Assuming Constant Uniform Income Tax Rates, a Three Bank-Account Analogy Demonstrating the Immediate and Long-Term Advantages of the Roth Conversion

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ASSUMING CONSTANT UNIFORM INCOME TAX RATES, A THREE BANK-ACCOUNT ANALOGY DEMONSTRATING THE IMMEDIATE AND LONG-TERM ADVANTAGES OF THE ROTH CONVERSION

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INITIAL ANALYSIS

Suppose I have three bank accounts, each with $100.

The first two bank accounts are in traditional IRA accounts with a zero basis. (These traditional IRA accounts may have been converted from 401(k) accounts at a prior employer.) The third account I own outright.

Suppose federal income taxes are 50% and shall remain 50% forever. Assume there will never be state income taxes.

In effect, the IRS has a half ownership in my two traditional IRA $100 bank accounts. If I take out part or all of the money from the IRA, I must pay the IRS half. The IRS is like a 50% partner.

If I convert the $200 in the traditional IRA accounts to a Roth, I must pay $100 in income tax. In effect, for $100, I am buying the IRS’s 50% partnership ownership. In other words, if I give the IRS the $100 bank account I own outright, the IRS conveys to me its half ownership in the two traditional IRA $100 bank accounts.

I start out with $100 outright and $200 in a 50% partnership with the IRS. I end up with $200 in a Roth IRA that I own outright. I give up $100 to get $100. From a net worth perspective, the result is a wash. My net worth remains $200.

Going forward, however, I have certain immediate and long-term advantages.

1. Interest on the $100 bank account that I owned outright was subject to income tax. Interest on the Roth IRA bank accounts are not subject to income tax, and all $200 of those accounts are now mine (versus only $100 earlier).

2. Unlike the traditional IRA, my Roth IRA has no required minimum distributions starting at age 70 ½. I can keep the Roth IRA until I die and leave the entire amount to my child (who may take distributions over her lifetime, and never pay any income tax).
3. By paying the $100 to the IRS in income taxes, I reduce my estate by $100. Before, although my net worth was really $200, my estate was $300. (Of course, a $300 estate is not taxable, and my estate might have the spousal deduction. Nevertheless, I might leave this $300 to my child and leave a sufficient amount of other assets to my child to make this $300 subject to estate tax.)

Suppose I did NOT convert and were to die when turning age 70. Assume I did not take any distribution from my ($200 plus interest) traditional IRA and left all my assets to my child. All three bank accounts ($300 plus interest) would be in my estate. The IRS would still have a half ownership in the traditional IRA accounts ($200 plus interest) that went to my child. Interest on the third ($100 plus after-tax interest) bank account would have been taxed during my lifetime and would continue to be taxed while held by my child.

Assume that I convert to a Roth IRA in 2010 and die when turning age 70. Of the original three accounts, only the two Roth IRA accounts would be in my estate ($200 plus interest). Interest on this Roth IRA account ($200 plus) would never be subject to income tax (including my remaining lifetime and my daughter’s).

ALTERNATE ANALYSIS

Again, suppose I have three bank accounts, each with $100.

The first two bank accounts are in traditional IRA accounts with a zero basis. The third account I own outright.

Again, suppose federal income taxes are 50% and shall remain 50% forever. Assume there will never be state income taxes. In effect, the IRS has a half ownership in my two traditional IRA $100 bank accounts.

Suppose the IRC allows me to convert the third $100 bank account (the one I own outright) to a Roth IRA with no tax (and also allows me to withdraw from the Roth at any time with no tax). Naturally, I convert the third account to a Roth IRA.

In effect, I would have three identical bank accounts:

1. two traditional IRA $100 accounts, one “owned” by me and one “owned” by the IRS.
2. one Roth IRA $100 account.

The $100 Roth IRA would cancel out the $100 account “owned” by the IRS. Whenever I wanted to liquidate entirely the two traditional IRA accounts, I could also liquidate the Roth IRA and have just enough to pay the tax.
The advantage of the Roth IRA over the $100 bank account I had before is that the Roth IRA would grow tax free. I would be better off.

Assume, however, that the IRC does NOT allow me to convert the third bank account (the one I own outright) into a Roth IRA or even a traditional IRA. Nevertheless, I can accomplish the same result by converting my traditional IRA’s into a Roth and giving up the third account. I no longer have the third account, but I also no longer have any tax liability on the traditional IRA. I have $200 that I own outright and on which I shall never owe any tax.

Of course, in both analyses above the major simplifying assumption is the constant and uniform income tax rate. Conversion of a large amount to a Roth might in fact thrust me into a higher marginal income tax bracket. Unclear is what my (or my child’s) tax bracket would be at the time of withdrawal from the traditional IRA.

Also unknown is the age at which I shall die. With the traditional IRA, I must start taking minimum distributions at age 70 ½.

Nevertheless, the analysis with these simplifying assumptions demonstrates the potential advantage of the Roth IRA conversion.

THE OPPORTUNITY TO RECHARACTERIZE (RESCIND) THE CONVERSION ENABLES ME TO INVEST SOME MONEY IN STOCKS AND ENJOY THE GAINS BUT AVOID THE LOSSES

If I convert to a Roth, the IRC allows me to recharacterize (rescind) the conversion by a certain deadline the following year. If my Roth IRA is invested in stocks, the opportunity to recharacterize the conversion offers a “heads I win, tails the IRS loses” opportunity.

Suppose I have three accounts, each with $100. Two are traditional IRA accounts (with a zero basis) invested in stocks. The third is a $100 bank account that I own outright.

Again, suppose federal income taxes are 50% and shall remain 50% forever. Assume there will never be state income taxes.

If I convert the $200 in the traditional IRA accounts to Roth accounts, I must pay $100 in income tax. In effect, for $100, I am buying the IRS’s 50% partnership ownership. My $100 investment in stocks increases to $200.

Assume that by the deadline for recharacterization, the stocks in my Roth IRA accounts double in value from $200 to $400. By effectively increasing my $100 stock investment to $200 through the Roth conversion, I gained an extra $100.

If I wished, I could even shift one of the $200 Roth IRA stock accounts into a bank account. I would then have a $200 Roth IRA in stocks and a $200 Roth IRA in a bank account.
Suppose I had not converted. Ignoring bank account interest, I would have a bank account of $100. My $200 in traditional IRA stock accounts would have doubled in value to $400. Taking into account the IRS’s 50% ownership, my interest would be worth $200. This $200 plus the $100 bank account results in a total of $300. The conversion made me $100 better off.

Suppose that by the deadline for recharacterization, the stocks in my Roth IRA accounts decline 50%, from $200 to $100. I can then recharacterize (rescind) my Roth conversion. In effect, I convey back to the IRS a 50% interest in my IRA accounts (worth $50) and receive in return the $100 in taxes paid upon conversion. Ignoring bank account interest, my situation is the same as if I had never converted. I have traditional IRA’s worth $100 (of which the IRS owns 50%) and a $100 bank account.

In short, the opportunity to recharacterize my Roth conversion (by a certain deadline) enables me to invest some money in stocks and enjoy the gains but avoid the losses. If the stock market goes up, I enjoy the gains on $200 worth of stock. If the market goes down, I suffer the losses on only $100 worth of stock. I could even open numerous separate Roth IRA accounts in different asset classes. If some accounts appreciate and others depreciate, I can recharacterize the ones that decline.

As before, I hypothesize a constant and uniform income tax rate. Throughout, I also assume that the Congress will not amend the Internal Revenue to tax distributions from previously created Roth IRA’s.