A Roth Conversion Is Not Necessarily More Attractive During a Significant Stock Market Decline: Separating the Tax and Market Timing Effects

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A Roth Conversion Is Not Necessarily More Attractive During a Significant Stock Market Decline: Separating the Tax and Market Timing Effects

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The conventional wisdom is that a Roth conversion is more attractive during a significant stock market decline. This statement is not necessarily true. Determining the benefit of a bear market conversion requires separating the market timing and tax effects.

Beyond the scope of this article is the debate of whether investors should try to time the stock market. If one believes in such an attempt, one might feel that all share purchases are generally more attractive during a bear market. A “Roth” conversion of a traditional individual retirement account (IRA) holding stocks is buying the portion owned by the government, i.e., a stock purchase.

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A conversion has no greater tax advantage during a down market and, in some situations, may even have a lesser benefit.

THE ESSENCE OF THE TRADITIONAL IRA: A JOINT VENTURE BETWEEN YOU AND THE GOVERNMENT

As discussed in my earlier piece, Myths About the Traditional and Roth 401(k)/IRA That Affect How People Use Them, the traditional IRA is a joint venture between you and the government. The government “invests” the income tax you would otherwise pay at the time of your contribution and owns part of the traditional IRA. The part you own is a Roth within the traditional IRA. With any withdrawal from the joint venture, the government takes its ownership share, and you take yours.

THE ESSENCE OF THE ROTH CONVERSION AND ITS BENEFIT

In exchange for the so-called “tax” on the conversion, you buy the government’s interest in the joint venture by using outside funds for the “tax,” and you shift an amount equivalent to the “tax” from an outside taxable account to the tax-exempt Roth.

For simplicity, assume that you will be in the same 33.33% combined federal and state tax bracket at both would-be Roth conversion and future distribution without conversion.

With a conversion, you buy the government’s share. The purchase price is the so-called income “tax.”

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2 Traditional IRAs are governed by §408; Reg. §1.408-1, et seq. All section references herein are to the Internal Revenue Code of 1986, as amended (the Code), or the Treasury regulations promulgated thereunder, unless otherwise indicated.

3 Roth IRA’s are governed by §408A; Reg. §1.408A-1–§1.408A-10.

4 See Wang, Note 1, above.
this quid pro quo transaction, you do not pay “tax” in the usual sense, any more than you pay “tax” if you buy land from the government.

Suppose land prices generally decline. Buying land from the government may be attractive, but so may be purchasing land from someone else.

To return to the Roth conversion, if you use outside money to pay the resulting so-called “tax,” you shift taxable funds into the tax-exempt Roth, sheltered from future tax. That is the conversion’s main tax benefit and results only if you pay the “tax” with outside funds.

In short, at the time of conversion you pay no tax de facto and will save on future taxes. When converting, if you purchase a stock position from the government, you increase your stock market exposure. In a bear market, you may be making a good market timing decision.

If so, the conversion has two separate benefits:

1. Shifting outside taxable funds into the tax-exempt Roth; and
2. Buying stock (from the government) at an opportunistically low price.

AN ILLUSTRATION WITH YOU HOLDING THREE ACCOUNTS AND CONSIDERING ONE OF FIVE ALTERNATIVE TRANSACTIONS, THREE OF WHICH INCREASE YOUR S&P HOLDING AND TWO OF WHICH DO NOT

Suppose your portfolio includes the following three accounts (among others):

1. $150,000 cash in a traditional IRA (throughout, the term “cash” includes near-cash, e.g., money-market funds and savings accounts).
2. $150,000 in an S&P 500 index fund in a traditional IRA.
3. $50,000 in cash held outright.

Note that this list includes two traditional IRAs, one with $150,000 cash and one with $150,000 invested in the S&P 500 index fund.

Assume the S&P index significantly declines. Contrast the following five alternative transactions:

1. Use your $50,000 of cash held outright to purchase an S&P 500 index fund held outright.
2. Within the $150,000 cash traditional IRA, shift $75,000 to an S&P 500 index fund. The government owns one-third of this joint venture; you own two-thirds. As a result of the $75,000 shift, you own $50,000 less cash and $50,000 more of the S&P 500 index fund.
3. Use your $50,000 of cash held outright to pay the $50,000 income “tax” to convert to a Roth the $150,000 S&P 500 traditional IRA. With the conversion, you pay $50,000 outside cash to buy the government’s $50,000 ownership interest of one-third of the IRA’s holding of $150,000 of the S&P 500 index fund.
4. This transaction starts the same as number three, with payment of $50,000 in “tax” to convert to a Roth the $150,000 S&P 500 traditional IRA. The result is the purchase of the government’s $50,000 ownership interest of one-third of the IRA’s holding of $150,000 of the S&P 500 index fund.

Nevertheless, you do not want the conversion to increase your stock market exposure. Within the new Roth IRA, you transfer $50,000 from the index fund to cash and thereby reverse the higher S&P holding.

5. Use your $50,000 of cash held outright to pay the $50,000 income “tax” to convert to a Roth the $150,000 cash traditional IRA (the first of your two traditional IRAs). With the conversion, you pay $50,000 cash to buy the government’s $50,000 one-third ownership interest of $150,000 in the IRA.

