EDUCATION

SECURE Act Passage Heightens Retirement Security

December 30, 2019

Yaqub Ahmed
Head of Defined Contribution & Insurance/Sub-Advisory – US
Franklin Templeton

Drew Carrington, CFA
Head of Institutional Defined Contribution
Franklin Templeton

Kevin Murphy
Head of Strategic Accounts
Franklin Templeton Defined Contribution

Roger Michaud
Director of Sales,
Franklin Templeton 529 College Savings Plan

A sweeping piece of legislation affecting how individuals save and invest for their retirement, known as the "SECURE Act," has recently been signed into law. Our investment professionals talk about the implications of the Act, and how it can enhance the retirement security of millions of Americans. And, they outline some changes in the legislation that also affect college savings plans.

Listen to our experts discuss on our "Talking Markets" podcast

SECURE Act: a Few Highlights

- *Raises the automatic-enrollment safe harbor escalation cap to 15% of pay from 10% of pay.*
- *Creates "open MEPs" or open multiple employer plans (also referred to as PEPs, or pooled employer plans), allowing two or more unrelated employers to join a pooled employer retirement plan.*
- *Creates new 401(k) plan coverage and access for small employers.*
- *Increases the required minimum age to begin taking distributions from a retirement plan to 72 from 70½.*
- *Allows employers to make their plan available to part-time workers, while still excluding them from the discrimination testing rules (and the employer match).*
- *Changes 529 college savings plan provisions to include the expansion of qualified expenses to apprenticeship programs and more flexibility in loan repayments.*

The long-awaited "Setting Every Community Up for Retirement Enhancement (SECURE) Act of 2019" represents the most significant legislative change affecting tax-qualified retirement savings since the Pension Protection Act (PPA) of 2006. An initial version of the SECURE Act passed the Senate Finance Committee in the fall of 2016, as the Retirement Enhancement and Savings Act (RESA). As we consider the individual impacts and the implications of the final SECURE Act, which was signed into law just over three years later, it's worth keeping in mind our high-level observation—the SECURE Act will improve the retirement savings system for many, many Americans, in multiple ways.

Increased Access, More Incentives

The headline changes in the Act fall under a few categories: increased access, lifetime income, changes to required minimum distributions (RMDs) and more incentives to start plans. The section that has received the most coverage and discussion is the creation of "open MEPs" or open multiple employer plans (also referred to as PEPs, or pooled employer plans). The idea is that unaffiliated employers can participate in a single plan, with a single plan audit, tax filing and investment lineup.

Further, the SECURE Act allows financial institutions to organize and sponsor MEPs/PEPs. More than 35 million US workers do not currently have access to an employer-sponsored plan, so that section is aimed at creating new 401(k) plan coverage and access for small employers, who have been deterred from starting plans for a variety of reasons including lack of familiarity, lack of scale, cost, complexity, etc.

Under a MEP, small employers can easily join an at-scale plan, and give their employees access to a state-of-the-art, lower-cost plan design immediately. The idea is that this will increase coverage in the small business sector, where retirement plan coverage is much lower than among large employers. We also feel this will help mitigate the potential “patchwork” impact and proliferation of state-level retirement plans to one that is more consistent and carries more benefits. There will likely be additional changes in the retirement plan landscape as a result of the introduction of MEPs. Some small plans (generally less than $10 million) may opt to join a MEP rather than continue offering a stand-alone plan, which will create consolidation in that market. Further, as we see in other defined contribution plan markets worldwide, such as the United Kingdom and Australia, some large or even very large employers may opt to exit the stand-alone plan business and join a MEP, in part to reduce their perceived exposure to fiduciary litigation.

There are some second- and third-order effects from the creation of MEPs as well. In addition to creating a new class of sophisticated large plan buyers, by building state-of-the-art plans with the latest features, existing plan sponsors will be able to point to these plans as first-movers that have “worked out the kinks” on new features (such as lifetime income options, as discussed below).

Plans with advanced features will also create pressure for existing plans to modernize, in order to compete with the MEPs in the marketplace. We know from a wide variety of sources that larger plans generally lead to better outcomes: lower costs, more features, more use of auto-enroll features, higher deferral rates and higher participation rates. Making those “at-scale” plans available to small employers should increase participation in the existing employer-sponsored tax-qualified savings system. This should reduce the ranks of those who have a job, but do not have access to a plan through their job. And, we expect to see an increase in the overall level of retirement savings as well. Longer term, this may be the most important game changer in the SECURE Act, much like the auto provisions were in the PPA of 2006.

