Fun and Games with the Roth IRA

Section 408A – Roth IRAs

By Daniel Halperin

On December 21, 1998, I wrote a viewpoint for this magazine entitled "I Want a Roth IRA for Xmas" (Tax Notes, Dec. 21, 1998, p. 1567). In what may have been an understatement, the cover of the issue described the piece as "A Scathing Critique of the Roth IRA." As I said then, "The Roth IRA is the antithesis of sensible tax and budget policy. Congress talked of simplification and a balanced budget but gave us both numbing complexity for ordinary citizens and budget busting, without any policy justification." In addition, the Roth approach significantly aggravates the extent to which our so-called savings incentives disproportionately benefit those with higher income. The Tax Increase Prevention and Reconciliation Act of 2005 (TIPRA; P.L. 109-222) made all of this true in spades. Hence, another scathing critique.

In 1998 Congress asserted that the introduction of the Roth IRA raised revenue, primarily from a provision that allowed those whose adjusted gross income did not exceed $ 100,000 to convert from a traditional to a Roth IRA. That supposedly permitted Congress to cut other taxes. In fact, the Roth lost revenue in the long run, making the budget picture much worse.

Well, as they say, here they go again. As illustrated in this magazine by Len Burman ("Roth Conversions as Revenue Raisers: Smoke and Mirrors," Tax Notes, May 22, 2006, p. 953), TIPRA (I cannot write out the full title without choking) expanded the opportunity for Roth conversions to raise $ 6.4 billion over the 10-year budget window. In fact, however, that action reduced long-term revenue by at least $ 14 billion (in present value terms).

That sleight of hand was accomplished by allowing taxpayers whose adjusted income exceeds $ 100,000 to convert traditional IRAs to Roth IRAs beginning in 2010. A tax payment is required at the time of the conversion, which is in the budget window. The future and greater tax loss from the absence of tax, on income from the savings used to pay the tax and on the withdrawal from the IRA, is mostly outside of the budget window. Thus, the tax loss does not count. To again quote my earlier piece, "I think Congress is on to something. When you overspend, say on a vacation, what you need to do is buy a very expensive automobile, . . . with a large dealer 'cash back' and a deferral of loan payments. The cash back pays for the vacation, enabling you to ignore what the vacation cost. While you do have to pay for the car eventually, that is outside the 'budget window.'"

As suggested above, that behavior, in addition to threatening our fiscal health, also increases the complexity of the tax law. To repeat again what I said in 1998, "Creating two alternatives for IRA savings adds only complexity, which is bound to lead to numerous errors by ordinary folks." In 2001 Congress compounded that error, allowing Roth treatment for 401(k) and 403(b) contributions, effective for the first time in 2006. As illustrated by the recent proposed regulations issued by Treasury under *section 402A*, "it ain't simple."

The title of my original piece, appropriate for December 21, was, of course, a tongue-in-cheek request that if Congress was going to engage in those shenanigans, they should at least raise the gross income cutoff so us "rich" law professors could get in on it. As the old adage goes, be careful what you wish for.

I don't want to look a gift horse in the mouth. However, not only did Congress make me wait 12 years (from 1998 to 2010) -- a real problem at my age -- but now that my Christmas present is in the offing, it appears that I'm not really rich enough to take advantage of it. Only the truly super rich can really benefit from the new conversion privilege. Why am I not surprised?

Thus, Burman tells me that there are five reasons to convert. First, by using other savings to pay the tax, one can increase the amount of tax-preferred savings. Second, because Roth IRAs need not be distributed during life, the tax preference can be extended. Third, the current tax payment reduces the size of the taxable estate. Fourth, you can lock in the current income tax rates. Fifth, the income cap on eligibility for tax-preferred IRAs is eliminated.

To start with his last reason first, according to Burman, "the conversion provision is tantamount to eliminating the income limits on contributions to Roth and traditional IRAs for people under age 70-1/2." What is required is to make a nondeductible contribution to a traditional IRA and then convert to a Roth when eligible to do so. If so, since I somehow neglected to plan for this largesse, I get one year -- 2006 -- before I reach 70-1/2. For the first time, I understand age discrimination. Up to now, being a senior has just meant cheaper movies and transit fares.

