

Retirement Planning Strategies Following the 2017 Tax Act

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Article Highlights

- The key comparison for determining whether to save in a tax-deferred account or a Roth account is between the relative sizes of the current marginal tax rate and the expected marginal tax rate in retirement.
- Expected higher marginal tax rates in retirement favor saving in a Roth type of account; expected lower tax rates favor saving in tax-deferred accounts.
- Saving in or converting to a Roth account now reduces the risk of higher future tax rates. For singles and married couples, the lower tax rates and higher standard deduction makes Roth conversions more attractive.

The Tax Cuts and Jobs Act (TCJA) of 2017 calls for generally lower tax rates from 2018 through 2025 before reverting back to 2017's higher tax rates (after inflation adjustments) in 2026.

Moreover, there is a possibility that Congress may raise tax rates before 2026. The TCJA affects several tax-based strategies related to retirement planning. This article addresses two strategies for those who believe, as we do, that tax rates in 2018 and the next few years will be lower than tax rates in later years.

We begin by discussing the implications of the TCJA for the choice between saving pretax funds in, say, a 401(k) or aftertax funds in, say, a Roth 401(k). We then explain how singles and married couples might use Roth conversions to reduce the effective tax rate they will eventually pay on pretax funds in 401(k) and similar tax-deferred accounts. In short, we consider what many taxpayers can do this year and beyond to take advantage of what we expect to be temporarily lower tax rates.

Choosing Between a 401(k) and a Roth 401(k), and Similar Accounts

In 2018, employees often have the choice of saving up to \$18,500 (or \$24,500 if age 50 to 70) of pretax funds in a



401(k) account, or saving the same amount of aftertax funds in a Roth 401(k) account. The same rules apply to similar types of employer-sponsor plans such as 403(b) or Roth 403(b) plans. Separately, most individuals under age 70 can contribute pretax funds to a traditional (deductible) individual retirement account (IRA) or aftertax funds to a non-deductible Roth IRA.

The key comparison that determines whether someone should save pretax funds this year in a tax-deferred account—such as a 401(k), 403(b), or traditional IRA—or an equivalent aftertax amount in a Roth 401(k), Roth 403(b), or Roth IRA is the relative sizes of the marginal tax rate this year and the expected marginal tax rate in retirement. If this year's marginal tax rate is greater than the expected marginal tax rate in retirement, then save pretax funds in a tax-deferred account, and vice versa.

The marginal tax rate is the tax rate paid on your next dollar of income. For almost everyone younger than retirement age, the year's marginal tax rate is the highest tax bracket you fall into.

For simplicity, but without loss of generality, Table 1 assumes Betty is deciding whether to save \$10,000 of pretax funds this year in a 401(k) or an equivalent aftertax amount in a Roth 401(k). [The same logic would apply to choosing between a 403(b) and a Roth 403(b) or a traditional IRA and a Roth IRA] Betty's marginal tax rate is currently 24%.

She can save either \$10,000 of pretax funds in a 401(k)

Table 1. Difference Between Saving in 401(k) and Saving in Roth 401(k)

	Savings This Year ($t_0 = 24\%$)	Withdrawal in Retirement ($t_r = 24\%$)
Tax-Deferred Account*	\$10,000 of pretax funds in 401(k) \$2,400 tax savings plus \$7,600 of aftertax funds (and reduced spending this year)	\$20,000 before taxes \$15,200 after taxes (spending amount)
Roth Account**	\$7,600 of aftertax funds in Roth 401(k)	\$15,200 after taxes

	Savings This Year ($t_0 = 24\%$)	Withdrawal in Retirement ($t_r = 28\%$)
Tax-Deferred Account*	\$10,000 of pretax funds in 401(k) \$2,400 tax savings plus \$7,600 of aftertax funds (and reduced spending this year)	\$20,000 before taxes \$14,400 after taxes (spending amount)
Roth Account**	\$7,600 of aftertax funds in Roth 401(k)	\$15,200 after taxes

	Savings This Year ($t_0 = 24\%$)	Withdrawal in Retirement ($t_r = 15\%$)
Tax-Deferred Account*	\$10,000 of pretax funds in 401(k) \$2,400 tax savings plus \$7,600 of aftertax funds (and reduced spending this year)	\$20,000 before taxes \$17,000 after taxes (spending amount)
Roth Account**	\$7,600 of aftertax funds in Roth 401(k)	\$15,200 after taxes

*Includes 401(k), 403(b) and traditional individual retirement accounts.

