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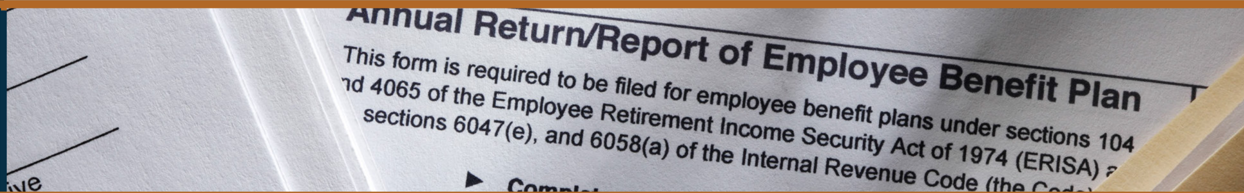
EMPLOYEE BENEFITS

A SHIPMAN & GOODWIN® ALERT

January 7, 2020



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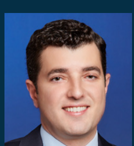

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What Plan Sponsors and IRA Owners Need to Know About the SECURE Act

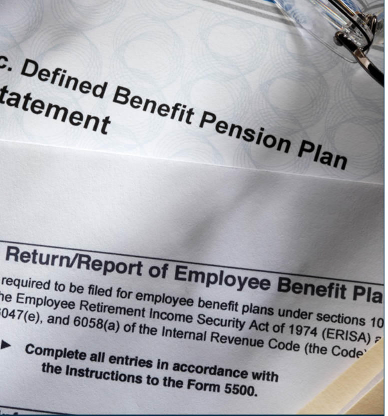
On December 20, 2019, President Trump signed into law H.R. 1865, the Further Consolidated Appropriations Act, 2020 (now Pub. L. 116-94) (the “Appropriations Act”), which, among other things, contains the Setting Every Community Up for Retirement Enhancement (SECURE) Act (the “Act”). The Act is a significant piece of retirement legislation which seeks to expand access to retirement savings for small businesses and part-time workers, promote the availability of annuities as a source of lifetime retirement income, and simplify defined contribution plan formation and administration. It funds its expansion of retirement savings in large part by eliminating the popular use of the “Stretch IRA” as a means of tax-efficient intergenerational wealth transfer. Absent some limited changes (discussed below), the bulk of the Act is identical to the heavily-publicized bill of the same name passed by the U.S. House of Representatives as H.R. 1994 on May 23, 2019.

The Act amends a broad assortment of retirement plan provisions in the Code and ERISA and ushers in certain operational changes that stakeholders of retirement plans of all types—particularly sponsors and administrators of defined contribution plans—should begin thinking about and processing now. However, plan amendments incorporating these operational changes are in general not required until the end of the 2022 plan year (2024 for governmental plans).

Below is a summary of the provisions of the Act that we believe are most immediately relevant to our clients and friends. Given the broad scope of the Act, we anticipate issuing future alerts on provisions not discussed here.

Changes to 401(k) Participation and Safe Harbor Plan Design Rules

- <u>Elective Deferrals for Certain Part-Time Employees (Generally effective for plan years beginning after December 31, 2020)</u>. The Code’s current participation rules permit a 401(k) plan to prevent employees who have not yet completed a year of service, defined as a year in which at least 1,000 hours are worked, from making elective deferrals under the plan. Once an employee completes a year of service, the plan may not exclude that employee from making elective deferrals on the basis of hours of service, even if he or she works less than 1,000 hours in subsequent years (but the plan may condition eligibility for nonelective or matching contributions in later years on such a service requirement). The effect of these rules has been to deny many long service, part-time employees (who never complete a “year of service” as defined above) the benefits of tax-deferred retirement savings under their employer’s 401(k) plan. In response, effective for part-time employee service years beginning on or after January 1, 2021, the



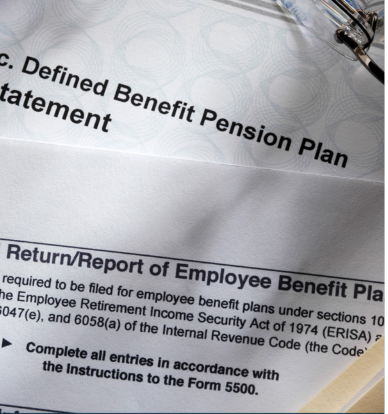
Act amends Code section 401(k) to require a plan to permit an employee who has worked at least 500 hours per year for at least three consecutive years (and has attained the age of 21 by the end of such third consecutive year) to make elective deferrals under the plan. No employer contributions are required, and the Act provides nondiscrimination and top-heavy testing relief for this group. Each year in which the part-time employee works at least 500 hours (regardless of whether that occurs over three consecutive years) will be treated as one service year for purposes of crediting vesting service under the plan for employer contributions, if provided. Service years that begin prior to January 1, 2021 will not count for determining eligibility, which means that part-time employees will not become eligible to participate in plans under this new rule until the 2024 plan year.

