Regard Roth Conversions Carefully

The article "Rethinking Retirement Contributions" explains why the new TCJA devalues putting money into traditional tax-deferred plans and favors Roth versions. Does the same reasoning apply to conversions from Roth to traditional accounts? From a tax viewpoint, the answer may be yes, but other factors indicate you should be cautious about such moves.

Example 1: Fred and Glenda Polk would have had $220,000 in taxable income in 2017 without contributing to their employers' traditional 401(k) plans. However, they contributed a total of $40,000 to the plan, bringing their income down to $180,000. The couple was in the 28% bracket last year, so the income deferral saved a total of $11,200 in tax: 28% times $40,000.

Assume they kept their $11,200 of tax savings in the bank. If their employers have a 401(k) plan that offers designated Roth accounts, they could convert the $40,000 they contributed in 2017 to the Roth side if the plans allow such moves. Alternatively, depending on the plan terms and the Polks' circumstances, they might be able to rollover the $40,000 to a Roth IRA. Yet another possibility, the Polks might leave the $40,000 in their 401(k)s but convert $40,000 of pretax money in their traditional IRAs to Roth IRAs.

With any of these strategies, the couple would generate a $9,600 tax bill (24% of $40,000) on the Roth conversion, because their joint income falls into the 24% tax bracket in 2018, in this example. The Polks could pay that $9,600 from their $11,200 of tax savings in 2017 and wind up ahead by $1,600.

Therefore, people who move into a lower tax bracket this year might be able to come out ahead with Roth conversions of income that had been deferred at a higher tax rate. Going forward, the money transferred to the Roth side may generate tax free rather than taxable distributions.

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Nevertheless, there are reasons to be cautious about Roth conversions now. For instance, U.S. stocks are trading at lofty levels. Roth conversions could be highly taxed at today's equity values.

Example 2: Heidi Morris has $300,000 in her traditional IRA, all of which is pre-tax. Investing heavily in stocks, Heidi has seen her contributions grow sharply over the years. With an estimated

$100,000 in taxable income this year, Heidi calculates she can convert $50,000 of her traditional IRA to a Roth IRA in 2018 and still remain in the 24% tax bracket.

However, stocks could fall heavily, as they have in previous bear markets. The $50,000 that Heidi moves to a Roth IRA could drop to $40,000, $30,000, or even $25,000. Heidi would not want to owe tax on a $50,000 Roth conversion if she holds only $25,000 worth of assets in the account.

Under previous law, Heidi had a hedge against such pullbacks, at least for Roth IRA conversions. These conversions could be recharacterized (reversed) to her traditional IRA, in part or in full, until October 15 of the following calendar year. In our example, Heidi could have recharacterized after a market setback, avoided a tax bill, and subsequently re-converted at the lower value. (Timing restrictions applied.)

Such tactics are no longer possible because the TCJA has abolished recharacterizations of Roth IRA conversions. (Conversions to employer-sponsored Roth accounts could never be recharacterized.) Now moving pre-tax money to the Roth side is permanent, so the resulting tax bill is locked in.

In the new environment, it may make sense to take it slowly on Roth conversions in 2018. If stocks rise, boosting the value of your traditional retirement accounts that hold equities, you won’t be sorry about the increase in your net worth; you can convert late in the year at today’s lower tax rate. On the other hand, if periodic corrections occur, they could be an opportunity for executing a Roth conversion at a lower value and a lower tax cost.