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How the Secure Act Changed the Landscape for Retirement and Estate Planning

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Overview

The Setting Every Community Up for Retirement Enhancement Act, also known as the SECURE Act, was signed into law on December 20, 2019, effective January 1, 2020. It was a late attachment to the US year-end spending bill.

There were some major changes created by the new law: some are beneficial and common-sense changes to catch up to current times; one change, however, can be viewed as a major change for the worse and will likely affect many retirement and estate plans. That change involves Inherited Retirement Accounts[1] and will be a major source of funding for many of the other provisions of the bill.

Inherited Retirement Accounts

Important Note: The new rule only applies to beneficiaries who inherit a retirement account from someone who passed away after December 31, 2019. It does not affect those who already inherited retirement accounts prior to 2020; they can continue to "stretch" RMDs. If that individual passes along the account upon death to a new beneficiary, at that point it would be subject to the new law.

Prior to the SECURE Act

Prior to the new law, if a non-spouse individual inherited a retirement account, they could choose to "stretch" the account (commonly known as a "Stretch IRA"). This meant that although they would have to take Required Minimum Distributions ("RMDs") each year, they could allow the balance to potentially grow. The RMDs would generally be based on the age of the beneficiary inheriting the account[2] (using IRS mortality tables), with lower RMDs the younger the age of the beneficiary.

Post-SECURE Act

Under the new law, upon the death of the account holder, full distributions to beneficiaries must be made within 10 years. There are no required distributions in the first 9 years, but the account must be emptied by the end of the 10th year. In most cases, the beneficiary will likely be better off taking distributions along the way and not leave everything until the 10th year, which would then include a tax bill for the entire amount.

There are a few exceptions, which include spouses, disabled or chronically ill individuals, and individuals not more than 10 years younger than the deceased account owner. Minor children of the account owner are also exempt, but only until they reach the age of majority. This only applies to minor ***children.***

[1] These accounts include traditional and rollover IRAs, ROTH IRAs (although distributions are not taxable), 401(k) plans, 403(b) plans, and 457(b) plans, among others. It appears that the effective date does not yet apply to certain plans such as collectively bargained plans, federal governmental plans, and some qualified annuities that have already been annuitized.

[2] In certain cases, if multiple beneficiaries inherited a portion of the same account and did not split the account up by the end of the year following the year of the owner's death, the RMDs would be based on the age of the oldest beneficiary.

Grandchildren of an account holder, even if a minor, are not exempt and would have to follow the 10-year rule.

Why did Congress Make This Change?

Congress changed the law to generate more tax dollars to pay for other provisions of the spending bill. Contributions to traditional retirement plans (up to limits) are generally tax-deductible and any growth on the account is tax-deferred until withdrawals are made. As a result, an individual's taxable income is lower, thereby generating lower income taxes. In addition, the government does not receive any taxes until distributions are taken. Many individuals only take RMDs if they do not need the money for retirement, deferring taxes for long periods of time. Because distributions are taxed as ordinary income at the individual's tax bracket (which can be a much higher rate than long-term capital gains rates), the new 10 year rule now means that tax dollars will be generated from these accounts much faster and at potentially much higher rates (because individuals may be in their peak earning years during the 10 year withdrawal period).

When Congress first started exploring the change to the law, they considered applying an account minimum. As enacted, however, it applies to inherited retirement accounts of all sizes.

How this Affects Retirement and Beneficiary Planning

Prior to the law change, the ability to "stretch" an inherited retirement account was very valuable and efficient for beneficiaries because taxes would only be due on the annual RMDs. The remaining account balance would continue to be tax-deferred until that individual needed it for their own retirement (or even passed along to another beneficiary upon death if a balance still remained). These tax benefits created a simple, tax-efficient way to leave funds to beneficiaries, especially younger ones.

Now that the law has changed, any retirement and/or estate plan that currently includes passing along retirement accounts to non-spouse beneficiaries certainly needs to be reviewed, and likely also needs to be revised. This especially includes individuals who named a trust as their retirement plan beneficiary. These trusts will likely not work under the new law and should be readdressed immediately.

