Saving/Investing for Retirement

Do Higher Contribution Limits Mean Higher Taxes?

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By Kris Tower

In October, the IRS announced cost-of-living adjustments for pension plans and other retirement-related investment plans, namely 401(k) and Roth IRA, for the 2018 tax year. Of note, the annual contribution amount for 401(k) plan participants increased from $18,000 to $18,500. This is a welcome sign for plan participants, because one of the initial proposed tax reforms included reducing 401(k) annual contribution limits to $2,400.

Taxpayers who want to deduct contributions to their traditional IRA from their taxable income also have reason to celebrate. The phase-out income range for single and head-of-household taxpayers rose from $62,000-$72,000 to $63,000-$73,000 for 2018. Married couples filing jointly also experience a slight increase in the phase-out income range, from $99,000-$119,000 to $101,000-$121,000. However, certain conditions must be met for the contributions to be eligible for deduction, which includes whether the plan participant or their spouse is covered by a workplace retirement plan.

Roth IRA plan participants are also experiencing a slight increase in phase-out income ranges for 2018. Single or head-of-household plan contributors saw an increase in phase-out income ranges from $118,000-$133,000 in 2017 to $120,000-$135,000 in 2018. Phase-out income ranges for married couples filing jointly when it comes to Roth IRA contribution increased from $186,000-$196,000 in 2017 to $189,000-$199,000 in 2018.

The recently approved Tax Cuts and Jobs Act of 2017 (TCJA) opens the conversation as to when the inevitable other shoe will drop. In short, what are the tax implications for retirement-related plan contributors in 2018? Do the contribution limit increases for 401(k) plan participants and IRA contributions carry any change in tax liability?

After careful consideration it appears the Tax Cuts and Jobs Act has little impact on 401(k) and IRA plan participants with three notable exceptions: rollover conversions, loan repayments to qualified plans, and hardship distribution waivers for those affected by natural disasters.

Big Change in IRA Conversion Practices

Rollover conversions from traditional IRA to Roth IRA funds are a popular taxpayer activity that aims to reduce future tax liability on gains. Conversions were previously allowed with the ability to reclassify, or "recharacterize" those funds up until your tax return date plus extensions in the following year. Some taxpayers earmarked conversions with partial recharacterizations that allowed them to reverse the transaction depending on tax liability.

As an example, all fund conversions need to occur by Dec. 31 from your traditional IRA to your Roth IRA. If the market experienced a poor performance or your income from the conversion edged you into a higher tax bracket, it was permissible for you to recharacterize all or some of the previously converted funds back to the traditional IRA without being liable for the additional tax consequences. This created space for taxpayers to consider the potential tax liability on their conversions and reverse the transaction if it led to unintended tax consequences.

With the newly adopted tax reform, the ability to recharacterize is now obsolete for tax year 2018 and beyond. However, the IRS provided a favorable ruling for 2017 Roth IRA conversions effectively extending the final recharacterization deadline:

"A Roth IRA conversion made in 2017 may be recharacterized as a contribution to a traditional IRA if the recharacterization is made by Oct. 15, 2018. A Roth IRA conversion made on or after January 1, 2018, cannot be recharacterized. For details, see "Recharacterizations" in Publication 590-A, Contributions to Individual Retirement Arrangements (IRAs)." Read from the IRS, IRA FAQS - Recharacterization of IRA Contributions.

In the early report of the about the Tax Cuts and Jobs Act, it was unclear whether taxpayers would still be able to recharacterize 2017 conversions or risk losing the option. The IRS's latest ruling should be good news for them.

Changes to Loan Repayments to Qualified Plans

The second notable change for retirement-specific plans from the TCJA involves loan repayments to qualified plans. There are essentially two options for loan repayment to qualified plans if employment ends.

The first option is transferring the outstanding balance of the loan into another qualified plan, such as an IRA. The second is choosing not to repay the outstanding balance and assuming that amount as a distribution, which is considered taxable income. If the distribution occurs before you're eligible for distribution, the balance incurs a 10% withdrawal penalty. Read about loans at 401k Help Center.

Before the TCJA, repayment of loans from qualified retirement plans was due within 60 days of ending employment. The Act effectively extended the repayment deadline to mid-April of the following year or later depending on filing extensions. Loan repayment is not required until the due date the federal tax return for the year, plus extensions in which the plan separation occurred.

While the changes in rollover conversion recharacterization and loan repayment on qualified plans are both significant, it seems to be notably less impactful than initial changes proposed in early iterations of the tax reform legislation. The TCJA effectively reduced the seven federal tax brackets for individuals, which created more gap inside tax brackets for taxpayers to assume income that would previously edge into the next tax bracket.

Hardship Distribution Tax Relief

The third noteworthy change brought about by the TCJA was relief of distribution tax liability for victims of natural disasters. With the devastating effects of Hurricanes Harvey and Irma affecting the Gulf Coast area and Florida, this provision acknowledges the need for relief as countless people rebuild much of what was lost.

The hardship distribution tax relief gives taxpayers key exceptions for distribution amounts up to $100,000 in payout. Taxpayers who are eligible for this relief are not subject to the mandatory withholding tax or 10% penalty for premature distribution. The income tax liability on the distribution is also eligible to be distributed over a three-year period instead of a single-payment payable in the year the distribution occurs.

There are also provisions to supersede in-service distributions based on age and allocation parameters. Finally, the distribution amount, or a portion of the amount, is also permitted for deposit into another qualified plan, such as an IRA, 403(b), 457(b), or other qualified plans, within the three-year window of the initial distribution due to hardship without tax liability.

These four exceptions are positioned to help people in tremendous need not have to consider the additional stress of tax liabilities. Taxpayers who are eligible for the hardship distribution tax relief were able to take advantage of this opportunity starting Jan. 1, 2018. It remains to be seen how the hardship distribution exceptions will translate to realized action by plan participants, but the opportunity and parameters are in place to create lasting change.

Should the TCJA Change Your Approach?

The short answer is probably not. Does the recent tax reform change the value of contributing towards and converting Roth IRA funds? It's worth asking a certified financial planner about Roth IRA conversions, especially if your tax bracket is at a lower level due to the recent tax reform. At the very least, securing more accurate tax liability projections is a worthwhile investment to ensure your tax liability is worth a IRA conversion.

The new individual tax brackets are set to revert to the 2017 bracket parameters in 2025. Until that time, it creates a seven-year window in which taxpayers may take advantage of greater investment opportunities and tax liabilities than in previous years. The time is now to consider how to leverage your new income tax rate to better meet your long-term financial goals.

Maximizing guaranteed tax advantages, such as investing in 401(k) and IRAs, may still be the best practice. With the Tax Cuts and Jobs Act lowering tax brackets for the next five years, the time may be now to shift your investments towards Roth IRA opportunities. However, as with all investing decisions and practices, it's best to consult with a certified financial planner to consider how investment opportunities may align with your greater financial goals.

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