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THE SECURE ACT

The "Setting Every Community Up for Retirement Enhancement" Act (the SECURE Act) was signed into law by President Trump on December 20, 2019. The SECURE Act contains landmark legislation that may affect how you plan for your retirement. Many of the provisions go into effect in 2020, which means now is the time to consider how these new rules may affect your tax and retirement-planning situation. This memo covers some of the more important elements of the SECURE Act that have an impact on individuals. Please do not hesitate to contact us if you would like to discuss these matters.

Partial elimination of stretch IRAs.

For deaths of plan participants or IRA owners occurring before 2020, beneficiaries (both spousal and nonspousal) were generally allowed to stretch out the tax-deferral advantages of the plan or IRA by taking distributions over the beneficiary's life or life expectancy (in the IRA context, this is sometimes referred to as a "stretch IRA"). This meant that young beneficiaries could extend the payout period over decades and, therefore, spread the payment of income taxes over a longer period of time.

However, for deaths of plan participants or IRA owners beginning in 2020 (later for some participants in collectively bargained plans and governmental plans), distributions to most nonspouse beneficiaries are generally required to be distributed within ten years following the plan participant's or IRA owner's death. So, for those beneficiaries, the "stretching" strategy is no longer allowed.

Exceptions to the 10-year rule are allowed for distributions to (1) the surviving spouse of the plan participant or IRA owner; (2) a child of the plan participant or IRA owner who has not reached majority; (3) a chronically ill individual; and (4) any other individual who is not more than ten years younger than the plan participant or IRA owner. Those beneficiaries who qualify under this exception may generally still take their distributions over their life expectancy (as allowed under the rules in effect for deaths occurring before 2020).

By way of illustration, take the example of an individual with a traditional IRA worth $2 million. The individual has named his 30 year old daughter as the IRA's beneficiary.

Under the old law, after the IRA owner's death, his daughter could stretch the IRA payouts over her expected lifetime resulting in a required minimum distribution to daughter of approximately $37,000 per year. Under the new SECURE Act, daughter must take the distributions over 10 years ($200,000 per year for ten years, placing the daughter in a much higher tax bracket). The new law's impact is a significant increase in both income and income tax for daughter.

Trust as beneficiary of the IRA.

Two types of trusts can qualify as a beneficiary under the SECURE Act. The first, a "conduit trust," has been a popular tool to turn an inherited IRA into a lifetime financial resource. Under a conduit trust, all distributions from an IRA must be paid immediately. Under the old law, these distributions were stretched out over the lifetime of the beneficiary. Under the new law, these distributions must be made within ten years. This could result in an unexpectedly large distribution and increases the risk that creditors could access the assets.

The alternative to a conduit trust planning is an "accumulation trust." An accumulation trust gives the trustee discretion on whether to pay out or retain distributions from an IRA within the trust and may potentially solve the problem of the trust beneficiary receiving an unexpectedly large distribution. To lower the tax burden due to income from an IRA distribution accumulating with a trust, an accumulation trust can be drafted to give the trustee discretion to make distributions in order to spread some of the tax burden to the recipients.

Repeal of the maximum age for traditional IRA contributions.

Before 2020, traditional IRA contributions were not allowed once the individual attained age 70½. Starting in 2020, the new rules allow an individual of any age to make contributions to a traditional IRA, as long as the individual has compensation, which generally means earned income from wages or self-employment.

Required minimum distribution age raised from 70½ to 72.

Before 2020, retirement plan participants and IRA owners were generally required to begin taking required minimum distributions, or RMDs, from their plan by April 1 of the year following the year they reached age 70½. The age 70½ requirement was first applied in the retirement plan context in the early 1960s and, until recently, had not been adjusted to account for increases in life expectancy.

For distributions required to be made after December 31, 2019, for individuals who attain age 70½ after that date, the age at which individuals must begin taking distributions from their retirement plan or IRA is increased from 70½ to 72.

Penalty-free retirement plan withdrawals for expenses related to the birth or adoption of a child.

Generally, a distribution from a retirement plan must be included in income. And, unless an exception applies (for example, distributions in case of financial hardship), a distribution before the age of 59½ is subject to a 10% early withdrawal penalty on the amount includible in income.

Starting in 2020, plan distributions (up to $5,000) that are used to pay for expenses related to the birth or adoption of a child are penalty-free. That $5,000 amount applies on an individual basis, so for a married couple, each spouse may receive a penalty-free distribution up to $5,000 for a qualified birth or adoption.