The Slott Report

President Obama's 2016 Budget Takes Aim At Your Retirement

By Jeffrey Levine, IRA Technical Expert

On Monday, February 2, 2015, President Obama's Fiscal Year 2016 Budget was unveiled to the American public, along with the Department of Treasury's Greenbook, which provides further explanation and details of the proposals in the President's budget. In truth, the President's budget is really more of a "wish-list" than anything else, but it's a good indication of where the administration is headed.

This year's version of the budget included a number of provisions targeting retirement accounts. That was no surprise, as provisions aimed at retirement accounts have been a regular feature in budgets in recent years. What was a surprise, however, is how many proposals were targeting retirement accounts, and how many new proposals there were. All told, this year's budget featured over a dozen provisions that, if they were to become law, could directly impact your retirement savings. Below you will find a complete list of these provisions, whether they are new or carryovers from previous years, a description of each, as well as some commentary to provide insight and perspective. I hope you find it helpful.

#1 - Eliminate the Special Tax Break for NUA

The proposal – Bye-bye NUA! NUA (net unrealized appreciation), one of the biggest tax breaks in the entire tax code for retirement accounts, would be eliminated if this proposal were to become law. A complete description of NUA is beyond the scope of this article, but suffice it to say NUA is a strategy that allows you to potentially trade the ordinary

income tax rates you normally pay on retirement account distributions for long-term capital gains rates. To be eligible to use the provision, you must have appreciated stock of your employer (or former employer) inside your employer (or former)-sponsored retirement plan.

By eliminating the special tax break for NUA, distributions of appreciated employer stock would be subject to ordinary income tax rates, just like the rest of your retirement account savings.

Many employees, however, would be grandfathered into the old rules. Any plan participant 50 or older by the end of this year (2015) would still be eligible for the special NUA tax break, provided they meet all the rules.

Comments - Where did this come from?! Talk about out of left field! The tax break for NUA has been around for decades and now, it suddenly finds itself under attack. Nothing more to say about this one.

#2 - Limit Roth Conversions to Pre-Tax Dollars

The proposal – After-tax money held in your traditional IRA or employer-sponsored retirement plan would no longer be eligible for conversion to a Roth account.

Comments – This one comes as a real surprise, especially since late in 2014 the IRS released guidance making Roth IRA conversions of after-tax money in employer-sponsored retirement plans easier and more favorable. It's almost like the left hand had no idea what the right hand was doing.

For years, many taxpayers that have been restricted from making contributions directly to Roth IRAs (because their income exceeded their applicable threshold) have instead, made contributions – often

non-deductible (after-tax) – to traditional IRAs. Then, shortly thereafter, they have been converting those contributions to Roth IRAs. This two-step process, widely known as the back-door Roth IRA, would be all but eliminated by this provision.

Perhaps the only bit of good news to come out of this provision is that for years some have questioned whether or not such conversions amounted to step transactions. While the administration does not explicitly say otherwise, it's inclusion of this provision appears to be a tacit endorsement of that strategy. There is no reason to create a rule to stop something that is already forbidden.

#3 - "Harmonize" the RMD Rules for Roth IRAs with the RMD Rules for Other Retirement Accounts

The proposal – In order to further "simplify" the RMD rules, the administration seeks to impose required minimum distributions for Roth IRAs in the same way they are imposed for other retirement accounts. In other words, this proposal would require you to take distributions from your Roth IRA once you turn age 70 ½ in the same way you would for your traditional IRA and other retirement accounts. If, however, you are already age 70 ½ at the end of this year (2015), you would be exempt from the changes that would be created by this proposal.

Comments – This is one of the most egregious proposals in the entire budget, hands-down. The proposal touts the benefit of helping to "harmonize" the RMD rules for plan Roth accounts and Roth IRAs, but if the administration is that concerned about doing so, they should simply eliminate required minimum distributions for plan Roth accounts instead of going about it the other way. Countless individuals have

made Roth IRA conversions over the last 17 years, and many of them have done so, in part, due to the fact that Roth IRAs have no required minimum distributions. To change the rules now, after people have already made these decisions, would be terribly unfair and would constitute a tremendous breach of the public's trust.

