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TOPIC: The SECURE Act Is Here, Now What Do We Do?

MARKET TREND: The SECURE Act adds new design features for 401(k) and other tax-qualified retirement plans beginning in 2020, some of which are voluntary design opportunities and others of which will require mandatory design changes.

SYNOPSIS: The SECURE Act encourages 401(k) plan sponsors to consider adding lifetime income products, such as annuity contracts, by removing some of the obstacles to those products. The SECURE Act also makes certain 401(k) safe harbor designs potentially more attractive. Small employers may also qualify for increased tax credits for start-up costs related to adopting a new plan or for adding certain automatic enrollment features to an existing plan. The SECURE Act also includes certain mandatory design features that may require employers to adopt plan amendments and change plan administrative practices. These new mandatory features include changes to required minimum distribution rules and a new eligibility requirement for certain long-term part-time employees.

TAKEAWAYS: Plan sponsors should explore with their advisors some of the new design choices made available by the SECURE Act and get ready for the design changes mandated by the act.

Many of these requirements will depend on guidance yet to come from the Internal Revenue Service and Department of Labor.

On December 20, 2019, the Setting Every Community Up for Retirement Enhancement Act of 2019 (the "SECURE Act") was signed into law resulting in a number of changes impacting 401(k) plans and other tax-qualified retirement plans. The SECURE Act creates several new, potentially attractive design choices for 401(k) plans, but also imposes new design requirements. This article reviews some of the key new design choices and requirements that plan sponsors and their advisors should begin to consider now.[1]

CHANGES THAT ENCOURAGE LIFETIME INCOME PRODUCTS IN 401(K) PLANS

401(k) plans have become the primary form of retirement savings offered by employers, but very few of those plans provide employees with an easy way to receive their plan benefits as lifetime retirement income, like an annuity. The SECURE Act includes three provisions intended to encourage greater adoption of lifetime income products by 401(k) plans:

1. Fiduciary safe-harbor for selecting lifetime income product providers;
2. Increased portability for lifetime income products offered in defined contribution plans; and
3. Required lifetime income disclosures for participants.

Fiduciary Safe Harbor For Selecting Lifetime Income Providers. Selecting an insurance company or other provider to make available a lifetime income product, like an annuity contract, for a 401(k) plan can raise potential fiduciary risk for the plan fiduciary selecting the provider. Concerns can arise, for example, if that provider later becomes financially troubled. The SECURE Act makes it easier for fiduciaries to select a lifetime income provider (the "insurer") by adding a safe harbor for plan fiduciaries in making that selection.

Under the SECURE Act, a plan fiduciary will be deemed to satisfy its fiduciary requirements under ERISA in selecting a lifetime income product offered by an insurer if the plan fiduciary:

- engages in an objective, thorough, and analytical search for the purpose of identifying insurers from which to purchase the annuity contract;

[1] This article is not intended to be a comprehensive summary of the SECURE Act. It focuses on certain features of the SECURE Act that are likely to be of interest to private sector employers that sponsor 401(k) or other qualified retirement plans for non-union employees. For example, the SECURE Act includes special rules and exceptions for governmental and collectively bargains plans and are not described in this article.

- considers the financial capability of such insurer to satisfy its obligations under the annuity contract; and

- considers the cost (including fees and commissions) of the annuity contract offered by the insurer in relation to the benefits and product features of the contract and administrative services to be provided under the contract.

To satisfy the safe harbor, the plan fiduciary should obtain a written representation from the insurer that:

- the insurer is licensed to offer annuity contracts; and

- the insurer, at the time of selection and for each of the immediately preceding seven plan years—

    - operates under a certificate of authority from the insurance commissioner of its domiciliary State which has not been revoked or suspended;

    - has filed audited financial statements in accordance with the laws of its domiciliary State under applicable statutory accounting principles; and

    - maintains (and has maintained) reserves which satisfies all the statutory requirements of all States where the insurer does business; and is not operating under an order of supervision, rehabilitation, or liquidation.

If the fiduciary determines that the insurer is financially capable of satisfying its obligations under the annuity contract and the relative costs of the contract are reasonable, the fiduciary will not be liable for any loses to the participant or beneficiary on account of the insurer's inability to satisfy its financial obligations under the terms of the contract.

Throughout the selection period, plan fiduciaries should document their decision-making process in the event it is ever challenged by the Internal Revenue Service ("IRS"), Department of Labor ("DOL") or a participant. Moreover, fiduciaries should also conduct a periodic review of the insurer. The safe harbor provides that a periodic review is deemed conducted if the fiduciary obtains the written representation noted above from the insurer on an annual basis. The safe harbor only relieves fiduciary liability with respect to the selection of the annuity provider. The plan fiduciary still has a duty in selecting the annuity (e.g., whether fees and services provided under the contract are prudent).