Another aspect of SECURE is also critically important to expanding retirement plan coverage as well, and that’s the expansion of plan availability to permanent part-time workers. Previously, employers with significant part-time workforces often excluded those employees altogether from access to their retirement plan, because their inclusion might cause the plan to fail various non-discrimination testing rules. Now under SECURE, an employer can make its plan available to part-time workers, while still excluding them from the discrimination testing rules (and the employer match). For employers with large permanent part-time workforces (such as retailers or restaurants), this change has the potential to dramatically increase retirement plan coverage of working Americans.

Additional Incentives to Create Plans and Encourage Saving

The Act offers some additional incentives for businesses to start a plan (an expanded start-up tax credit for creating a plan, including joining a MEP), as well as a brand new credit for small employers that adopt automatic plan provisions, such as auto-enrollment and auto-escalation. While the amounts are relatively small and are limited to employers with under 100 employees, tax incentives tend to drive behavior. At the margin, this, coupled with the availability of MEPs, will likely increase plan availability in the small-employer market.

Changes to Current Plan Rules

The impacts for current participants in 401(k) plans under SECURE are extensive and positive, in our view. The most important impacts would be the changes regarding lifetime income in 401(k) plans, and the increase in the cap on auto-enrollment and escalation beyond 10%. Starting with the latter, under the existing rules, plans that wanted to claim “safe-harbor” status and avoid discrimination testing were limited from both initially enrolling participants at savings levels over 10%, and auto-escalating their contributions beyond 10%. Under SECURE, that limit moves to 15%, which sends a powerful signal to all sponsors (even those that are not safe harbor plans) that 15% is the right goal for savings levels.

Changes Regarding Lifetime Income in 401(k) Plans

With respect to lifetime income, SECURE has three new changes:

1. Mandating that plan sponsors communicate a participant’s plan balance as an income amount;
2. Creating a new form of qualified distribution, which enables portability for lifetime income options;
3. And, most importantly, creating a broad safe harbor for annuity selection for plan sponsors.

The portability section addresses the concerns of plan sponsors of being “trapped” in a product that they no longer want to offer and addresses another long-standing hurdle to the consideration and adoption of lifetime income solutions. The fiduciary concerns regarding annuity selection have been a roadblock to almost all consideration of retirement income solutions in plans, and the removal of that hurdle will spark activity and innovation on this front. Ultimately, for participants, these changes mean more clarity around their account balance in income terms in retirement, more availability of tools, solutions and products to help with the transition from saving to spending, and more institutionally constructed-and-priced income solutions inside plans. We think this is a real win for retirement savers.

Changes to Required Minimum Distributions and Age-Related Restrictions on IRA Contributions

The single biggest impact for existing individual retirement account (IRA) holders in the SECURE Act is the change in the age for required minimum distributions (RMDs). Before the passage of the Act, holders of traditional IRAs and 401(k) plans were required to withdraw from their tax-qualified accounts (and pay taxes on the withdrawal), starting in the year in which they turn 70½. That starting age has been in place since the early 1960s—predating 401(k)s—and hasn’t been updated to reflect either improvements in expected longevity or changes in the nature of retirement itself (with more individuals over the age of 65 in the workforce).

SECURE builds on recent IRS changes to the RMD calculation itself, and extends the initial withdrawal to age 72. In addition, SECURE also repeals the age limit on contributions to traditional IRAs, enabling those that are working (those with earned income) over age 70½ to make ongoing contributions to IRAs. These two sections in SECURE have flown under the radar compared with the higher-profile topics of MEPs and lifetime income, but we believe they will have a meaningful impact on millions of retired Americans, because the vast majority of IRA holders (almost 80% in 2016, according to the Employee Benefit Research Institute) use the RMD as a signal for when to begin taking distributions from their tax-qualified accounts, and how much to take from those accounts. The later starting dates (and reduced amounts under the revised IRS tables) means that more money will likely remain in tax-preferred accounts for longer, enabling the dollars to grow, and reducing the potential likelihood that individuals and households run out of assets very late in life.

