DANA CONSULTING GROUP

memorandum

Innovative Design and Administration of Retirement Plans

S E C U R E A C T C H A N G E S

On December 20, 2019, President Trump signed into law the Secure Act (short for Setting Every Community Up for Retirement Enhancement Act of 2019). This firm memorandum summarizes the pertinent changes to the rules governing retirement plans under the Secure Act.

Timely Adoption of New Retirement Plans

We get a lot of new clients in the dying days of December each year looking to set up new retirement plans. The Secure Act liberalizes this rule and permits an employer to establish a plan after the end of the year but before the income tax filing deadline (including extensions). This is effective for new plans adopted for tax years beginning after December 31, 2019.

NOTE: This new rule only allows employer contributions to be made for the initial year. 401(k) contributions cannot be made until the plan document is actually signed and deferral elections made, including for self-employed individuals.

Example: Jones Company does not offer a retirement plan but has a profitable year in 2020 and wants to establish a plan for 2020. Under current rules, the plan had to be in place (including a financial account) before the end of 2020. Under the new rules, the company can set up the plan before it files its 2020 income tax return and claim a deduction on that tax return.

Alternatively, let's say Jones Company maintains a 401(k) plan and decides it wants to set up a new cash balance plan for 2020. The new rules will permit the company to set up that plan in 2021 for the 2020 year. However, and this is a BIG however, in many cases there are amendments to the 401(k) plan that are needed to sync that plan with the new cash balance plan and the company's ability to make those retroactive amendments is going to be limited. For that reason (and others), we still recommend a company start the process for setting up a new plan as early in the current year as possible. We recommend clients and prospects look at a cash balance plan for 2020 as part of 2019 year-end administration.

Greater Incentives to Adopt a Retirement Plan

Under current law, the tax code provides small businesses with an annual tax credit of up to $500 for three years for start-up costs relating to establishing a retirement plan, like a 401(k) plan or cash balance plan. The Secure Act increases that tax credit to up to $5,000 per year for up to three years. However, and this is a BIG however, the amount of the credit is limited by the number of "non-highly compensated employees (NHCEs)" who are eligible for the new plan. Also, the new rule retains the current rule that there has to be at least one NHCE eligible for the new plan. So owner-only plans do not qualify for the credit.

An eligible employer is an employer who had no more than 100 employees who received at least $5,000 in annual compensation in the preceding year.

Effective Date: Tax years of the employer starting after December 31, 2019.

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Examples:

- John Jones owns Jones Company with no employees other than John, and sets up a new retirement plan. The company is not eligible for any tax credit.

- Jones Company maintains a 401(k) plan and decides to set up a new cash balance plan that will cover at least one NHCE. Jones Company is not entitled to a tax credit since the company maintained another plan in the preceding three years.

<u>Delay in RMD Commencement Date</u>

Required Minimum Distributions (RMDs) must currently commence once the participant or IRA owner attains age 70½. The Secure Act generally raises the age to 72, but there are exceptions.

- IRA owners who attain age 70½ after 2019 can delay RMDs until they attain age 72. If an IRA owner has attained age 70½ before 2020 but is not yet 72, he/she must continue taking RMDs.

- Participants in a qualified retirement plan (who are not more-than-5% owners) can wait until they attain age 72 (or retire if later) before starting their RMDs provided they have not attained age 70½ by January 1, 2020.

Example: Maggie participates in her employer's 401(k) plan and intends to work until she is 100. Maggie is not an owner of her employer. She does not have to start taking RMDs until she retires, even if that is after she attains age 72. This is the same as under current rules.

Example: Maggie retired when she was 60 but left her account balance in her employer's 401(k) plan. Previously she had to start taking her RMDs once she attained age 70½. If she attains age 70½ after 2019, her RMDs do not need to start until she attains age 72. NOTE: Many 401(k) plans provide that a participant who does not elect to take a distribution at termination of employment is mandatorily cashed out at normal retirement age (generally age 65). The new RMD rules do not supercede that and Maggie would be cashed at age 65 if the plan imposed that mandatory cash out rule.

Example: Maggie owns the company that maintains the 401(k) plan and intends to work until she is 100. If Maggie was not age 70½ by December 31, 2019, she has to start taking her RMDs once she attains age 72, even if she continues working.