For years, Roth IRA converters have counted on having no required minimum distributions after the conversion. At the very least – and I mean the very least – the administration should grandfather any existing Roth IRA money into the "old" rules, should this provision ever become law. Score one for those who say "you can't trust the government to keep it's word."

#4 - Eliminate RMDs if Your Total Savings in Tax-Favored Retirement Accounts is $100,000 or Less

The Proposal - If you have $100,000 or less across all of your tax-favored retirement accounts, such as IRAs and 401(k)s, then you would be completely exempt from required minimum distributions. Defined benefit pensions paid in some form of a life annuity would be excluded from this calculation. If this provision were to become law and you had $100,000 or less in your retirement accounts, you could take as much or as little from those accounts as you want during retirement, without fear of penalty. Required minimum distributions would phase in if your total cumulative balance across all retirement accounts is between $100,000 and $110,000. Those amounts would be indexed for inflation.

Comments – It's really hard not to be a fan of this provision. There's really no reason why someone with a 15,000, $20,000 or even $100,000 IRA should be forced to withdraw specified amounts from their retirement account each year. It simply creates complexity

without any real benefit. In fact, the projected cost, in terms of lost tax revenue, by making this change, amounts to just $5 million total over the next five years. I'd call that a drop in the bucket on budgetary scales, but it wouldn't even be the size of a drop!

Sure, some will argue that those with $200,000 in their retirement account should be exempt from required minimum distributions. Others will argue $300,000, and still others will argue the limit should be $1 million. In the end, the line has to be drawn somewhere and there will always be those on the other side. The only thing I can point to in this provision that I'm not a fan of is the phase out range. The required minimum distribution rules are hard enough without factoring in a phase out on top of it. Perhaps this would be one area where a phase out should be eliminated and replaced with a cliff. Those with $100,000 or less in their retirement accounts would have no required minimum distributions, while those with more would have them. That would make the rule simpler, and in the end, the cost of compliance for those with between $100,000 and $110,000 in retirement account savings probably isn't worth the benefit anyway.

#5 - Create a 28% Maximum Tax Benefit for Contributions to Retirement Accounts

The proposal - The maximum tax benefit (deduction or exclusion) you could receive for making a contribution to a retirement plan, like an IRA or 401(k), would be limited to 28%. Thus, if you are in the 28% ordinary income tax bracket or lower, you would be unaffected by this provision. However, if you are in a higher tax bracket, such as the 33%, 35%, or top 39.6% ordinary income tax bracket, you would not receive a full tax deduction (exclusion) for amounts contributed or deferred into a retirement plan.

For example, suppose you had $500,000 of taxable income (lucky you!) and defer $10,000 into a 401(k). Without making that deferral, you'd owe tax at the highest rate, 39.6%. By making the deferral, however, you would pay no income tax at all on that $10,000 amount. If this proposal were to become law, that would no longer be the case.

Instead of escaping ordinary income tax altogether, your $10,000 salary deferral would effectively be taxed at an 11.6% (39.6% - 28% = 11.6%) tax rate, since the maximum tax benefit of making the contribution would be 28%. This restriction would apply to other specified above-the-line deductions and income exclusions, as well as all itemized deductions.

Comments – This one is sure to be another politically divisive aspect of the overall budget proposal. If this provision were to become law, it would create a terrible compliance burden for those in the highest tax brackets with respect to their retirement accounts. According to the Greenbook, if a tax benefit for a contribution to a retirement plan was limited by this proposal, it would create basis within a person's retirement account.

How would this work for employer plans? Don't ask me! There's no mechanism for an employer plan to be able to determine how much of a salary deferral would become basis per this provision – and that's something they certainly won't be interested in taking on anyway. Presumably, the onus would be placed on retirement account owners, themselves, but that's not much better. Even without this complication in the law, many IRA owners, who are already responsible for keeping track of their own basis, fail to adequately do so on Form 8606.

