POINT TO REMEMBER

Is It Worthwhile to Realize Capital Gains to Finance the Tax for the Roth Conversion?

By William K.S. Wang*

My earlier article, Some Immediate and Long-Term Advantages of a Roth IRA Conversion, NewsQuarterly, Winter 2011, at 10, analyzed the general benefit of a Roth conversion assuming a constant flat ordinary income tax rate and assuming the taxpayer had the cash to pay the resulting ordinary income tax. It did not address whether the taxpayer would still benefit were she to realize capital gains to finance the ordinary income tax due.

In fact, even in that situation, the Roth conversion should be advantageous assuming the following: (1) a constant flat ordinary income tax rate; (2) a constant flat capital gains tax rate; (3) a zero basis on the asset that would be sold to finance the ordinary income tax for the Roth conversion; (4) possession of enough cash to pay the capital gains tax at conversion; and (5) an equal increase in the values of the assets held in either the Roth IRA or, alternatively, the traditional IRA and the accounts holding the tax amounts that would otherwise be paid. (The Roth conversion may or may not be beneficial in the event of an equal decrease in the values of the assets held in either the Roth IRA or the alternative accounts.)

The Appendixes to this article contain several other illustrations, including one that assumes a $40 (rather than zero) basis on the $100 capital asset that would be sold to finance the tax for the conversion and examples that assume a lower capital gains rate at liquidation than at possible conversion.

I do not address borrowing to pay the income tax on the Roth conversion. Were the Roth IRA in stock mutual funds, the borrowing would increase risk.

Adaptation of Earlier Analysis and Terminology

For simplicity, as in my original article, I shall assume that the federal ordinary income tax rate will be a flat 50% forever and that there will be no state income or capital gains taxes. (I could also have assumed some other constant flat federal ordinary income tax rate. For example, with a constant flat 33 1/3% ordinary income tax rate, the two hypothetical accounts would be a $300 traditional IRA account and a $100 account I own outright.)

I start with two accounts holding the same stock mutual fund: (1) a $200 traditional IRA account with a zero basis; and (2) a $100 account I own outright. In effect, the Service has a half ownership in my traditional IRA $200 account. If I withdraw part or all of the money from the IRA, I must pay the Service half. The Service is like a 50% partner. Throughout this article, I refer to these accounts as, respectively, the traditional IRA account (or the first account) and the non-IRA account (or the second

* Professor, University of California, Hastings College of Law, San Francisco, CA. I greatly appreciate the valuable comments of Mr. C. Joseph Smith and Ms. Kwan Wang, Dean Malcolm Morris, and Professors Ellen Aprill, Bryan Choi, John Crawford, Herbert Lazerow, Jack Miller, and Stephen Schwarz.
account). Unless the article indicates otherwise, all holdings are in the same stock mutual fund. I use the term “liquidation date” as the date on which I shall liquidate the accounts, which is not necessarily the date on which I retire from the workforce.

If I convert the $200 in the traditional IRA account to a Roth, I must pay $100 in ordinary income tax. In effect, for $100, I am buying out the Service's 50% “partnership” interest. In other words, if I give the Service my outrightly owned $100 account (and pay any capital gains tax due on that account), the Service conveys to me its half ownership in the $200 traditional IRA account.

I start out with $100 outright and $200 in a 50% “partnership” with the Service. I end up with $200 in a Roth IRA that I own entirely. I give up $100 to get $100. Ignoring the capital gains tax due, from a net worth perspective the result is a wash. My net worth remains $200.

Nevertheless, the Roth conversion results in certain immediate and long-term advantages. First, before conversion, dividends and capital gains on the $100 non-IRA account were subject to income tax. After conversion, dividends and capital gains on my Roth IRA account are not subject to income tax, and all $200 of this account is now mine (versus only $100 earlier). Second, unlike the traditional IRA, my Roth IRA has no required minimum distributions starting at age 70½. I can keep the Roth IRA until I die and leave the entire amount to my spouse (or my child or grandchild), who may take distributions over her lifetime and never pay income tax of any sort. My analysis ignores certain proposals made by President Obama. He has proposed that the Roth IRA be subject to the same required minimum distributions as the traditional IRA. He has also proposed a five-year required minimum distribution period for non-spousal beneficiaries of all 401(k)s, IRAs, and similar vehicles. See Andrea Coombes, Beware Leaving a Roth for Heirs: The Idea Makes Sense, but New IRA Rules Could Make the Decision Harder, WALL ST. J., Sept. 8, 2014, at R6.

