Changes to Your Retirement Plan - Transcript

Tim Mullooly: Welcome back to living with money. This is Tim Mullooly. This is episode number 104. Tom Mullooly is here with me today.

Tom Mullooly: Hello everyone.

Tim Mullooly: We wanted to talk about a topic today that, if you're not in the financial services industry, you might not have known that this legislation was passed through Congress at the end of 2019 and it's going to effect a lot of people with retirement plans at work. So, we're going to be talking about the Secure Act today.

Tom Mullooly: Which is hilarious because every time I read this, I read these different facts. I think to myself, this is the most insecure act I've ever seen.

Tim Mullooly: Yeah. Secure Act. The secure is actually an acronym. It stands for Setting Every Community Up for Retirement Enhancement. I feel like they just pick the word secure and then had to find words to fit into the acronym. That's kind of a bulky way to say we're making changes to your retirement plan.

Tom Mullooly: Well, in the mid-eighties they came out with TEFRA, T-E-F-R-A which was the Tax Equity and Fiscal Responsibility Act, but it soon morphed into Tax Every F Resource Available.

Tim Mullooly: The Secure Act, like I said, it was passed right at the end of last year, December 19th of 2019 after it had been previously tabled for a while. I think it has been-

Tom Mullooly: April or May-

Tim Mullooly: I was going to say, I think it was the beginning of the summer when it had originally got to the floor of Congress and then it kind of sat there and people thought that it was just going to become another one of those bills that never really got pushed through. And then all of a sudden at the end of the year it got tacked on to the bill to keep the government up and running and people are like, "Oh, it's back."

Tom Mullooly: It came through very quickly, right at the end of December and it had implications immediately.

Tim Mullooly: Right. Yeah. I mean the changes are going to be taking place 2020 and going forward. So, there was two weeks there for people to kind of digest what is in this new act and how it's going to affect people from a financial planning standpoint.

Tom Mullooly: So, basically if you've got a retirement account at work or an IRA, this is going to have some kind of impact on you and we want to spend this time today just talking about some of these things.

Tim Mullooly: Yeah. The first thing or I think one of the biggest points that people bring up about the Secure Act is the fact that it's going to, or it did eliminate the stretch IRA for most non-spousal beneficiaries of an inherited IRA. What does that mean? Getting rid of the stretch IRA? First, let's start with what was the stretch IRA?

Tom Mullooly: The stretch IRA, sometimes called beneficiary IRA, what that would permit beneficiaries to do was, if you had someone with an IRA pass away and you are named as a beneficiary, you could then set up a beneficiary IRA. This is not something that can be merged into your traditional IRA or your Roth. This was a totally separate beneficiary IRA, but it permitted you to do one of two things. If your original owner had not begun their required minimum distributions, you could stretch the distributions over your lifetime. You inherit something from a parent. Say your parent passes away in their seventies or eighties, you're in your forties you could, in theory, stretch this distribution, this IRA over 30 or 40 more years. That's a lot of compounding that could take place and a lot of taxes that the IRS is missing out on.

Tim Mullooly: Right? Because you don't, the amount that you have to take out every year, is going to be significantly less because it's-

Tom Mullooly: Based on your life expectancy, which is you still got a long way to go.

Tim Mullooly: Right, exactly.

Tom Mullooly: The second way that these work were, if your original owner of the IRA was already taking required minimum distributions, it was a different calculation, but again, you could stretch this out over a much, much longer period of time. We had a situation where we had a client pass away suddenly, unexpected. His daughter wound up becoming the beneficiary on retirement money and this money, she's in her twenties, and this money is going to be stretched over 55-57 years, something like that. These things were terrific in terms of how you could defer paying taxes on this money for an entire generation and then some, really good.

Tim Mullooly: So ,that is what the stretch IRA was. This act has kind of almost killed it in a sense. There are a couple exceptions, which we'll get to in a little bit, but the new rules now, what are they and do you think that it's a good or a bad thing for individuals inheriting these IRAs?

