

## Roth Conversions with the New Deduction

**Take-Away:** The new deductions in the recent tax bill signed into law, along with their phaseout rules, can negatively impact a planned Roth conversion.

**Senior Tax Deduction:** The new tax legislation creates a \$6,000 tax deduction for individuals over the age of 65 years, or \$12,000 per married couple, aka the *senior deduction*. However, from \$150,000 to \$250,000 of modified adjusted gross income [MAGI] a phaseout of this new income tax deduction occurs; the *senior* deduction can be reduced to zero because of this phaseout.

**Impact on Roth Conversions:** The phaseout of the *senior deduction* can create a threshold issue for Roth conversions. At \$150,000 of MAGI, this *senior deduction* for a married couple is \$12,000, resulting in tax savings \$2,640. While a \$100,000 Roth conversion would generate a federal income tax liability of \$22,000 at a 22% rate, the actual result is an increase of federal income tax of \$24,640, not \$22,000, with the difference being the loss of the *senior deduction* due to the increase in reportable MAGI caused by the Roth conversion amount.

**SALT Deduction:** Roth conversions are subject to both state and federal income taxes. Since 2018 state income taxes have largely been non-deductible when the SALT deduction was limited to \$10,000. With the new tax law, the SALT deduction was increased to \$40,000. The new \$40,000 SALT deduction reduces the effective state and federal combined tax rate, which thus increases the efficacy of Roth conversions for some individuals. If planning a serial Roth conversion plan over several years, it would be wise to consider limiting Roth conversions in such a way to avoid exceeding the \$40,000 SALT limitation per year. Just like with the *senior deduction*, this new SALT deduction should be isolated and looked at to determine whether it benefits the efficacy of a Roth conversion.

**Impact on Roth Conversions:** Along with the beneficial increase in the SALT deduction, there comes yet another phaseout problem. The phaseout of the SALT deduction starts with those individuals with income over \$500,000. This deduction is subject to a phaseout of 30% of modified adjusted gross income (MAGI) over \$500,000. At \$600,000 of MAGI the SALT deduction will be reduced to a statutory floor of \$10,000. Thus, the phase-in kicks in

and the SALT deduction is reduced from \$50,000 to \$10,000. [ $\$600,000 - \$500,000 = \$100,000 \times 30\% = \$30,000$ .]

**Example:** Fred and Ethel have MAGI of \$500,000, with itemized deductions of \$75,000 including their tentative SALT deduction of \$40,000. Fred executes a Roth conversion of \$100,000 of his traditional IRA. That Roth conversion increases Fred and Ethel's reported MAGI to \$600,000. But now, their SALT deduction is reduced to the statutory floor of \$10,000 due to the additional income derived from the Roth conversion. While Fred and Ethel increased their reportable income by \$100,000 with Fred's Roth conversion, their reported *taxable* increased by \$130,000. If Fred and Ethel were in the marginal federal income tax bracket of 35%, their *effective* tax rate on the increase from \$500,000 to \$600,000 of MAGI is 45.5% [ $35\% \text{ marginal rate} \times 130\% = 45.5\%$ ]. In short, this *hidden* 10.5% tax rate increase might eliminate most, if not all, of the benefits of the contemplated with Fred's Roth conversion.

**Conclusion:** This is not to say that no one should consider a Roth conversion after these new income tax deductions. Not at all. Rather, when determining the benefits of a Roth conversion, now must be factored in the impact of the new *senior deduction* and the increase in the SALT deduction, or more accurately the impact of their phaseout rules. These deductions enhance the opportunity of a Roth conversion, but their phaseouts may put at risk larger Roth conversions for high earners.

If you would like to read additional missives, [click here](#).