#6 - Establish a “Cap” on Retirement Savings Prohibiting Additional Contributions

The proposal - This proposal would prevent you from making any new contributions to any tax-favored retirement accounts once you exceeded an established “cap.” The cap would be calculated by determining the lump-sum payment it would take to produce a joint and 100% survivor annuity of $210,000 per year, beginning when you turn age 62. Currently, this would cap retirement savings at approximately $3.4 million. The cap, however, would be a soft cap, as your total tax-favored retirement savings could exceed that amount, but only by way of earnings. Adjustments to account for cost-of-living increases would also apply.

Comments – While I understand the administration’s reasoning behind this proposal, I’m not a big fan of it. I believe we should be inspiring people to save as much as possible for retirement, because as 2008 showed us, you never know when the next rainy day is going to come. Here’s the bigger question though, at least for me. What happens if someone is over their applicable limit, but would otherwise be eligible to receive employer contributions, such as profit-sharing contributions, to their retirement account. It would appear that, under the proposal, these amounts would be forfeited altogether. That would be a completely unjust outcome and would be something either Congress or the regulations would have to address.

#7 - Create a new “Hardship” Exception to the 10% Penalty for the Long-Term Unemployed

Proposal – A new 10% early distribution penalty exception would be created to help those with financial hardships due to being unemployed

for long periods of time. The exception would apply to IRAs, as well as employer-sponsored retirement plans. In order to qualify, an individual would have to be unemployed for more than 26 weeks and receive unemployment compensation during that period (or less if due to State law). Furthermore, the distribution would have to occur in either the year the unemployment compensation was paid, or the following year. Finally, the exception would be limited to certain amounts.

All qualifying individuals would be eligible to use this exception for at least $10,000 other eligible retirement account distributions. However, if half of their IRA balance or plan balance exceeded this amount, then that amount, up to $50,000, would be eligible for the exception.

Comments – For years taxpayers have been trying to claim an exemption to the 10% early distribution penalty for financial hardship. The problem though, is that such an exception, to date, does not exist. Despite this fact, many people have gone to Tax Court and fought, unsuccessfully, to eliminate the 10% early distribution penalty from their tax burden. While the Court has often sympathized with those taxpayers, their hands have been bound by the law, and they have been unable to provide relief.

This provision, which seems pretty straightforward, would change that. It would also seem pretty hard for either political party to fight against it. No one likes to be looked at as kicking someone while they're down.

#8 - Mandatory 5-Year Rule for Non-Spouse Beneficiaries

Proposal – The overwhelming majority of non-spouse beneficiaries would be forced to empty their inherited retirement accounts by the end of the fifth year after the account owner's death. In contrast, today such beneficiaries are generally able to extend distributions from their

inherited retirement accounts over their life expectancy. To be very clear, this provision would effectively mark the death of the "stretch IRA," and all the tax benefits that come along with it. The tax deferral provided by an inherited retirement account would be reduced, and distributions would generally be larger, potentially pushing beneficiaries into higher tax brackets and phasing them out of key deductions, credits and other benefits tied to their income.

The provision would, however, exempt certain beneficiaries from this substantial reduction in the benefits provided by their inherited retirement account. Disabled beneficiaries, beneficiaries who are chronically ill and beneficiaries who are not more than 10 years younger than the deceased retirement account owner would still be able to stretch distributions over their life expectancy. Minor children would also be given a break, but would still be required to distribute their inherited retirement account no later than five years after they reach the age of majority.

The proposal would not impact those who are already beneficiaries, but rather, only those who inherit in 2016 and beyond.

Comments - If retirement accounts are really for retirement, then as much as you may not like this provision (I don't either), it's not an unreasonable position for the administration to take. Our government is broke and the stretch IRA, by providing tax benefits to individuals the accounts were never really intended to benefit, costs the government a lot of money. In fact, the budget proposal estimates that by implementing this change, it could collect almost an additional $5.5 billion dollars over the next decade.

Personally, I have three significant reservations with the proposal, as written. First, the proposal is included under the section of the budget entitled "loophole closers." I take some umbrage with this assertion.

Those beneficiaries who are stretching distributions are not using any sort of gimmick or trickery to do so. They are following the law and regulations precisely as they were created and were intended to be followed. To claim otherwise casts those smart enough to maximize the value of their inherited accounts by stretching distributions in an unfairly negative light.