Tom Mullooly: Okay, so what's changed now is, well, let's talk about what hasn't changed.

Tim Mullooly: Okay.

Tom Mullooly: If you're married and you pass away or your spouse passes away, the surviving spouse basically can take that retirement account and roll it into their own existing IRA. And so it becomes theirs. And so that just continues to go on. However, now with the Secure Act in place, anyone who is not a surviving spouse, anyone pretty much, is now subject to... they can stretch out the distributions, but they have to be done on the 10th anniversary of the date of death. So, you can take it in 10 equal installments over 10 years. You could do nothing and wait until the 10th year and pay a whopper full of taxes. It's really by the 10th year got, to be cleaned out.

Tim Mullooly: Yeah. There's an article written by Michael Kitces and I'll link to it in the show notes where we got a lot of this information and in there, in that example he said, "Let's say that you're 60 years old and you inherit an IRA and let's say you plan on retiring when you're 65. From a planning standpoint, you could defer taking those distributions for the first five years while you have income coming in and then once you retire, you take all the money out in the last five years. There is no real structure of how you need to take the money out over the 10 years. It just needs to be emptied by the end of the 10th year.

Tom Mullooly: Interesting point that I'm going to raise that it's probably going to come back later in this conversation. If you have a deferred annuity, the rules are that if you pass away with a deferred annuity in your name, your beneficiaries have to clean out that account within five years from the date of death. You can take it out once a year, once a month. By the end of the fifth year on the fifth anniversary, that account's got to be closed.

Tim Mullooly: Yeah.

Tom Mullooly: Interesting that they set up these new rules for stretch IRAs. In the same vein, this one's 10 years. With the annuities, it's five years and I have a hunch we'll be talking about annuities in a little bit.

Tim Mullooly: Yeah, we definitely will be. So, that's kind of what they've done to the stretch IRA. It's not dead. It's just that you can't stretch it as long as you used to. You can only stretch it 10 years, in most cases. Like we mentioned before, there are eligible beneficiaries who can still use the stretch IRA, the spouses like Tom mentioned, the other people who would qualify as an eligible designated beneficiary to use the stretch IRA would be disabled or chronically ill beneficiaries, individuals who are not than 10 years younger than the decedent.

Tom Mullooly: That's important.

Tim Mullooly: Yeah, and certain minor children, but only until they reach the age of majority and then once they turn 18 then the 10 years kicks in for them.

Tom Mullooly: Right.

Tim Mullooly: There are some people who will still be able to utilize the old stretch IRA, but way less than they used to be able to.

Tom Mullooly: And Tim, we received, we're recording this in mid-January, we received a rash of phone calls January 2nd, 3rd and 4th.

Tim Mullooly: Yeah. I want to make sure that it's clear that this change is for those who inherit IRAs in 2020 and beyond. For those who passed away in 2019 and prior to 2019, you won't be affected by this for your stretch IRAs. You can keep doing what you're doing. It's just for January 1st, 2020 through into the future.

Tom Mullooly: Why do you think this was included in this Secure Act?

Tim Mullooly: It feels like a way for the government to be able to tax some of the income and IRAs and you can't stretch it out longer. So, it's a good way for the government to kind of generate some more revenue, taxing money coming out of these IRAs quicker. You can only stretch it over 10 years.

Tom Mullooly: I agree. And the whole concept of stretch IRAs has only been around for, check my math on this, but I think it's either 10 years or 15 years. Stretch IRAs have not been around all that long. If you passed away in the eighties or nineties and you had an IRA, it was going to be paid out.

Tim Mullooly: Yeah.

Tom Mullooly: It's the way it is. You know even the IRA itself was created in 1982, so it hasn't been around all that long. This is really the IRS and Congress kind of right sizing these things as they've discovered over time. "Wow. These stretch IRAs is a lot of money getting socked away in these things." But I recognize some of that revenue-

Tim Mullooly: Is almost too good. We got to take some of it away.

