Year-End Retirement Tax Planning

A major feature of the TCJA is the reduction of income tax rates owed by individuals. For example, married couples filing jointly for 2018 may have taxable income up to $77,400 and remain in the 12% bracket, up to $165,000 and stay in the 22% bracket, and up to $315,000 and stay in the 24% bracket. For single filers, the taxable income numbers are exactly 50% of those in the last sentence. Keep in mind that the numbers are for taxable income after all deductions have been taken.

In terms of retirement planning at year-end, one result is that low tax rates make tax deferral less attractive. Boosting your 401(k) contributions now may have less of a payoff than in previous years.

On the other hand, withdrawing from tax-deferred retirement accounts has become less difficult. That includes converting pre-tax dollars from a traditional, SEP, or SIMPLE IRA to a Roth IRA for potential tax-free distributions after five years, if you are at least age 59½.

No Looking Back

Roth IRA conversions have a catch, though. You no longer can reverse (recharacterize) a Roth IRA conversion back to a pre-tax IRA.

Example 1: Suppose Stephanie Jackson converts a $100,000 traditional IRA to a Roth IRA in November 2018. No matter what happens to that Roth IRA's value in the interim, Stephanie will report $100,000 of taxable income on her 2018 tax return.

Therefore, the end of a calendar year can be the best time for a Roth IRA conversion. By then, you may have a good idea of your taxable income for the year, so you can make a tax-efficient partial conversion.

Example 2: Stephanie and her husband Tom calculate that they will have about $110,000 in taxable income on their joint return for 2018. Thus, one or both Jacksons could convert up to $55,000 and stay in the 22% tax bracket. Instead, they choose to have Stephanie convert $40,000 in late 2018. That will add $8,800 to their 2018 federal income tax bill (22% of $40,000), an amount they can comfortably pay from their cash reserves.

Planning Ahead

An alternate approach is to set aside an amount to convert from a traditional to a Roth IRA each year.

Example 3: Chet and Doris Carson report from $200,000 to $250,000 of taxable income each year, placing them squarely in the 24% tax bracket. Between them, they have $600,000 in traditional IRAs. The Carsons plan to convert $60,000 to a Roth IRA every year, generating a $14,400 annual federal income tax obligation. After 10 years, their traditional IRAs will be mostly or fully depleted, so the Carsons will owe little in the way of RMDs after age 70½. Roth IRA owners never have RMDs.

Roth IRA distributions are completely tax-free once the age 59½ and the five-year hurdles are cleared. Any Roth IRA conversion in 2018, no matter how late in the year, has a start date of January 1, 2018, so the five-year requirement after a year-end conversion will be met in just over four years.

Double Trouble

Tax-deferred retirement accounts generally have RMDs after age 70½. Therefore, taxpayers in this age group should be sure to meet their annual requirement by year-end. Any shortfall can trigger a 50% penalty.

In addition, each spouse must withdraw the RMD from his or her own account to avoid the penalty.

Example 4: Robert and Jan King each have a $20,000 RMD for 2018. Suppose Robert withdraws $40,000 from his IRA in 2018, but Jan does not take anything from her IRA.

In this situation, the IRS has collected the amount owed by the Kings. That makes no difference. Jan will still face a $10,000 penalty: 50% of her $20,000 RMD shortfall.