- Permitted Increase in Default Contribution Rate for Qualified Automatic Contribution Arrangements (QACAs) (Effective for plan years beginning after December 31, 2019). Under pre-Act law, to achieve exemption from nondiscrimination testing, a QACA safe harbor section 401(k) plan design must provide for automatic enrollment for eligible participants (subject to participant opt-out) at a rate of no less than 3% of compensation in the first year of eligibility, with gradually increasing annual minimum contribution rates thereafter, but subject in all years to a 10% maximum default contribution. To encourage greater rates of deferral and more retirement savings in such QACA plans, the Act permits sponsors of QACAs to increase default contribution rates for automatically enrolled participants to 15% of compensation for the second year of eligibility and thereafter. This QACA change is permissive and if adopted by the plan sponsor, can take effect for the 2020 plan year.

- Removal of Barriers to Adopting Nonelective Contribution-Type Safe Harbor Plans (Effective for plan years beginning after December 31, 2019). Currently, a 3% nonelective employer contribution safe harbor plan design may not be implemented in the middle of a plan year, because certain safe harbor notices must be sent out to participants prior to the first day of the plan year. The Act simplifies the formation of nonelective safe harbor 401(k) plans by eliminating this notice requirement. Traditional 401(k) plans may now be amended mid-year to become a nonelective contribution safe harbor plan. If the mid-year amendment is adopted fewer than 31 days before the end of the plan year, the nonelective contribution for the plan year must be at least 4% of compensation (rather than 3%), and the written amendment to the plan must be adopted no later than the end of the next plan year. This change is effective for plan years beginning after December 31, 2019.

Changes to Rules Regarding Distributions and Withdrawals from Plans

- Increase in Age for Required Minimum Distributions (RMDs) (Effective for individuals turning 70 ½ after December 31, 2019). Under pre-Act law, RMDs must generally begin to be taken by April 1 of the calendar year following the year in which the retired employee or IRA owner attains age 70 ½. Responding to the fact that many Americans are now working past the traditional retirement ages of the past, and also to increased life expectancies since the introduction of the Code's RMD rules in 1962, the Act increases the age at which RMDs (from plans and IRAs) are triggered from 70 ½ to 72. This new rule applies to individuals who attain age 70 ½ after December 31, 2019. In practice, the change will first apply to retirees born after June 30, 1949. The Act also permits



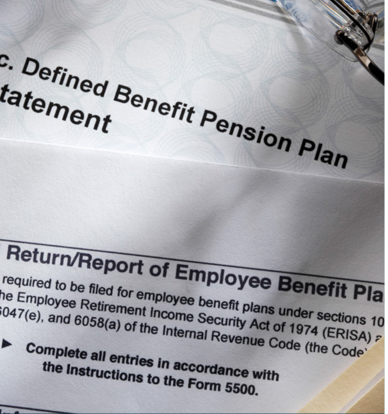
individuals to contribute to a traditional IRA after attaining age 70 ½, effective for taxable years after December 31, 2019.

- Elimination of Stretch IRA for Most Child Beneficiaries (e.g., 10-Year Distribution Rule for "Ineligible" Designated Beneficiaries) (Effective for post-death distributions after December 31, 2019). Under pre-Act law, if a participant/IRA owner dies prior to receiving a distribution of their full account balances, the designated beneficiary may receive the account balance over the beneficiary's life (i.e., the designated beneficiary may "stretch" RMDs therefrom over their lifetimes, allowing for the possibility of decades of additional tax-free growth). The Act largely eliminates this estate-planning strategy by requiring that savings in retirement accounts inherited by individuals other than eligible designated beneficiaries— defined by the Act as spouses, minor children (until reaching majority), disabled and "chronically ill" beneficiaries, and other beneficiaries less than 10 years younger than the employee—be distributed in full within 10 years of the employee's death. The rules apply separately to each beneficiary in a multi-beneficiary trust which itself has been designated as a beneficiary. This change applies in general to distributions from plans other than qualified defined benefit, section 403(b), governmental 457(b) plans, and annuity contracts, and takes effect for plan years beginning after December 31, 2019 (after December 31, 2021 for collectively-bargained plans and governmental plans).

