The Siller & Cohen Report

2nd Quarter 2018

IN THIS ISSUE

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Are State and Local Taxes Reasons for Relocation?

As many people are all too aware, some states and localities impose higher income and property taxes than others. Residents of high tax areas may have taken some solace by itemizing deductions on their tax returns and reducing federal income tax obligations by deducting the taxes paid.

Example: Jennifer Knight deducted $25,000 worth of state income tax and local property tax on her 2017 tax return. Assuming Jennifer was in a 25% tax bracket, she reduced her net outlay for those taxes with $6,250 in tax savings (her 25% tax rate times the $25,000 tax deductions). In this scenario, Jennifer's actual tax cost was $18,750, not $25,000, because she cut her federal tax bill by $6,250.

New rules

Under the Tax Cuts and Jobs Act of 2017 (TCJA), there is still an itemized deduction for taxes paid, but it is now capped at $10,000 a year, starting in 2018. Some people refer to this as the SALT deduction for state and local taxes. It mainly covers property and income taxes, although taxpayers can choose to include sales tax instead of income tax towards the $10,000 cap. (The $10,000 limit is the same for single filers and couples filing jointly, so there is a true "marriage penalty" here.)

As might be expected, taxpayers and politicians in high tax states and localities have loudly protested the cutback in the deduction for taxes paid. Is this the final straw? The added burden that will drive people to move to areas where income and property tax (and perhaps estate tax) are less of a burden?

Relocation may make sense, but such a decision should be made with care. Calculate how much extra you'll be paying in tax now, considering the loss of the taxes paid deduction and all the other features of the TCJA. Don't forget to include the alternative minimum tax (AMT), which still impacts many individuals. People who owe the AMT get no tax benefit from deducting state or local taxes.

Then, find out how much you'd owe after a move to a different area. Include income taxes and, assuming you'll be a homeowner, likely property tax. Find out if sales tax will be meaningful in the new area. Determine the state's estate tax exemption and estate tax rates, if you expect to leave assets to loved ones.

Typically, you'll discover that relocating is a puzzle with many different parts of varying sizes. Effectively paying more in state and local tax under the TCJA may be a key piece of that puzzle, but it's just one thing to consider before calling the movers.

Keep in mind that these tax laws, like all tax laws, are subject to change, and some states are considering replacing their traditional state income taxes with another type of tax that may be deductible.

Rethinking Retirement Contributions

The TCJA generally lowered federal income tax rates, with some exceptions. Among the ways in which lower rates impact tax planning, they make unmatched contributions to traditional employer retirement plans somewhat less attractive.

Example 1: Chet Taylor has around $100,000 in taxable income a year. Chet contributed $12,000 to his company's traditional 401(k) in 2017, reducing his taxable income. He was in the 28% tax bracket last year, so his federal tax savings were $3,360 (28% of $12,000). An identical contribution this year will save Chet only $2,880, because the same income would put him in a lower 24% bracket.

Planning pointers

Considering the changes in tax rates, participants in employer sponsored retirement plans should review their contribution plans. If your company offers a match, be sure to contribute at least enough to get the full amount. Otherwise, you're giving up a portion of your compensation package.

Beyond that level, decide whether you wish to make unmatched tax-deferred contributions to your traditional 401(k) or similar plans. The value here is tax deferral and the ability to compound potential investment earnings without paying current income tax. Deferring tax at, say, 12%, 22%, or 24% in 2018 will be somewhat less desirable than similar deferrals were last year, when tax rates were 15%, 25%, or 28%.

On the Roth side

If you decide to cut back on tax-deferred salary contributions, spending the increased current income won't help you plan for your future retirement. Other savings tactics may be appealing.

For instance, your employer might offer a designated Roth account in its 401(k) plan. These accounts offer no upfront tax benefit because they're funded with after-tax dollars. The advantage is all withdrawals, including distributions of investment income, will avoid income tax after age 59½, if you have had the Roth account for at least five years. (Other conditions can also qualify distributions from a Roth account for full tax avoidance.)

With higher incomes ($120,000 or more of modified adjusted gross income for single filers in 2018, $189,000 for couples filing jointly), Roth IRA contributions are limited or prohibited. People facing this barrier may able to fund a nondeductible traditional IRA, up to $5,500 or $6,500 this year, then convert those dollars to a Roth IRA with little or no tax at this year's tax rates.

Generally, the lower your current tax bracket and the higher your expected tax bracket in retirement, the more attractive Roth contributions can be.