Below is an outline of transactions three and four.

Before Conversion
• Traditional IRA—$150,000 of the S&P 500 index fund, of which you own two-thirds, or $100,000.
• Outside Cash — $50,000.

After Conversion (Transaction Three)
• Roth IRA — $150,000 S&P 500 index fund (entirely owned by you, increasing your S&P 500 index fund by $50,000).
• Outside Cash — $0.

Note that, with no change in net worth, you have shifted $50,000 from a taxable account into a completely tax-exempt one.

After Conversion, With Offsetting Shift of $50,000 Within New Roth To Restore Your Original Portfolio Composition (Transaction Four)
• Roth IRA — $100,000 S&P 500 index fund; $50,000 cash (both entirely owned by you).
The Three Transactions That Increase Your S&P 500 Holding

The first three transactions are roughly equivalent as to stock market timing. With each of the three, you have $50,000 less cash and $50,000 more in the S&P 500 index fund.

If you wish to increase your S&P 500 index fund holding by $50,000, which of the first three alternatives is best?

With the third choice, the conversion of your $150,000 S&P 500 traditional IRA, you shift $50,000 of outside taxable funds into the tax-exempt Roth. Because of the increased shelter from future income tax, the third transaction is the best of the three otherwise roughly equivalent ways to increase your S&P holding, for better or worse.

One minor complication is that the conversion’s taxable income might tip you into a higher Medicare premium bracket. Nevertheless, the future tax savings are for multiple years, while any Medicare premium increase is only for a single year. If you can estimate your taxable income precisely, and the conversion would move you only a tiny amount into another Medicare premium bracket, you might combine a large conversion with a small amount of one of the other two (non-conversion) transactions that raise your S&P exposure. Alternatively, you might convert more gradually over several years.

The Two Conversion Transactions That Do Not Enlarge Your S&P 500 Holding and Why You Might Want No Increase

Both the fourth and fifth transactions (conversions) do not augment your S&P 500 holding and have no market timing consequence.

For various reasons, you may want no increase in your S&P 500 stock market holdings from the conversion. Perhaps you have decided either to accept passively the market decline or to rebalance later. Alternatively, after the market decline, you may already have raised your market exposure to the level you desire by adjustments elsewhere in your portfolio, e.g., shifting into the S&P 500 stock market within one of your other retirement accounts.

Suppose you wait to do transactions three or four (converting the entire traditional IRA containing just the S&P 500 index fund and possibly offsetting the increased market exposure by shifting to cash within the new Roth). In the interim, this S&P 500 traditional IRA goes down further from $150,000 to $120,000. You now own two-thirds, or $80,000; the government owns one-third, or $40,000.

If you convert the now $120,000 S&P 500 traditional IRA, you need $40,000, not $50,000, of outside cash to pay the so-called “tax,” the purchase price of the government’s one-third ownership, consisting of $40,000 of the S&P 500 index fund.

Because the so-called “tax” on conversion is $40,000, not $50,000, you transfer a smaller outside taxable amount into the tax-exempt Roth. Again, the conversion’s primary tax benefit is the shift of outside taxable funds into the completely tax-exempt Roth, which avoids future taxes.

Note that the conversion is less beneficial tax-wise when the S&P index is lower.

Nevertheless, if you want to use the entire $50,000 outside cash account for Roth conversion, you can convert both the whole depreciated $120,000 S&P 500 IRA and $30,000 of your other traditional IRA. For the two conversions, the combined “tax” would be $50,000, with the result of transferring all the taxable $50,000 cash account held outright into your two new tax-exempt Roth accounts. Within your new Roths, you could offset your increased market exposure by shifting from S&P stock holdings to cash.

Nevertheless, if your sole traditional retirement account is the IRA with just S&P holdings, you are worse off tax-wise if the S&P index declines before you convert. The lower the value of your sole traditional, the less “tax” on the conversion and the less shifted from an outside taxable account into the tax-exempt Roth.

SUMMARY

A Roth conversion is not necessarily more attractive during a significant stock market decline. Determining the benefit of a bear market conversion requires separating the market timing and tax effects.

When you convert, the so-called “tax” is the amount you pay to purchase the government’s owner-
ship share of the joint venture traditional retirement account.

If you convert a traditional account containing shares, you raise your stock market exposure, for better or worse.

If you desire this increase, converting a stock traditional retirement account using outside cash is better than alternative transactions that also augment your stock holding, e.g., purchasing shares outright or, within your retirement accounts, shifting from cash/fixed-income into stock. Unlike the alternatives, the conversion shifts outside taxable funds into the Roth, the main benefit of any conversion.

The stock price decline may already have caused you to make adjustments elsewhere in your portfolio (including within other retirement accounts) to achieve your desired market exposure. For this or other reasons, you may not wish the conversion to enlarge your stock holdings. If so, you can reverse the increase by shifting from stock to cash within the new Roth.

As opposed to any market timing consequence, the conversion does not have a greater tax advantage in a bear rather than bull market. You are actually worse off tax-wise converting after a general stock market decline if your sole traditional retirement account is a traditional IRA with stock holdings. The lower the value of your only traditional IRA, the less “tax” on the conversion and the less shifted from an outside taxable account into the tax-exempt Roth.