The chart below summarizes the results of the analysis in this article and its Appendixes. It assumes a constant flat ordinary income tax rate.

### The Effect of Paying Capital Gains Tax on the Amount Used to Pay the Ordinary Income Tax Resulting from Conversion

Because the Code requires me first to liquidate the $100 non-IRA account, pay capital gains tax, and then pay the $100 ordinary income tax for the Roth conversion, my analysis must take both taxes into account. On the $100 non-IRA account, I shall artificially assume a zero basis. For ease of calculation, I shall also assume two alternative constant capital gains tax rates: either 20% or 50%. (Later, I shall alternatively assume a tripling, doubling, or halving of all the mutual fund accounts.) Thus, to finance the ordinary income tax on the Roth conversion, I must liquidate the $100 non-IRA account (also referred to as the second account) and pay capital gains tax of either 20% or 50% of $100 ($100 minus the zero basis): either $20 or $50. For simplicity, I assume that I have this $20 or $50 in a savings account (also referred to as the third account).

With the Roth conversion, I would have $200 in a Roth IRA. Without the Roth conversion, I would have the following: (1) a $200 traditional IRA in effect half owned by the Service, making my net ownership interest $100; (2) $100 in a zero-basis non-IRA account, subject to capital gains tax at liquidation; and (3) either $20 or $50 in a savings account. Assume that I switch the $20 or $50 to an account with the same stock mutual fund as the others.

At some hypothetical date called “liquidation,” I shall assume liquidation (without penalty) of either the Roth IRA or all three of the alternative accounts. (On the one hand, the first option, liquidation of the Roth, removes the advantage of holding the tax-free Roth IRA until my death and leaving it to a beneficiary who then holds the tax-free Roth for some period. On the other hand, the other option, liquidation of the

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three alternative accounts, eliminates the benefit of a stepped-up basis at death on the two non-IRA accounts.)

**Account Values Triple**

Suppose that by the liquidation date, all the mutual fund accounts triple in value with reinvestment of all dividends and capital gains distributions. With the Roth conversion, I would have $600 in a Roth IRA, exempt from all income tax. Without the Roth conversion, I would have: (1) $600 in a traditional IRA, in effect half owned by the Service; my net ownership interest is $300; (2) $300 in a non-IRA account owned outright minus capital gains tax at liquidation; and (3) either $60 or $150 in another non-IRA account owned outright minus capital gains tax at liquidation. On the second and third accounts, I would also have had to pay tax on any interim dividends and capital gains distributions.

Assume that at the liquidation date, my capital gains tax rate is the same as at possible conversion: either 20% or 50%. Without the Roth conversion, were I to liquidate the $300 second account, I would pay either 20% or 50% on the capital gains of $300 ($300 minus the $0 basis): either $60 or $150. That is exactly the amount in the third account. In other words, as long as the capital gains rate is constant over time, the amount in the third account is exactly equal to the capital gains tax due on the second account. (For the moment, I shall ignore the upward adjustment of the zero basis resulting from the reinvested dividends and capital gains distributions.)

On the third account, the capital gains tax at liquidation is either $8 or $50: 20% of $40 ($60 minus the preliminary unadjusted $20 basis) or 50% of $100 ($150 minus the preliminary unadjusted $50 basis). After this preliminary capital gains tax, the $52 or $100 in the third account is less than the either $60 or $150 necessary to pay the preliminary capital gains tax on the second account. Initially, the Roth conversion appears better.

The above analysis ignores two countervailing factors: (1) the non-Roth detriment of interim taxes on the dividends and capital gains distributions (on the second and third accounts); and (2) the non-Roth benefit of the tax advantage of the upward basis adjustment resulting from the reinvested dividends/distributions (for those same two accounts).