More seriously, if the code as written allows for that gimmick, it surely must be a mistake -- or at least it should have been. According to Burman, the effective elimination of the income limits is responsible for more than two-thirds of the long-term revenue loss of the provision. Surely, additional saving incentives for the richest among us is hardly a top priority. It does not even offer the redeeming virtue of supporting the congressional effort to game the budget effect of the bill. The opportunity to convert nondeductible IRAs, in fact, loses revenue during the budget window.

Allowing a choice of two alternative IRAs is erroneously justified by the claim that, assuming constant tax rates, Roth IRAs offer equivalent benefits to traditional IRAs. As suggested below, that equivalence assumes there is no change in the timing of distributions and that the tax due on the deposit in a Roth is paid out of the amount that would have been contributed to a traditional IRA or, in the case of a conversion, out of the IRA account. In short, the Roth can be claimed to be equivalent only if the accumulation is smaller (65 percent of the amount in the traditional IRA if the marginal tax rate is 35 percent).

In any event, there is no scenario under which a Roth is not clearly better than a nondeductible traditional IRA. In both cases, the original contribution is not deductible, but the Roth offers the opportunity for a tax-free withdrawal while with the traditional IRA, earnings on the account are taxable on distribution. Conversion would exempt future earnings from tax. That is clearly an enhanced opportunity for tax-free savings for the wealthy and is unsupportable even by the low standard set by TIPRA. Thus, there is absolutely no reason to allow a conversion to the extent the traditional IRA balance is derived from nondeductible contributions. To those who will complain that this adds complexity, I would say that if it's simplicity you crave, just put a stop to the whole Roth phenomenon./1/

Of course, the main advantage of the Roth conversion is the ability to increase tax-free savings by paying the conversion tax from outside funds. In effect, some portion of the traditional IRA, including the opportunity for a tax-free buildup, belongs to Treasury, which will get its share of any distribution. By using outside funds to pay the tax in order to maintain the account at the same level, conversion effectively buys out the Treasury's interest in the advantage of the tax-free buildup. The taxpayer now owns the whole IRA, not just 65 percent of it (assuming a 35 percent marginal rate).

So I should retire, take my accumulated 403(b) retirement benefit in a lump sum, and roll it into a traditional IRA. The next step is to convert to a Roth IRA and use other savings to pay the tax. Ah! There's the rub! Where do I find those savings? My retirement benefit, after 32 years of teaching, is quite generous, but my efforts to keep within hailing distance of the Joneses means that there is nowhere near enough additional savings to pay the tax. Since I will have to use the IRA balance to pay the tax, I will not be able to increase the effective amount of tax-preferred savings./2/

Given the paucity of other assets, I also will not be able to take advantage of a third benefit of the Roth: prolonging the tax- free buildup by leaving the funds untouched until death. Strangely, I need my retirement savings for living expenses.

The next purported advantage is the potential reduction of estate taxes because the tax payment on conversion reduces the size of the estate. As I understand it, however, the income in respect of a decedent rules are supposed to offset the excess estate tax with income tax savings. They don't work perfectly when postdeath income recognition is deferred, but in any event, I, unfortunately, don't expect a big estate tax burden. For me, that means the only advantage of conversion would be to lock in current income tax rates.

Obviously, all rational persons understand that the existing budget deficit cannot go on forever and that the growing cost of entitlement programs will only make things worse. Because substantial budget cuts of the necessary magnitude appear unlikely, the only alternative would be to raise taxes. Sure, but what does this have to do with the reality on the ground? We continue to hear from administration spokesmen that tax cuts will lead to enough growth so that revenue will in fact increase in the long run. We are far beyond the free-lunch syndrome; it is more like a free banquet. Because it would be beyond optimistic for me to expect to live to the point when the Social Security Trust Fund would be inadequate to pay current benefits, I think it is probably not a good idea to rely on higher taxes in my lifetime to justify a conversion. It looks like I will have to return my Christmas present. Is it possible I can request an exchange?

However, all may not be lost. Fortunately, I live in Cambridge, Mass. This means that if we can preclude a bursting of the housing bubble, there is enough equity in my home to pay the conversion tax. I could be patriotic, joining the rest of America in increasing my mortgage to the maximum my bank will allow. Of course, most of the interest on that new loan would be nondeductible. Because borrowing pretax entirely eliminates the advantage of the tax-free buildup, I need help.