**Includes Roth 401(k), Roth 403(b) and Roth IRAs.

t_0 = This year's marginal tax rate.

t_r = Expected marginal tax rate in retirement.

or \$7,600 of aftertax funds in a Roth 401(k). The \$10,000 contribution of pretax funds to a 401(k) is equivalent to a \$7,600 contribution to a Roth 401(k) because they each reduce the amount that she can spend this year by \$7,600. If she contributes \$10,000 of pretax funds to a 401(k) it will reduce her taxable income by \$10,000 and her tax bill by \$2,400 [$\$10,000 \times 24\%$ tax rate = \$2,400]. If she opts for the Roth 401(k) instead, she is contributing aftertax dollars, which equate to \$7,600 (\$10,000 less \$2,400 paid in taxes).

To hold everything else constant, we assume the underlying investments in the 401(k) and the Roth 401(k) are the same. Table 1 assumes that the underlying investments' cumulative pretax return is 100% between now and when Betty withdraws the funds to spend in retirement. If she contributes \$7,600 of aftertax funds to the Roth 401(k), the

amount would be worth \$15,200 on an aftertax basis when she withdraws the funds in retirement. Returns in a Roth account grow tax free if the account has been in existence for at least five years and the account owner is at least age 59½ at the time of withdrawal. So, she could buy \$15,200 of goods and services using aftertax dollars. The effective tax rate on funds held in a Roth account is 0%.

For comparison, the \$10,000 in the 401(k) will double and be worth \$20,000 before taxes when Betty withdraws and spends the funds in retirement. This \$20,000 of pretax funds will be reduced then by the prevailing marginal tax rate [$\$20,000 \times (1 - \text{marginal tax rate})$] when the funds are withdrawn in retirement.

The top third of Table 1 assumes her marginal tax rate in retirement will be 24%. In this case, this \$20,000 withdrawal from her 401(k) will allow

her to buy \$15,200 of goods and services [$\$20,000 \times (1 - 24\%) = \$15,200$]. Conceptually, this year's \$2,400 of tax savings in the 401(k) grows to \$4,800, and this pays the full taxes on the \$20,000 withdrawal [24% of \$20,000 = \$4,800.] Since the marginal tax rates this year and in retirement are the same, Betty should be indifferent between saving \$10,000 in a 401(k) and \$7,600 in a Roth 401(k), all else being equal.

The middle third of Table 1 demonstrates that if Betty expects to have a higher marginal tax rate in retirement, then she should save in the Roth 401(k). For example, if she will have a marginal tax rate of 28% in retirement, then her 401(k) would be worth \$14,400, [$\$20,000 \times (1 - 28\%)$] on an aftertax basis in retirement. This would be less than the \$15,200 aftertax amount available with the Roth 401(k). Conceptually, the \$2,400 of tax savings this year from the 401(k)

contribution grows to \$4,800 in retirement, but the tax bill on the \$20,000 withdrawal from the 401(k) would be \$800 more at \$5,600 [$\$20,000 \times 28\% = \$5,600$]. So, the 401(k) is worth \$800 less after taxes in retirement than the Roth 401(k) due to her higher tax rate.

The lower third of Table 1 shows that if Betty expects to have a lower marginal tax rate in retirement, then she should save pretax funds in the 401(k). For example, if she will have a marginal tax rate of 15% in retirement, then the 401(k) would be worth \$17,000 [$\$20,000 \times (1 - 15\%)$] on an aftertax basis. This would be more than the \$15,200 aftertax amount available with the Roth 401(k). Conceptually, the \$2,400 of tax savings in 2018 grows to \$4,800 in retirement, but only \$3,000 will be needed to pay the tax bill. So, she keeps the additional \$1,800. That explains why the \$17,000 aftertax amount from the 401(k) is \$1,800 higher than the \$15,200 aftertax amount that would be available from the Roth 401(k). The effective tax rate on this 401(k) is negative.

