

Tax Reform Proposals for Roth IRAs

Saving for retirement is good for individuals and good for the country—but Roth individual retirement accounts (IRAs) are costing America dearly. They'll add to the deficit far into the future, and the amount they add is set to explode. Let's discover why, and look at some ways to hold down the damage.

In contrast to other retirement accounts, contributions to Roth IRAs have already been taxed. That's it for the Treasury from Roths. Instead of an upfront tax break, they get a permanent tax break: no more taxes, ever. The tradeoff effectively guarantees untold billions in downstream losses.

The losses are unlimited. They occur because the untaxed capital gains in Roth accounts can easily reach several multiples of taxed Roth contributions. All other accounts ultimately pay taxes on both contributions and gains; Roths pay only on the usually far smaller contributions amount.

Congress has twice sharply increased America's future losses from Roth IRAs. On New Year's Day 2013, the fiscal cliff agreement opened the door to immediate Roth conversions by tens of thousands of 401(k)s, 403(b)s and 457s. (Conversions turn tax-deferred plans into tax-free Roths. Until now, only regular IRAs could convert before age 59 1/2. Conversions raise Treasury receipts initially, since they require the payment of the taxes due on the base accounts.) Earlier, starting in 2010, a Bush Administration law removed the \$100,000 adjusted gross income limit for Roth conversions.

Ending the income cap on conversions followed the Bush pattern of tax breaks for the wealthy. The bipartisan pattern of playing fiscal games also helped drive Congress's action. In July 2010, with conversions booming, tax expert Howard Gleckman described the Roth game: "Congress adopted the tax change in part as a fiscal gimmick. That's because, within the 10-year budget window (all that matters in Washington accounting), the conversions raise revenue. At the time the law passed, CBO [the Congressional Budget Office] figured it would generate about \$6.5 billion from 2010-2015. But in the long run, turning billions of dollars from tax-deferred to tax-free savings will be a huge loser for Treasury. My colleagues at Tax Policy Center figure that, through mid-century, allowing unlimited Roth conversions will reduce federal revenues by \$100 billion." That figure, of course, doesn't count the losses that began piling up when the accounts were launched in 1998.

There's no stopping the red ink already flowing from Roth IRAs. With the nation struggling to balance the books, it's time for Congressional damage control. Here are three deficit-reducing Roth reforms:

Abolish conversions. The largest Treasury losses will come from the largest Roth accounts, i.e., conversions. Congress should override the fiscal cliff provision and abolish all future Roth conversions. At a minimum, it should restore the income ceiling.

End Roth Startups. Other retirement plans are genuine two-way bargains: savers enjoy tax advantages, but repay the country via taxable distributions. Roths eat away at America's fiscal future, taking ever-bigger bites as more accounts come on-stream. The second reform, just as important as the first, is to stop opening new Roth IRAs.

Require distributions. Minimum distribution requirements—standard on all other retirement plans—have never applied to Roths. Accounts created under the fiscal cliff agreement will require distributions, and Congress should extend the rule to all Roths. Tax-free Roth payouts would pump extra money into the economy, and give governments at all levels a chance to recoup some of their lost revenues.

Senate Majority Whip Dick Durbin (D-IL) sees tax reform as one way to help close the federal deficit. As he told CNN, “There are plenty of things within that tax code, these loopholes where people can park their money on some island offshore and not pay taxes.” Nobody has to go offshore. All anyone has to do is convert a retirement account to a Roth IRA, or build one from scratch.