The non-Roth detriment of interim taxes on the dividends and capital gains distributions in the second and third accounts compounded to future value at the liquidation date should be worth more than the non-Roth benefit of the tax advantage of the upward adjustment of basis on the same two accounts. The Roth conversion should be better.

Note that the amount in the third account is exactly the same as the preliminary capital gains tax on the second account (with the unadjusted basis). Therefore, another way of coming to the same conclusion is to compare (1) the above non-Roth detriment, plus the capital gains tax on the liquidation of account three, with (2) the above non-Roth benefit. The first amount should exceed the second, and the Roth conversion should be better.

**Account Values Double**

Alternatively, by the liquidation date, assume that all the accounts only double in value with all dividends and capital gains distributions reinvested. With the Roth conversion, I would have $400 in a Roth IRA. Without the Roth conversion, I would have: (1) $400 in a traditional IRA, in effect half owned by the Service; my net ownership interest is $200; (2) $200 in a non-IRA account, minus capital gains tax at liquidation; and (3) either $40 or $100 in another non-IRA account, minus capital gains tax at liquidation. On the second and third accounts, I would also have had to pay tax on any interim dividends and capital gains distributions.

Assume that at the liquidation date, my capital gains tax rate is the same as at possible conversion: either 20% or 50%. Without the Roth conversion, were I to liquidate the $200 second account, I would pay either 20% or 50% on the capital gains of $200 ($200 minus the preliminary unadjusted $0 basis): either $40 or $100. As before, that is exactly the amount in the third account.

On the third account, the capital gains tax at liquidation is either $4 or $25: 20% of $20 ($40 minus the preliminary unadjusted $20 basis); or 50% of $50 ($100 minus the preliminary unadjusted $50 basis). After this preliminary capital gains tax, the $36 or $75 in the third account is less than either the $40 or $100 necessary to pay the preliminary capital gains tax on the second account. Initially, the Roth conversion appears better.

Again, the above analysis ignores two countervailing considerations: (1) the non-Roth detriment of the interim taxes on the dividends and capital gains distributions (on the second and third accounts) and (2) the non-Roth benefit of the tax advantage of the upward basis adjustment resulting from the reinvested dividends/distributions (for those same two accounts).

The non-Roth detriment of the interim taxes on the dividends and capital gains distributions in the second and third accounts compounded to future value at the liquidation date should be worth more than the non-Roth benefit of the tax advantage of the upward adjustment of basis on the same two accounts. The Roth conversion should be better.

Again, note that the amount in the third account is exactly the same as the preliminary capital gains tax on the second account (with the unadjusted basis). Therefore, another method of demonstrating the same point is to compare: (1) the above non-Roth detriment, plus the capital gains tax on the liquidation of the third account with (2) the above non-Roth benefit. The first
Account Values Are Halved

Alternatively, by the liquidation date, assume that all the accounts fall by 50% with all dividends and capital gains distributions reinvested. With the Roth conversion, I would have $100 in a Roth IRA. Without the Roth conversion, I would have: (1) $100 in a traditional IRA, in effect half owned by the Service; my net ownership interest is $50; (2) $50 in a non-IRA account, minus capital gains tax at liquidation; and either $10 or $25 in another non-IRA account. On the second and third accounts, I would also have had to pay tax on any interim dividends and capital gains distributions.

Assume that at the liquidation date, my capital gains tax rate is the same as at possible conversion: either 20% or 50%. Without the Roth conversion, were I to liquidate the $50 second account, I would pay either 20% or 50% on the capital gains of $50 ($50 minus the preliminary unadjusted $0 basis): either $10 or $25. As before, that is exactly the amount in the third account.

On liquidation of the third account, the preliminary capital loss is either $10 or $25: $10 minus the preliminary unadjusted $20 basis, or $25 minus the preliminary unadjusted $50 basis. Initially, the Roth conversion appears worse because of the absence of the preliminary capital loss of $10 or $25.

