CHIEF INVESTMENT OFFICE

Tax Bulletin 2019–05

SECURE: Retirement Legislation

January 2, 2020

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OVERVIEW

On December 20, 2019, new tax legislation was enacted, the Setting Every Community Up for Retirement Enhancement Act of 2019, known by its acronym "SECURE." This new legislation, which is part of a broad appropriations bill for fiscal year 2020, makes several changes to tax laws that could have a significant effect on retirement planning. More broadly, SECURE is aimed at providing retirement plan access for small business employees by making it easier for small business employers to offer plans (on their own or by joining with other employers in a multi-employer plan) and by providing enhanced, initial and annual, tax credits to certain employers starting new plans. This Tax Alert summarizes several provisions of SECURE likely to be of interest to clients.

PROVISIONS AFFECTING IRAs AND 401(K)s

Increase in Age for Required Minimum Distributions

Participants in a qualified plan (e.g., a 401(k)) and owners of traditional IRAs are generally required to begin taking distributions at age 70½, though they may defer the distribution for the year in which they reach age 70½ until April 1 of the following year. There is an exception for an employee participating in a qualified plan like a 401(k) who is not a 5% owner of the company. In that case, the employee may defer withdrawals until retirement from the company.

The SECURE Act increases the required minimum distribution age from 70½ to 72. This change would be effective for required minimum distributions for individuals who attain age 70½ after December 31, 2019. For those turning age 70½ in 2019 or earlier, this new provision would not apply and they must continue to take their annual required minimum distributions under the pre-SECURE rules.

The End of "Stretch" Distributions From IRAs and Qualified Plans

Upon the death of an IRA owner or qualified plan participant, it is common planning to leave the retirement assets to one's spouse. If there is no spouse, it is common planning to leave the retirement assets to one's child(ren) or grandchild(ren). If structured properly, the retirement assets can then be distributed over the child's or grandchild's lifetime, often referred to as a "stretch" provision. This ability to stretch the retirement asset distributions allows undistributed amounts inside the retirement accounts to continue to grow on a tax-deferred basis until distributed. Moreover, the younger the beneficiary,

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the longer the life expectancy. The longer the life expectancy, the smaller the annual required distributions and the greater potential for deferring income taxes and growing the retirement account.

The SECURE Act changes this rule and severely limits the ability to stretch distributions from retirement assets in IRAs and qualified plans like 401(k)s. The new legislation generally requires non-spouse beneficiaries to take complete distribution of the benefits by the end of the tenth calendar year following the account owner's death. This rule would apply regardless of whether the account owner died before or after his or her required beginning date.

There are exceptions to this new 10-year rule for a designated beneficiary who is (i) the spouse, (ii) a minor child, (iii) a disabled or chronically ill person, or (iv) a person not more than 10 years younger than the account owner. However, in the case of a minor child, the benefits would have to be distributed within 10 years from when the child attains majority. The age of majority is 18 in most, but not all, states. Hopefully there will be regulatory guidance from the IRS to clarify the age of majority.

This change would generally become effective for account owners dying after December 31, 2019.

IRA Planning. Following are some suggestions to address the new 10-year rule that will end stretch distributions. These suggestions apply for IRA owners and are not as suitable for participants in qualified plans such as 401(k)s. You should consult with your tax advisor when determining whether these might be appropriate for your particular situation.

- **Trust as IRA Designated Beneficiary.** For IRA owners, if you currently name a trust as the beneficiary of your IRA, this new tax provision might significantly alter your distribution plan. Depending on the terms of your trust and your intended planning, an IRA that you expected to be paid into a trust over the beneficiary's lifetime might be fully distributed within 10 years, producing a very different result. Because of that, it would be prudent to review your IRA beneficiary designations(s) and understand the impact of the new SECURE legislation.
- **Charitable Remainder Trusts (CRTs).** Consider naming a CRT as a beneficiary of a retirement plan. A CRT is exempt from income tax and therefore could receive IRA benefits in a lump sum without any tax consequences. This could allow for payouts over the lifetime of a child or children who are beneficiaries of the charitable trust (or, alternatively, for a fixed period of up to 20 years). At the end of the CRT term, any remaining property passes to charity. The CRT payout would not necessarily increase over time, but could provide for a fixed percentage payout each year to the beneficiaries. Such a trust could restore a prolonged payout period, provide for a longer period of tax-free growth and defer income taxes.

