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Retirement Planning Techniques May Be Shut Down

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A number of President Obama's recent budget proposals are directed at eliminating certain retirement planning techniques. Congress for many years has focused on tax incentives to encourage Americans to save for their retirement, but with the number of recent proposals aim at closing down certain retirement planning techniques, taxpayers need to plan for the possibility of losing certain retirement incentives.

Taxpayers are permitted to make contributions to a Roth IRA only if the taxpayer's modified adjusted gross income (MAGI) is less than a specified limit. For example, for 2015, a married taxpayer filing a joint return is permitted to make a full contribution to a Roth IRA, if the taxpayer's MAGI is less than $183,000. If taxpayers exceed this amount, the contribution limit is then phased out over the range of $183,000 to $193,000. (Code Sec. 408A(c)(3))

Contributions to a Roth IRA are not deductible, nor are the qualified distributions from a Roth IRA included in income. The amount that can be contributed to a Roth IRA is subject to the same limitations that apply to regular IRAs. Currently, there is no income limits on a taxpayer's ability to make nondeductible contributions to a regular IRA or to convert amounts 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. The amount is includible in income to the extent it is not a return of basis. (Code Sec. 408A(d)(3)(A)(i))

Therefore, a taxpayer who is not able to make a contribution to a Roth IRA can contribute just as much into a nondeductible IRA and then convert that nondeductible IRA amount into a Roth IRA. This ability to convert money from an IRA to a Roth provides a "back-door" approach to a Roth IRA. The proposal is looking at eliminating this technique.

PROPOSED CHANGES TO ROTH IRA REQUIREMENTS

The proposal also focuses on creating a 28% maximum tax benefit for contributions and accruals of benefits inside of an individual's 401(k)s, defined benefit plans, and IRAs, 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%) would not receive a full tax deduction for amounts contributed or deferred into a retirement plan. For example, suppose a taxpayer had $450,000 of taxable income with effective tax rate of 33% and deferred $18,000 into a Code Sec. 401(k) plan. The taxpayer would pay tax equal to the effective tax rate, less 28% of the $18,000 401(k) contribution amount. Effectively, the taxpayer is losing a tax benefit of 5% on the amount deferred.

The 2016 proposed budget, as well as many recent tax-related bills, have included a provision to kill the “stretch IRA” and require beneficiaries other than spouses to withdraw the money within five years. However, exceptions would apply to any beneficiary who, as of the date of the IRA participant's death, is disabled or chronically ill, and to individuals who are 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.

Contact SD Medallion Services for more information on these proposed changes, or other issues related to tax planning. We also invite you to visit our tax blog to read more articles on related topics.

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