The above analysis ignores two countervailing factors: (1) the non-Roth detriment of the interim taxes on the dividends and capital gains distributions (on the second and third accounts), plus the decrease in capital loss resulting from the upward basis adjustment in the third account, versus (2) the non-Roth benefit of the tax advantage of the upward basis adjustment resulting from the reinvested distributions for the second account.

As before, the amount in the third account is exactly the same as the preliminary capital gains tax on the second account (with the unadjusted basis). Therefore, whether the Roth conversion is beneficial depends on a comparison of (1) the non-Roth detriment compounded to future value at the liquidation date (the interim taxes on the dividends and capital gains distributions in the second and third accounts) with (2) the non-Roth benefit (the tax advantage of the upward adjustment of basis in the second account) plus the tax advantage of the capital loss of on the liquidation of the third account adjusted downwards to reflect the upward adjustment of basis resulting from the reinvestment of dividends and capital gains distributions. The relative value of the two amounts is unclear, so the Roth conversion may or may not be advantageous.

Summary

This article assumes the payment of capital gains tax on the asset liquidated to pay the ordinary income tax on the Roth conversion. Nevertheless, the conversion avoids future capital gains and other income tax on the amount converted.

Future investment appreciation cuts both ways. On the one hand, the greater the appreciation, the larger the opportunity cost of the funds used to pay the capital gains tax (on the asset liquidated to pay the ordinary income tax on the amount converted). On the other hand, the higher the appreciation, the bigger the tax savings resulting from the conversion.

The tax savings are more than the opportunity cost of the capital gains tax paid on the asset sold to finance the conversion under certain assumptions: (1) constant flat ordinary income and capital gains tax rates; (2) a zero basis on the asset that would be sold to finance the ordinary income tax due upon conversion; (3) the possession of enough cash to pay the capital gains tax at conversion; and (4) an equal increase in the Roth account or, alternatively, the traditional IRA account and the non-IRA accounts holding the amounts that would have been paid in tax upon conversion.

One of several illustrations assumed a constant flat ordinary income tax rate of 50% and a constant flat capital gains tax rate of either 20% or 50%. The illustration also postulated three accounts: (1) a $200 traditional IRA account that might be converted to a Roth; (2) a zero basis $100 non-IRA account that might be liquidated to pay the $100 income tax (50% of $200) on the Roth conversion; and (3) either $20 or $50 in a savings account that might be used to pay the capital gains tax on the second account were it liquidated to pay the ordinary income tax for the Roth conversion of the first account. Without the Roth conversion, I assume that this $20 or $50 is switched to an account with the same stock mutual fund as the others.
With the Roth conversion, I have $200 in a Roth IRA account. Without the conversion, I have the three accounts above. At the hypothetical account liquidation date, I assume liquidation (without penalty) of either the Roth IRA or all three accounts.

Regardless whether all accounts triple or double by the liquidation date (with reinvestment of all dividends and capital gains distributions), the amount in the third account is exactly the same as the preliminary capital gains tax due on the second account (with no upward adjustment in basis for the reinvested dividends and capital gains distributions). Initially, the two alternatives (Roth or no Roth) seem equivalent.

The correct analysis is more complicated. One comparison is of the following two dollar amounts: (1) (non-Roth detriment) the interim taxes on the dividends and capital gains distributions in the second and third accounts compounded to future value at liquidation of the two accounts, plus the capital gains tax on the liquidation of the third account with (2) (non-Roth benefit) the tax advantage of the upward adjustment of basis of the second and third accounts because of the reinvestment of the same dividends/distributions. The first amount should exceed the second, and the Roth conversion should be better.

If, instead of appreciating, the accounts decline in value by the liquidation date, assuming a constant capital gains rate, the Roth conversion might be better or worse.

The Appendixes illustrate some alternative possibilities. One assumes a 23.8% capital gains rate at possible conversion and a $40 (rather than a zero) basis on the $100 second account (that would be liquidated to pay the ordinary income tax on the conversion). In that situation, if the accounts appreciate between possible conversion and the liquidation date, the Roth conversion should generally be advantageous even with a lower 15% capital gains tax at liquidation; on the other hand, if the accounts decline in value between possible conversion and liquidation, the conversion may be better or worse but would often be worse (again assuming a lower 15% capital gains tax rate at liquidation).

