NORTHERN TRUST

TAX BENEFITS THROUGH ROTH CONVERSION

Roth and traditional retirement accounts can complement each other by creating tax diversification and potentially maximize benefits for investors.

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UNCERTAINTY OF FUTURE TAX RATES

Traditional 401(k)s and individual retirement accounts (IRAs) allow investors to make pre-tax contributions, defer tax on investment returns, and then pay income tax on all withdrawals. Roth 401(k)s and Roth IRAs, in contrast, require that investors pay income tax on contributions up front and then accrue returns and make withdrawals with no tax obligations.

The eventual outcomes of traditional vs. Roth accounts depend on the future vs. present tax rates. If the future tax rate is lower, it is advantageous for investors to utilize traditional accounts to dodge the currently higher tax rate and pay at a lower rate in the future; conversely, Roth wins out.

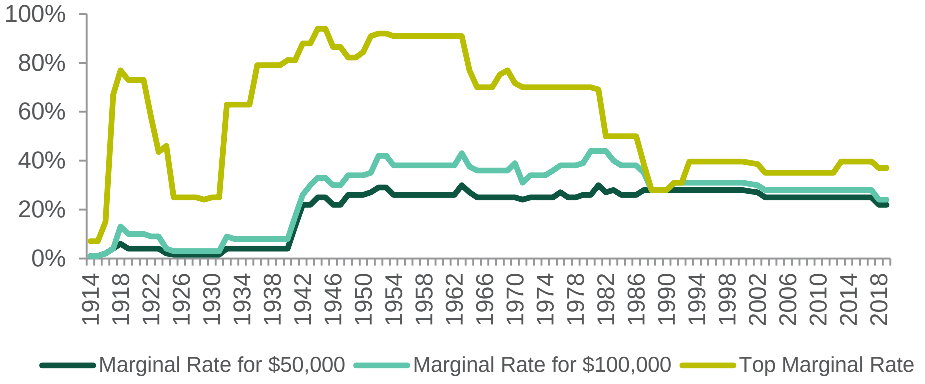
However, it is hard to predict the trajectory of future tax rates. This makes a case for adding or utilizing Roth accounts in combination of traditional accounts to diversify the impact of tax.

HISTORY OF TAX RATES AS A REFERENCE

The current U.S. income tax rates are lower than many other periods in history. The top marginal individual income tax rates were above 90% in the 1950s and early 1960s (Figure 1). These top rates were only applicable to those highly paid but indicate that much higher tax rates could reemerge. A "wealth tax" is being contended recently by some to address the income inequality.

Middle class workers also face the odds of a future tax rate hike. The U.S. public debt stands at more than 100% of GDP. Economic growth could shrink the debt burden; or alternatively taxes would need to rise to pay down the debt. Workers making $50,000 in 2019 are paying the lowest marginal tax rate right now, compared with those making an equivalent amount in history (adjusted for inflation), since World War II (Figure 1). The same pattern holds for workers making $100,000 or equivalent in history.

Figure 1: Marginal federal income tax rates for hypothetical workers



Notes: Deductions and exemptions are ignored for simplicity. Illustrations here do not constitute investment or tax advice.
Source: Northern Trust illustrations based on "Federal Individual Income Tax Rates History," Tax Foundation.

The Tax Cut and Jobs Act (TCJA) of 2017 reduced tax rates (e.g., top rate at 37%) and expanded standard deductions, among other provisions. Many tax reduction provisions of TCJA are temporary and scheduled to expire in 2025, absent further legislation by Congress.

If the investor believes the applicable income tax rates are more likely to rise in the future, they should consider tilting towards Roth and converting a portion of assets in traditional accounts to Roth accounts. The TCJA could be viewed as offering a favorable time window to do so.

HOW TO UTILIZE ROTH?

When contributing, an investor can direct new savings into Roth, paying income tax, while she is operating in a low income tax bracket; and she can switch to a traditional account, deferring income tax, when her pay rises and her tax bracket jumps to a high-enough level to tip the scales.

Regarding the existing traditional accounts, investors could convert part or all of the assets into Roth accounts, if this move is deemed beneficial. This may not always be doable for 401(k) accounts, because not every company offers an in-plan Roth 401(k) option.

There is income tax due upon Roth conversions. Conversions count towards adjusted gross income for the year and are subject to ordinary income tax. Moreover, withdrawing an amount from the traditional 401(k) or IRA to pay the tax is deemed a distribution, which is subject to 10% penalty, if the withdrawal is earlier than age 59 ½. It is recommended that outside funds be used to cover such tax so that the 401(k)/IRA funds stay intact to grow.

For clarity, Roth 401(k) has no income limit for qualified employees to participate. In contrast, high-paid workers may not be eligible for contributing to an IRA. For instance, a single taxpayer can make the full $6,000 tax-deductible IRA contribution if their modified adjusted gross income is less than $122,000, a reduced contribution after that, and no tax deduction above $137,000 for the 2019 tax year. But the IRS does not prohibit the conversion of an existing traditional IRA to a Roth IRA. The 2017 tax reform blocks the reversal (recharacterization) of Roth IRA conversions, however, which was allowed in the past.

EXPECTED TAX BENEFITS OF ROTH

Roth accounts *de facto* enjoy a larger contribution limit. For instance, at a 25% tax rate, the after-tax $19,000 contribution limit for Roth 401(k) in 2019 is equivalent to $25,300 pre-tax for a traditional account. Note that traditional and Roth contributions combine to count towards the contribution limit for preferential tax treatments.

Ownership of both types of accounts can accommodate more flexibility. It allows investors to coordinate taxable and tax-free withdrawals, from traditional and Roth accounts, respectively, together with Social Security benefits, to minimize income taxes in retirement. Also, Roth accounts are not subject to the required minimum distribution (RMD), which is binding on traditional accounts at age 70 ½. Thus Roth accounts provide investors with more flexibility of withdrawals.

Roth accounts can assist with estate planning. Owners of Roth accounts effectively prepay income tax for heirs without owing any gift tax or using up the unified federal gift and estate tax exemption ($11.4 million for individuals in 2019, which is scheduled to revert in 2025 back to $5 million, adjusted for inflation). Distributions from inherited Roth accounts are not subject to income taxes. Assets intended for charitable bequests would not benefit from Roth conversion, because the donations are not taxed in the first place.

This brief discussion does not suggest that Roth is definitely superior to traditional account, or vice versa. It mainly highlights that Roth is worth serious consideration for many workers for its merits of tax diversification and withdrawal flexibility.

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[1] Asset under management as of December 31, 2018.