So can I ask Congress to allow interest to be deducted on home equity loans above $ 100,000 if the loan proceeds are used to pay the tax on an IRA conversion? Why not? It is a revenue raiser. The tax on the additional conversions, which become desirable, would more than offset the interest deductibility during the budget window. Why shouldn't Congress accept my offer to pay more taxes? It would be my Christmas present to them.

Putting aside the sarcasm for a moment, obviously, it would be best if Congress came to its senses sometime between now and 2010 and retained the current limits on the conversion privilege. If that is not to be, at the very least two changes are essential. First, as noted above, nondeductible contributions to traditional IRAs should not be convertible to a Roth. That would recoup a substantial portion of the projected long-term revenue loss. Second, as discussed below, a conversion should be final. Taxpayers should not be given the opportunity to change the date of the conversion to reduce the tax burden in the event of a market decline.

While I enjoyed the opportunity in 1998 (and again today) to give vent to my anger and frustration over the Roth IRA (while, I hope, being funny at the same time), the main purpose of the earlier piece was to try to persuade Treasury to rethink its generosity, which allowed "those who convert from a traditional to a Roth IRA the opportunity to change the effective date of the conversion." I asserted that this opportunity "will permit taxpayers to game the system and will further aggravate both the confusion and the revenue loss." I repeat that plea should this irresponsible legislation's provisions be allowed to take effect in 2010.

To quote the preamble to the 1998 proposed regulations, Treasury relied on a provision:

> intended to permit a taxpayer who had converted an amount held in a non-Roth IRA to a Roth IRA and later discovered that his or her modified adjusted gross income for the year of the conversion exceeded $ 100,000 to correct the conversion by retransferring the converted amount to a non-Roth IRA. The proposed regulations interpret *section 408A(d)(6)* liberally to provide broad relief to taxpayers who wish to change the nature of an IRA contribution (and not only to allow taxpayers to correct Roth IRA conversions for which they were ineligible). (Emphasis added.)

The purpose of that generous rule was apparently to provide relief to taxpayers when the market dropped between the time of the Roth conversion and the time that tax was due. Through providing the opportunity to "recharacterize and reconvert" (a fancy term for changing the date of the Roth conversion), I claimed Treasury provided well-advised taxpayers with an "opportunity to game the system by delaying the tax payment as long as possible." By doing so, the taxpayer creates a situation whereby taxes stay the same when the market rises but decline when the market drops.

As the examples in the earlier piece demonstrate (at p. 1569), "Treasury bears the downside risk (if the market declines, the . . . tax liability declines along with it) without participating in the upside (if the market goes up, the tax liability . . . does not change)." Thus, an aggressive investor who invests the amount of the pending tax liability in the market "gains when the market rises [he pockets the amount of the increase], without losing if it falls." Similarly, a conservative investor who puts the tax money in a CD "breaks even when the market rises and benefits when the market decline decreases the Treasury's interest in the cash."

That relief is not only generous but is also unnecessary. First, with removal of the income limits on eligibility to convert, the original reason for the ability to reconvert to a traditional IRA is no longer present. Moreover, an investor could avoid any hardship by simultaneously paying tax or converting to cash as of the date of conversion. Funds placed in a CD would be sufficient to pay the tax, regardless of a market decline. Alternatively, the investor could make an estimated tax payment at the time of the conversion. A conversion should be irreversible. In the absence of any real hardship, do-overs at the election of one participant have no more place in the tax field then they do on the golf course. Is it too much to ask that we should at least get that right?

FOOTNOTES

/1/ Many years ago at a House Ways and Means Committee markup I attended, a congressman, whose identity I will protect, remarked after a claim of complexity, "You know, I sometimes think we have two sets of draftsmen working for us. The first group, which drafts the liberalizing provisions, is absolutely terrific. Then we have this other group for antiabuse legislation. Those guys can't get anything right."

/2/ Transferring the after-tax amount to the Roth IRA would reduce the present value of the tax liability (assuming constant rates) if one converted in 2010 and took advantage of the opportunity to defer the tax payment.