Other Appendix examples assume (1) a 23.8% capital gains tax rate at possible conversion; (2) a zero basis on the second account (the capital asset that would be sold to finance the Roth conversion); and (3) a lower 15% capital gains tax rate at liquidation than the 23.8% rate at possible conversion. Under these circumstances, the conversion may be better or worse but would often be worse. The net result depends in part on the size of the interim taxes on dividends and capital gains distributions paid in the absence of the conversion.

This article’s analysis makes a great many simplifying assumptions. The major one is the constant and uniform ordinary income tax rate. In reality, this rate is neither constant nor uniform. My conversion of a large amount to a Roth might thrust me into a higher marginal ordinary income tax bracket. In addition, I do not know what my marginal ordinary income tax rate will be at the time all the accounts are liquidated. Nevertheless, the analysis with its simplifying assumptions demonstrates the potential advantage of a Roth IRA conversion even when financed by the sale of a capital asset with accompanying capital gains tax.

**APPENDIXES**

Again, suppose I start with two accounts holding the same stock mutual fund: (1) a $200 traditional IRA account with a zero basis; and (2) a $100 account I own outright. As before, assume that the federal ordinary income tax rate will be a flat 50% forever and there will be no state income or capital gains taxes.

If I convert the $200 in the traditional IRA account to a Roth, I must pay $100 in ordinary income tax. In effect, for $100, I am buying out the Service’s 50% “partnership” interest. In other words, if I give the Service my outrightly owned $100 account (the second account) and pay any capital gains tax due on that account, the Service conveys to me its half ownership in the $200 traditional IRA account.

**Appendix I**

The analysis in Appendix I assumes a $40 basis in the second account instead of a zero basis. It also assumes a 23.8% capital gains rate (20% maximum federal capital gains tax rate plus the 3.8% federal tax on investment income) at the time of converting the traditional IRA to a Roth and possession of enough cash to pay the capital gains tax at conversion. Finally, it assumes a 15% capital gains tax rate at the eventual liquidation date.

To finance the ordinary income tax on the Roth conversion, I must liquidate the second account and pay capital gains tax of 23.8% of $60 ($100 minus the $40 basis): $14.28. For simplicity, I assume that I have this $14.28 in a savings account.

With the Roth conversion, I would have $200 in a stock mutual fund Roth IRA. Without the Roth conversion, I would have the following: (1) a $200 stock mutual fund traditional IRA in effect half owned by the Service; my net ownership interest is $100; (2) $100 in a stock mutual fund owned outright, subject to capital gains tax at liquidation; and (3) $14.28 in a savings account owned outright. Assume that I switch the $14.28 to an account with the same stock mutual fund as the others.

Again, at some hypothetical date called “liquidation,” I shall assume liquidation (without penalty) of either the Roth IRA or all three of the alternative accounts.

**Account Values Triple**

Suppose that by the liquidation date, all the mutual fund accounts triple in value with reinvestment of all dividends and capital gains distributions. With the
Roth conversion, I would have $600 in a Roth IRA, exempt from all income tax. Without the Roth conversion, I would have: (1) $600 in a traditional IRA in effect half owned by the Service; my net ownership interest is $300; (2) $300 in a non-IRA account owned outright minus capital gains tax at liquidation; and (3) $42.84 in another non-IRA account owned outright minus capital gains tax at liquidation. On the second and third accounts, I would also have had to pay tax on any interim dividends and capital gains distributions.

Assume that at the liquidation date, my capital gains tax rate is only 15%. Without the Roth conversion, were I to liquidate the $300 second account, I would pay 15% of the capital gains of $260 ($300 minus the $40 preliminary unadjusted basis): $39.

Capital gains tax on liquidation of the $42.84 third account would be 15% of $28.56 ($42.84 minus the preliminary unadjusted $14.28 basis): $4.28. The preliminary net liquidation amount for the third account would be $42.84 minus $4.28: $38.56. That is only 44 cents less than the preliminary $39 capital gains tax due on liquidation of the second account. Initially, the Roth conversion appears slightly better.