It’s worth noting that other retirement bills which have been proposed (for example, the “Retirement Security and Savings Act” from Senators Portman and Cardin), build on these developments by further extending the RMD age, and potentially exempting smaller balance tax-preferred accounts from RMDs altogether.

A Word About 529 College Saving Plans

In addition to retirement savings, the SECURE Act also impacts college savings. The legislation expands qualified distributions for 529 plans to include:

Apprenticeships Programs: Per bill language, 529 plan qualified distributions now include expenses for fees, books, supplies and equipment required for the participation in an apprenticeship program registered and certified with the Secretary of Labor under section 1 of the National Apprenticeship Act. The Department of Labor provides a search tool to find out if an apprenticeship program is eligible.

Repayment of Student Loans: Allows families to take qualified, tax-free 529 distributions for the payment of principal or interest on any qualified education loan of a 529 plan designated beneficiary or a sibling of the designated beneficiary. The law includes an aggregate lifetime limit of $10,000 in qualified student loan repayments per 529 plan beneficiary and $10,000 per each of the beneficiary's siblings. It is, however, important to bear in mind that the portion of student loan interest that is paid for with tax-free 529 plan earnings is not eligible for the student loan interest deduction.

Also, the provision does not appear to directly encompass the repayment of student loan debt incurred by parents on behalf of the designated beneficiary. Both of these changes are retroactive; they apply for 529 distributions made after *December 31, 2018.* We are excited to see the passage of the SECURE Act into law. It is sweeping and far-ranging, and we believe it will have significant, positive impacts on the savings and security of millions of Americans.

Important Legal Information

All financial decisions and investments involve risks, including possible loss of principal. *529 plan underlying funds have risks that will cause your investment return and principal value to fluctuate. Stocks tend to fluctuate dramatically over the short term. Bond prices generally move opposite to interest rates; as bond prices adjust to a rise in interest rates, a fund's share price may decline. High-yield, lower-rated bonds generally have greater price swings and higher default risks. Foreign investing, especially in developing markets, has additional risks such as currency and market volatility and political or social instability.*

An investment in Franklin Templeton 529 College Savings Plan does not guarantee any specific rate of return or that your college investing goals will actually be met. The value of an investment in the plan may fluctuate, and investors may have a gain or a loss from investment in the plan. This is not a recommendation of any particular security, is not based on any particular financial situation or needs, and is not intended to replace the advice of a qualified financial advisor. Before making any financial commitment regarding a Section 529 college savings plan, consult with an appropriate financial advisor. Investors should carefully consider Section 529 college savings plan investment goals, risks, charges and expenses before investing.

To obtain a 529 plan disclosure document, which contains this and other information, talk to your financial advisor or call Franklin Templeton Distributors, Inc., the manager and underwriter for a 529 plan at (800) DIAL BEN / (800) 342-5236 or visit franklintempleton.com. You should read the 529 plan disclosure document carefully before investing or sending money and consider whether your or the account beneficiary's home state offers any state tax or other state benefits such as financial aid, scholarship funds, and protection from creditors that are only available for investments in its qualified tuition program.

This communication is general in nature and provided for educational and informational purposes only. It should not be considered or relied upon as legal, tax or investment advice or an investment recommendation, or as a substitute for legal or tax counsel. Any investment products or services named herein are for illustrative purposes only, and should not be considered an offer to buy or sell, or an investment recommendation for, any specific security, strategy or investment product or service. Always consult a qualified financial professional or your own independent financial advisor for personalized advice or investment recommendations tailored to your specific goals, individual situation and risk tolerance.

Franklin Templeton (FT) does not provide legal or tax advice. Federal and state laws and regulations are complex and subject to change, which can materially impact results. FTI cannot guarantee that such information is accurate, complete or timely; and disclaims any liability arising out of your use of, or any tax position taken in reliance on, such information. Because market and economic conditions are subject to rapid change, comments, opinions and analyses are rendered as of the date of the posting and may change without notice.

To get insights from Franklin Templeton delivered to your inbox, subscribe to the Beyond Bulls & Bears blog.

For additional timely insights, follow us on Twitter @FTI_US and on LinkedIn.