<u>Modified "Stretch" RMD Rules</u>

Under current law, beneficiaries of Inherited IRAs can stretch distributions over their lifetime. This stretch feature continues for "eligible designated beneficiaries" but all others must complete distributions with ten years of the original participant's or IRA owner's death. An eligible designated beneficiary is the surviving spouse, minor children, disabled or chronically ill individual, beneficiaries who not more than ten years younger than the participant or IRA owner. The current rule that permits surviving spouses to delay distributions until the participant or IRA owner would have attained age 70½ remains in effect.

Effective Date: Participants or IRA owners who die after December 31, 2019. Collectively bargained retirement plans have a delayed effective date.

Safe Harbor 401(k) Plans

Most of our clients' 401(k) plans offer a safe harbor contribution feature, either the 3% non-elective contribution or the safe harbor match. Effective in plan years beginning after 2019, the annual notice no longer has to be given for the 3% non-elective safe harbor contribution. Plans using the safe harbor match must continue to provide the notice.

Under current law, a 401(k) plan can only adopt or change its safe harbor contribution at the beginning of a plan year. The Secure Act liberalizes this rule and permits employers to retroactively adopt a non-elective safe harbor contribution (but not safe harbor match). There are two options. This new rule is effective in plan years beginning after December 31, 2019.

Example: Jones Company maintains a 401(k) plan with the calendar year as the plan year. The company's 401(k) plan does not offer a safe harbor contribution. Under current law, Jones Company would have to have amended its plan at least 30 days before January 1, 2020 (and give the 2020 safe harbor notice) to offer a 3% safe harbor contribution for the 2020 plan year. Under the new rules, the company has two options:

- Amend the plan by December 1, 2020 to offer the 3% non-elective safe harbor contribution for 2020. This is essentially the codification of the conditional safe harbor contribution feature now permitted with the benefit that no safe harbor notice has to be given anymore.

- Amend the plan by December 31, 2021 to offer a 4% (vs 3%) non-elective safe harbor contribution. As a practical matter this must be done before Jones Company files its 2020 federal income tax return to claim the deduction for the contribution. Again, no safe harbor notice has to be given.

Automatic Enrollment Enhancements

Congress likes automatic enrollment/escalation and the current deferral cap of 10% of a participant's wages is increased to 15% for 401(k) plans using a QACA arrangement (for "qualified automatic contribution arrangement"). The goal is to encourage participants to save greater amounts in their employer's 401(k) plans – always an admirable goal.

Effective Date: Plan years beginning after December 31, 2019.

Our Comment: There are significant penalties for not properly administering an automatic enrollment/escalation feature. This is essentially a payroll function and somebody has to be monitoring when employees become eligible to participate and, therefore, have to be automatically enrolled, and when contribution rates have to increase. In our experience, larger companies have the payroll resources to be doing this monitoring correctly but smaller employers often do not. If you cannot administer this, you should not adopt it. We have substantial experience with automatic enrollment/escalation and if this is feature you are interested in, please give Lee T. Jennings in our office a call at (630) 802-7644.

In-Service Withdrawals From Pension Plans

Under current law, a defined benefit plan, cash balance plan or money purchase plan may not permit in-service withdrawals before a participant attains age 62. The Secure Act reduces this age threshold to 59½. This is effective in plan years beginning after December 31, 2019.

This is not a mandatory provision. So pension plans that do not permit in-service withdrawal can retain that restriction or a plan that offers the withdrawal option can retain its current age limit or reduce it to as low as 59½.

<u>"Baby" Withdrawals</u>

Congress liberalized the hardship withdrawal provisions in 2017 and again in 2018, and they are at it again with new rules allowing in-service withdrawals for the birth or adoption of a child. [We have prepared a firm memorandum on the new Hardship Withdrawal rules that can be downloaded from our website at www.danconsulting.com under the Education Center tab.]

Under the new rules, a qualified retirement plan may permit participants to take an in-service withdrawal of up to $5,000 during the one-year period following the birth or adoption of a child of the participant. These "baby withdrawals" are exempt from the 10% early withdrawal penalty for payments before age 59½.

Effective Date: Withdrawals after December 31, 2019.

Example: Maggie gives birth to twins. She can take a baby withdrawal of up to $10,000. Also, the twins' father can also take a baby withdrawal of up to $10,000.