So eliminating the stretch IRA was one of the bigger points of the Secure Act. Another one that was in the act was that there's no more restrictions on contributing to a traditional IRA after age 70 and a half. So the old rule obviously was once you hit 70 and a half, you can't put any more money into your traditional IRA. That's no longer the case. However, you still have to have earned income to contribute to this IRA. So as long as you're still working and you still have money coming in, or you have some sort of earned income, you can contribute to your traditional IRA, as long as you want.

Tom Mullooly: So, if you're 70 or 71, you're still working and you want to put money into an IRA, if you qualify, according to the tax brackets, then you can still do it where you couldn't. You had to stop at 70 before that, which was really kind of a goofy rule in the sense that if you worked for a company and you were a participant in their 401k, as long as for every year that you worked, you could participate in the 401k even though you had to take money out at 70, you were putting money in and taking money out. It was ridiculous the way that that was set up, but you couldn't do that for an IRA, but now you can.

Tim Mullooly: Do you think that it has anything to do with the fact that they're realizing that, one, people aren't as prepared for retirement as they thought, so they want people to continue putting more money away for retirement, and, two, people are just working longer because of reason number one? They're working longer because they're not ready for retirement, so they want people to still be able to put money into their accounts when they retire.

Tom Mullooly: Okay. So my answer, my initial answer is yes to all of that. The cynical side of me says, "I wonder how many letters were going back and forth between IRA account holders and the IRS saying, 'You miscalculated 70 and a half. Is it in the year I turned 70 and a half or is it April 1st of the year after I turned 70 and a half and then do I have to take two distributions?' " I think this change that they've made now just kind of makes it easier for everybody. Don't you think so?

Tim Mullooly: Yeah. Don't have to worry about, "Can I still contribute or not?" It's yeah, there's no restriction, so yes. The answer is yes. As long as you have money coming in, it doesn't matter how old you are, you can give money away. On the same vein, there's another change. They increase the age from 70 and a half to 72 for the onset of having to take RMDs. A clear outcome of this, like you said, it's just a cleaner number now. You don't have to... How many people have called into the office and been like, "So I just turned 70. I know that some point soon I'm going to have to start taking RMDs. I don't know when it is. Do I have to take two this year or I turned 70 last year."

Tom Mullooly: Yeah, Tim. "My birthday's in September. That means I'll be 70 and a half next year. What does that mean right now?"

Tim Mullooly: Now, it doesn't matter.

Tom Mullooly: It doesn't matter. You turn 72, money's coming out. You It doesn't matter what day of the year.

Tim Mullooly: You should be able to know when you turn 72. It's easier to calculate than 70 and a half. Yeah, for sure. So that's a change. You don't have to start taking these RMDs, required minimum distributions until you're 72. Again, for those who have already started taking your RMDs, you won't be affected. You're kind of grandfathered into the way that it was. So you don't need to worry about that.

Tom Mullooly: I hope in the show notes we're able to underscore that so people can actually see that because we've gotten calls about that too. Like, "Oh, I don't have to take my RMD until I'm 72 but I just took one last year." Yeah, you've already started it. Keep it going.

Tim Mullooly: Yep. Keep doing what you're doing.

Tom Mullooly: That's it.

Tim Mullooly: In the same Michael Kitces article, he said that they found that 80% of people already taking money from their IRAs were taking more than the required minimum distribution amount every year anyway. So the change in RMD calculations that they would do going from 70 and a half to 72 wouldn't really matter for most people because they're taking more than they had to anyway.

Tom Mullooly: Yeah. May not move the needle. I think that there's, just in my experience, I think there's two camps with that. There are people who take more than they're required to take each year because it's part of their income that they have for their household. Right. And that's great. Yeah. This is what this money's for.

Tim Mullooly: Exactly.

Tom Mullooly: There's another group of people who say, "Do I have to take it again this year? Like I don't want it. I don't need it. What do I do?" For those people, the answer is yes, you have to take it and you may want to consider doing a charitable RMD where you take your required minimum distribution and instead of you taking it, it goes straight to a charity of your choice. And the income is not taxable to you. You won't get a write-off for it, but you're taking money out that you're required to take out and you're doing something for a charity that you care for.

