Fiduciary Commentary

Winter 2014/2015

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By: Brant Griffin - February 16, 2015

On February 2, 2015 the Fiscal Year 2016 Budget was released by the White House. As political happenings go, Obama's budget is more of a wish-list. However, it is often seen as an indication of the administration's intent on shaping fiscal policy and a starting point in negotiations with Republican leaders on the budget.

Similar to previous years, this budget contains many provisions targeting retirement accounts that if become law, would directly impact plan sponsors and savers alike. Retirement plans again appear to be in the cross hairs as the administration seeks provisions in the tax code to pull government revenue forward. However, the prevalence of retirement plan related initiatives outlined in Obama's proposal does hint that the administration views that the retirement plan landscape is ripe for reform.

Here are some of the key points:

Expansion of Coverage of Retirement Plans

Mandatory IRAs

The president's proposal would require employers with 10 or more employees that have been in business for at least 2 years to automatically enroll their workers in an IRA if they do not currently offer a retirement plan. This effort would expand access to employer based retirement programs to an estimated 30 million workers. Employees could choose between allocating contributions to a traditional (pre-tax) IRA or a Roth IRA. In the absence of an affirmative deferral election, contributions will be made to a Roth IRA at 3% of salary unless savers opt out.

The proposals provide tax credits to offset the cost of this program to employers with less than 100 employees. The President has also proposed a tax credit of $1,500 to small employers who add auto-enrollment to their existing retirement plans.

Access for Part-Time Workers

Current law permits qualified plan sponsors to require an employee to work 1000 hours in a plan year to become eligible to participate in a qualified plan. Obama's proposal would reduce that requirement allowing employees that have worked at least 500 hours a year for three consecutive years, to make deferrals to a retirement plan. Those eligible employees would not be required to receive employer contributions.

Retirement Plan Contribution and Deduction Limitations

Retirement Savings Cap

Further contributions to tax-preferred retirement plans would not be permitted once the account reached an established cap under the President's measures. This limit would be determined by the savings needed to provide a joint and

100% survivor annuity of $205,000 per year (indexed to inflation) beginning at age 62, which is approximately $3.4 million account value presently. Although savers would be prohibited from contributing additional savings into these tax-preferred vehicles once this threshold is reached, the accounts could still grow. The actual limits would reset each year depending on actuarial assumptions and interest rates.

Roth Conversions Limited to Pretax Dollars

Conversions to a Roth account from a traditional IRA account would only be eligible from pretax dollars. After-tax money would no longer be permitted to be converted to a Roth under Obama's proposal. This measure would effectively close the "back door Roth IRA" whereby taxpayers, ineligible to make Roth contributions due to exceeding the income threshold, make after-tax IRA contributions and then convert those contributions to Roth IRAs.

28% Tax Bracket

The administration's budget proposal would place the maximum tax deduction on contributions to retirement plans at 28%. Effectively, tax payers in the 33%, 35% or top 39.6% ordinary income tax brackets would not receive the full tax deduction for retirement plan contributions under the proposal. If one's income bracket was 28% or below, the savers would be unaffected by this provision. This initiative would potentially create a tax basis in a participant account.

Retirement Distribution Rules

Inherited Retirement Accounts

Currently, the law allows the beneficiary of an inherited retirement account to extend account distributions over their individual life expectancy in a strategy frequently referred to as stretch (IRA) payments. In a potential game changer for many estate plans, Obama's budget would effectively end this elongated payment strategy for most non-spouse beneficiaries and force the distribution of the retirement savings to no more than five years. The proposal would allow for an exemption covering certain beneficiaries who are disabled, chronically ill or within 10 years of age of the deceased account owner.

Harmonize RMD Rules for Roth and IRA Accounts

The budget proposes to standardize the required minimum distribution rules (RMD) for all IRA accounts. This initiative would impose the RMD rules on Roth IRAs the same way as other retirement accounts, whereas presently, Roth IRA savers have been exempt from the required distribution rules. The only exception in Obama's proposal would be if the saver was 70½ at the end of 2015, the present rules would apply and distributions would not be required.

Elimination of RMD for Small Account Balances

Obama's proposal would eliminate RMD requirements for account balances below $100,000 (as indexed) allowing savers with lower account balances to continue to accumulate savings and avoid the complicated RMD rules.

Elimination of NUA

The White House's measure would repeal the exclusion of net unrealized appreciation (NUA) of employer securities. NUA is a provision that allows savers who take in-kind distributions of employer securities from an employer plan to pay the tax at long-term capital gains rates on the securities' gains when they are sold. Obama's proposal would permit those 50 or older by the end of 2015 to make use of the current NUA provisions.

Conclusion

With every exemption, deduction and credit in the tax code under close scrutiny, there is considerable pressure for lawmakers to restrict or eliminate current income exclusions to alleviate the swelling federal budget deficit. As we've seen in years past, many of Obama's 2016 Budget initiatives are familiar themes of earlier proposals. Retirement plans, long benefiting from a favored position in the Internal Revenue Code again appear to be among the targets ripe for reform. Critics argue that the preferential tax treatment bestowed on retirement plans is too generous and disproportionately benefits the wealthy (an odd position since qualified plans are intended to be broad based by law).

Not surprising given Washington's shortsightedness, many of Obama's proposals would serve to limit savings opportunities and accelerate the recognition of government revenue at the expense of future generation's tax receipts. Unfortunately, those that wish to effect changes to the private retirement system often neglect to discuss that retirement plan tax incentives are not a permanent tax deduction. They are an income deferral that will be taxed sometime in the future.

Given the new balance of power in Washington, it remains very unlikely that Obama's budget will pass without substantial opposition. With mounting pressure to be fiscally prudent however, the proposals strongly suggest that the administration views retirement plans as a valuable revenue target. If successful, these proposals could diminish many of the tax incentives offered by retirement plans that have long been taken for granted.

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