Obama Administration Again Proposes Taxing Some Roth IRA Distributions And Other Law Changes

Below is a summary of the President's fiscal year 2017 budget proposal for IRA and pension law changes. Unsurprisingly, the proposals seek to reduce the tax benefits realized by individuals with higher incomes.

1. The law will "cap" the tax benefit (exclusion or tax deduction) that a person may receive from an IRA, 401(k) or other tax preferred plan at the 28% bracket. That is, those individuals in a higher tax bracket (33%, 35%, 39.6%, etc) would not be able to claim a tax deduction for the full amount or claim a full tax exclusion. This is the first proposal or discussion making some Roth IRA distributions taxable. New for 2016.
2. The standard RMD rules would apply to a person who had funds within a Roth IRA in the same manner as they know apply to funds within a traditional IRA, SEP-IRA and SIMPLE IRA. This change does not generate any additional tax revenues, but is being made to lower the amounts in Roth IRAs earning tax free income. Proposed in 2015. This change would only apply to those Roth IRA accountholders who attain age 70½ in 2016 or later.
3. Required distributions would no longer apply to individuals who had an aggregated balance of less than $l00,000 in IRAS, 401(k)'s and other retirement accounts. A special rule would apply in the case of certain defined benefit plans. Proposed in 2015.
4. A person who has after-tax dollars in an IRA or pension plan would lose the right to convert such dollars into a Roth IRA. That is, a person will be eligible to convert only "taxable" funds, he or she could not convert after-tax funds. New for 2016.
5. Require most non-spouse beneficiaries to take required distributions using the 5-year Rule. The life distribution rule no longer could be used. This is a large revenue raiser and it raises greatly the taxes to be paid by non-spouse beneficiaries. This change would only apply if the IRA accountholder died on or after January 1, 2017.
6. The proposed law will "cap" the amount of funds a person may accumulate within tax preferred plans. This was also proposed in the 2015 budget proposal. The person would be required to aggregate the balance he or she has within personal IRAs with the balance within all employer sponsored retirement plans. Once a certain limit is reached, then no additional contributions could be made by the individual or by the individual's employer on his or her behalf. The account balance could grow if due to earnings, but not on account of new contributions. The law would permit a person to accumulate an initial balance of $3,400,000 as that is the actuarial equivalent of a joint and 100% survivor annuity of $210,000 per year. The $210,000 limit would be adjusted for cost of living increases.CWF Observation. This proposal would greatly complicate the administration of IRAs and pension plans. There would be a tremendous increase in the need for actuarial and accounting services. It may well be an employee would need to inform his/her current employer what he/she has accumulated in his/her IRAs and other pension plans.
7. The proposed law would allow certain non-spouse beneficiaries who mistakenly are paid a distribution from an inherited to roll over such distribution if certain rules are met. This was also proposed in the 2015 proposal.
8. The 401(k) plan rules would be changed so that an employer would have to let those employees working 500-999 hours per year for three consecutive years to be able to make elective deferral contributions. Under current law, an employer is not required

to allow employees who work less than 1,000 hours to participate in the plan. Although the employer would have to let such employees make elective deferral, the employer would not be required to make any contributions, matching or profit sharing, on behalf of such employees.

9. The IRS and the DOL are big fans of automatic enrollment pension plans. Under current law an employer's decision to sponsor a pension or profit sharing plan is totally voluntary. Many small and moderate size employers choose to not offer a plan due to the regulatory complexity. The IRS and the DOL don't seem to accept why so many employers choose to not offer such plans. Their solution, change the law so an employer must offer a simplified retirement plan. An employer with more than 10 employees which has been in business for at least two years would be required to offer a payroll deduction IRA program. Employees would automatically be enrolled to have 3% of compensation withheld unless they expressly waived coverage. An employee could have a larger percentage withheld. Funds could go into either a traditional IRA or a Roth IRA. To offset some of the cost for maintaining this plan there would various tax credits extended to the small employers.
10. The current tax rules applying to the taxation of net unrealized appreciation would be repealed. The general tax rule is, when a person takes a distribution from his or her IRA or 401(k) plan, such amount is combined with other wage or ordinary income for such year and taxed at the applicable marginal income tax bracket. Many times a person will move into a higher tax bracket on account of the IRA/401(k) distribution. Current law allows an employee who has been distributed employer stock to be taxed differently. He or she will include the cost basis of the stock in his or her income for the year of distribution, but is able to defer further taxation to when the stock is subsequently sold. There is no time limit by when the individual must sell the stock. It may be the government won't see any tax revenues for 20-50 years. Example. Jane works for ABC, Inc from ages 22-38. Her employer has a profit sharing which invests in employer stock. The corporation has been very successful. The corporation contributes stock which at the time contributed had a cost basis of $45,000, but has a value of $450,000 when distributed to her. Although she has various options, she elects to have the stock distributed to her inkind. Under this method she includes the $45,000 in her income and pays tax on such amount. Now assume the stock appreciates to $600,000 and she then decides to sell the stock. She would have $555,000 of long term gain and it would be taxed at a rate of 28% under current law. That is, she will not pay any tax on the stock appreciation until she sells the stock. And at that time she will most likely qualify to pay tax at then existing capital gain rates on the stock gain. The current tax rate is 28% but there were times during 2009-2012 when the tax rate was 10%, 15% or 20%. This change would not apply to a person who was age 50 or older as of 12/31/15.
11. The current tax laws allowing a publicly traded company to claim a tax deduction for dividends paid with respect to stock held in an ESOP would be repealed. Most of the above proposals have little chance of being enacted as the Republicans for the time being control Congress. The purpose of this article is, the politicians will certainly be discussing many of these same IRA and pension topics with some modifications. CWF believes it is only a matter of time before the law is changed to reduce the distribution period applying to an inheriting IRA beneficiary. The reason, the life expectancy approach means there is too long of a time of tax deferral and the

government is waiting too long time to receive the tax payments associated with these tax-deferred funds. Tax laws should be reasonable, but what one person thinks is reasonable another person does not. Compromises will be made.