retirement distribution/estate planning a client may have previously completed.

ELIMINATING THE STRETCH ADVANTAGE

The change that's responsible for the largest financial hardship to the client is, the change to the length of time a non-spouse beneficiary that inherits a traditional IRA must make their distributions and pay their associated tax obligations. The ability to spread out these distributions after the death of the IRA owner for a limitless amount of time was known as the 'Stretch IRA.' Under the SECURE Act,[3] if the beneficiary is more than 10 years younger than the IRA owner, they must liquidate the account within 10 years unless they are a spouse, disabled, chronically ill, or a minor child which is discussed more in detail below. For example, under the old law, IRA owners could pass their IRA onto their children and grandchildren. The kids or grandkids of IRA owners could stretch the IRA distributions over the life of the beneficiary. What once was a very tax efficient means of accumulating and allocating assets for members of the next generation is no longer available.

For example, 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% bracket, would be about $4,195. Under the SECURE Act, the beneficiary will have to withdraw all the money within 10 years. Thus, the beneficiary would withdraw $100,000 per year and pay $24,000 in taxes each year or withdraw all the money in the tenth year and pay the prevailing tax at that time. One way to offset that higher tax burden on the beneficiaries would be for the owner of the IRA to gift IRA assets to be used to purchase additional life insurance to make up for the additional taxes due for the increased distributions, as well as for the higher rates as a result of having to bunch up their distributions over a shorter period of time, particularly in their peak earning years.

IRA owners certainly considered naming a non-spouse beneficiary to their IRA. However, the income tax they would have to pay was an issue. To avoid the large income burden, RMDs were paid to a ''conduit trust'' that would pass the RMDs to the beneficiary. Using a trust, preserved the balance of the IRA by protecting it from beneficiaries who might spend all of the inheritance. Under the SECURE Act, the IRA assets in a conduit trust will have to be distributed under the new 10-year period.

EXCEPTIONS FOR RECIPIENTS

Congress did give an exception to certain people from this new 10-year rule. Spouses can roll retirement assets, like IRAs, 401(k)s, and other retirement plans, over to their own IRA and take their RMDs once they reach age 72.

CHRONICALLY ILL

Other exceptions include chronically ill heirs and disabled heirs. Chronically ill is defined as someone unable to engage in any substantial gainful activity because of any medically determinable physical or mental impairment which can be expected to result in death. Chronically ill is also defined as an illness that is indefinite duration. Under the SECURE Act, disability is defined as being unable to perform (without substantial assistance from another individual) at least two activities of daily living for at least 90 days due to a loss of functional capacity.

That means on the date of death, a chronically ill beneficiary will need a doctor's note stating that on the date of death they were chronically ill and unable to engage in any substantial gainful activity. A dis-

[2] *See* §401(a)(9)(C)(i)(I). All section references herein are to the Internal Revenue Code of 1986, as amended (the "Code"), or the Treasury regulations promulgated thereunder, unless otherwise indicated.

[3] *See* §401(a)(9)(H), as added, and §401(a)(9)(E), as amended.

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abled beneficiary will need to show that they cannot perform at least two activities of daily living. This may result in higher taxes on disabled or ill people who couldn't prove their disability or illness.

MINOR CHILDREN

The last exception is for minor children. If the child is considered a minor, the 10-year rule doesn't apply. Once the child is no longer considered a minor, then the child must withdraw the IRA proceeds within the 10-year period. There is a question as to what age a child is considered a minor. Most states provide that the age of majority is 18, but it can be argued that the federal age of majority can be based on an extended time if one is engaged in a specific course of education and is under age 26.

FUTURE PLANNING OPPORTUNITIES

Now that the SECURE Act has passed, what should your clients do now? Anyone who has left money to a child, grandchild, or trust will need to revisit their estate plan and beneficiary forms to see how the SECURE Act has affected them. Special consideration should be paid to retirement plans and certain IRA institutions. Without a beneficiary on file, some retirement plans and certain IRA institutions will default to the estate. This would be devastating to a spouse who should have inherited the money and would have avoided the 10-year rule. Without a beneficiary on file, the estate would immediately pay the tax on the retirement asset.

A WORD ABOUT LIFE INSURANCE

Life insurance will become a more visible and important planning tool as people realize that life insurance is a very efficient way for children and non-spouse beneficiaries to pay the increased income taxes on their distributions so as to prevent the further erosion of their inheritance. There will be many useful, creative, and efficient new ways to use life insurance and annuities to supplement and ease the tax burden of the beneficiaries. One way to offset the higher taxes would be for the owner of the IRA to gift IRA assets to be used to purchase sufficient life insurance to pay for the additional taxes. Taxes which may be at the higher rates as a result of beneficiaries having to bunch up their distributions over a shorter period of time, particularly since many may be in their peak earning years.

Some of the more popular planning strategies can include converting all or a part of the proceeds to a Roth IRA, or simply using a Charitable Remainder Trust (CRT) to make a charity a beneficiary, thereby retaining the ability to defer paying the taxes beyond the 10 year-period. The IRA holder can then purchase a single life or second to die life insurance policy in that amount, providing a leveraged and tax- free death benefit back to the family. There's also an opportunity to provide life insurance payouts on an inter-generational basis where the IRA holder can make a gift of life insurance to insure the second generation, (sons and daughters), for the future benefit of the third generation, (the grandkids).