Tim Mullooly: Besides having a cleaner number, 72 and deferring it for another year and a half for people, do you see any kind of big impact that moving it from 70 and a half to 72 has for people? Or is it, it kind of just like makes things more convenient?

Tom Mullooly: It's going to change my narrative in the sense that I used to tell people all the time that the first time that they're taking their RMD based on their life expectancy, it's going to be, I said a good back of the envelope number is 4%, I got to get a new number and I'm…

Tim Mullooly: Going to change that a little bit.

Tom Mullooly: Yeah, so it's probably going to be five or five and a half percent because they have less years of life expectancy. That's just an average folks. That's not you.

Tim Mullooly: Those will probably change too, though. I mean life expectancy continues to go up, always moving and people are living longer, so maybe the calculations will end up working out to 4% and we can keep our good clean number.

Tom Mullooly: Yeah. That's the negative side of it. The plus side is you get a couple extra years of compounding, which is always helpful. The longer you can compound your money, the better.

Tim Mullooly: Right, so you had mentioned charitable contributions. A big question that people had when they were discussing this bill was whether they were going to change the age for qualified charitable contributions from your IRA to 72 as well, because that was also 70 and a half. And the article from Kitces said emphatically, "No." So the age for a qualified charitable contribution remains at 70 and a half. They didn't change it to 72. Kitces said how, "This kind of creates a unique one and a half, two year window where people can take an IRA distribution and that can be qualified as a charitable contribution but not as a required minimum distribution."

Tom Mullooly: That's right.

Tim Mullooly: Because you don't have to start taking the RMDs until 72 but if you do a contribution for a charity when you're 70 and a half, it's still qualifies, but it's not an RMD.

Tom Mullooly: That's correct. And it's little things like this that get discovered weeks and months after the ink dries on these kinds of bills where they say, "Hey, next year, let's close that." And so I would fully expect that some of these nuances are probably going to get closed in a future bill.

Tim Mullooly: There are a couple more smaller points that the Secure Act touches on. The stretch IRA and the different ages that we just talked about for IRAs and RMDs where the big points that people kind of focused on the most, but one, they created an allowance for a penalty free distribution up to $5,000 for qualified childbirth or adoption.

So, that's a new change. So, you can take $5,000 of an allowance penalty free out of your IRA to pay for a qualified childbirth or an adoption. That's something that didn't exist before.

Tom Mullooly: I can't stress this enough that this is penalty free. It's not tax free.

Tim Mullooly: Yes.

Tom Mullooly: It's penalty free.

Tim Mullooly: Definitely a good point.

Tom Mullooly: So this is, someone in their twenties or thirties they're going through... Their family is growing one way or the other naturally or through adoption processes. That's great. Congratulations. I don't know if raiding your retirement account to pay for it is really such a hot idea.

Tim Mullooly: Yeah, I don't know if it's the best idea. There are some other financial planning topics that we could talk about to get ready for that in a different way, but it's nice to know, I guess, that if you really do need it, it is an option and you won't be penalized for it. You'll be taxed on it. You won't be penalized on it.

Tom Mullooly: The thing that I, a lot of people lose sight of is the difference between, as I mentioned a moment ago, penalty free and tax free. So, this money for the most part has never been taxed, so it's got to get taxed at some point. Yeah. Whether it comes with a penalty, really kind of depends on your situation. There are a lot of exceptions now where you can take money from a retirement account without a penalty. And well, that's really for another podcast, but you can take money out of some of these plans without penalty. It's almost always going to be taxable.

Tim Mullooly: A couple more details about this penalty free allowance. It's up to $5,000 per child, they said. So it starts over for each child. It's not-

Tom Mullooly: What if you're having triplets?