  However, using a CRT to implement a deferred payout that can stretch well beyond 10 years comes at a cost: the charity's interest in the CRT must be at least 10% of the value of the trust, calculated at the inception of the CRT.
- **Life insurance.** You may also consider withdrawing funds from your IRA, which could then be used to purchase insurance. If properly structured, the insurance could be owned by a trust and any insurance proceeds paid to it could be free from income and estate tax. The insurance proceeds would be payable to the trust and available to distribute to the beneficiary over an extended period of time.
- **Roth conversions.** Converting a traditional IRA to a Roth could become more popular due to a combination of two factors: (1) the 10 year payout rule will lessen the importance of deferral, and (2) the lower income tax rates enacted at the end of 2017, which are scheduled to last through 2025, offer a temporary opportunity to convert a traditional IRA to a Roth at a lower income tax cost. While a Roth conversion triggers an upfront income tax, a Roth does not have any mandatory distribution during the owner's lifetime and distributions are tax-free. After the owner's death, beneficiaries would be subject to the 10-year payout limit but would receive distributions tax-free. Deciding whether to convert to a Roth needs to be carefully examined.
- **Trusteed IRAs.** For Trusteed IRAs, limited payout options remain unaffected for spouses and other eligible designated beneficiaries. For other non-spouse beneficiaries, a 10 year stretch provision applies for deaths after 12/31/19.

Penalty-free Withdrawals from Retirement Plans for Individuals in Case of Birth or Adoption

With certain exceptions, there is a 10% penalty on distributions from qualified plans and IRAs before age 59½. The SECURE Act adds an additional exception under which 401(k) participants and IRA owners could withdraw up to $5,000 for expenses for each qualified birth or adoption, without penalty. (Interestingly, adopting the child of one's spouse does not qualify for this provision. The withdrawn amounts would still be taxable as income; this new provision only removes the penalty. In addition, amounts withdrawn could later be recontributed and treated as a rollover).

The new provision is effective for distributions made after December 31, 2019. However, in order to qualify for this exception, the distribution must be made during the 1-year period beginning on the date on which the child is born or the adoption is finalized.

PROVISIONS AFFECTING IRAS ONLY

Repeal of Maximum Age for Traditional IRA Contributions

Prior to enactment of SECURE, you could not contribute to a traditional IRA in the year you turned 70½ and thereafter. (There is no such limitation for contributions to Roth IRAs.) SECURE removes that limitation, effective for taxable years beginning after December 31, 2019. So, beginning in 2020, you can contribute to a traditional IRA regardless of your age. However, other limitations continue to apply to IRA contributions, such as:

- For all IRA contributions (both traditional and Roth), there is an annual limit on how much you can contribute. For 2020, the annual limit is $6,000 per person (plus an additional $1,000 if you are age 50 or older on December 31, 2020). (In addition, contributions to a Roth cannot be made if modified adjusted gross income exceeds certain thresholds.)
- For all IRA contributions (both traditional and Roth), you cannot contribute more than your "compensation" for the year. (For a married couple, a non-working spouse can rely on the working spouse's compensation to satisfy this requirement. This is known as a "spousal IRA.")
- If you contribute to a traditional IRA, it is a separate question whether that contribution is deductible for federal income tax purposes.
- There's a conforming change involving Qualified Charitable Distributions (QCDs) from an IRA (If certain requirements are met, up to $100,000 can be transferred directly from a traditional IRA to a qualified charity without being included in income. Such a distribution is called a "Qualified Charitable Distribution."). In the case of a QCD, the amount that can be excluded from income as a QCD is decreased by cumulative net deductions allowed because of this change allowing tax deductible contributions to an IRA after age 70½.

Example. For 3 years beginning with the year you turned 70½, you contributed $6,000 to your traditional IRA(s), a total contribution of $18,000. You were eligible to deduct the entire $18,000. In the next year you have $30,000 distributed directly from your traditional IRA(s) to a qualified charity as a QCD. The amount you can exclude from income under the QCD rules would be $30,000 minus $18,000, or $12,000. The remaining $18,000 would be included in income (assuming no basis in the IRA). The extent to which there would be a corresponding charitable income tax deduction would be a separate calculation. If you had not been eligible to deduct any of the $18,000 of contributions, then your $30,000 QCD would be unaffected and you could exclude the entire $30,000 from income.

Treat Certain Taxable Non-Tuition Fellowship and Stipend Payments as Compensation for IRA Purposes

Generally you cannot contribute to an IRA unless you have compensation. Under prior law, stipends and non-tuition fellowship payments received by graduate and postdoctoral students were not treated as compensation, even if taxed. Therefore, students who only had that type of income could not make IRA contributions.