Second, the proposal states that if an individual is not more than 10 years younger than the retirement account owner, they are exempt and can take distributions over their life expectancy. This could create a situation where, if a 32-year-old retirement account owner died leaving their money to a 22-year-old sibling, that beneficiary would be able to extend distributions for more than 60 years (just take my word on this one). In contrast, if the beneficiary were just one year younger at the time, 21 years old, he or she would be forced to distribute all of the inherited funds within five years. This makes no sense and seems both arbitrary and unfair.

Finally, I question whether the provision would have the revenue-raising effect that the administration believes. Sure, some retirement account owners would continue to leave their assets in their retirement accounts, subjecting their beneficiaries to the five-year rule. Those that are using IRA assets as part of their legacy planning, however, would likely turn to other avenues. For instance, such a provision would likely lead to an uptick in the use of life insurance, which can generally be inherited by beneficiaries tax free. Other options would include naming a charitable trust as an IRA beneficiary, which could produce results similar to the stretch IRA, except instead of Uncle Sam getting a big chunk, it would be the charity. In either case, the revenue raising impact would likely be dampened.

#9 - Allow Non-Spouse Beneficiaries to Complete 60-Day Rollovers for Inherited IRAs

The proposal – This one is very simple. Non-spouse beneficiaries would be allowed to move money from one inherited retirement account to another via a 60-day rollover, in a similar fashion to the way retirement account owners can move their own savings.

Comments – This proposal has been included in the President's budget for several years now and it's somewhat a testament to Washington's inability to accomplish just about anything constructive that it hasn't yet been passed into law. There is absolutely no downside to including such a provision in the tax code, as the budget consequences would be "negligible." This is a provision that should be supported by everyone in Congress, regardless of whether they are blue, red, or somewhere in between, because it would eliminate one of the most common, damaging and irreversible mistakes made with inherited retirement accounts.

While the budget proposal makes no such mention of this possibility, it would seem as though if this provision were to become law, that such rollovers would be subject to the new interpretation of the once-per-year rollover rule.

#10 - Require Retirement Plans to Allow Participation from Long-Term Part-Time Workers

The Proposal – Retirement plans would be required to allow participation from workers who have worked at least 500 hours per year for three consecutive years with the sponsoring employer. Employees eligible to participate in a plan because of this provision would not be required to receive employer contributions, however,

including employer-matching contributions. In other words, this provision would only require qualifying employees to be able to contribute their own funds to their employer's retirement plan.

Comments – While the goal of this provision – encouraging people to save more for their retirement – is certainly laudable, it's hard to imagine employers getting behind it. If they wanted to cover these employees now, they could. Although they're not required to do so, they certainly are not prohibited from doing so either. A lot of it comes down to expenses. Part-time employees often have lower plan balances, which as the budget proposal points out, "can be costly to administer relative to the size of the balance." Although the proposal does take steps to mitigate this impact, it's hard not to imagine additional costs being picked up by either other plan participants or the sponsoring employer itself.

#11 - Require Form W-2 Reporting for Employer Contributions to Defined Contribution Retirement Plans

The proposal – The header here really tells it all. Simply put, this proposal would require companies to report any amounts they contribute to an employee's defined contribution retirement plan (i.e., 401(k)) on the employee's Form W-2.

Comments - I don't really see a great need for this additional reporting, and companies are bound to be against it if it increases their reporting burden in even the slightest way (which it does), but this provision is not likely to be the one that holds up any major bill in Congress. Would it be nice for an employee to see this information on the W-2? Sure, but it's not that big of a deal.

#12 - Mandatory Auto-Enrollment IRAs for Certain Small Businesses

The Proposal – Employers in business for at least two years and have more than ten employees would be required to offer an automatic IRA option to its employees if it doesn't already offer another type of employer-sponsored retirement plan (i.e., 401(k), 403(b), SEP IRA). These automatic IRAs would be funded via payroll deductions. A standard notice would be provided to employees letting them know about the automatic IRA and would give them the opportunity to establish their own contribution rate or to opt out altogether. Employees would also be able to choose between allocating their salary deferrals to a traditional IRA and a Roth IRA. In absence of an election, employees would automatically be enrolled at a default rate of 3%, and contributions would be made to a Roth IRA.