Before leaving this section, we want to add two points. First, returns in a Roth account (held for at least five years and withdrawn after age 59½) grow tax free. The effective tax rate is 0%. The effective tax rate is negative on returns in a tax-deferred account when the marginal tax rate in retirement is less than this year's marginal tax rate. By making the better choice between saving in a Roth account or a tax-deductible account, your effective tax rate is 0% or less! These are attractive tax rates. Therefore, when saving for retirement, you should save all you can afford to save in these tax-advantaged savings vehicles.

Second, suppose your marginal tax rate this year, which is probably your tax bracket, is the same as your expected tax bracket in retirement. In this case, we encourage you to save in the Roth account for two reasons. First, as the example in the top third of Table 1 shows, for a taxpayer with a 24% marginal tax rate this year, saving \$7,600 of aftertax funds in a Roth 401(k) is equivalent to savings \$10,000 of pretax funds in a 401(k). Thus, saving \$18,500 of aftertax funds

in a Roth 401(k) is effectively a larger savings amount than saving \$18,500 of pretax funds in a 401(k). Since the effective tax rate on savings in a Roth is 0%, you should save in the Roth account if you can save the maximum amount.

Second, as we will explain in a later article, the marginal tax rate for many retirees will be higher than their tax bracket. As a preview, due to the taxation of Social Security benefits, many lower- and middle-income taxpayers will pay a marginal tax rate that is either 150% or 185% of their tax bracket. For example, a single retiree receiving Social Security benefits may be in the 22% tax bracket, but will have to pay a federal marginal tax rate of 40.7%, [$22\% \times 1.85$], on distributions from their 401(k) or other tax-deferred accounts. A forthcoming *AAL Journal* article will also explain why income-based increases in Medicare premiums will cause some high-income taxpayers to pay extremely high marginal tax rates on their tax-deferred account distributions. In short, many low-income through high-income taxpayers will have much higher marginal tax rates in retirement than their tax brackets. So, if your marginal tax rate this year is the same as your expected tax bracket in retirement, you should save in the Roth account.

Roth Conversions Strategy

In this section, we present several examples where it would be better for a taxpayer to convert funds to a Roth account, while tax rates are temporarily lower, than to not make Roth conversions and have these pretax funds taxed at a higher marginal tax rate when withdrawn in retirement. As before, the key to whether a Roth conversion makes sense this year is the comparison of this year's marginal tax rates to the marginal tax rate if the funds are retained in the tax-deferred account and withdrawn in retirement.

For the first example consider Mary, who is 60 years old and single. Her projected taxable income this year will be about \$108,000. Her marginal tax rate (and tax bracket) this year will be 24%, but she expects her marginal tax rate in

retirement to be higher than 24%. At the end of this year, Mary should estimate her calendar-year income, including such things as interest, dividends and capital gains on assets held in taxable accounts. She should then convert sufficient pretax funds from a traditional IRA, rollover IRA or 401(k) to a Roth account to take her taxable income to the top of the 24% tax bracket. To be conservative, she may convert an amount to take her income slightly below the limit. After all, even at the end of the year, Mary may not know her precise income level before the Roth conversion. As demonstrated in Table 1, it is better to give the government 24% of the conversion amount now than to give the government a higher percentage of the pretax withdrawal amount in retirement.

For the second example, consider a widow, age 67, whom we are working with at our firm www.incomestrategy.com. She should aggressively pursue Roth conversions from her rollover IRA before she turns 70½. If she does not, her required minimum distributions (RMDs) when she turns 70½ will place her in the 22% tax bracket based on the TCJA's 2018–2025 tax rates or place her in the 25% tax bracket beginning in 2026 (if the TCJA's lower tax rates expire). Due to the rules affecting the taxation of Social Security benefits, she will pay a marginal tax rate of more than 40% on much of her IRA distributions. (For a wide range of tax-deferred account withdrawals, each \$100 withdrawn will cause another \$85 of Social Security benefits to be taxed. So, her taxable income increases by \$185, and 22% of \$185 is \$40.70. Thus, her marginal tax rate is 40.7%.) By aggressively converting funds to a Roth account to take her to the top of the 24% tax bracket in each year before turning 70½, she will be able to reduce funds in her tax-deferred IRA and thus reduce, if not eliminate, the size of her required minimum distributions (RMDs) subject to the 40.7% or higher marginal tax rates. (By reducing her RMDs, Mary lowers the amount of taxable income used to determine how much of her Social Security benefits will be taxed.)