Again, the above analysis ignores two opposite effects: (1) the non-Roth detriment of interim taxes on the dividends and capital gains distributions (on the second and third accounts) and (2) the non-Roth benefit of the tax advantage of the upward basis adjustment resulting from the reinvested dividends/distributions (for the same two accounts). Because this variation assumes a 15% capital gains tax at the liquidation of the two accounts, the non-Roth tax advantage of the upward basis adjustment is less than with a 23.8% capital gains tax rate.

Account Values Double

Alternatively, by the liquidation date, assume that all the mutual funds only double in value with reinvestment of all dividends and capital gains distributions. With the Roth conversion, I would have $400 in a Roth IRA. Without the Roth conversion, I would have: (1) $400 in a traditional IRA, in effect half owned by the Service; my net ownership interest is $200; (2) $200 in a non-IRA account minus capital gains tax at liquidation; and (3) $28.56 in another non-IRA account minus capital gains tax at liquidation. On the second and third accounts, I would also have had to pay tax on any interim dividends and capital gains distributions.

Assume that at the liquidation date my capital gains tax rate is only 15%. Without the Roth conversion, were I to liquidate the $200 second account, I would pay 15% of the capital gains of $160 ($200 minus the preliminary unadjusted $40 basis): $24.

Capital gains tax on liquidation of the $28.56 third account would be 15% of $14.28 ($28.56 minus the preliminary unadjusted $14.28 basis): $2.14. The preliminary net liquidation amount for the third account would be $28.56 minus $2.14: $26.42. That is $2.42 more than the preliminary $24 capital gains tax due on liquidation of the second account. Initially, the Roth conversion seems worse.

Again, the above analysis ignores two opposite effects: (1) the non-Roth detriment of interim taxes on the dividends and capital gains distributions (on the second and third accounts) and (2) the non-Roth benefit of the tax advantage of the upward basis adjustment resulting from the reinvested dividends/distributions (for the same two accounts). Because this variation assumes a 15% capital gains tax at the liquidation of the two accounts, the non-Roth tax advantage of the upward basis adjustment is less than with a 23.8% capital gains tax rate.

The Roth conversion is better if, compounded to future value at the liquidation date, the non-Roth detriment of interim taxes on the dividends and capital gains distributions in the second and third accounts is worth more than the non-Roth benefit of the tax advantage of the upward adjustment of basis on the same two accounts plus $2.42 (the preliminary “excess” in the third account at that date).

Compounded to future value at liquidation, the non-Roth detriment of interim taxes on dividends and capital gains distributions in the second and third accounts should be worth significantly more than the non-Roth benefit of the tax advantage of the upward adjustment of basis on the same two accounts due to the same dividends and capital gains distributions. This difference would likely be more than $2.42 (the preliminary “excess” in the third account). The difference may be slight, but the Roth conversion is likely better.

Interestingly, with the $40 basis on the $100 mutual fund owned outright and the lower 15% capital gains tax rate at liquidation, the benefit of the Roth conversion is less pronounced with a doubling than a tripling of the value of all accounts by the liquidation date.

Account Values Are Halved

Alternatively, by the liquidation date, assume that all the mutual funds fall by a half with all dividends and capital gains distributions reinvested. With the Roth conversion, I would have $100 in a Roth IRA. Without the Roth conversion, I would have: (1) $100 in a traditional IRA; (2) $50 in a non-IRA account, minus capital gains tax at liquidation;
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and (3) $7.14 in another non-IRA account. On the second and third accounts, I would also have had to pay tax on any interim dividends and capital gains distributions.

Assume that at the liquidation date, my capital gains tax rate is only 15%. Without the Roth conversion, were I to liquidate the $50 second account, I would pay 15% on the capital gains of $10 ($50 minus the preliminary unadjusted $40 basis): $1.50. The $7.14 in the third account is $5.64 more than the $1.50 capital gains tax on the second account. In addition, on liquidation of the third account, the preliminary capital loss is $7.14: $7.14 minus the preliminary unadjusted $14.28 basis. Initially, the Roth conversion appears worse because of the tentative $5.64 “excess” in the third account at liquidation plus the absence of the preliminary capital loss of $7.14.