To offset some of the costs associated with establishing the automatic IRAs, and to further encourage employers to offer more robust retirement savings options, the proposal would also expand existing tax credits, while establishing some new ones as well. Small employers with no more than 100 employees would be eligible to claim a non-refundable tax credit for expenses associated with establishing the automatic IRAs up to $1,000 for the first three years (this is up from $500 in the first year and $250 in the second year that was proposed in last year's budget). These employers would also be eligible to receive an additional non-refundable credit of $25 per employee, up to $250 per year, for six years (same as in last year's budget).

The proposal would also expand the existing non-refundable "start-up costs" tax credit for small employers from its current maximum of $500 per year for three years to a maximum of $1,500 (up from $1,000 in last year's budget) per year for four years. Finally, the budget calls for an auto-enrollment credit of $500 per year, for up to three years. This

credit is a new feature of the proposal, not seen in previous budgets, and would be eligible to be claimed by small businesses that establish new retirement plans that include auto-enrollment features, or by small businesses that incorporate such a feature into an existing plan.

Comments – The real endgame for the administration with this proposal is probably not automatic IRAs. Instead, it seems that the real goal is to encourage more employers to establish employer-sponsored retirement plans. Indeed, the budget may have tipped the administration's hand by saying "automatic IRAs could encourage employers to adopt an employer plan, thereby permitting much greater tax-favored employee contributions than an IRA and offer the option of employer contributions." In other words, the administration seems to be saying, "Well, if you're going to be required to have automatic IRAs, you might as well establish a real retirement plan."

Another interesting aspect of this proposal is that the default option for the automatic IRA is a Roth IRA. This could lead to some unintended consequences. Unlike traditional IRAs, which have no maximum income limits for contributions (though in some cases deductions may be limited), Roth IRA contributions are prohibited once a person exceeds their applicable income threshold. If a person has exceeded their applicable threshold and makes Roth IRA contributions anyway, those contributions are subject to a 6% excess contribution penalty every year until the problem is corrected.

To be sure, this provision is aimed at those with lower incomes, but there may be certain employees and small businesses making significant incomes. Or an employee with modest income could have a spouse who has high income, pushing the couple above their applicable Roth contribution income threshold. If that were the case, but 3% of the employee's paycheck was sent to a Roth IRA per this provision, it's

possible that, without taking any action on their own, an employee's own salary could be diverted to a retirement account they're ineligible to contribute to, ultimately leading to penalties that the IRS has no authority to waive. That doesn't seem fair.

#13 - Facilitate Annuity Portability

The Proposal – If an employer-sponsored retirement plan decided to offer an annuity investment within the plan, but at some later point changed its mind and prohibited such an investment from being authorized to be held under the plan, plan participants would be eligible to roll over the annuity within their plan to an IRA or other retirement account via a direct rollover. This distribution would be allowed even if such a distribution would otherwise be prohibited.

Comments – In recent years the administration has taken numerous steps to increase annuity options within retirement accounts for savers. For instance, last year, the Department of Treasury issued guidance making the use of deferred annuities within target date funds offered by 401(k) plans more viable. In addition, the department also created a new type of retirement account annuity, qualifying longevity annuity contracts (QLACs), which can be excluded from a retirement account owner's RMD calculations.

This provision seems like the next logical step in that progression. Given that there is no requirement here for employers to offer annuity options, there would be no added expenses and the provision doesn't seem to favor either the wealthy or the poor, it would seem that our lawmakers should be able to get together on this one. There's really no downside, so make it happen.

#14 - Eliminate Deductions for Dividends on Stock of Publicly-Traded Companies Held in ESOPs

The proposal – In general, publicly traded companies would no longer be allowed to claim a deduction for dividends paid that are attributable to stock held in an ESOP (employee stock ownership plan).

Comments – Publicly traded corporations (and their employees) may not like this one, but it makes sense as a matter of tax policy. There should be no additional tax incentive for a company to offer stock to its employees via an ESOP than there is to offer them the same stock via a 401(k) or other retirement plan.