Increased Portability Of Lifetime Income Options. One potential drawback of lifetime income options in a 401(k) or other defined contribution plan is that they can be difficult or costly to remove from the plan investment line-up. These lifetime income options typically take the form of a guaranteed investment contract, which often imposes a fee when liquidated. But plan sponsors and fiduciaries need the flexibility to make changes to the investment line-up in their plans. Prior to the SECURE Act, participants had no good way to preserve a lifetime income option in the event an employer no longer authorizes that lifetime income option under the plan.

As a result, participants not only would lose the benefit of the guaranteed retirement income provided by the lifetime income option, but also may have to pay a fee to liquidate the investment.

To address this potential drawback, for plan years beginning after December 31, 2019, the SECURE Act allows plan participants invested in a lifetime income investment option to take a distribution in the event the investment is no longer authorized under the plan. The distribution may take the form of a direct trustee-to-trustee transfer to another employer-sponsored qualified plan or IRA, or by the plan's purchase and distribution to the participant of an annuity contract. The distribution must occur at least 90 days prior to the date that the lifetime income investment is no longer authorized to be held as an investment option under the plan.

> Practical Considerations. Plan sponsors will likely be required to revise their plans, summary plan descriptions ("SPDs"), distribution forms, and participant communication materials if they wish to offer participants this option.

Required Lifetime Income Disclosures. Whether or not a plan makes available a lifetime income product, the SECURE Act requires that the plan administrator provide participants with a lifetime income disclosure. The disclosure must provide an estimate of the amount of monthly income that the participant or beneficiary would receive if their account balance under the plan was paid as a single life annuity or joint survivor annuity. The lifetime income disclosure must be included in the participant's annual pension benefit statement and furnished at least once every 12 months.

An employer will not incur fiduciary liability if it uses the DOL assumptions and guidance in calculating the applicable annuity amount. The SECURE Act directs the DOL to develop a model disclosure and prescribe the assumptions that administrators may use in determining the estimated annuitized amount. This requirement becomes effective for benefit statements furnished more than 12 months after the latest of the DOL's issuance of an interim final rule or the model disclosure and assumptions.

> Practical Consideration. It is possible that once employers begin to provide employees with these lifetime income disclosures, participants may put more pressure on their employers to add lifetime income options as a plan investment choice.

CHANGES THAT ENCOURAGE 401(k) SAFE HARBOR PLANS

401(k) plans normally must pass mathematical annual discrimination tests—sometimes called the "ADP" and "ACP" tests— which limit the amount of elective and matching contributions for highly compensated employees based on the amount of elective and matching contributions for non-highly compensated employees. The Code includes certain "safe harbor" plan designs which, if adopted, allow employers to avoid these nondiscrimination tests. The SECURE Act includes two provisions that further encourage certain of these safe harbor plan designs, effective for plan years beginning after December 31, 2019.

Increase in Maximum Automatic Deferral Rate. One type of 401(k) safe harbor plan design utilizes an automatic enrollment feature. Under the qualified automatic enrollment

("QACA") safe harbor design (which requires a certain level of matching contributions), unless an employee elects otherwise, the employee is treated as electing to make elective deferrals at a default rate equal to a percentage of compensation that is stated in the plan and is at least (a) 3% of compensation for the first year the deemed election applies to the participant (the first deemed election year); (b) 4% during the second year; (c) 5% during the third year; and (d) 6% during the fourth year and afterwards. Automatic enrollment safe harbor plans may provide for default contribution rates higher than the above minimums but cannot exceed a maximum rate of 10% for any year. For plan years beginning after December 31, 2019, the SECURE Act increases the maximum automatic deferral rate for a QACA safe harbor plan from 10% to 15% after the first year of automatic deferrals. But, for the first year of the participant's default contributions, the maximum default rate remains 10%. This rule only applies for safe harbor plans. For non-safe harbor plans there is no maximum limit.

> Practical Considerations. Generally, increasing the automatic default contribution rate encourages more saving for retirement by the participants. Although not required, if a plan sponsor wishes to implement this increased maximum default contribution rate, a plan amendment and updated administrative procedures, enrollment forms, SPDs, and any other participant communications are required. Safe harbor plans generally cannot be amended mid-year unless an exception applies. Plan sponsors that wish to make a mid-year change should consult with legal counsel to ensure that regulatory requirements are met.

Extended Time to Adopt Safe Harbor Plan with Nonelective Contributions. Under the nonelective contribution safe harbor plan design, a 401(k) plan automatically passes annual nondiscrimination testing if the plan provides for a nonelective contribution of at least 3% of an employee's compensation on behalf of each non-highly compensated employee eligible (and satisfies certain other requirements). To qualify for the safe harbor, each eligible employee must receive a safe harbor notice explaining his rights under the plan within a reasonable period *before* the beginning of the plan year. Generally, safe harbor plan provisions must be adopted prior to the beginning of the plan year and remain in effect for the entire plan year unless an exception applies. These provisions can make a safe harbor design less attractive for some employers.

