BLOGS - RETHINKING RETIREMENT

Required Minimum Distributions for Roth IRAs?

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President Obama's 2015 budget includes a number of proposed changes aimed at retirement accounts. Six out of the seven provisions (or similar versions of them) detailed below and unveiled Monday, were included in last year's budget.

If you're hoping that some or all of these proposals will actually become law, it's probably not a good idea to hold your breath.

The fact that all of the major retirement account-related proposals from last year are repeated in this year's budget should tell you something – none of them were enacted from last year's budget. They all require at least some level of Congressional action to implement, so the Vegas odds are probably not too high on getting much more implemented this year.

Nevertheless, it's important to know the key retirement account provisions included in the President's budget this year, because they certainly could happen and, at the very least, they are an indication as to where the administration wants to head. Here are the key changes you should know about:

'HARMONIZE' ROTH IRA RMD RULES WITH OTHER RETIREMENT ACCOUNTS

This is the only new one on the list this year and when people catch on to it, it's bound to make some major waves. Under the premise of simplifying the tax rules for retirement accounts, President Obama's 2015 budget calls for a provision that would require Roth IRAs to follow the same required minimum distribution (RMD) rules as other retirement accounts.

In other words, you would have to begin taking RMDs from your Roth IRA when you turn 70 ½, the same way you do with your traditional IRA and other retirement accounts. If this were to come to pass, it would be a major game-changer when it comes to retirement planning.

The fact that Roth IRAs have no RMDs is one of the key reasons many people decide to contribute or convert to Roth IRAs in the first place.

If this proposal were to become law, conversions would make sense for far fewer people. Not only that, this proposal gives all those who haven't made Roth conversions over the years because they "don't trust the government to keep their word" more ammunition.

MAXIMUM BENEFIT FOR RETIREMENT ACCOUNT CONTRIBUTIONS

The maximum tax benefit (deduction) for making contributions to defined contribution retirement plans, such as IRAs and 401(k)s, would be limited to 28%. As a result, certain high-income taxpayers making contributions to retirement accounts would not receive a full tax deduction for amounts contributed or deferred.

Example: Currently, if an individual with $500,000 of taxable income defers $10,000 into a 401(k), they will not pay any federal income tax on that $10,000. Without that salary deferral, that income would be taxed at 39.6% (currently the highest federal income tax rate).

However, if this proposal were to become effective, that $10,000 would effectively be taxed at 11.6% (39.6%-28% = 11.6%), since the maximum tax benefit that a client could receive would be limited to 28%. That equates to an additional tax bill of more than $1,000.

MANDATORY 5-YEAR RULE FOR NON-SPOUSE BENEFICIARIES

Most IRA (and other retirement plan) non-spouse beneficiaries would be required to empty inherited retirement accounts by the end of the fifth year after the year of the IRA owner's death (known as the 5-year-rule). The proposal does call for certain exceptions to this rule, such as for disabled beneficiaries and a child who has not yet reached the age of majority.

While this proposal might simplify the required minimum distribution (RMD) rules for most beneficiaries, it would mark the death of the "stretch IRA." Most non-spouse beneficiaries would face more severe tax consequences upon inheriting retirement accounts and as such, the value of these accounts as potential estate planning vehicles would be diminished.

RETIREMENT SAVINGS 'CAP' PROHIBITING ADDITIONAL CONTRIBUTIONS

New contributions to tax-favored retirement accounts, such as IRAs and 401(k)s, would be prohibited once you've exceeded an established "cap." This cap would be determined by calculating the lump-sum payment that would be required to produce a joint and 100% survivor annuity of $210,000 starting when your turn 62.

At the present time, this formula produces a cap of $3.2 million. If you ended up with more than this total in cumulative retirement accounts at the end of a year, you would be prohibited from contributing new dollars to any retirement accounts in the following year. The cap would be increased for inflation.

RMD ELIMINATION IF RETIREMENT ACCOUNTS TOTAL $100,000 OR LESS

This one's simple. If you have $100,000 or less - across all of your retirement plans combined - you would be exempt from required minimum distributions. Failing to take the proper RMD amount comes with one of the stiffest retirement account penalties there is, a 50% penalty on any shortfall.

This proposal would eliminate that possibility if you have $100,000 or less in retirement accounts and would allow you to take as much, or as little, as you want without a penalty.

INHERITED ASSETS: ALLOW 60-DAY ROLLOVERS FOR NON-SPOUSE BENEFICIARIES

Non-spouse beneficiaries would be allowed to move inherited retirement savings from one inherited retirement account to another inherited retirement account via a 60-day rollover (in a manner similar to which they can currently move their own retirement savings).

Unifying the rollover rules for retirement account owners and beneficiaries would greatly simplify this aspect of retirement accounts and reduce the number of irrevocable and costly mistakes that are often made by beneficiaries under the current rules.

MANDATORY IRA AUTO-ENROLLMENT FOR SMALL BUSINESSES

Employers in business for at least two years that have more than 10 employees and don't offer another retirement plan already would be required to offer auto-enrollment IRAs to their employees. Contributions to employees' IRAs would be made on a payroll-deduction basis.

Employees would be able to elect how much of their salary they wish to contribute to their IRA (up to the annual IRA contribution limit), including opting out entirely. In the absence of any election, 3% of an employee's salary would be contributed to their IRA. Employees would be able to choose whether to contribute to an IRA or Roth IRA, with the Roth being the default option.

The provision would also enhance incentives, in the form of a tax credit for small businesses, to adopt a company-sponsored retirement plan.

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