- Reduced Age for In-Service Distributions (Effective for plan years beginning After December 31, 2019). A provision in Division M of the Appropriations Act (separate and apart from the SECURE Act) reduces the minimum age for allowable in-service distributions from (a) qualified retirement plans subject to Code section 401(a)(36), from age 62 to age 59 ½, and (b) governmental section 457(b) plans, from age 70 ½ to age 59 ½. This will eliminate some plan design complexity for plans wishing to allow in-service distributions at an age that is younger than the plan's definition of normal retirement age. This change will be available for plan years beginning after December 31, 2019.

- Treatment of Section 403(b) Plan Terminations (Guidance to be issued by Treasury Department within 6 months). Because section 403(b) plans often hold assets in the form of annuity contracts and mutual funds in custodial accounts in the names of the participants, rather than in a trust, it can be difficult for sponsors to terminate the plan and distribute its assets. The Act directs the Treasury Department to issue rules in 2020 regarding terminations of section 403(b) plans, which will permit distributions of the custodial accounts in-kind to participants, and require custodians of those assets to continue treating them for tax purposes as if the contracts or accounts remained in a section 403(b) plan. These rules will have retroactive effect.

- Penalty-Free Withdrawals up to $5,000 for Childbirth or Adoption (Effective for distributions after December 31, 2019). The Act amends Code section 72(t) and provides that the early-distribution penalty thereunder will not apply to distributions from all plans (other than qualified defined benefit plans) up to a maximum of $5,000 (per parent) on an aggregated controlled group basis for a "qualified birth or adoption distribution," which is defined as any distribution up to $5,000 occurring within a year of the child's birth or the date the legal adoption of a minor or adult-disabled child is finalized. The provision allows the distributed amount to be later recontributed to the plan in the same manner as a



rollover from another plan or IRA. The amendment to section 72(t) provides that a plan that allows these withdrawals will be treated as satisfying the Code's in-service distribution rules. The change takes effect for plan years beginning after December 31, 2019.

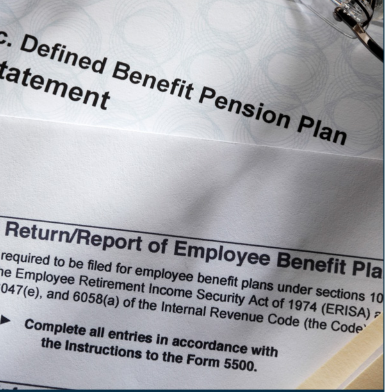
- Elimination of Participant Loans by Credit Card (Effective for loans made as of December 20, 2019). The Act amends Code section 72(p) to eliminate the loan treatment for plan loans taken in the form of a "credit card or any other similar arrangement," presumably due to concerns that these arrangements would raise compliance challenges for qualified plans offering them. The change is effective as of December 20, 2019.

Expanded Access to Annuities as a Source of Lifetime Retirement Income

- ERISA Fiduciary Safe Harbor for Selection of Annuity Provider (Immediately effective). The decline of defined benefit pension plans, with their lifetime annuity payments, has largely left retirees responsible for ensuring that their defined contribution account balances will last them throughout retirement. Because it is difficult for individuals to predict how long they will live, and what expenses they will incur through their retirement years, some retirees (who have otherwise saved adequately throughout their working years) experience a funding shortfall in later years, and this has been perceived as a problem in the current system of retirement security. Although there has never been a rule preventing annuity contracts from being offered as an investment option within defined contribution plans, the fiduciary decision to offer them has been, under existing guidance, a complicated and risky one in light of the possibility that a selected annuity provider may later default on its obligations to participants. The existing ERISA safe harbor for selection of an annuity provider for distributions from individual account plans, 29 C.F.R. § 2550.404a-4, requires the plan fiduciary to engage in a thorough evaluation of the annuity provider, and many employers find it too complicated to provide meaningful guidance. The Act now simplifies the fiduciary's decision-making process by providing an express, statutory safe harbor for the selection of an annuity provider that largely defers to state insurance commissioners' current and ongoing evaluations of the providers' financial health. However, the safe harbor still requires a fiduciary to prudently evaluate the costs and features of the offered annuity products, and makes clear that a prudent decision in this respect will not require selection of the lowest cost annuity option. This safe harbor amends ERISA as of December 20, 2019.