Those most affected by the new law on the current account owner side will be those with larger retirement accounts who had planned on leaving them to children and/or grandchildren. Those most affected on the beneficiary side will be those inheriting larger retirement accounts during their peak earnings years where their tax bracket may be at the highest point of their lives. Having to include distributions as ordinary income, in addition to employment income, could send someone into a higher overall tax bracket.

The end the of the "Stretch IRA" certainly changes the landscape of beneficiary planning, but the good news is there may be other ways to more efficiently pass retirement assets on to non-spouse beneficiaries. Potential options will be based on a specific individual's situation, such as their mix of retirement and non-retirement accounts, health, marital status, charitable inclinations, and beneficiary choices, among others.

Other Changes

The following is a highlight of some of the other changes made by the SECURE Act, and my view on each of those changes.

Required Minimum Distributions (RMDs)

Required Minimum Distributions (RMDs) from retirement accounts will now start at age 72, rather than the previous age 70½.[3]

- *My view on this update is positive and has been long overdue, as lifespans have been increasing and many people continue to work later in life. For those not yet needing withdrawals from their retirement accounts, it provides a slight delay for required taxable distributions, but likely won't move the needle in terms of retirement planning.*

IRA Contributions

Individuals can contribute to their traditional IRA after age 70½, provided they continue to have earned income.[4]

- *As with the later RMD age, my view on this update is positive and has also been long overdue, as lifespans have been increasing and many people continue to work later in life. In my view this change is slightly more beneficial than the later RMD start date because rather than just delaying paying taxes, this change allows those who are still working to continue adding to their retirement funds, as well as potentially reducing their taxable income by deducting retirement contributions.*

Birth and Adoption Expenses

The new law provides penalty-free (not tax-free) withdrawals from retirement plans for birth or adoption expenses. The new rules allow each parent (assuming each has their own retirement account) to withdraw up to $5,000 penalty-free.

- *My view on this change is mixed. While this change can provide additional financial resources for birth or adoption fees, I generally do not recommend using retirement funds for non-retirement expenses unless there is no other option. Nonetheless, for those who need the funds it can be viewed as a positive in that there are no penalties on the withdrawals. The low limits also help to protect from derailing retirement savings in a significant way.*

[3] This applies to only those who will turn 70½ in 2020 or later. If an individual turned 70½ in 2019 they will still need to take RMDs, as will those who are currently receiving RMDs because they are over 70½.

[4] For individuals already over 70½ they may not make 2019 contributions.

529 College Savings Plans

Up to $10,000 of 529 college savings plan assets can now be used to repay student debt. The $10,000 is a lifetime amount, so it is somewhat limited. If there are other siblings with student debt, however, an additional $10,000 per child can be used to pay off their student debt as well. One caveat is that if 529 plan money is used to pay down student loan interest, that interest is no longer tax deductible.

- *While I view this as a positive change, the impact of this change is probably limited because few people are likely to finish college with both student loans and excess funds in their 529 plan.*

Annuities in 401(k) Plans

401(k) plans now have a safe harbor provision if including annuities as an investment option. Prior to this change 401(k) plan sponsors were generally open to lawsuits arising from the use of annuities and were very hesitant to use them as investment options. A new safe harbor provision will protect plan sponsors from fiduciary liability for selecting an annuity provider even if it later fails to meet its annuity obligations. Essentially, if the annuity fails to work out, employees will not be able to sue their employer.

- *I have some major issues with this part of the SECURE Act. It appears as if this section was included to allow individuals the ability to choose to include annuities in their 401(k) plan, which could provide a steady income stream upon retirement. While annuities may be beneficial to some, their use should be analyzed on a case by case basis. This legislation may have been included due to the massive lobbying efforts by the insurance industry (which creates and sell annuities), which has long been attempting to get their products into the extremely large 401(k) market. My fear is that many individuals may be pushed into the annuity portion of a 401(k) plan without understanding the complex nuances and potentially high fees of many annuities. Furthermore, the new rule does not appear to regulate the type of annuity or their costs, and there is the potential for people to be taken advantage of or unwittingly select an annuity that is not in their best interest.*

In addition to the above there were also some other changes: the new law allows multiple employer retirement plans, which combine different businesses into one plans; and it also allows long-time, part-time employees to participate in 401(k) plans by requiring employers to offer the plan to any employee who worked 1,000 hours in a year, or 500 hours over the consecutive three year period.

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