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PROVISION IN TAX-CUT BILL EFFECTIVELY ELIMINATES INCOME LIMITS ON ROTH IRAS

Establishes Major New Tax Shelter for High-Income Households

By Aviva Aron-Dine and Robert Greenstein

The tax reconciliation bill conference agreement gives the appearance of retaining the current income limits on who can make contributions to Roth IRAs. In reality, however, the legislation changes the Roth IRA rules in a way that effectively eliminates the income limits on these contributions. *As a result, all income limits on the use of Roth IRAs would in effect be dismantled by the legislation.* [1]

Currently, taxpayers may not convert traditional IRAs into Roth IRAs if their incomes exceed $100,000 and may not contribute to Roth IRAs if their incomes exceed $160,000 (for married couples filing jointly) or $110,000 (for singles and heads of household). Households may contribute to non-deductible traditional IRAs, however, regardless of their income level.

The reconciliation bill conference agreement would eliminate the income limits on Roth IRA conversions starting in 2010, while leaving the income limits on Roth IRA contributions in law. But by lifting the income limits on conversions, the conference agreement provision effectively eliminates the income limits on contributions to Roth IRAs as well, by making possible a two-step process that circumvents those limits. High-income households first would be able to contribute several thousand dollars every year to a non-deductible traditional IRA, for which there is no income limit. Then, starting in 2010, they could convert their non-deductible IRAs to Roth IRAs.

Consider a married couple with income above the $160,000 Roth IRA contribution limit. Each year, beginning in 2006, the couple could contribute $8,000 to a non-deductible traditional IRA. [2] The amount that the couple could contribute would rise to $10,000 a year in 2008 and increase with inflation thereafter (assuming the pension provisions of the 2001 tax cut are made permanent, as they very likely will be). Then, beginning in 2010, the couple would be able to "roll over" the amount that had accumulated in its non-deductible IRA into a Roth IRA (paying tax only on the returns the IRA account had earned to that point), and all earnings on the Roth IRA from that point forward would be forever tax free.

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[1] For a more detailed discussion of the issues addressed here, and for the Tax Policy Center's detailed revenue estimates, see Leonard E. Burman, "The IRA Conversion Provision in the 2006 Tax Reconciliation Bill: Smoke and Mirrors," Tax Policy Center, May 11, 2006, http://www.taxpolicycenter.org/publications/template.cfm?PubID=9736.

[2] For purposes of this example, the couple is assumed to have no other traditional IRA accounts.

Moreover, in every year after 2010, the couple could deposit $10,000 in a non-deductible IRA, roll over these funds into its Roth IRA *the very next day*, and pay no tax on the amount converted (since the conversion would be from a non-deductible IRA containing contributions made with after-tax dollars). This process could be repeated *every year*. Over time, the couple could build its tax-protected Roth IRA to a very substantial level, with the account being permanently sheltered from taxation.

It is in large part because of this rather stunning aspect of the Roth IRA provision that it ultimately would carry a significant cost. The Joint Committee on Taxation's official cost estimate of the conference agreement shows that this provision will raise about $6.4 billion through 2015. But the Urban Institute-Brookings Institution Tax Policy Center, while concurring with the Joint Tax Committee's estimate for the period through 2015, projects that the provision will *lose $100 billion* through 2049. (The projected loss through 2049 equals between $14 billion and $15 billion in "net present value;" this represents the amount that, if set aside today and allowed to collect interest for the next 45 years, would offset the cost of this tax cut.) The TPC estimate also indicates that roughly two-thirds of this revenue loss, measured in net present value, would be due to the effective elimination of the income limits on contributions to Roth IRAs.

Moreover, TPC Director Leonard Burman points out that "these revenue estimates may turn out to be wildly optimistic"[3] — that is, the provisions could cost substantially more than this. First, these estimates assume that the pension provisions of the 2001 tax cut, which raised contribution limits for IRAs, are allowed to expire. Virtually all observers expect that these provisions will be extended. If they are, this will increase substantially the cost of the new Roth IRA provision. In addition, larger revenue losses are likely if financial firms heavily advertise and promote the new option for high-income households to place funds in non-deductible IRAs and then roll the funds over immediately into a Roth IRA.

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[3] Burman, *op cit.*