- Lifetime Income Disclosure (Effective date delayed until after DOL guidance). Employers that sponsor defined contribution plans subject to ERISA will be required to provide participants an annual statement detailing the estimated monthly income stream at retirement that would result from the purchase of a qualified joint and survivor and single life annuity with the participant's account balance. (This type of information is often already made available by recordkeepers online, but participants have to locate it, which can be difficult.) The Act directs the U.S. Department of Labor (DOL) to issue a model disclosure and the assumptions required to be used. These requirements will take effect for affected plans twelve months after the DOL publishes its guidance.

- Portability of Annuity Products in Event of Certain Contingencies (Effective for plan years after December 31, 2019). The Act provides that, beginning with the 2020 plan year, participants may make direct trustee-to-trustee transfers of



"lifetime income investments," or transfer the actual annuity contracts, from one eligible retirement plan to another, or between a plan and an individual retirement account (IRA), without regard to plan restrictions on in-service distributions, to help avoid surrender charges or penalties if the lifetime income investment is removed from the plan lineup.

Changes to Nondiscrimination Rules for Certain Closed Defined Benefit Plans (Generally effective as of December 20, 2019)

The Act provides relief in special circumstances from the Code's nondiscrimination, minimum coverage and minimum participation rules for certain participants in some closed and soft frozen plans, to permit greater flexibility in providing continued accruals to certain groups of participants (generally older and longer service employees) without a full freeze of accruals under the plan. These rules are highly technical. The rules are generally effective on December 20, 2019, but retroactive application may be available in certain cases.

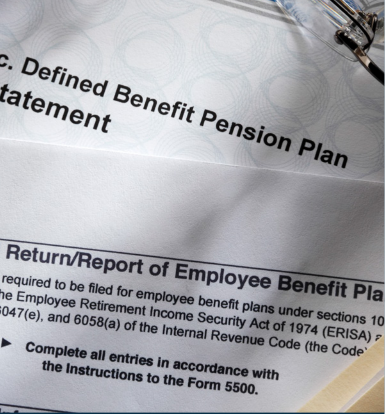
Administrative Changes and Increased Penalties

- <u>Plan Adopted by Filing Due Date (Effective for plans adopted for years beginning after December 31, 2019)</u>. In general, a qualified retirement plan must be adopted by the end of a given taxable year to be treated as in effect for that year. The Act now permits plans to be treated as adopted by employers by the end of Year 1, provided the Plan is adopted by the time the employer's tax return for Year 1 is due to be filed (including extensions) in Year 2. This change is designed to make it easier for employers to start plans by giving them the benefit of reviewing the company's financial performance for Year 1 before making plan design decisions applicable to formation of a plan effective that year. This change applies to plans adopted for taxable years beginning after December 31, 2019.

- <u>Increased Penalties for Failure to File Certain Returns (Effective for filings required after December 31, 2019)</u>. The Act substantially increases penalties, and penalty caps, for failure to file certain retirement-related information returns, including the Form 5500 (from $25/day up to $15,000 total, to $250/day up to $150,000 total), the annual retirement plan registration statement and notification of changes (from $1/per participant per day of the failure up to $5,000 and $1,000 respectively, to $10/per participant per day of the failure up to $50,000 and $10,000 respectively), and annual withholding notice (from $10/failure up to $5,000 total, to $100/failure up to $50,000 total). The Act also increases the penalty for failure to file individual information returns unrelated to retirement plans. Note that some of these increases are significantly greater than provided for in earlier versions of the Act. The increases affect returns, statements, and notifications required to be filed, and notices required to be provided, after December 31, 2019.

Repeal of "Cadillac Tax" (Effective for tax years beginning after 2019)

A provision in Division N of the Appropriations Act (separate and apart from the SECURE Act) repeals the much-maligned "Cadillac Tax"—the Affordable Care Act's excise tax on high-cost employer sponsored medical plans. The Cadillac Tax was originally scheduled to go into effect in 2018, but was delayed by Congress twice, and had most recently been set to apply in 2022.



The Act requires some near-term operational changes for many plans, particularly with respect to the changes to the RMD rules, which plan sponsors and recordkeepers should begin jointly processing. The Act also presents several opportunities for plan design enhancements as the new decade gets underway. For questions on this Alert, or the SECURE Act in general, please contact any of the following:

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Please also consider registering for our webinar, What Plan Sponsors and IRA Owners Need to Know About the SECURE Act, from noon-1:00 p.m. on January 23, 2020.

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