The above analysis ignores two countervailing factors: (1) the non-Roth detriment of the interim taxes on the dividends and capital gains distributions (on the second and third accounts), plus the decrease in capital loss resulting from the upward basis adjustment in the third account (resulting from the reinvested dividends/distributions), versus (2) the non-Roth benefit of the tax advantage of the upward basis adjustment in the second account (resulting from the reinvested dividends/distributions).

Because this variation assumes a 15% capital gains tax at the time of liquidation of the two accounts, the tax effect of both the capital loss and the upward basis adjustment is less than with a 23.8% capital gains tax rate.

Compounded to future value at the time of liquidation of the two accounts, the non-Roth detriment of interim taxes on the dividends and capital gains distributions in the second and third accounts may be worth more or less than the following non-Roth benefits: (1) the tax advantage of the upward adjustment of basis on the second account, plus (2) the tax advantage of the preliminary capital loss of $7.14 on the third account adjusted downwards to reflect the upward adjustment of basis resulting from the reinvestment of dividends and capital gains distributions, plus (3) the tentative $5.64 “excess” in the third account. The Roth conversion may be better or worse but would often be worse.

Appendix II
The analysis in Appendix II assumes a zero basis in the second account instead of a $40 basis. It also assumes a 23.8% capital gains rate (20% maximum federal capital gains tax rate plus the 3.8% federal tax on investment income) at the time of converting the traditional IRA to a Roth and possession of enough cash to pay the capital gains tax at conversion. Finally, it assumes a 15% capital gains tax rate at the eventual liquidation date.

To finance the ordinary income tax on the Roth conversion, I must liquidate the second account and pay capital gains tax of 23.8% of $100 ($100 minus the $0 basis): $23.80. For simplicity, I assume that I have this $23.80 in a savings account.

With the Roth conversion, I would have $200 in a stock mutual fund Roth IRA. Without the Roth conversion, I would have the following: (1) $200 in a stock mutual fund traditional IRA in effect half owned by the Service; my net ownership interest is $100; (2) $100 in a stock mutual fund owned outright, subject to capital gains tax at liquidation; and (3) $23.80 in a savings account owned outright. Assume that I switch the $23.80 to an account with the same stock mutual fund as the others.

Account Values Triple
Again, suppose that by the liquidation date, all the mutual fund accounts triple in value with reinvestment of all dividends and capital gains distributions. With the Roth conversion, I would have $600 in a Roth IRA, exempt from all income tax. Without the Roth conversion, I would have: (1) $600 in a traditional IRA in effect half owned by the Service; my net ownership interest is $300; (2) $300 in a non-IRA account owned outright minus capital gains tax at liquidation; and (3) $71.40 in another non-IRA account owned outright minus capital gains tax at liquidation. On the second and third accounts, I would also have had to pay tax on any interim dividends and capital gains distributions.

Suppose, at the liquidation date, my capital gains tax rate is only 15%. Without the Roth conversion, were I to liquidate the $300 second account, I would pay 15% on the capital gains of $300 ($300 minus the preliminary unadjusted $0 basis): $45.

Were I to liquidate the $71.40 third account, the capital gains tax would be 15% of $47.60 ($71.40 minus the preliminary unadjusted $23.80 basis): $7.14. After this preliminary $7.14 capital gains tax, the $64.26 in the third account is $19.26 more than the $45 necessary to pay the preliminary capital gains tax on the second account. Initially, the Roth conversion seems worse.

As before, the above analysis ignores two opposite factors: (1) the non-Roth detriment of the interim taxes on the dividends and capital gains distributions (on the second and third accounts) and (2) the non-Roth benefit of the tax advantage of the upward basis adjustment resulting from the reinvested dividends/distributions (for those same two accounts). Because this variation assumes a 15% capital gains tax at the liquidation date, the non-Roth tax advantage of the upward basis adjustment is less than with a 23.8% capital gains tax rate.

