Top 10 Opportunities and Pitfalls for Individuals in the New SECURE Act

Legislation known as the “SECURE Act” -- passed as part of the year-end spending package adopted by the U.S. Congress and signed into law shortly thereafter – provides a host of expanded options for individuals planning for retirement and for their estate, but also some new pitfalls that require awareness.

The intent of the SECURE Act (of which the full name is the Setting Every Community Up for Retirement Enhancement Act) is to facilitate improved retirement savings for individuals.

- The Act provides improved **incentives to encourage individuals to plan for retirement**.
- But – beware! – the Act provides those incentives at the expense of **new restrictions on the use of retirement plans for estate planning purposes**.

Here are 10 ways in which the new Act will affect individuals who are planning for retirement and distribution of their estate:

1. <u>Restrictions on the Ability to “Stretch” an IRA</u>. Prior law permitted an individual retirement account (“IRA”) that was inherited by a beneficiary to be “stretched” over the lifetime of the recipient. That is, the balance of the inherited IRA could be withdrawn over time and (since traditional IRA balances are only taxed upon distribution) the resulting tax burden spread out. As a result, IRAs were commonly used in estate plans, often paired with a trust that protected the recipient from imprudent spending of the principal.

   The SECURE Act, in order to shift priorities to retirement, eliminates the ability to “stretch” an inherited IRA in many cases (see exceptions below). Instead, the inherited IRA must be distributed within 10 years of the decedent’s death. There are no required distributions during the 10-year period.

   The taxation of the mandatory distributions may hit during the recipient’s peak earning years and, if the recipient waits until the end of the 10-year period, the tax consequences could be substantial. As a result, if an IRA of significant size is likely to be inherited, then the account owner should engage in careful consideration of the tax consequences.

   - The repeal is NOT retroactive to existing inherited accounts. The repeal of the “stretch” only applies to inherited accounts from decedents who pass away after December 31, 2019. IRAs that have already been inherited can continue to “stretch.”
   - Certain beneficiaries will retain the ability to “stretch”:
     - Spouses;
     - Disabled or chronically ill persons;

    - Minor children during their minority (but such children must distribute the account balance within 10 years after reaching majority); and

    - Beneficiaries of an age within 10 years of the decedent's age (in other words, a sibling beneficiary may be allowed to stretch but a child or grandchild beneficiary will not).

- All beneficiaries of inherited accounts for decedents who pass away after December 31, 2019 who are not included in the above list will lose the ability to stretch.

2. Need for Renewed Planning. In light of the repeal of the "stretch" in many cases, owners of retirement accounts should reconsider the tax consequences of the disposition of such accounts in their estate plans.

    - While many commentators are suggesting that retirement plan trusts are no longer useful, a properly designed trust can still minimize taxes and provide asset protection to beneficiaries. A "stretch" can always be achieved through a trust. It is simply the tax consequences that change. To the extent a stretch was desirable to ensure a life income stream for a beneficiary (versus just saving taxes), retirement trusts remain viable.

    - Use of life insurance held in trust for beneficiaries not eligible for the stretch also may be a desirable option.

    - Beneficiary designations on retirement accounts – particularly designations to non-spouses – should be considered. Designation of persons not eligible for the stretch may result in unexpected tax burdens for such beneficiaries. Designation of charities or certain types of charitable trusts may be an option.

    - For those eligible, conversion of some retirement balances to "Roth" status may be an efficient means to redistribute tax burdens. "Roth" accounts can be distributed tax free since the account owner pays the tax "up front."

3. Greater Flexibility for 529 Plans. Section 529 plans permit tax-advantaged savings for education expenses. The Act permits owners of 529 accounts to use the tax-advantaged savings with greater flexibility.

    - Since not all beneficiaries may pursue higher education, the Act permits use of 529 funds for expenses of qualifying apprenticeship or other trade programs.

    - The Act will permit up to $10,000 of a 529 account to be used to repay student loans for the beneficiary or a sibling.

4. Required Minimum Distributions Begin Later in Life. The Act moves the starting age for required minimum distributions from retirement accounts from 70-1/2 to

72. Account owners will be able to build up account balances for a longer period before withdrawals must begin. The amendment is intended to take into account longer life expectancies compared to the adoption of the original age requirement in the 1960s.

- Account owners who turn 70-1/2 in 2020 need not make required minimum distributions until the year in which they turn 72. Account owners who turned 70-1/2 in 2019 are subject to the prior rules.

5. Coverage of Long-Term Part-Time Employees in 401(k) Plans. Current law allows employers to exclude part-time employees from 401(k) plans by setting an eligibility limit no less than 1,000 hours worked per plan year. The Act adds a second lower boundary for eligibility for part-time workers who work at least 500 hours per plan year, but for a period of three consecutive years. Employers will be required to allow part-time employees who meet the threshold to participate in the plan.

   - The expansion to cover long-term part-time employees will take effect for 401(k) plan years beginning after December 31, 2020.

   - Long-term part-time employees have been limited to individual accounts under prior law. The Act will expand access to employer-sponsored retirement plans for such employees.

6. Repeal of IRA Age Limit. Prior law prevented account owners from making further contributions to an IRA after age 70-1/2. The limit applied even if the account owner continued working. The Act repeals the age limit so that account owners can contribute as long as desired regardless of age.

   - The repeal takes effect for persons turning 70-1/2 after December 31, 2019.

7. Withdrawal Without Penalty for Birth or Adoption. Certain types of expenses can be funded with withdrawals from a retirement account without the usual early withdrawal penalty. The Act adds a new category of exclusion for parents incurring expenses following a birth or adoption. The withdrawal for such expenses is limited to $5,000 for each birth or adoption.

   - Withdrawals for such purposes can be made without penalty if made after December 31, 2019.

8. Treatment of Income of Graduate Students & Home Health Workers. Certain payments to graduate students and home health workers are excluded from gross income for federal income tax purposes. While avoiding taxation, such treatment also prevented such payments from being used as the basis for contributions to retirement accounts. The Act will treat such payments as included in gross income solely for the purpose of calculating permitted contributions to retirement accounts.

- Such treatment will apply for tax years after December 31, 2019.

9. Limits on Form of 401(k) Loan Plans. Certain employers have offered loan options under their 401(k) plans in the form of a credit card. The Act will prohibit such options. Employees using or anticipating use of such a loan option will not be able to do so.

    - The prohibition takes effect immediately.

10. Lifetime Income Options under 401(k) Plans. The Act adopts provisions intended to make "lifetime income" options (usually annuities) more attractive under employer-sponsored plans. Persons interested in ensuring a lifetime income stream will receive new information from employers about such options under employer-sponsored plans.

Individuals will have a variety of reasons to reconsider their retirement and estate planning options in light of the Act, particularly if there is the possibility of a significant inherited IRA passing to a beneficiary that is not eligible for the stretch.

Vandenack Weaver attorneys can assist in your analysis.

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