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Keri: Hello. My name is Keri McCollum and I am the product manager for our print and E-Forms content here at Wolters Kluwer. Thank you for viewing this informational video. Our goal in sharing this information today is to inform you of the recent Tax Reform changes, educate you on those changes and how they impact your IRA owners, and provide direction on what your action items should be due to this legislative change.

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Keri: As I'm sure you are aware, on December 22, 2017, President Trump signed the Tax Cuts and Jobs Act of 2017 or, as many people call it, the Tax Reform Act, into law. The Act has been called the most significant rewrite of the U.S. Tax Code in a generation. And, as fate would have it, it includes a number of provisions that affect individual retirement accounts, or IRAs.

If the new 5305's posted by the IRS last year didn't already have you focused on your tax-advantaged accounts business this IRA season, this new act certainly will.

So as we did last fall with the 5305 updates, Wolters Kluwer once again thought it would be helpful to create a video that will help you understand the impact of these changes on your IRA business.

With me once again to help you understand these changes are Karl Leslie and Mike Schiller. Karl is a principal attorney in our Compliance Center of Excellence and the lead attorney in our tax-advantaged accounts line of business. Mike is an IRA consultant on our Compliance Solutions team. Together, Karl and Mike have over 50 years of experience in the financial services industry.

Welcome, gentlemen!

Karl: Thanks, Keri.

Mike: Great to be here.

Keri: Karl, let me direct my first question to you. Can you give us a little background on these changes? I know the Trump administration was promising tax reform, but it almost seems like these changes came out of nowhere.

Karl: Well, Keri, in a way it did come out of nowhere. In November, there were promises of a tax bill by Christmas but the situation was very fluid. Eventually, both the U.S. House and the Senate passed separate bills. But they were significantly different. And there was a lot of uncertainty as to whether we would even see a final bill all the way up to within a couple days before the conference committee agreed upon the final language. As you may recall, Senator Rubio was nearly a last second holdout.

Keri: Ah yes, I do remember seeing that on the news. So nobody really knew exactly what was in the bill right up until it was signed, correct?

Karl: That's right, Keri. And to be honest, it's a very complex bill, so I'm sure that a lot of tax analysts will be studying it for a while longer.

Keri: But we know what the changes are that affect IRAs, right, Mike?

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Mike: We have a really good handle on the changes impacting IRAs, Keri. There are eight areas we've focused on.

They include:

- The repeal of the rule that allowed recharacterizations of conversions;
- The provision for an extended rollover period for plan loan offset amounts;
- The temporary reduction of the medical expense deduction floor;
- The suspension of miscellaneous itemized deductions;
- The use of retirement fund distributions for 2016 disasters;
- The inclusion of a new qualified hazardous duty area;
- The repeal of provisions providing a deduction for alimony payments and for the inclusion of alimony in gross income; and
- Changes to the cost-of-living adjustment calculation

Keri: That's a lot of change, Mike. Do all these changes affect our IRA documentation?

Mike: While five of these changes have a direct impact on the content of our IRA documents they all could affect how someone manages his IRA.

Keri: Okay. Let's take a little time to review those changes individually?

Mike: Sure. I think we can at least give you a general understanding of the changes and maybe even provide a few examples to help people understand the practical impact.

Keri: Great. Let's start at the top. So, Karl, can you tell me what a recharacterization is and what impact the repeal of the rule allowing recharacterization of conversions will have on IRA owners?

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Karl: Sounds good, Keri. Let me start with the definition. In general, a recharacterization is a method by which an IRA owner can redesignate a contribution made to a traditional IRA as being made to a Roth IRA, or vice versa. Under prior law, there were several things an IRA owner could accomplish using the recharacterization rules. For example, if an IRA owner made a regular contribution to a traditional IRA for a tax year that she determined was nondeductible, she could recharacterize that nondeductible contribution as a regular contribution to a Roth IRA. The deadline to do that was on or before her federal tax-filing due date, including extensions.

By the way, that specific example was not changed by the Tax Reform Act.

Another thing an IRA owner could do under the prior recharacterization rule was to "unwind" a conversion or a qualified rollover from an employer-sponsored retirement plan to a Roth IRA.

In other words, if an IRA owner converted assets from a traditional IRA to a Roth IRA, he could later use the recharacterization rules to move some or all of those assets back to a traditional IRA to, for example, avoid having to pay taxes on converted assets that were taxable coming out of the traditional IRA.