Conversions Between Traditional and Roth Accounts

As discussed above, the TCJA seems to encourage contributions to Roth retirement accounts over traditional retirement accounts. Along this same thinking, does it encourage owners of traditional retirement funds to convert those funds to Roth? From a tax viewpoint, the answer may be yes, but other factors indicate you should be cautious about such moves.

Example 1: Fred and Glenda Polk would have had $220,000 in taxable income in 2017 without contributing to their employers' traditional 401(k) plans. However, they contributed a total of $40,000 to the plan, bringing their income down to $180,000. The couple was in the 28% bracket last year, so the income deferral saved a total of $11,200 in tax: 28% times $40,000.

Assume they kept their $11,200 of tax savings in the bank Depending on their 401(k) plan rules, and other assets that the Polks may have, they may have three different options for converting their traditional retirement funds to Roth retirement funds:

• If their employers have a 401(k) plan that offers designated Roth accounts, they could convert the $40,000 they contributed in 2017 to the Roth side if the plans allow such moves.

• Alternatively, depending on the plan terms and the Polks' circumstances, they might be able to rollover the $40,000 from the employer 401(k) to an outside Roth IRA.

• Finally, if the Polks have other IRA money outside of their 401(k) plans, they could leave the $40,000 in their 401(k)s but convert $40,000 of pretax money in their Traditional IRAs to Roth IRAs.

With any of these strategies, the couple would generate a $9,600 tax bill (24% of $40,000) on the Roth conversion, because their joint income falls into the 24% tax bracket in 2018, in this example. The Polks could pay that $9,600 from their $11,200 of tax savings in 2017 and wind up ahead by $1,600.

To summarize, the Polks could take advantage of the 4% reduction in their tax bracket by paying taxes this year on funds that they did not pay taxes on last year. After deferring taxes on funds that would have been subject to a 28% tax rate in 2017, the Polks could pay a 24% tax on these funds in 2018, and pocket the difference.

The conclusion of the Polk's example is that people who move into a lower tax bracket this year might be able to come out ahead with Roth conversions of income that had been deferred at a higher tax rate. Going forward, the money transferred to the Roth side may generate tax free rather than taxable distributions.

One-way street

Nevertheless, there are reasons to be cautious about Roth conversions now. Under previous law, Roth conversions could be recharacterized (reversed) to traditional IRAs, in part or in full, until October 15 of the following calendar year. However, the TCJA has abolished recharacterizations of Roth IRA conversions (conversions to employer-sponsored Roth accounts could never be recharacterized.) Now moving pre-tax money to the Roth side is permanent, so the resulting tax bill is locked in.

Retirement Contribution Limits for 2018

Whether you are contributing to an employer plan or an individual plan, or a traditional plan or a Roth plan, make sure you keep the annual contribution limits in mind. The table below summarizes these limits:

Type of Account	Standard Contribution Limit	Catch-Up Contribution Limit (Available if you have reached age 50)
401(k) or Roth 401(k) (Employer Plan)	\$18,500	\$24,500
Traditional IRA or Roth IRA (Individual Plan)	\$5,500	\$6,500

Remember, contributions across traditional and Roth retirement plans are aggregated. So, for example, if you are under 50, you can only contribute \$18,500 total between your 401(k) and Roth 401(k), and you can only contribute \$5,500 total between your IRA and Roth IRA.

Also keep in mind that any employer match usually goes into the traditional 401(k), even if the contribution is to the Roth version, so income tax on the matching money is deferred.

Conclusion

Ultimately, the choice between traditional and Roth retirement accounts will largely depend on expectations of future tax rates. Deferring tax in a traditional plan this year and saving 24% in tax may not turn out to be a good deal if future withdrawals are taxed at 28%, 30%, or 35%. The fact that the TCJA rates are among the Act's provisions that are due to sunset in 2026, reverting to 2017 rates, may tilt the scales a bit towards the Roth side, where distributions eventually may escape tax altogether.

What's New At Siller & Cohen: 2nd Quarter 2018

Industry Participation & Honors

• Randy Siller recently became the Chairman of the Estate Planning Committee of the New York State Society of CPAs.

• Jeffrey Cohen recently co-founded the Lincoln Executive Consulting Group. This group focuses on complex financial planning and investment issues specific to high-earning executives.

Speaking Events

• As a founding member of the Lincoln Executive Consulting Group, Jeff recently spoke at The Resource Group's Executive Planning conference, providing an in-depth presentation on executive planning to over fifty financial professionals.

• As newly-appointed Chairman of the Estate Planning Committee of the New York State Society of CPAs., Randy recently spoke at the NYSSCPA Annual Conference. His presentation centered on insurance and retirement tax traps and creative planning solutions to avoid or undo them.