BAIRD
Private Wealth Management

Highlights of the SECURE Act

Increased accessibility for retirement savers; additional beneficiary designation complexities

After several Congressional delays, the Setting Every Community Up for Retirement Enhancement Act of 2019 (SECURE Act) set to finally become law.

Financial & Estate Planning Department

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For the first time in more than a decade, Congress has pushed through important measures to help millions of Americans save more towards retirement. This bill, as signed into law by President Donald Trump on December 20, 2019, provides many changes to ensure accessibility for all, and will become effective on January 1, 2020.

MAJOR CHANGES TO INDIVIDUAL RETIREMENT ACCOUNTS (IRAS)

One of the more notable changes enacted by the SECURE Act is the removal of the age cap on making a contribution to a Traditional IRA. Currently, individuals are prohibited from making contributions to a Traditional IRA starting in the year they turn 70 ½. Starting in 2020 and similar to the current contribution rules for a Roth IRA, an individual with earned income can make a contribution to a Traditional IRA. This is a huge step for retirement savers, especially as people, on average, are working longer.

Not only are more individuals working longer, Congress has also recognized that people are living longer too. As a result of the increase in life expectancy, the required beginning date for taking distributions from a Traditional IRA has now increased from 70 ½ to 72. However, it should be noted that the required minimum distribution start date change only applies to those individuals that have not attained age 70 ½ in 2019 or before. Individuals who have attained age 70 ½ in 2019, or before, cannot defer future required minimum distributions until reaching age 72. Rather these individuals must continue the course of taking their required minimum distributions (RMDs), annually.

WEALTH TRANSFER PLANNING IMPLICATIONS

Since 2012, Congress has made various attempts to limit a non-spouse beneficiary from stretching out an Inherited IRA over their lifetime while continuing to allow the Inherited IRA to grow on a tax deferred basis. This benefit is magnified with younger beneficiaries. By accelerating the taxation of the Inherited IRA, individuals would not only pay taxes faster, but the increased distribution amounts could lead the individual to owe a greater amount of taxes in that year. Moreover, once the money was outside of the Inherited IRA, the individual would either spend the after tax amount in the economy or invest in the economy. By investing in the economy the IRS would again be set to tax the increase in value upon sale of the asset. In fact, the IRS has projected that removing the stretch-out provision for non-spouse beneficiary would generate over $2 billion in tax revenue within 10 years. After seven years of failed attempts to change the stretch-out rules, Congress has finally achieved its goal to eliminate the stretch-out of an Inherited IRA. Instead, most beneficiaries must fully withdraw the balance, and thus recognize the income, by the end of the 10th year starting in the year after the original IRA owner's death. These new rules apply to all IRA owners that die after December 31, 2019.

However, there are exceptions that allow certain “Eligible Beneficiaries” to avoid the 10-year, anti-stretch, rule. The following individuals may elect to stretch their Inherited IRA within applicable limits, each determined as of the date of the decedent/owner’s death:

(i) **Spouses**: A spouse may continue to elect to roll a deceased spouse’s IRA into their own, or they may elect to receive an Inherited IRA to be distributed over the course of their life expectancy;

(ii) **Minor children**: A minor beneficiary may stretch the Inherited IRA over their life expectancy until they reach the age of majority. However, the 10-year clock starts running upon the attainment of such age, and they must fully withdraw the funds from the Inherited IRA within the 10 year window starting in the year in which the child attains the age of majority;

(iii) **Disabled Persons**: Certain individuals with disabilities defined under I.R.C. 72(m)(7) may stretch the Inherited IRA over their life expectancy;

(iv) **Chronically ill Persons**: Certain individuals with chronic illness as defined under I.R.C. 7702B(c)(2) with certain required certifications made may stretch the Inherited IRA over their life expectancy; and

(v) **Persons Close in Age**: A person who is not more than 10 years younger than original IRA owner may stretch the Inherited IRA over their life expectancy.

The anti-stretch provision drastically changes how your advisors will view IRAs as a wealth transfer vehicle. Strategies have changed and it is imperative that you work with your advisors to thoughtfully consider your options when naming beneficiaries and, perhaps, taking steps during your lifetime to change the tax status of a portion of your Traditional IRAs.

In the past, a common estate planning technique for IRA owners with sizable IRA values has been to establish long-term trusts for their children and naming the trust as the beneficiary of their retirement accounts. These trusts could include “conduit provisions,” to allow for the Inherited IRA payments to be stretched over the lifetime of the trust’s beneficiary (child), by requiring that all retirement account distributions to the trust (the required minimum distribution amount and any other distribution from the Inherited IRA), be further distributed outright to the beneficiary. This offered the best of both worlds: tax deferral for the beneficiaries, and protection of the principal. However, now that the SECURE Act requires a 10-year payout, conduit provisions may cause the rapid depletion of an important trust asset, while negating the spendthrift and creditor protection over substantial trust funds. It will become important for retirement account owners to consider their primary goals in estate planning with their accounts.

Regardless of your goals, it is imperative that you review the beneficiary designations on all of your accounts, with your advisors, to identify new planning opportunities and minimize unintended consequences.

SAVINGS FOR STUDENTS & HOME CARE WORKERS

Prior to the passage of the SECURE Act, students who were the recipients of stipends and non-tuition fellowship payments were not able to count those funds as earned income. Under the new law, these dollars will now count as earned income, and subsequently, can make one eligible for contributions into an IRA.