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The big change here is that, under the new law, an IRA owner cannot use the recharacterization rules to unwind a conversion or a qualified rollover from an employer-sponsored retirement plan to a Roth IRA that occurred in 2018 or later.

Again, however, the new law does not change an IRA owner's ability to treat a regular contribution made to one type of IRA as being made to another type of IRA as long as the recharacterization of the contribution is completed on or before his or her federal tax-filing due date, including extensions.

Keri: Thank you, Karl. So why do you think the government made that change?

Karl: It's pretty simple, Keri. I think the government is trying to prevent people from gaming the system to avoid paying taxes. After all, the system is pretty flexible. IRA owners can recharacterize mistaken regular contributions and can even convert assets from a traditional IRA to a Roth. But that's as far as they can go under the new law. They can't keep moving assets back and forth based on how their investments do.

One example of gaming that we had heard of is some individuals were making high risk investments with their traditional IRA assets, and then converting those assets to the Roth IRA, if the assets performed well they left them, and the profits, in the Roth IRA - with the profits eventually being tax free. However if the investments incurred significant losses, the individual would recharacterize those assets back to the traditional IRA and then these same assets could have been converted later at a lower value.

I also think that some individuals, without doing much planning, were rolling employer-sponsored retirement plan assets directly to a Roth IRA and then, when completing their tax returns, were deciding how much they wanted to pay tax on, and would recharacterize the remainder. In any case, going forward, deciding to convert assets may require more advance planning with a tax professional.

Keri: Makes sense. Mike, can you tell me about this new plan loan offset rule?

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Mike: Sure, Keri.

Basically, the new law provides for an extended rollover period for certain loans considered distributed from an employer-sponsored retirement plan.

For example, if an individual severs employment with a company but has an outstanding loan against her employer-sponsored retirement plan, the loan balance is basically considered a taxable distribution. This outstanding balance is sometimes referred to as a "plan loan offset amount."

Under prior law, recipients of a distribution had to follow the standard rollover rules and had 60-days to roll over the amount considered distributed into an IRA.

Under the new law, an individual has until her tax-filing due date, including extensions, for the tax year in which the amount is considered distributed, to roll over that amount to an IRA.

Keri: So that means they will always have more than 60 days to complete the rollover, right?

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Mike: Exactly right. For example, if an individual severed her employment on August 1, she would have at least until April 15 of the following year to roll over the loan offset amount. I'm sure the government recognized that if someone involuntarily had their employment terminated, it might be difficult to come up with money to pay back the balance of the loan within 60 days.

Keri: And it's probably not top of mind at that point in time either.

Mike: Exactly right, again, Keri.

Keri: Karl, can you tell me about the temporary reduction of the medical expense deduction floor and how that impacts IRA owners?

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Karl: Sure, Keri. So if someone younger than age 59½ takes distribution from an IRA, the taxable amount is generally subject to a 10 percent early distribution penalty tax. There are several exceptions to that rule, however. One such exception is if the distribution is used for the payment of medical expenses.

Under prior law, the medical expense exception generally applied to distributions taken for medical expenses that exceeded 10 percent of an individual's adjusted gross income.

Under the new temporary law, the floor is reduced from 10 percent to 7½ percent. Thus, the 10 percent penalty tax would not apply to medical expenses that exceed 7½ percent of an individual's adjusted gross income.

Importantly, the new law only applies to distributions taken in the 2017 and 2018 tax years. The 10 percent floor is set to return beginning with the 2019 tax year.

Keri: So help me understand. Is that a good thing or a bad thing for your average IRA owner?

Karl: It's a good thing, Keri. Here's where it will help to look at an example.

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Assume an individual younger than age 59 ½ has AGI of $100,000. Under the prior law, if the individual took early distributions from an IRA to pay for medical expenses and those distributions exceeded $10,000 for the tax year, she would not have to pay the 10 percent penalty tax on the amount that exceeded $10,000.

Under the current law, medical expense distributions in excess of $7,500 will avoid the 10 percent penalty tax. So the threshold, or floor, is lower – meaning an IRA owner would pay the 10 percent penalty tax on a smaller amount.

Now, using this example, let's assume an IRA owner had $50,000 of medical expenses which she paid with early distributions and look at the differences between the old rule and the new rule.

