JULY 6, 2019

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Tax Rate Debate

I'M PONDERING whether to make my biggest transaction in four years—and it might be the trickiest financial decision I've ever made. My quandary: Should I take advantage of today's low tax rates to convert a big chunk of my traditional IRA to a Roth?

This financial navel-gazing was sparked by an article by John Yeigh, one of HumbleDollar's contributors. As John pointed out, you can now have a much higher annual income and still avoid the top federal tax brackets, thanks to the tax law passed in late 2017 and which took effect in 2018. That means it's possible for folks to make a large conversion from a traditional IRA to a Roth and pay taxes at a relatively low rate.

Remember, you have to pay federal—and possibly state—income taxes on the taxable sum converted to a Roth. To cover the resulting tax bill, you'll want money set aside in a regular taxable account.

In return for paying those taxes today, you get a handsome reward: Money in a Roth IRA grows tax-free, plus there's no required minimum distributions once you turn age 70½. Sound appealing? Problem is, the current window of opportunity may slam shut at the end of 2025, when many provisions in 2017's tax law sunset, and it could close even earlier—depending on what happens in 2020's election.

To understand what's at stake, suppose you claim the standard deduction. In 2019, if you're married filing jointly, you could have total income of up to $345,850 and still remain in the 24% federal tax bracket. Above that level, additional income is taxed at 32%. By contrast, in 2017, before the new tax law took effect, you'd have been taxed at 25% once your total income got above $96,700. This latter figure reflects 2017's standard deduction, plus two personal exemptions.

What if you're single? In 2019, you can have total income of up to $172,925 and pay taxes at 24% or less. Contrast that with 2017, when you would have been taxed at 25% on income above $48,350. Meanwhile, if you file taxes as head of household and claim one dependent, you can have total 2019 income of as much as $179,050 and remain in the

24% bracket, versus reaching the 25% tax bracket at $68,250 in total income in 2017.

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The bottom line: Unless you already have a huge income, it looks like there's plenty of room to do a hefty Roth conversion in 2019 and get taxed at 24% or less. That alone, however, isn't enough to justify a big conversion. Instead, you also need to be reasonably confident you'll be taxed at a higher rate later on, especially once you reach age 70½ and start taking required minimum distributions from your retirement accounts.

I'm 56½, which means I'm 14 years from that point. If my traditional IRA notches a 4% after-inflation annual return, it'll balloon 73% over the next 14 years—and I'll be looking at required minimum distributions of around $95,000, based on the IRS's uniform lifetime table. (I'm using my portfolio's potential after-inflation return because, over the 14 years, I presume tax thresholds will continue to rise with inflation.)

Take that $95,000 IRA distribution and add my Social Security benefit, my taxable account's gains, my wife's Social Security and her portfolio income, and it looks like we could easily be paying taxes at a 25% marginal federal rate and perhaps more—assuming we return to something that looks like the tax law that applied to 2017 and earlier years.

To be sure, I could reduce the tax hit somewhat by spending maybe a third of my IRA in my 60s. But even then, it looks like my wife and I would still be in the 25% tax bracket once we're in our 70s—again, assuming we revert to something like the old tax law.

The question: Should I do a big Roth conversion this year and perhaps in the years that follow, paying federal income taxes at 24% or less, so that—14 years from now—we could potentially avoid paying taxes at 25% or more.

A big conversion today, and hence less taxable income later, may also result in lower Medicare premiums. What about my Social Security benefit? That, alas, will almost certainly be taxable.

As I weigh all of this, there are so many unknowns. Maybe we won't revert to something that looks like the old tax law. Maybe we'll cut federal income taxes and instead adopt a national sales tax, which would make income-tax-free withdrawals from a Roth less valuable. Maybe Congress, in its infinite wisdom, will decide to tax Roth accounts.

I long ago learned that you don’t want to get into the forecasting business—not just when it comes to the financial markets, but also when contemplating future tax rates. At this juncture, all we can say with any certainty is that 2017’s individual income tax rates will return in 2026, unless Congress acts.

So if I don’t want to forecast, how do I decide whether to take advantage of today’s low federal tax rates? As always, the trick is to eschew predictions and focus on managing risk. Because none of us can be sure what will happen to tax rates, my inclination is to hedge my bets and convert maybe $50,000 to a Roth this year and perhaps a similar sum in the years that follow.

But I might convert far more—if the stock market plunges. That’ll allow me to convert a larger percentage of my traditional IRA to a Roth, while still paying the same amount in taxes. My fondest wish: The stock market nosedives, I convert, the market comes roaring back—and the entire gain is tax-free.