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Retirement planning techniques that could be going away soon

While Presidents and Congresses have for decades championed tax incentives for Americans to save for their retirement, a number of recent proposals aim to close down certain retirement planning techniques that some deem inequitable. In this article, we discuss three of those techniques and some of the proposals that would close down their use.

High earners getting disproportionate share of tax benefits. Under our current tax structure, taxpayers are encouraged to save for retirement by the rules allowing individuals to defer the tax on income that they contribute to retirement plans, and on the earnings on those contributions, until the individual retires or until after his death. However, since higher earners are taxed at a higher graduated rate, the biggest rewards from retirement incentives also go to high earners. A high earner saves 39.6 cents on the dollar by participating in a Code Sec. 401(k) plan. The comparable benefit for a low earner is 15 cents on the dollar. This raises two basic questions. Does it make sense to have the size of the incentive depend on earnings? And, in terms of the Federal deficit, isn't it likely that the high earner would have saved even without such a large tax incentive?

Under current law, there are several existing rules that attempt to limit the retirement benefits available to high earners, but some suggest that further limits are necessary in light of the above questions, among others.

In recent years, there have been numerous proposals to further change who gets the benefits of retirement incentives. For example, in both his 2015 and 2016 budgets, President Obama has proposed a cap on the total amount of savings in a tax-deferred retirement vehicle. This proposal would put a limit of approximately $3.4 million on the total amount of contributions and accruals of benefits inside of an individual's 401(k)s, defined benefit plans, and IRAs. That amount would increase with the cost of living.

And, the President's 2016 budget creates a 28% maximum tax benefit for contributions to retirement accounts. Thus, a taxpayer in the 28% ordinary income tax bracket or lower would be unaffected by this provision. However, a taxpayer in a higher tax bracket, i.e., the 33%, 35%, or 39.6% ordinary income tax bracket, would not receive a full tax deduction (exclusion) for amounts contributed or deferred into a retirement plan. For example, suppose a taxpayer had $500,000 of taxable income and deferred $10,000 into a Code Sec. 401(k) plan. He would pay tax equal to the rate applicable to $500,000, less 28% of the $10,000.

And former House Ways and Means Committee chairman Dave Camp, a Republican, in his Tax Reform Act of 2014, proposed limiting the deduction for retirement account contributions to 25%. See Weekly Alert ¶ 1 03/06/2014 .

Back-door Roth IRA conversions. A Roth IRA is treated as a traditional IRA except to the extent that special rules apply to it. (Code Sec. 408A(a)) Contributions to a Roth IRA aren't deductible. (Code Sec. 408A(c)(1)) The amount that can be contributed to a Roth IRA is subject to the same limitations as apply to regular IRAs. (Code Sec. 408A(c)(2)) Qualified distributions from a Roth IRA aren't included in income (Code Sec. 408A(d)(1)), and other distributions are treated as a return of investment to the extent of contributions to Roth IRAs. (Code Sec. 408A(d)(4))

A taxpayer is permitted to make a contribution to a Roth IRA only if the taxpayer's modified adjusted gross income (MAGI) is less than a specified limit that is indexed for inflation. For example, for 2015, a married taxpayer filing a joint return is permitted to make a full contribution if the taxpayer's MAGI is less than $183,000, and the contribution limit is phased out over the range of $183,000 to $193,000. (Code Sec. 408A(c)(3))

However, there are currently no income limits on a person's ability to make *nondeductible* contributions to a regular IRA or to convert money from a regular IRA to a Roth IRA. A taxpayer who converts an amount held in a traditional IRA must include the converted amount in income to the same extent it would be includible in income if distributed and not rolled over. That is, the amount is includible in income to the extent it is not a return of basis. (Code Sec. 408A(d)(3)(A)(i))

This ability to convert money from an IRA to a Roth provides a "back-door" to a Roth IRA. That is, a taxpayer who is not able to make a contribution to a Roth IRA because of the rule of Code Sec. 408A(c)(3) can nonetheless put just as much into a nondeductible IRA and then convert that nondeductible IRA into a Roth IRA.

President Obama's 2016 budget proposal provides that future Roth conversions be limited to pre-tax money only. Thus, after-tax amounts (those attributable to basis) held in a traditional IRA could not be converted to Roth amounts. A similar rule would apply to amounts held in eligible retirement plans. This proposal would effectively kill most back-door Roths.

> RIA observation: An employer's Code Sec. 401(k) plan, or Code Sec. 403(b) annuity, may include a qualified Roth contribution program (i.e., a "Roth 401(k)") that allows participants to elect to have all or part of their elective deferrals treated as Roth contributions-that is to make "designated Roth contributions." (Code Sec. 402A) Designated Roth contributions, which are currently includible in income, aren't subject to the MAGI phaseouts that apply to regular Roth IRA contributions; neither the President's budget nor any other major proposals would change that rule.

"Stretch" IRAs. In most cases, people who inherit an IRA have the option of taking distributions over their lifetimes. (Code Sec. 408(a)(6) , Reg. § 1.401(a)(9)-5 , Q&A 5(a), Reg. § 1.401(a)(9)-5 , Q&A 5(c)(1)-the so-called "stretch IRA rules") As a result, a taxpayer with a Roth IRA can potentially provide tax-free income to his heirs for decades since Roth withdrawals are typically not taxed and the funds in the IRA will continue to grow tax-free.

The President's 2016 budget and many recent tax-related bills have included a provision to kill the stretch IRA and replace it with a law requiring beneficiaries other than spouses to withdraw the money within five years. Under the President's plan, exceptions would apply to any beneficiary who, as of the date of the IRA participant's death, is disabled, a chronically ill individual, an individual who is not more than 10 years younger than the participant or IRA owner, or a child who has not reached the age of majority.

For traditional IRA beneficiaries who may be forced to withdraw larger amounts of money over a shorter period than they otherwise would, this proposal could potentially result in a significant tax increase. Roth IRA beneficiaries wouldn't face the same tax increase but would lose the ability to have a tax-free source of income (and enjoy tax-free growth for funds in the IRA) for an extended period.

> RIA observation: This change certainly would affect the decision to convert an IRA to a Roth IRA, particularly where the decision comes about later in the IRA participant's life. That is, there will be many situations where: a) currently paying the tax on the previously non-taxed Roth IRA

amounts, followed by tax-free growth while the Roth IRA is paid out over the heir's *lifetime expectancy,* under current law, was a good strategy; but b) currently paying the tax on the previously non-taxed Roth IRA amounts, followed by tax-free growth while the Roth IRA is paid out over *five years,* is not.

RIA recommendation: Build into your retirement planning checklists items in which you mention to your client the possibility of these law changes and help him evaluate whether any given planning technique makes sense if one of the potential law changes is enacted.

References: For rollovers/conversions to Roth IRAs from traditional IRAs, see FTC 2d/FIN ¶ H-12290.15 ; United States Tax Reporter ¶ 408A4 ; TaxDesk ¶ 283,316 ; TG ¶ 8608 .