

SECURE Act Eliminates Stretch IRA - Harms Small Business Retirement Plans and Employees

By Paula Calimafde

The **SECURE Act** recently passed by the House of Representatives contains two very negative provisions aimed squarely at small businesses that already sponsor retirement plans for their employees and their small business owners (mostly middle class and upper middle class taxpayers). These owners and employees are likely to see the value of their IRAs reduced significantly while their businesses could be subject to draconian penalties that are likely to result in reduced company contributions to the plan in future years.

These small business owners and employees took saving for their retirement seriously and now stand to have their beneficiaries face disastrous income tax treatment by changing the rules in the last 5 minutes of the game.

The first negative provision, eliminating the "stretch IRA," is in reality a new hidden death tax which will reduce the value of retirement plan money – some have calculated by up to a third. A stretch IRA begins when a small business owner "rolls-over" his or her retirement plan benefit (which the owner paid for by reducing his or her take home pay) to an IRA. The beneficiaries of the IRA are most often the surviving spouse, and if none, the children. Under this proposal, spouses would still be allowed to continue to receive payments over their lifetimes. Children, on the other hand, over the age of majority would have to take out any amounts left in the IRA within 10 years, rather than over their life expectancy, as is the law today. In most cases this will be an income tax and economic disaster for these children. Thus, the value of this asset will be decreased significantly because the IRA money will be taxed much faster than under existing law. Note - this is a retroactive change because there is no grandfathering of the benefits already accumulated in the plan or IRA and is to be effective for most non-spousal beneficiaries of IRA and plan account balances of owners who die after December 31, 2019.

If the SECURE Act becomes law, it will set off an immediate search to find ways to mitigate this negative tax treatment. Already experts are discussing new planning ideas to replace the stretch IRA ranging from conversions of traditional IRAs to Roth IRAs, establishing charitable remainder trusts, as well as investing in other tax advantaged vehicles such as insurance products. Many of these new planning ideas require the owners to freeze company contributions to the plan (which would have been contributed not only to the owners but to the employees as well, as required by law) and take that money as additional compensation. In short, the money that would have gone into the plan for the small business owner and the employees will be paid out to the owner and will be invested in more tax advantaged assets outside of the company because of the elimination of the stretch IRA. Those who are experts in the small business retirement plan system know that the current tax incentives available to the owners are the lynchpin of this voluntary and at present, successful system.[1]

Additionally, most existing beneficiary designations and trusts that are beneficiaries of existing IRAs will immediately require significant changes to accommodate the new law. More legal fees for these owners to pay to comply with a harmful provision aimed squarely at them!

Unfortunately, it is small business owners and their employees who will be hurt most by this new death tax - the vast majority of whom are middle to upper-middle income taxpayers, despite claims that only the top 1% wealthiest Americans will be hurt by the elimination of the stretch IRA. The wealthiest income earners do not rely upon qualified retirement plans for their retirement; rather they look to other sources, including non-qualified retirement plans to accumulate income which cannot be rolled over to an IRA.

Strangely, some members of Congress believe that the stretch IRA can be kept going for many generations. This is untrue; the law is crystal clear that the IRA can only be "stretched" over the life

expectancy of the beneficiary of the inherited IRA or plan assets. For instance, if a child is the beneficiary of an inherited IRA and dies before her life expectancy is reached, her children could be the beneficiaries of whatever is left in the IRA but it would have to be paid out to them over their mother's life expectancy. The required distributions from the child's IRA cannot be paid over the life expectancies of the grandchildren.

The elimination of the stretch IRA also presents age inequity issues. Older Americans will not be able to divert the tax disaster awaiting their children because they have already saved for their retirement in plans at Congress' encouragement. Only the younger owners will have enough time to stop saving in the retirement plan to avoid the negative tax treatment.

The Senate version of the elimination of the stretch IRA in its retirement plan bill (known as RESA) would at least exempt \$400,000 per beneficiary from this draconian treatment. However, apparently this provision has been deemed unworkable so that it is important for small business owners to contact their members of Congress and urge them to vote against the SECURE Act and to instead vote for a bill that would allow payments from IRAs to be made over the life expectancies of the children (regardless of whether they are minors). Hopefully, the Senate will understand how detrimental this provision is to small business employees who are already covered by a retirement plan and will adopt either its own provision in RESA (which we think is workable) or far better, allow payments to be made over the children's life expectancies.

The second negative provision in the SECURE Act dramatically increases penalties on the late filing of certain retirement plan forms – in some cases by up to 10 times. For instance, today the maximum penalty for the late filing of form 5500 is \$15,000 – if the SECURE Act gets passed this penalty will be increased up to \$150,000! Large companies are almost never late filing these forms, rather it is small businesses who lack in-house accounting and benefit departments that miss the deadlines. Part of the problem is that small business owners have businesses to run which at times can get in the way of the myriad IRS and DOL forms and notices the owners are required to file or hand out. Just a reminder: the 28 million small businesses in the United States account for 55 percent of all American jobs – so one would think that Congress should want to make life easier for small business owners, not harder. Unfortunately, these additional penalties assessed against and paid by small businesses are likely to reduce the amount of employer contributions these businesses can contribute to the plan for the employees in the following year(s).

The long and the short of the proposed elimination of the stretch IRA is that it is an inequitable new tax on money that small business owners had been advised would be helpful to them throughout their and their spouses' retirement and if anything was left over, over the lifetimes of their children. What a travesty that Congress is asking the small businesses who sponsor plans and the owners who paid for their own retirement benefit and for their employees' benefits to foot the whole cost of this bill.

Moreover, the Senate should stay with its own penalty provisions, which even though they do increase the penalties for late filing of retirement forms, they do so on a far more modest basis.

If this Act becomes law, feel free to contact us so that we can work on ways to ameliorate the negative tax treatment awaiting your non-spousal beneficiaries and to update your beneficiary designation and other estate planning documents to make the changes required due to this law.

[1]Social Security Bulletin, Vol. 75, No. 2, released May 2015. Congress tends to look at statistics that show that roughly 50% of all employees are not covered by a retirement plan. While these statistics are based on the entire workforce, so that they include part-time employees who are not required to be covered by a retirement plan, they also do not break down the data to determine which size companies sponsor retirement plans and which do not. They also do not rely upon actual W-2 data. This Social Security Bulletin does dissect the data and it shows that approximately 75% (not 50%) of all private sectors workers are covered by a retirement plan. The data also shows that coverage decreases dramatically with businesses with fewer than 10 employees. Within this demographic are businesses that are just starting up, unstable, struggling to stay alive or closing down. This study showed that once a small business has significant employees, it offers a retirement plan at almost the same rate as big business. Note that the small business plans that do exist provide very meaningful employer contributions for all of the employees – often at more generous levels than big business. It is these small business retirement plans that the SECURE Act is targeting for hidden taxes and penalties.