Tim Mullooly: It's per child and it's also on an individual basis so each parent can take up to $5,000 so realistically you could take $10,000 if both parents had money in their IRAs that they needed, that they wanted to take out for.

Tom Mullooly: If you're ready for a nickel's worth of free advice, if you're really in a jam and you know that your family is about to get bigger, you may want to think about how much you're contributing to your retirement plan at work.

Tim Mullooly: Yeah, that's what I was alluding to earlier with other financial planning topics. Like you got to think if you're planning on starting a family, you shouldn't be socking as much money away into your IRAs retirement plans as possible because you're going to need that money for kids.

Tom Mullooly: Let's have a conversation.

Tim Mullooly: Exactly. Yeah. So you know, you can put that money in different places where you don't have to worry about penalties and stuff like that.

Tom Mullooly: As long as we're talking about kids, I think they did make some kind of 529 mention in the new act as well.

Tim Mullooly: Yep. So they continue to expand the use of 529 plans and what you can use the money for. We get so many calls and we've done blog posts, podcasts and videos about this topic. People seem hesitant to use 529s because what if-

Tom Mullooly: What if my kid's not going to go to college?

Tim Mullooly: Exactly right. Not so long ago, you could really only use the money for four year traditional college. That's not the case anymore. And with this new provision, they expanded it even further. 529 plans can be used for apprenticeships and up to $10,000 could be used for student loan repayment.

Tom Mullooly: That's big.

Tim Mullooly: That is very big. 529 plans, we've done a lot of work on that. I'll link to some of them in the show notes. You can read and listen to more about it, but there's a lot more uses than people think.

Tom Mullooly: Let's talk about 401ks. And the Secure Act.

Tim Mullooly: So, another article that we read was from one of our friends, Tony Isola. He works for Ritzholtz Wealth Management. Listeners of the podcast, I interviewed his wife, Dena Isola, couple months ago. Great episode. I'll link to that in the show notes.

Tom Mullooly: Great people.

Tim Mullooly: Shameless plug.

Tom Mullooly: Yeah, they're great people. They're friends of the firm. We like them quite a bit. Tony's a Knick fan, condolences, but just really, really great.

Tim Mullooly: Yeah, they do a lot of great work, especially with 403B plans with teachers, but just with retirement plans for people in general. So, Tony was talking about some of the changes that are coming in the Secure Act in terms of annuities inside of 401ks. Not something that had previously been utilized that much. I think Tony's article said 10% of 401ks had some sort of annuities inside of them-

Tom Mullooly: It might even be less.

Tim Mullooly: But they're looking to change that. So, the Secure Act provides what they call a fiduciary safe harbor for ERISA fiduciaries, selecting insurance companies to provide annuities within their plans.

Tom Mullooly: All right. So I just want to pump the brakes on that. So safe harbor implies that you're not going to get sued if you play in this harbor.

Tim Mullooly: Right.

Tom Mullooly: Okay. So, fiduciary safe harbor. So, you're not going to be breaching your fiduciary responsibility if you're choosing an insurance company to provide annuities inside a 401k-

Tim Mullooly: As long as they met these-

Tom Mullooly: Couple of things and it's just a couple.

Tim Mullooly: It was two requirements and they were pretty light.

Tom Mullooly: One of them is not. Do you have a pulse? But it's pretty close. Yeah.

Tim Mullooly: So, Tony outlines the specifics of those requirements but let's just say that they're relatively on the light side in terms of what these insurance providers need to do to fit the bill to be able to offer you annuities. And in terms of fees and commissions, which is probably the most egregious part about annuities in general, especially within retirement plans, the only thing that it says about that is that fees and commissions need to be in quotes reasonable. And of course they didn't define what reasonable means. Your guess is as good as mine when it comes to reasonable.

Tom Mullooly: And so fiduciaries now are not required to choose the lowest cost contract.

Tim Mullooly: Right. Yeah, they're not required to pick the one that costs the least. It's one of the things that they should consider amongst a number of other things when choosing the insurance providers for these annuities, but a lot of times, in our opinion, the cost is the biggest part.

