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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*.

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*,[1] the traditional IRA is a *joint venture* between you and the government.[2] 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[3] *within* the traditional IRA.[4] 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." In

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[1] William K.S. Wang, *Myths About the Traditional and Roth 401(k)/IRA That Affect How People Use Them*, Daily Tax Rep. (Feb. 3, 2020).

[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 opportunely 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 cash 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).

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- Outside Cash — $0.

Before conversion, you owned two-thirds of the $150,000 S&P 500 index fund in the traditional IRA, or $100,000.

With transaction *four*, after conversion and the adjustment *within* the *new* Roth, you own 100% of $100,000 of the S&P 500 index fund.

Before conversion, you had $50,000 *outside* cash. After conversion, you have no *outside* cash.

With transaction *four*, after conversion and the adjustment *within* the *new* Roth, you hold $50,000 cash in the new tax-exempt Roth, completely owned by you.

With transaction *four*, *with no change in portfolio composition or net worth*, you have shifted $50,000 cash from a taxable account to a completely tax-exempt one.

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-*

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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.

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