SECURE changes that. Now, stipends and non-tuition fellowship payments will be considered compensation for IRA contribution purposes. The change will enable these students to begin saving for retirement and accumulate tax-favored retirement savings. This change is effective for taxable years beginning after December 31, 2019.

PROVISIONS AFFECTING 401(K)s ONLY

Annuities in 401(k)s

401(k) retirement plans offer a variety of investment options. Although 401(k) plans can offer annuities, only about 10% do. This is in part because of the credit risk associated with a commercial annuity (the payor insurance company could fail). In such a case, the 401(k) sponsor company might be sued by 401(k) participants. SECURE would protect 401(k) sponsor companies from such liability, if certain conditions are met. SECURE would also make such annuities "portable," meaning that if a participant leaves the company, the annuity could be rolled into another 401(k) or an IRA without triggering surrender charges.

Allowing Long-term Part-time Workers to Participate in 401(k) Plans

Employers may generally exclude part-time employees (those who work less than 1,000 hours) from participating in defined contribution plans. The Ways and Means Committee summary of the SECURE Act explains that the current rules can be harmful to women who are more likely to work part-time. SECURE requires employers to allow employees with 500 hours of service in three consecutive years to participate in 401(k) plans. However, the employer may elect to exclude these employees from testing under the nondiscrimination and coverage rules, and from the application of the top-heavy rules.

This change would be effective for plan years beginning after December 31, 2020.

OTHER PROVISIONS NOT INVOLVING RETIREMENT PLANNING

Expansion of 529 Plans

A 529 Plan is exempt from federal income tax. When funds are withdrawn to pay for the beneficiary's education expenses, such withdrawals are not taxable if the withdrawals are for the beneficiary's "qualified higher education expenses."

The SECURE legislation expands the expenses that are considered "qualified," allowing them to be paid with distributions from a 529 Plan without triggering federal income tax. Qualified higher education expenses now include costs associated with registered apprenticeships and up to $10,000 (cumulative, not annual) of qualified student loan repayments of principal and interest of the 529 Plan's beneficiary. However, amounts excluded from income as a qualified student loan repayment will reduce amounts otherwise deductible as student loan interest. This new provision is effective for distributions made after December 31, 2018.

For qualified student loan repayments, the statute has a special rule that allows student loan repayments of the beneficiary's siblings to be considered qualified student loan repayments. The wording of the statute, however, is unclear and it would be best to consult with your tax advisor before trying to take advantage of this special rule for siblings' student loan repayments.

NOTE: Because this change to 529 Plans was enacted so late in the year, you might have already paid 2019 expenses that are now "qualified" for reimbursement from a 529 Plan (the effective date for this change is for distributions made after December 31, 2018).

If you can get reimbursed in 2019 for those expenses, that would fall under this new rule. If, however, you plan to get reimbursed in early 2020 for those 2019 expenses, the statute is silent as to whether a withdrawal from a 529 Plan must be in the same year as the qualified expenses are incurred. You should check with your tax advisor if this is an issue for you.

Reinstatement of the "kiddie tax"

Prior to enactment of the Tax Cuts and Jobs Act in December 2017, the unearned income of children could be income taxed at the top marginal rate of their parents. This was known as the "kiddie tax" and involved complex calculations. The Tax Cuts and Jobs Act repealed the kiddie tax (through 2025) and instead taxes the unearned income of children at the same compressed income tax rates that apply to trusts. SECURE repeals that change and re-instates the kiddie tax.

This change is motivated in part because of the unintended consequences of the 2017 legislation. The kiddie tax was aimed at high net worth individuals, to prevent the shifting of investment income to children's lower brackets. However, other examples of "unearned income" can include scholarships and military survivor benefits, which are received by those in lower tax brackets. Having those items taxed at parents' rates under the kiddie tax meant those items could still be taxed at lower rates. The 2017 change, however, would cause those items of income to be taxed at the same high rates as apply to trusts, which rates are very compressed and quickly reach the top marginal rate of 37%. As a result, under the 2017 legislation these items are subject to a higher rate of tax.

This change is effective for tax years beginning in 2020. However, you can elect to apply this change to 2018 or 2019 (or both).

CONCLUSION

The SECURE Act makes many changes that will have a significant impact on planning. We invite you to contact your advisor if you have any questions on this new, important legislation.