It would be better for her to pay 22% or 24% on Roth conversions each of the next few years than to retain these funds in her tax-deferred IRA and have these funds taxed at over 40% a few years later.

For the third example, let's consider a higher-income single female who is age 55. Her income, once RMDs begin after age 70½, will be so high that she cannot avoid paying taxes on 85% of her Social Security benefits, which is the maximum taxable amount. She should consider converting pretax funds from her tax-deferred accounts such as a 401(k) to a Roth account from, say, ages 55 to 62. Since she will begin Medicare at age 65, these conversion amounts through age 62 will not affect the size of her Medicare premiums at age 65 or later. The reason is that Medicare premium levels at age 65 will be based on her income level two years earlier, or age 63. By converting funds to Roth accounts from, say, age 55 to 62, she may reduce the size of her RMDs and thus the size of her future Medicare premiums.

The fourth example is similar to the prior example, except that the single taxpayer or married couple filing jointly may be decades from retirement. Consider a married couple in their late 30s. They have been saving aggressively in their firms' 401(k) plans. They could convert funds to the top of the 22% or 24% tax bracket in 2018 and each year thereafter that these lower tax rates apply. As explained in Table 1, these Roth conversions will enhance their aftertax wealth in retirement if their marginal tax rate in retirement will be higher. By converting pretax funds to aftertax funds and paying say 24% on the con-

verted amounts, these young taxpayers do not have to worry about the impacts of taxation of Social Security benefits and income-based Medicare premiums on their marginal tax rate in retirement. This example demonstrates that the new tax code has retirement-planning implications for people decades from retirement.

Furthermore, by converting some of their pretax funds in a 401(k) or other tax-deferred accounts to a Roth account in the next few years, these young workers are practicing a form of tax diversification. That is, by converting some of their tax-deferred funds to a Roth in the next few years, they are reducing the risk that Congress may substantially raise future tax rates, which would affect the marginal tax rate on all funds withdrawn from their tax-deferred accounts in retirement.

Let's consider a fifth example. An older same-age married couple will have an adjusted gross income of \$90,000 in 2018. After deducting their \$26,600 standard deduction, which includes \$2,600 for both spouses being over 65, their taxable income will be \$63,400. Furthermore, most of this income comes from RMDs. Beginning one year after the death of the first spouse, the survivor will likely have a similar level of adjusted gross income, but due to the lower standard deduction for a single household, the survivor's taxable income may be about \$76,400, [\$90,000 – \$13,600 standard deduction]. Based on the TCJA tax structure, as a married couple they will be in the 12% tax bracket. After the death of the first spouse, the survivor may either be in the 22% tax bracket based on the TCJA's

2018–2025 tax rates or in the 25% tax bracket beginning 2026 (if the TCJA's brackets expire). In short, after the death of the first spouse, the survivor will usually be subject to a higher tax bracket. Such couples should consider converting funds to a Roth while both partners are alive to fill their relatively low tax bracket. It may be better for them to convert funds to a Roth account when they can file as a married couple filing jointly and the TCJA's temporarily lower 2018–2025 tax rates apply than to not make such conversions and force the surviving spouse to pay a substantially higher tax rate on the distribution of these pretax funds later in retirement.

Summary

The TCJA established lower tax rates for 2018–2025 than 2026 and beyond. And there is no guarantee that Congress may not raise tax rates before 2026. In this article, we discuss two retirement-related strategies that should help many taxpayers take advantage of these temporarily lower tax rates. These strategies apply to taxpayers who have a lower marginal tax rate this year than they expect to have in retirement.

The first strategy is for these taxpayers to make contributions this year to tax-exempt Roth accounts instead of making tax-deductible contributions to tax-deferred accounts such as a 401(k) or traditional IRA. The second strategy is for these taxpayers to make Roth conversions if their marginal tax rate this year, which is probably their tax bracket, is below their expected marginal tax rate in retirement. ▲

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