Compounded to future value at the time of liquidation of the two accounts, the non-Roth detriment of interim taxes on the dividends and capital gains distributions in the second and third accounts might be worth more or less than the non-Roth benefit of the tax.
advantage of the upward adjustment of basis on the same two accounts plus $19.26 (the initial “excess” in the third account at liquidation). The Roth conversion might be better or worse but would often be worse.

**Account Values Double**

Alternatively, suppose that by the liquidation date, all the mutual funds only double in value with all dividends and capital gains distributions reinvested. With the Roth conversion, I would have $400 in a Roth IRA. Without the Roth conversion, I would have: (1) $400 in a traditional IRA, in effect half owned by the Service; my net ownership interest is $200; (2) $200 in a non-IRA account minus capital gains tax at liquidation; and (3) $47.60 in another non-IRA account minus capital gains tax at liquidation. On the second and third accounts, I would also have had to pay tax on any interim dividends and capital gains distributions.

Suppose at liquidation my capital gains tax rate is only 15%. Without the Roth conversion, I would have: (1) $200 in a non-Roth benefit of the tax advantage of the preliminary unadjusted $23.80 basis). Because this variation assumes a 15% capital gains tax at the time of liquidation of the two accounts, the non-Roth tax advantage of the upward basis adjustment is less than with a 23.8% capital gains tax rate.

Compounded to future value at the time of liquidation of the two accounts, the non-Roth detriment of the interim taxes on the dividends and capital gains distributions in the second and third accounts might be worth more or less than the non-Roth benefit of the tax advantage of the upward adjustment of basis on the two accounts plus $14.03 (the initial “excess” in the third account). The Roth conversion might be better or worse but would often be worse.

**Account Values Are Halved**

Alternatively, suppose that by the liquidation date, all the mutual funds do not appreciate but instead fall by a half with all dividends and capital gains distributions reinvested. With the Roth conversion, I would have $100 in a Roth IRA. Without the Roth conversion, I would have: (1) $100 in a traditional IRA, in effect half owned by the Service; my net ownership interest is $50; (2) $50 in a non-IRA account minus capital gains tax at liquidation; and (3) $11.90 in another non-IRA account. On the second and third accounts, I would also have had to pay tax on any interim dividends and capital gains distributions.

Again, at the liquidation date my capital gains tax rate is only 15%. Without the Roth conversion, I would have: (1) $50 in a non-Roth benefit of the tax advantage of the preliminary unadjusted $0 basis): $7.50. The $11.90 in the third account is $4.40 more than the preliminary $7.50 capital gains tax on the second. On liquidation of the third account, the preliminary capital loss is $11.90 ($11.90 minus the preliminary unadjusted $23.80 basis). Initially, the Roth conversion appears worse because of the absence of the preliminary capital loss of $11.90 and the tentative $4.40 “excess” in the third account at liquidation.

Again, the above analysis ignores two opposite factors: (1) the non-Roth detriment of interim taxes on the dividends and capital gains distributions (on the second and third accounts) plus the decrease in capital loss resulting from the upward basis adjustment in the third account, versus (2) the non-Roth benefit of the tax advantage of the upward basis adjustment resulting from the reinvested distributions (for the second account). Because this variation assumes a 15% capital gains tax at the time of liquidation of the two accounts, the tax effect of both the capital loss and the upward basis adjustment is less than with a 23.8% capital gains tax rate.

Compounded to future value at the time of liquidation of the two accounts, the non-Roth detriment of interim taxes on the dividends and capital gains distributions in the second and third accounts may be worth more or less than the combination of the following three non-Roth benefits: (1) the tax advantage of the upward adjustment of basis on the second account; plus (2) the tax advantage of the preliminary capital loss of $11.90 on the third account adjusted downwards to reflect the upward adjustment of basis resulting from the reinvestment of dividends and capital gains distributions; plus (3) the tentative $4.40 “excess” in the third account at liquidation. The Roth conversion may be better or worse but would often be worse.