COMMITTEE REPORT:
RETIREMENT BENEFITS

By **Bruce D. Steiner**

Tax Reform Opens a Window for Roth Conversions

Middle and upper income IRA owners should consider this opportunity

Clients often consider whether it's wise to convert their individual retirement accounts to Roth IRAs. There are pros and cons to doing so. But, for some clients, the reduced tax rates under the Tax Cuts and Jobs Act of 2017[1] (the Act) and other changes it made may tip the scales in favor of converting substantial amounts now.

Benefits of Roth Conversion

There are several benefits to converting to a Roth IRA. The principal benefit is that, assuming the IRA owner has other funds to pay the tax on the conversion, the IRA owner is effectively shifting additional wealth into the IRA. Converting has the effect of making a substantial additional contribution to the IRA.

Example: Assume a constant 25 percent income tax bracket. An IRA owner has a $100 traditional IRA and $25 in a taxable account. If he converts, he has a $100 Roth IRA. Over some period of time, it grows to $200, all of which is tax free. Over the same period of time, if he doesn't convert, his traditional IRA will grow to $200, or $150 after income tax. His $25 taxable account will grow to less than $50, because the income and gains on the taxable account will be taxable each year.

There are several other benefits to the Roth conversion. There are no required minimum distributions (RMDs) from a Roth IRA during the IRA owner's lifetime or the lifetime of the IRA owner's spouse if he's the beneficiary. The Roth conversion increases the level of asset protection in states where they're protected against creditors. If the IRA owner leaves the IRA to his beneficiaries in trust rather than outright, the trust tax rates won't apply to distributions from the Roth IRA that are accumulated in the trust. The Roth conversion also avoids the double tax in states that have a state estate tax because the Internal Revenue Code Section 691(c) income tax deduction for estate taxes only covers the federal estate tax but not the state estate tax. By converting to a Roth IRA, the income tax is removed from the estate.

Income Tax Tradeoff

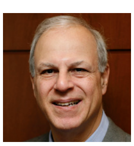
There's often an income tax tradeoff in converting to a Roth IRA. As a general rule, the Roth conversion makes sense to the extent the tax rate on the conversion is less than, equal to or not "too much" higher than the tax rate that would otherwise apply to distributions from the IRA. For that reason, many IRA owners spread the conversion out over a number of years or wait until they retire to convert or to begin to convert.

Many IRA owners who expected to be in the 15 percent bracket during retirement converted as much as they could each year while remaining in the 15 percent bracket. They often had a window between retirement and when they began receiving Social Security or between retirement and when they had to take distributions from their traditional IRA on reaching age 70½.[2] IRA owners who expected to be in higher brackets during retirement often converted up to the top of the 25 percent or 28 percent bracket.[3]

Tax Rates on Joint Returns

For many years, the tax brackets for joint returns were twice the width of the brackets for taxpayers who were single.

To provide relief for singles, the Tax Reform Act of 1969 changed the brackets so that if two individuals with similar incomes married, their tax would increase



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(resulting in a marriage penalty). However, if two individuals, only one of whom had income, were to marry, their tax would decrease (resulting in a marriage bonus).

To ameliorate the marriage penalty, the Economic Growth and Tax Relief Reconciliation Act of 2001[4] widened the 10 percent and 15 percent brackets on a joint return to be twice the width of the corresponding brackets for single returns. This continued to be the case through 2017, when the 15 percent bracket ranged from $9,325 to $37,950 for singles and from $18,650 to $75,900 for joint returns. To balance the interests of singles and married couples, the joint return brackets above 25 percent were wider than but not double the width of the corresponding single brackets. The 25 percent bracket ranged from $37,950 to $91,900 for singles and from $75,900 to $153,100 for joint returns, and the 28 percent bracket ranged from $91,900 to $191,650 for singles and from $153,100 to $233,350 for joint returns.

In addition to reducing the tax rates, the Act widened the tax brackets on joint returns to double the width of the brackets for singles up to and including the 32 percent bracket for taxable income up to $200,000 (single) or $400,000 (joint).

For single individuals, the regular income tax rates in 2018 are 10 percent up to $9,525, 12 percent up to $38,700, 22 percent up to $82,500, 24 percent up to $157,500, 32 percent up to $200,000, 35 percent up to $500,000 and 37 percent over $500,000.

For joint returns, the regular income tax rates in 2018 are 10 percent up to $19,050, 12 percent up to $77,400, 22 percent up to $165,000, 24 percent up to $315,000, 32 percent up to $400,000, 35 percent up to $600,000 and 37 percent over $600,000.

Under the new tax rates, many IRA owners will convert each year to the extent they can do so in the 10 percent or 12 percent income tax bracket. Other IRA owners may convert each year to the extent they can do so within the 22 percent or 24 percent bracket. IRA owners who expect that they and their beneficiaries will always be in a very high tax bracket may convert their entire IRA as quickly as they can.

Other factors, such as the effect of the conversion on the zero tax rate for qualified dividends and long-term capital gains for taxpayers in the 12 percent bracket and the effect of the conversion on the taxation of Social Security benefits, may affect the decision as to how much, if anything, to convert to a Roth.

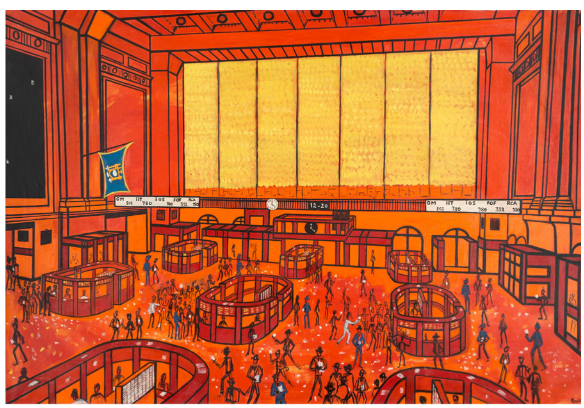
In particular, because the 22 percent and 24 percent brackets on a joint return are now twice the width of the single brackets, a couple filing a joint return will be in the 22 percent bracket up to $165,000 of taxable income and the 24 percent bracket up to $315,000 of taxable income.

This offers a window for many middle and upper middle income IRA owners to convert substantial amounts to a Roth IRA within the 22 percent or 24 percent bracket. This covers couples with taxable income up to $315,000.

This is especially attractive to IRA owners who'll always be in at least the 22 percent bracket as a result of pensions, Social Security, RMDs and investment income.

Endnotes

1. Pub. L. 115-97.
2. The required beginning date is generally April 1 of the year when the individual retirement account owner reaches age 70½. However, if the IRA owner defers the required minimum distribution (RMD) for the year in which he reaches age 70½ until the following year, the IRA owner will have to double up on the following year by taking both the RMD for the year in which he reached age 70½ as well as the RMD for the following year.
3. Bruce D. Steiner, "Roth Conversions Are More Attractive Under ATRA," *Trusts & Estates* (April 2013).
4. Pub. L. 107–16.



SPOT LIGHT

Trade Off

New York Stock Exchange by Nicola Ortis Poucette sold for $8,437.50 at Heritage Auctions' The Estate of Zsa Zsa Gabor Signature Auction on April 14, 2018 in Beverly Hills, Calif. Though portraits seem to be the theme of the auction, items up for sale included everything from Gabor's prescription pill bottles to a gold and diamond cigarette case.