The SECURE Act encourages the nonelective employer contribution safe harbor design by loosening some of these requirements. The SECURE Act eliminates the notice requirement for these safe harbor plans. The SECURE Act also allows the employer to delay the decision as to whether to make a safe harbor nonelective contribution. The new rules allow the employer to:

- add a 3% safe harbor nonelective contribution feature to its 401(k) plan during and up to 30 days before the end of the plan year; or

- add a 4% safe harbor nonelective contribution feature to its 401(k) plan if the plan is amended after 30 days before the end of the plan year and no later than the close of the following plan year.

> <u>Practical Considerations</u>. This change gives employers flexibility to wait until after the end of the plan year to assess non-discrimination testing results and eliminate failures by amending the plan to provide for at least a 4% nonelective employer safe harbor contribution. Employers who want to take advantage of this new rule should review their safe harbor policies and procedures, notices, plan documents, SPDs, and participant communications to determine whether revisions are necessary.

This new rule does not apply to employers that use a safe harbor matching contribution design. Those safe harbor plans still must provide a safe harbor notice before the plan year and have limited ability to change design during the plan year.

<u>CHANGES THAT ENCOURAGE SMALL EMPLOYERS TO ADOPT PLANS</u>

<u>Increased Tax Credit for Small Employer Retirement Plan Startup Costs</u>. Prior to the SECURE Act, a small employer that wished to adopt a new qualified retirement plan was eligible receive a nonrefundable tax credit (the "Start-Up Tax Credit") capped at $500 per year. For purposes of the Start-Up Tax Credit, a small employer is one that does not have more than one-hundred (100) employees earning more than $5,000 in compensation from the employer in the preceding year ("small employer").

Effective for plan years beginning after December 31, 2019, the SECURE Act increases the Start-Up Tax Credit to not less than $500, and as much as $5,000, depending on the number of non-highly compensated employee eligible to participate in the plan. The Start-Up Tax Credit applies for up to three years beginning with the year the plan is first effective, or, at the election of the employer, with the year preceding the first plan year and for each of the two taxable years immediately following the first credit year.

Under the Start-Up Tax Credit, qualified start-up expenses include, (i) the establishment or administration of an eligible employer plan, or (ii) the retirement-related education of employees with respect to such plan. For purposes of the Start-Up Tax Credit, an eligible employer plan is a qualified plan with at least one non-highly compensated employee eligible to participate.

> <u>Practical Considerations</u>. Small employers may want to consider adopting a qualified retirement plan if they do not already have one to take advantage of the increased tax credit. Qualified plans are a great way to attract and retain employees and encourage them to save for retirement. Moreover, small employers should consider retirement-related educational planning so their employees better understand their rights and responsibilities under the qualified plan.

<u>New Small Employer Auto-Enrollment Credit</u>. The SECURE Act also creates a new nonrefundable general business tax credit for small employers adding an eligible automatic contribution arrangement ("EACA") to a new or existing plan (the "Auto-Enrollment Tax Credit"). Under an EACA, elective deferrals are made at specified rates (when the employee becomes eligible to participate) unless the participant elects a different percentage or not to participate. Effective for taxable years beginning after December 31, 2019, small employers will be eligible

for the Auto-Enrollment Tax Credit in the amount of $500 for each year during a 3-year credit period beginning in the first taxable year in which the employer adds an EACA in its qualified plan.

> Planning Considerations. Small employers with a 401(k) plan should consider including an EACA. EACAs generally encourage participants to save for retirement by automatically enrolling them in the plan and contributing a small percentage their compensation as soon as they become eligible. For some employers, the increase in participation and contributions will help to alleviate certain problems with nondiscrimination testing, where the level of participation and contributions made by rank and file employees is compared to that of highly compensated employees.

ACTION REQUIRED: MANDATORY DESIGN CHANGES

While the SECURE Act makes a number of favorable changes that give employers more choices when offering qualified retirement plans, it also imposes several mandatory design changes that will require employers with plans to take action.

Required Minimum Distribution Changes. Prior to the SECURE Act, participants were generally required to begin taking required minimum distributions ("RMDs") from their plan by April 1 of the year following the year they attained age 70-1/2 (the "required beginning date"), except that non-5% owners could delay the RMD payments until April 1 of the year following the year they retire.

The SECURE Act raises the age for RMDs from 70-1/2 to 72. This change applies for RMDs required to be made after December 31, 2019 for individuals who attain age 70-1/2 after December 31, 2019.