The government is also doing its share to make it easier for retirement accounts to be converted to a lifetime annuity through safe harbor provisions that allow employers to offer annuities inside qualified plans. Since the SECURE Act will be a major reason for many agents and brokers to suggest that their client's purchase new life insurance and annuities, keep in mind that there are many different types of life insurance products, each with their own distinct features, benefits, and best uses.

While your clients should be made aware of the various risks involved with each product they're considering, many will none-the-less, not fully understand their exposure to the various risks they're accepting. This despite the fact that an agent or broker under the new 'Best Interest 'rules must provide their client's with full written disclosure as to the risks involved, and an understanding of what a particular type of life insurance product can and cannot accomplish.[4]

It's also important for client's to be aware of the varying costs for those products and riders, as some contain guarantees, and others do not. Some contain long term care riders, which provide coverage for such expenses, while others do not. Lastly help your clients understand that life insurance is a 'Buy and Manage' asset, not a 'Buy and Hold' asset, as many mistakenly believe. This means that ratings and financial information including internal costs, and crediting rates will change, therefore requiring the owners ongoing active management to prevent their coverage from expiring prematurely, as an increasing number of life Insurance policies already have. The point is your clients could now use a little extra assistance with their life Insurance, to make certain they understand what they're actually purchasing, and to avoid any unpleasant surprises in the future. They'll thank you.

EASIER RETIREMENT PLAN ACCESS FOR SMALL BUSINESS

If a business does not have a 401(k) plan, the SECURE Act made it easier for small businesses without a 401(k) to get one and it provides incentives. There are new and increased tax credits for employers to start a plan.[5] There is also an additional $500 per

[4] 11 NYCRR §224.4.

[5] §45E, §45T.

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year tax credit (up to three years) for employers who use automatic enrollments in their 401(k) plan.

For small businesses looking to get into a low cost 401(k) plan, the SECURE Act changed the Multiple Employer Plans (MEPs) rules.[6] There are two types of MEPs: open; and closed. Closed MEPs have become very popular for businesses that had some commonality. For example, businesses that belonged to a trade group, a chamber of commerce, or a similar business association were considered a closed MEP. Because all members of a trade group or association had something in common, they could all belong to the trade group's 401(k) plan. With everyone coming together under one plan, all of the members could get better pricing on the 401(k); since they had more money and more negotiating power.

Open MEPs, on the other hand, were businesses that had no commonality and due to bad legislation, were prohibited from banding together to get better 401(k) pricing. However, the SECURE Act contains adjustments to MEP provisions that make it much easier for small businesses to start or join a MEP. Your business no longer needs to have any commonality with other businesses in the MEP 401(k). Thus, you will not have to join a trade group or association to get a low cost 401(k) plan. The new MEP provisions will not take effect until January 1, 2021.

Another benefit to come from the SECURE Act, is that 401(k) plans can now be set up before the due date of the tax return. Under current law, a 401(k) will need to be set up before the end of the plan year. This gives businesses a great tax planning opportunity to set up a 401(k) in January or February for the previous tax year. Besides, employers will now be required to advise employees of the amount of sustainable monthly income that their 401(k) balance could support. This rule now opens the door to income planning, which may include annuities and educational advice that many employees and their families will benefit from.

EASIER RETIREMENT PLAN ACCESS FOR PART-TIME EMPLOYEES

Since 401(k) plans started, they were predominately for full-time employees. Part-time employees who worked under 1,000 hours could be excluded from 401(k) and Profit-Sharing Plans. The SECURE Act now allows employees who work at least nine and a half hours per week and have been with the employer for at least three consecutive years to contribute to a 401(k).[7] The SECURE Act also excludes these long-term part-time employees from profit-sharing, matching, and top-heavy contributions. It even removes them from non-discrimination testing, which is of great news to business owners. This new long-term part-time employee rule will not take effect until 2021 and any service before 2021 will not be counted toward the three consecutive year rule.

THE BAD NEWS FOR BUSINESSES

The SECURE Act will increase certain fines and penalties for 401(k) and other retirement plans. When a business has a retirement plan, it needs to file a Form 5500 with the Department of Labor. Form 5500 is due seven months after the close of the plan year, which is July 31 for a calendar year plan. There is a two-and-a-half-month extension available, allowing calendar year businesses to file on October 15.

The penalty for submitting the Form 5500 late was $25 per day up to a maximum penalty of $15,000. The SECURE Act increased the penalty to $250 per day up to a maximum of $150,000.[8] The Department of Labor can also levy a fine for not filing the Form 5500 promptly. The Department of Labor penalty is $2,194 per day with no maximum. The Department of Labor penalty is in addition to any penalty that the IRS may levy. For being one year late with a Form 5500, potential penalties are in the hundreds of thousands and could bankrupt a small business. Thus, it behooves all attorneys to make sure that their clients file the Form 5500 on time.

IN SUMMARY

While the SECURE Act does make beneficial changes, the changes don't go far enough to help Americans save for retirement. Also, the changes are very complex. Attorneys need to become familiar with those changes and guide their client's through the maze of options explaining what the individual benefits and detriments are for each choice. Perhaps our most important role is to educate the client and make them aware of the new rules with the intent of assisting them to maximize their retirement assets that they've allocated to the next generation, in the most economical and tax-efficient manner.

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[6] *See* §413(e), as added.

[7] §401(k)(2)(D), §401(k)(15).

[8] §6652(e).

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