Tom Mullooly: So, Congress through the Secure Act has built this gigantic on-ramp, a runway for insurance companies to start offering annuities in 401k plans, which has up until this time, been very, very rare to see. I can understand one instance where an annuity in a retirement plan would be helpful and that would be if you wanted to do a lifetime income distribution from a Roth IRA, you don't have taxes involved, that would be a great opportunity to say, "Hey grandma, let's put this money into an immediate annuity. You're going to get X amount of dollars every month for the rest of your life. Even if you live to 110." But in almost all other circumstances you're taking a tax deferred vehicle and you're putting it inside a tax deferred plan like an IRA or a 401k.

Tim Mullooly: Right, and you don't get any sort of enhanced tax deferment from having it inside of the tax. It's like inception, like a dream inside a dream. It's not like tax deferred inside of tax deferred equals like tax deferred squared-

Tom Mullooly: Your analogy is better than mine.

Tim Mullooly: It doesn't work that way. One other thing I think that I wanted to mention was that in the act it said, "If a fiduciary satisfies these requirements that we have dubbed as light for the insurance providers, they are not liable for distribution of any benefits or any loss that may result from the insurer's inability to satisfy its financial obligations." Yikes.

Tom Mullooly: Jinx.

Tim Mullooly: Yeah. We said that at the same time, but I mean the requirements to offer these annuities are not that strict and also the person choosing them is not liable, if for some reason this annuity or this insurance company, let's say, goes under and they can't pay out the contracts that they promised, so they're not held responsible for that either. You're kind of just left floating in the waves.

Tom Mullooly: It's a shame. It's a real shame and when I first read about the Secure Act in the spring, I was like, "This thing will never work. It'll never work. They're trying to put annuities into 401ks. This will not work," and it got tabled, set aside and then it got tacked on to the omnibus spending bill right at the end of the year. Shame on them for ramming this through because honestly we're going to look back, in my opinion, we're going to be looking back in the next few years and say, "Holy cow, the 401k industry has been totally demolished because of these high cost products that are now jammed into it. Who cares if we could now continue to defer income from 70 and a half to 72? That's nothing. We're getting ripped off every year with the fees in these annuities and our 401ks.

Tim Mullooly: That was the nice thing about 401ks, was that the annuities weren't really a factor. Whereas Tony and Dina, most of their work is with 403Bs and the nightmares that they see from people and salespeople that go in and they jam these high costs. They said, "5 3/4% sales charge on annuities-

Tom Mullooly: Every dollar.

Tim Mullooly: For every dollar that goes in. They have horror stories of people who just-

Tom Mullooly: Put more in than it's worth.

Tim Mullooly: Yeah. On the surface, if in a perfect world where every consumer, every person in this plan is completely educated on the ins and outs of the annuities, how much they cost, how much they're worth, what they can do for you, this is great. It could be useful for people, but the fact is, they're not educated. People don't know the ins and outs of annuities and salespeople do, and they're going to go in and they're going to exploit it.

Tom Mullooly: Well, I know what's going to happen. We're going to be sitting here at the conference table at some point down the road five years from now, six, seven, eight years from now, and someone's going to say, "At my workplace, somebody came in and they said, 'How would you like all the upside of the stock market with no downside?'" And I said, "Yeah, I definitely want that." And they never made a nickel after that.

Tim Mullooly: Right. It's a shame and I think with all of these changes that we've been talking about, it's a lot to wrap your head around, and one of the first things I said was, "If you're not in the financial services industry you might not have known that any of these changes even took place. So I think to kind of wrap up, just in general, this is a good reminder to, if you're confused about your workplace retirement plan or things you can and can't do, or different products, get in touch with a financial planner or someone that knows what they're doing. The stakes are too high. That's really the main message for this episode. We'll link in the show notes to the different articles. You can read more about the Secure Act and all the changes that we outlined here for you. That's going to wrap up this episode of living with money. Thanks for tuning in and we'll catch you on the next one.