So she had an AGI of $100,000

Medical expenses of $50,000

And a taxable early distribution of $50,000 to pay for those medical expenses

Let's look at the old rule first: 10% of her AGI is $10,000 so she would pay the 10% penalty tax on $10,000 (or a penalty tax of $1,000)

Looking at the new rule: 7 ½ % of her AGI is $7,500 so she would pay the 10% penalty tax on $7,500 (or a penalty of $750)

Again, the 7½ percent floor only applies to early distributions taken in taxable years 2017 and 2018. Beginning with the 2019 tax year, the 10 percent floor is set to return.

Keri: Thank you for that helpful example. So, can you also tell me about the suspension of miscellaneous itemized deductions and the impact to IRA owners?

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Karl: Of course. And actually, this one's pretty straight forward. The new law suspends the deduction for miscellaneous expenses.

For tax years prior 2018, some IRA owners that paid IRA fees directly, rather than having fees taken from the IRA balance, may have been able to deduct the fees as miscellaneous itemized deductions. For example, if an IRA owner had a traditional IRA with annual maintenance fees that he paid separately, he may have been able to claim those fees as miscellaneous itemized deductions on his federal income tax return.

Under the new law, beginning in the 2018 tax year, no deduction would be allowed for those same fees.

The catch to this one is the ability to take a deduction is only suspended, it's not permanent. Specifically, the provision will sunset after the 2025 tax year. Thus, for the 2026 tax year, the IRA owner could once again potentially take a deduction for those kind of fees if they were incurred in the 2026 tax year and beyond.

Keri: Okay, Mr. Schiller, It's back to you. I understand that there are more changes affecting an IRA owner's ability to use retirement funds to help pay for disasters. Can you help us understand this change?

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Mike: Well, Keri, the rules haven't changed. It's actually the list of disasters that qualify for special tax treatment has been expanded.

As we described in our prior video on the 5305 changes, the law provides special tax treatment for retirement plan distributions taken by taxpayers affected by Hurricanes Harvey, Irma, and Maria.

That special tax treatment includes the ability to spread the income tax on the distribution over a three-year period, avoid the 10 percent early distribution penalty if applicable, and to roll the distribution back into a retirement plan within three years after having taken the distribution.

Keri: Didn't that come out of the Disaster Tax Relief and Airport Extension Act or something like that?

Mike: Good memory, Keri. But under the 2017 Disaster Tax Relief Act, there was no special tax treatment to help people recover from 2016 disasters.

Under the Tax Reform Act, the existing special tax treatment rules for Hurricanes Harvey, Irma, and Maria distributions have been extended to include 2016 presidentially declared disaster-related distributions taken before January 1, 2018.

So, if at the time of the disaster, an individual lived in a 2016 presidentially declared disaster area, suffered economic loss, and took a distribution before 2018 from his IRA to help pay for the recovery, he may be entitled to the special disaster relief I just described.

Keri: But 2016 has come and gone. Wouldn't everyone have already filed their taxes? Or could they amend?

Mike: If an individual took a distribution in 2016, she would probably need to go back and amend her 2016 taxes, and we would suggest anyone in that circumstance consult a tax professional to better understand all available options.

Keri: So, Mike, you said there was a new qualified hazardous duty area. Is that true?

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Mike: That's right, Keri. That tax reform act adds the Sinai Peninsula of Egypt as an additional hazardous duty area for military members serving in that region after June 9, 2015 as well as any subsequent taxable years prior to January 1, 2026.

That means that servicemembers deployed to that region during those time periods qualify for an extended contribution period currently available under existing law. Under that current law, members of the U.S. Armed Forces serving in certain combat zones or hazardous duty areas are allowed an extended time period to make IRA contributions for a prior year. That period is the time the participant was in the designated zone or area plus at least 180 days.

For example, if you are a servicemember deployed to the Sinai Peninsula of Egypt during the relevant time period, and your deployment ended on April 30, 2018, you would have at least until October 13, 2019, to make an IRA contribution for the 2018 tax year.

Again, we strongly suggest that anyone in that circumstance consult a tax professional to better understand all available options.

Keri: Karl, can we talk about the exclusion of alimony from gross income? And can you clarify the effective date of this section of the tax reform act?

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Karl: Of course. The new tax law removes the deduction for alimony payments and also removes provisions for the inclusion of alimony in gross income. However, the new law applies to a divorce or separation instrument executed after December 31, 2018. But it's a little bit convoluted in that it can apply to divorce or separation instruments executed earlier but modified after that December 31, 2018, date.

Let me explain. Alimony received through a divorce or separation instrument executed by December 31, 2018 is and continues to be considered compensation for purposes of making an IRA regular contribution.

