Retirement planning after tax reform

Several tax reform ideas affecting retirement planning were bandied about as the recent legislation was being prepared, including limits on deductible 401(k) contributions, elimination of "stretch IRAs," and requiring minimum distributions from Roth IRAs, similar to the treatment of traditional IRAs. In the end, only one significant change made it into the final legislation, together with a few minor ones.

The important change is that, beginning in 2018, conversions of traditional IRAs to Roth IRAs are irrevocable.

Until now, taxpayers could change their minds and undo a conversion to a Roth IRA through a "recharacterization" of the transaction. The reversal could be made until the due date for the taxpayer's return, including extensions. That generally meant October 15 of the year following the conversion.

Conversion of a traditional IRA is a serious decision, not to be made lightly. Why might one have second thoughts, and regret the change? Perhaps the investments in the Roth IRA did very poorly, or perhaps the tax situation changed, making the conversion appear unwise.

Example 1. George converted his $150,000 traditional IRA to a Roth in February of Year 1. The full amount must be included in George's taxable income for that year. Unfortunately, George's Roth IRA investments did very poorly, dropping the value of the account to only $100,000 a year later. What's more, George otherwise had a very good year, earning a substantial bonus. That plus the inclusion of the income from the conversion will push George into a top tax bracket. In April of Year 2, George realizes his mistake, and so cancels the conversion.

Example 2. Janet has two IRAs, each $100,000. She converts each to a Roth IRA, and has very different investment strategies for each. After a year, one account has increased in value and the other decreased. Janet recharacterizes the account that went down in value, to avoid the loss, and keeps the tax-free gain in the other account.

How many taxpayers engaged in such strategies? Unknown, but that opportunity is now closed. However, the opportunity to fix contribution mistakes remains.

Example 3. Amy has a Roth 401(k) account. At her retirement, she directs the plan administrator to roll the money into her Roth IRA. Through a mistake by either the adminstrator or the Roth IRA custodian, the money is rolled into Amy's traditional IRA. This is not a valid rollover, and if left uncorrected would be a distribution of the funds to Amy. Fortunately she is still allowed to recharacterize the rollover to save the Roth IRA.

Although the new tax law is very clear that 2018 conversions to Roth IRAs will be irrevocable, there is an ambiguity regarding conversions that happened in 2017, before the new law was signed. It would be harsh to, in effect, impose the new rule retroactively on taxpayers who did a conversion earlier in 2017, relying upon the old rules. But an argument can be made either way, given the new statutory language. It will be up to the IRS to resolve the issue.

Tax issues at retirement remain knotty, and are best addressed by an experienced professional.

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