Example: Maggie marries Jim and adopts Jim's child. Maggie cannot take a baby withdrawal for that. But if Maggie and Jim adopt a non-related child, each can take baby withdrawals.

Example: Maggie takes a baby withdrawal and would like to "repay" some or all of the withdrawal later, either to the originating retirement plan or her IRA. The Secure Act permits this but we think it best to wait for Treasury regulations to spell out exactly how this is done.

This is not a mandatory provision and plans do not have to offer this feature. When the liberalized hardship withdrawal rules were enacted, our view was (and remains) that plans should not turn into bank accounts for allowing all kinds of in-service withdrawals. Our view extends to these baby withdrawals as well. The new rules do permit the participant to repay the withdrawal at a later date but in our experience with similar situations, that never occurs.

<u>Lifetime Income Features</u>

The US Labor Dept is directed to issue regulations for defined contribution plans (like 401(k) plans, profit sharing plans and money purchase plans) to include with an annual benefit statement what is called a "lifetime income disclosure." The purpose of this disclosure is to show the participant what his/her account balance could provide as an annuity for life. Several surveys have shown many Americans think they can retire with account balances of as little as $25,000, with little outside assets. This disclosure is attempting to educate Americans on their need to save more money for retirement.

Effective Date: Benefit statements issued more than 12 months after the Labor Dept issues regulations, a model disclosure or assumptions to be used to calculate the annuity.

Speaking of annuity options, the Secure Act makes several changes to encourage defined contribution plans to offer a true annuity option, including relief from the normal ERISA fiduciary liability rules. We included an article in our November 2019 issue of ***the dana report*** (available on our website under the Education Services tab) referencing an article (also on our website) by Fred Reish on his predictions relating to this annuity option. If this is something you are interested in, we strongly recommend you read our November article and the Fred Reish article.

Plan Participation for Part-Time Employees

Under current law, employees who have not attained age 21 and worked for the employer for 12 months in which he/she is credited with 1,000 or more hours of service can be excluded from participating in a 401(k) plan. The Secure Act provides that long-term part-time employees must be allowed to make 401(k) contributions once they have worked for the employer for three consecutive 12-month periods with at least 500 hours of service in each period. [This rule does not apply to collectively bargained employees.]

These employees are not required to receive any employer contributions and they are ignored for coverage, discrimination and top-heavy testing. However, it is likely eligible part-time participants are counted for purposes of determining if the plan requires an independent CPA audit each year.

Our Comment: It is unlikely these part-timers will make significant contributions to the plan but they may contribute something. Additionally, employers are unlikely to make any contributions for them since they don't have to and so these account balances are likely to be perpetually small. Many 401(k) platforms structure their fees to discourage small account balances. Plans can and do force out small accounts once the employees terminate, but these part-timers cannot be forced out until they terminate. It remains to be seen how platform fees will be affected by this new rule.

Effective Date: Plan years beginning after December 31, 2020. Also, only service performed after 2020 must be considered for purposes of the three consecutive 12-month service rule. So as a practical matter this rule will not require inclusion of any part-time employees until 2024 at the earliest.

Closed Defined Benefit Plan Relief

A "closed" defined benefit plan is a plan that no longer accepts new participants but current participants continue to earn retirement benefits. The issue here is whether the plan can continue to pass the coverage and discrimination testing rules when no new participants (who tend to be "non-highly compensated employees) are excluded but longer service employees (who include many if not most of the "highly compensated employees") continue to earn benefits. The IRS for several years has given these plans a pass on coverage and discrimination testing and the Secure Act simply codifies that subject to certain restrictions.

Miscellaneous

- Beginning in 2020, working Americans who work after age 70½ may continue (or resume) making IRA contributions.

- IRS penalties for failure to file a Form 5500 is increased from $25 per day to $250 per day, not to exceed $150,000. That is a 10x increase. This will make the Labor Dept Delinquent Filers Voluntary Correction Program (DFVC) and the comparable IRS program for Forms 5500-EZ (under Rev Proc 2015-32) that much more valuable.

> NOTE: These amnesty programs are great but are only available if you file with the agency before the agency finds out the Form 5500 (or 5500-EZ) is late.

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Please visit our website at www.danaconsulting.com for more information about the firms and their services. If you have any questions, please feel free to contact Lee T. Jennings at (630) 802-7644.

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