Similarly, individuals who provide in-home health care had previously been unable to count income that would otherwise be considered a “difficulty of care” payment. These payments will now be considered compensation for purposes of calculating contributions to retirement plans and IRAs.

529 RELATED PROVISIONS

While most updates to the law centered on retirement savings, there were a few additions to the bill in other areas. For families, there have been two major changes. Up to $10,000 of 529 plan assets can now be used to pay off student debt of a 529 plan beneficiary during an individual’s lifetime. Up to $10,000 can also be used for any siblings of the plan beneficiary. Eligible loan expenses include any payments made to principal or interest. This change is effective at the federal level, but plan owners and/or beneficiaries ought to check with their specific state plan, as this tax free treatment at the federal level may not carry over at the state level.

The definition of a qualified education expense for which 529 proceeds can be used has also been expanded. Qualified education expenses now include expenses related to apprenticeship programs registered and certified with the Secretary of Labor.

ADDITIONAL EXCEPTION TO EARLY WITHDRAWAL PENALTY FROM QUALIFIED PLANS AND IRAS

The SECURE Act adds a new exception to the 10% early distribution penalty from retirement accounts for qualified childbirth or adoption expenses. An IRA owner is allowed to withdraw up to $5,000 during their lifetime for this exclusion. A qualified birth or adoption distribution refers to any distribution that was made during the one-year period beginning on the date on which a child of the individual was born or on the date during which a legal adoption is finalized.

To qualify for the adoption portion of the provision, an “eligible adoptee” means the adopted individual has not attained the age of 18 or is mentally incapable of self-support at the time the adoption occurs. The distribution cannot be taken before the child is born or adopted, even if it’s for costs related to a planned birth or adoption.

If the distribution is taken from a qualified plan, it is exempt from the mandatory 20% withholding requirement.

OTHER PROVISIONS OF SECURE ACT

Two other non-retirement related provisions that were included in the SECURE Act include:

For volunteer firefighters and emergency medical responders, a special exclusion has been reinstated allowing for reimbursement payments to qualifying individuals. The exclusion for these payments has gone up to $50 per month in those months where the individual has participated in volunteer services.

The other change increases the penalty for failure to file taxes, aimed at reducing the number of taxpayers that miss filing deadlines or skip filing altogether. For taxpayers, this figure is now the lesser of $400 or 100% of the tax due. There was also an increase in the penalty for failing to file for retirement plan returns, which can promote timely filing and adherence to the rules.

CHANGES TO EMPLOYER RETIREMENT PLANS

Many of the changes resulting from SECURE Act focus specifically on employer retirement plans and increasing accessibility for retirement savers abound. In some cases, the changes seem slight in nature, but for participants in retirement plans, both large and small, these can have a big impact over time. Employer retirement plans must go through vigorous testing each year to ensure they are in compliance and some of the changes enacted through the new bill increase plan scrutiny, including increased plan access for new employees. Previously, it was challenging for a part-time employee to get access because employers could stipulate that they had to work at least 1,000 hours during the year to become eligible. Now, the rules are more flexible, and a participant can be admitted if they meet the 1,000-hour minimum in a single year, or if they have at least 500 hours of service annually in three consecutive years.

Additionally, employers can elect to have an auto-enrollment feature in the plan whereby new additions get enrolled at a starting percentage of the individual’s salary and each year that percentage goes up. Previously, employers had a maximum of 10% that this percentage could go up to, but the SECURE Act has changed that to 15%. For those employees with a ‘set it and forget it’ mindset, this feature can amount to greater savings without much effort.

Along those same lines, stricter rules have been enacted around plan notices, which allow for greater flexibility and more seamless plan administration, so employers can focus on what matters most, such as providing fair disclosures on what an individual’s potential balance could generate in annual income. To encourage more small businesses to set up plans, the bill offers increased credit opportunities to employers to help offset the startup fees of starting a plan, making the barriers to entry much lower. Further, depending on the plan type started, employers can get an additional credit for adding an auto-enrollment option to their plan, which has been shown to increase participation across the board.

One of the most notable changes in the retirement plan space from SECURE Act is the additional language it has provided around pooled retirement plans. As previously noted, the barriers and costs to starting a retirement plan are not cheap, and one option now available is to allow multiple small businesses to share in a single plan, helping to add scale and making administration more affordable. The bill further outlines the protection offered to each employer, in the event one of the other employers in the plan does not conform to the rules.

FIXES AND EXTENDERS

Congress tied the SECURE Act to the Appropriations Bill, which allowed Congress to add-on various tax extenders, while also fixing a provision from the Tax Cuts and Jobs Act (TCJA) of 2017.

Under TCJA, a child’s unearned income (“kiddie tax”) was taxed under Trust & Estate Tax rates. The fix moves the child’s unearned income back to the parents’ tax rates beginning in 2020.

As for tax extenders, individuals itemizing their unreimbursed medical and dental expenses will continue to use the 7.5% adjusted gross income (AGI) floor instead of the 10% of AGI floor, which was the default for 2020.

Many of the changes enacted in the SECURE Act are aimed at helping the millions of Americans saving for retirement. If you have additional questions on the SECURE Act or would like to further discuss how it impacts your financial plan, do not hesitate to contact your Baird Financial Advisor.