Under the new law, alimony received through a divorce or separation instrument executed after December 31, 2018, will not be taxable to the recipient, and therefore will not be considered compensation for purposes of making an IRA regular contribution. The new law, and this same rule, also applies to any divorce or separation instrument executed on or before December 31, 2018, but is subsequently modified after the December 31, 2018 date, if the modification expressly provides that the new law applies to the modification. In other words, the parties who are modifying an earlier instrument can elect to follow the provisions of the new law.

Keri: So what's the impact of this change?

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Karl: Well, if an IRA owner was, for example, to receive alimony as the result of a divorce decree executed on January 31, 2019, and had no other source of income in 2019, she would not be eligible to make a contribution to her IRA for the 2019 tax year because the rules require that an individual have compensation in order to make an IRA contribution.

Keri: Ok, that makes sense. Karl, can you also explain how the calculation of the annual cost-of-living adjustments is changing?

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Karl: The government has been using something called the Consumer Price Index or CPI to calculate cost-of-living adjustments to various IRA-related dollar amounts. With the enactment of the Tax Reform Act, the calculation is now going to be based on something called the Chained CPI. The bottom line is that, while COLAs will still be calculated annually, the rate at which the numbers will change will be less frequent using the Chained CPI.

The best explanation I've heard is that the Consumer Price Index looks at the cost of a bag of groceries and then looks at the cost of that same bag of groceries year-over-year. On the other hand, the Chained CPI takes into consideration how consumers will substitute an item in that grocery bag, if it becomes too expensive, for another less expensive item.

So, for example, if orange juice becomes too expensive a person might substitute cranberry juice in place of the OJ. The Chained CPI is considered more realistic but causes increases to occur more slowly.

Keri: Wow. Thanks, guys. That's a lot of great information. But what does all this mean for financial institutions?

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Mike: Well, Keri, clearly there are a lot of changes. Their varied and sometimes quite subtle in nature. And they're likely to impact a broad spectrum of a financial institution's customers: servicemembers, people impacted by disasters, and people that have depended on using recharacterization as a way to manage certain tax implications, just to name a few.

Karl: And, as we mentioned, most of these changes will impact their IRA documentation. In fact, we've updated a number of documents including our organizers, booklets and amendments so that our agreements and disclosure statements reflect these changes.

Keri: So as a result of this legislative change, Wolters Kluwer is recommending that all financial institution send amendments? Is that accurate?

Karl: Absolutely. As Mike said, there are a lot of changes that, while they won't affect all customers, will affect a broad cross-section of IRA owners. And the basic reasons for sending an amendment that we discussed in the 5305 video haven't changed. In addition, because of the complexity of some of these changes, institutions may even want to include a copy of an educational brochure we've created that helps explain the changes, including examples, in a more plain language style. Finally, I think an institution would want to let customers know about these changes and there may be some risk in not letting them know. For example, what if an IRA owner recharacterizes a conversion when no longer permitted to do so under the rules? I think it would be very natural for the IRA owner to blame the institution for not telling them about the change.

Keri: Great insight. Now we touched on it earlier but, I think we also need to talk about the recent 5305 changes and how these new changes from the Tax Reform Act are coming out right in the midst of financial institutions responding to the IRS having issued new 5305s. What's your take on that?

Mike: It's unprecedented. I've never seen anything quite like this. In fact, I was talking with my manager who's been working with IRAs for over 35 years and he said he's never seen two distinct IRA change events overlap like this before – much less two events with elements as significant in scope as these changes.

Karl: I agree with Mike. The good news for financial institutions is that the Tax Reform Act is only affecting IRAs – so CESAs and HSAs were left alone this time. But some of the earlier versions of the tax bill had changes that could have impacted those types of accounts as well. So we dodged that bullet.

The other good news is that, at your direction, Keri, we're trying to make it a little easier on financial institutions regardless of whether they've already sent amendments or have yet to send amendments for the 5305 changes. So normally our amendments would only include the most recent changes because drafting to amend for multiple changes creates a lot of logistical problems. But our

amendments for these most recent changes will include not only the changes due to the Tax Reform Act, but will also reference the changes we made last fall for the 5305 updates. These unusual circumstances demanded a unique solution.

Keri: Great information, Karl. And thank you for rising to the challenge and coming up with a solution that will help our customers out regardless of where they're at in the current amendment process.

Keri: Thank-you to Mike and Karl.