> Practical Considerations. For retired participants or 5% owner participants who attained 70-1/2 in 2019, the first RMD must still be paid by April 1, 2020. For retired participants or 5% owners who attain age 70-1/2 in 2020, RMDs must begin by April 1 of the year following the year they attain age 72. This change impacts administrative procedures, plan documents, summary plan descriptions, and rollover notices. Sponsors should work with their third party administrators to ensure that administrative procedures are updated accordingly.

Post-Death Required Minimum Distribution Change for Designated Beneficiaries. Prior to the SECURE Act, the RMD rules that apply after the employee's death differ depending on (a) whether an employee dies before, on, or after the required beginning date, and (b) whether there is a designated beneficiary. If the employee dies on or after the required beginning date, the remaining interest must generally be distributed at least as rapidly as under the method of distribution being used before death. If an employee dies before the required beginning date and any portion of the benefit is payable to a designated beneficiary, the distributions are generally required to begin within one year of the employee's death and are allowed to be paid over the life or life expectancy of the designated beneficiary. If the beneficiary of the employee is the employee's surviving spouse, distributions are not required to begin until the year in which the employee would have attained age 70½ (age 72 under the SECURE Act). If the surviving spouse dies before the employee would have attained age 70½ (age 72 under the SECURE Act), these rules apply after the death of the spouse as though the spouse were the employee. If an employee dies before the required beginning date and there is no designated beneficiary, then the entire remaining interest of the employee must generally be distributed by the end of the fifth calendar year following the individual's death.

Under the SECURE Act, generally, for an employee who dies after December 31, 2019, the remaining account must be distributed to designated beneficiaries within 10 years after the date of death, regardless of whether the employee died before, on, or after the required beginning date. This 10-year rule does not, however, apply to an eligible designated beneficiary, in which case the remaining account balance may generally be distributed over the life or life expectancy of the eligible designated beneficiary beginning in the year following the year of death. An "eligible designated beneficiary" is an individual with respect to the employee who on the date of his or her death is:

- the employee's surviving spouse;
- the employee's minor child;
- a chronically ill individual; and
- individual who is not more than 10 years younger than the employee.

Practical Considerations. This change does not apply to defined benefit plans. This change in law will require a plan amendment, updated administrative procedures, and participant communications. Guidance is still needed to determine administrative issues, for example, what is the age of majority. Sponsors should consult with counsel to ensure that plan documents and administrative processes are in place to comply with the change in law.

Eligibility of Long-Term Part-Time Employees. Qualified retirement plans generally may exclude from participation employees who do not attain age 21 or complete a year of service (a 12-month period with at least 1,000 hours of service (the "1,000 hour service rule")) during a plan year, and cannot impose longer service requirements. A plan can also exclude an employee from receiving an allocation of employer nonelective or matching contributions for a plan year unless the employee completes 1,000 hours of service during the plan year or is employed on the last day of the plan year (even if the 1,000 hour service rule is met).

The SECURE Act adds a new eligibility requirement for certain long-term part-time employees who would not otherwise meet the 1,000 hour service rule. Effective for plan years beginning after December 31, 2020, part-time employees who work for at least 500 hours per year with an employer for at least three consecutive years that meet age 21 by the end of the three-consecutive-year period must be eligible to participate in their employer's qualified retirement plan. Although this change is effective for plan years beginning after December 31, 2020, the three-consecutive year period does not take into account any 12-month periods beginning before January 1, 2021. Once a long-term part-time employee meets the age and service requirements, the employee must be able to commence participation no later than the earlier of (1) the first day of the first plan year beginning after the date on which the employee satisfied the age and service requirements, or (2) the date six months after the date on which the individual satisfied these requirements.

Employees eligible to participate due to this rule can be excluded from nondiscrimination and coverage rules and the application of top-heavy rules. This essentially means that these employees can be excluded from any employer matching or nonelective contributions without causing testing issues.

> Practical Considerations. For plans that do not exclude part-time employees, no action is required. For plans that exclude part-time employees, a plan amendment may be required to add the new 500 hours in three-consecutive year rule. Plan sponsors that exclude part-time employees (or other long-term employees) based on hours of service should review their documents to determine whether an amendment is required, work with their counsel and third-party administrators to ensure that administrative processes (including tracking hours and determining how to handle transfers from part-time to full-time employment) and participant election forms, SPDs, and other participant communications are updated. The earliest a part-time employee may participate under the new eligibility rules is 2024, since the three-consecutive year period first begins in 2021.

WHAT'S NEXT

The SECURE Act represents one of the most significant updates to the rules for qualified retirement plans in the last decade. While many of these rules become effective starting in 2020, we will need guidance from the IRS and DOL on the details. Plan recordkeepers will need to begin considering updates to plan administration platforms. Plan amendments will be required over the next couple of years. Employers should begin now to understand the new design choices made available by the SECURE Act, as well as the mandatory changes that will soon be required, and begin to discuss these changes with their advisors.