A Look at New IRA Rules and Withdrawal Regulations

Retirement Plan Distributions

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Occasionally we get tax questions from clients about IRA and 401(k) accounts that aren't that easy to answer. Usually this is because the tax code doesn't address these issues directly — what a surprise — or the questions may be a bit out of the ordinary. Recently, we received some questions like this and would like to share the answers with you.

401(k) Withdrawal by a Business Owner

Recently, Tom, who was more than 70½ and had a 401(k), asked us to tell him what his required minimum distribution should be this year. In this case, the client held an individual 401(k), as he owned the business. This is an important fact, since 401(k) participants who are still working don't have to start taking distributions unless they own 5 percent or more of the company for which they work.

So, in this case, Tom had to take an RMD from his 401(k) plan. As a side note, IRAs, as opposed to 401(k)s, have no such provision. Account holders are required to take a distribution starting the April 1 after they turn age 70½.

Here's where Tom's 401(k) situation got interesting. He has a loan outstanding against his 401(k). So how does the loan affect the required withdrawal from the 401(k)? The Internal Revenue Service has no specific verbiage to address this issue!

Again, IRAs are easier, as you can't have loans against them although you can withdraw money one time per year for 60 days. In fact, pledging an IRA as collateral for a loan disqualifies an IRA.

RMDs are based on the prior year-end account value for both 401(k) accounts and IRAs. So Tom's 2015 distribution is based on his Dec. 31, 2014, account value. This value is then multiplied by a factor from the appropriate choice of three tables published by the IRS. Normally IRS Table II is used. The twist here is that loans often don't show up on the year-end statements as part of the account value.

The answer for Tom is that the loan is indeed an asset of the plan and so the loan balance on Dec. 31, 2014, must be added to the other statement asset values to determine the 2015 RMD. This answer actually involved some communication directly with the IRS.

401(k) Withdrawal by an Employee

Another situation we encountered was with Mary, who was still working, was more than 70½ and didn't own 5 percent or more of the company for which she worked. In this case, Mary didn't have to take an RMD from her current 401(k) based on the rules laid out earlier. The twist here was that Mary had a dormant 401(k) account from a previous employer in addition to her 401(k) account with her current employer. Her question was whether the RMD on the dormant account could also be extended, as it was on her current 401(k). Our answer to Mary was that the extension for RMD for a 401(k) participant still working extends only to her current employer's plan, not to any prior plans that remain as 401(k) accounts.

But there may be another solution. If the working participant's current 401(k) plan allows transfers in from prior plans, the client can transfer the balance into the current plan and not be required to take a distribution. One caveat here: For this to have worked for the 2015 distribution, the previous account balance would have had to have been moved to the current 401(k) account prior to Dec. 31, 2014.

Moving forward, this strategy can still work if there was a balance at the end of 2014. But the 2015 RMD must be taken from the dormant plan prior to transferring the balance to the current plan. If this doesn't happen, as RMDs aren't allowed to be rolled into other qualified plans, there would be a 6 percent penalty on the amount rolled in as well as the earnings as an excess contribution penalty.

In addition, there's a 50 percent penalty for RMDs that were supposed to be taken but were not. Even if Mary had transferred the 401(k) to an IRA, the new IRA would have to make a corrective distribution of excess contributions, as 401(k) distributions cannot be met with IRA distributions.

"Stretch IRAs" and Proposed New Rules

Under current rules, a nonspouse beneficiary of an IRA can extend IRA distributions over this person's lifetime. This applies to both traditional and Roth IRA accounts. The current administration is considering doing away with the ability to "stretch" these distributions out for subsequent generations. This may have the effect of altering planning strategy for some, as taxes will be accelerated for traditional IRAs to be recognized by the beneficiaries of those accounts. In addition, although Roth IRAs have no RMD for the living account holder, the nonspouse beneficiaries are required to distribute accounts over their life expectancies.

Roth IRA distributions aren't taxable; however, the distributions no longer enjoy the protection of Roth IRA tax-favored status, shielding the earnings from taxation. Should beneficiaries be required to distribute inherited Roth IRA accounts, the current owners of these accounts

will have to carefully examine whether it's worth converting assets to Roth status to begin with, as the conversion is a taxable event. It may not make sense to convert and pay taxes at a high rate to leave funds to a beneficiary who cannot continue to protect earnings in those accounts from taxation.

Traditional IRAs left to beneficiaries could also create a large tax burden on those beneficiaries if they're required to distribute the funds as a lump sum.

It may be that current account holders would be better advised to withdraw more than the minimum distributions required on these accounts rather than leave a large lump sum to be taxed at a higher rate. One important note, as of the writing of this article, the elimination of "stretch IRAs" is only a proposal and not law.

Any change will be highly publicized and will warrant further attention and evaluation.

New IRA Rollover Rules From the IRS

It's important you understand the difference between a rollover and a direct transfer. A "rollover" occurs when the IRA account holder actually gets a check made out to him and has 60 days to put it in a different IRA or back in the same IRA. It effectively allows the person 60 days to use the money. A "direct transfer" occurs when an account holder moves an IRA account directly from one IRA account to another IRA. In this case, the account holder doesn't receive the funds and doesn't have use of them.

Beginning in 2015, you can make only one rollover from one IRA to another — or the same — IRA in any 12-month period, regardless of the number of IRAs you own. The limit will apply by aggregating all your IRAs, including SEP and SIMPLE IRAs as well as traditional and Roth IRAs, effectively treating them as one IRA for the purposes of the limit. But trustee-trustee transfers between IRAs aren't limited and rollovers from traditional IRAs to Roth IRAs (conversions) aren't limited.

Knowing the Rules

We try to help inform readers of the rules so that they will not accidentally step into an inadvertent tax trap. The severe tax penalties of 50 percent for amounts not taken for RMDs and 6 percent for excess contributions make it important to be aware whether any of these situations may affect you!

If you're moving funds from one retirement account to another and are approaching age 70, make sure you discuss with your accountant the potential tax effects. ■

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