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George W. Bush's 2010 Tax Miracle

By Donald L. Luskin

With the federal budget deficit estimated at $1.342 trillion for next year, it's going to take a miracle to put America's fiscal house in order. Happily, a tax revenue miracle may be just around the corner. At a minimum, it will reduce next year's deficit by 15%. It might end up cutting it in half.

When this miracle happens, don't let anyone tell you it was Obamanomics or "stimulus" that caused it. In reality, it will be the unexpected result of an obscure provision of the Bush tax cuts that's been hiding in plain sight since 2006. That's right, the much-maligned Bush tax cuts are going to save the day.

Here's how it's going to happen. In the 2010 tax year, for the first time, there is no $100,000 income limitation on the ability to convert IRAs and other tax-deferred retirement accounts into Roth IRAs. Abolition of the limit was set in May 2006, as part of the 2005 Tax Increase Prevention and Reconciliation Act, which extended the expiration of the Bush tax cuts on wages, dividends and capital gains through 2010.

To convert to a Roth entails paying any deferred taxes now, in exchange for freedom from taxes forever after on principal, income and gains, whether for one's self or one's heirs. The tax and estate planning benefits are so compelling that the wealthiest Americans are likely to convert in droves. When the conversions are reported next year in tax-year 2010 filings, that's going to drive hundreds of billions of dollars in unexpected revenue.

Is the IRA market really big enough to do that? Maybe not on its own, but qualified distributions from 401(k), 403(b) and even defined-benefit pension plans could be converted to Roth IRAs under the new rules, according to Mann Associates, a benefits consulting firm in Riverwoods, Ill. My firm, Trend Macrolytics, estimates that there is at least $9 trillion in these tax-deferred vehicles. About 60% of that, or $5.4 trillion, is in the hands of the wealthiest 10% of households, and most of that is eligible to be converted. If just 10% of it is converted, then taxes would be paid on $540 billion at a 35% rate—generating a $189 billion revenue surprise for the U.S. Treasury.

A miracle? We think it's practically a sure thing. A recent poll sponsored by the investment firm USAA shows that 12% of Americans with household incomes above $100,000 plan to convert, and another 17% are undecided.

But that's merely the minimum. The very wealthiest Americans, who control most of the eligible assets, have utterly irresistible tax incentives. They'll benefit most from paying taxes today while the low Bush-era rates are still in effect, and by avoiding them in the future when soak-the-rich Obama-era rates come in. The USAA poll found that 61% of the highest-earning households planning to convert are thinking along those lines.

The estate-planning element is key. Converting now allows one's children to accumulate and withdraw Roth assets tax-free over their lifetimes. And paying the taxes now in order to convert reduces the size of one's estate subject to the death tax.

We think that 35% conversion isn't all that much of a stretch. If 35% of eligible assets are converted, that's $662 billion in surprise tax revenues, and the budget deficit gets cut almost in half.

How could the budget mavens in Washington not be expecting the flood-tide of revenues sure to come from this? The Congressional Budget Office (CBO) told us that its baseline revenue estimates assume only about an $8 billion bump from increased Roth conversions. That's the amount estimated in 2006 by the Joint Committee on Taxation.

How'd they come up with $8 billion? According to an eyewitness who spoke on condition of anonymity, $8 billion was the amount needed to make the budget math work in order to be able to extend the Bush tax cuts under filibuster-proof reconciliation rules—so that's the amount they came up with. The CBO simply adopted that number and is only now beginning to take a closer look.

To be sure, this tax revenue miracle will likely be short-lived. With taxes sure to rise, the wealthiest Americans will act quickly to lock in low rates by converting right away and paying as soon as possible. So the effect will be much smaller in future years.

Moreover, critics might point out that the bigger the miracle in the short run, the worse for tax revenues in the long run. Taxes paid today because of conversions mean less taxes paid in the future—after all, wealthy taxpayers wouldn't convert at all if they didn't think it would save them money over time. But that static analysis ignores possible supply-side benefits. Converting to a Roth is, in essence, a way of lowering the tax bite on investment returns. That will encourage more capital formation—the cornerstone of growth. Any long-term costs of Roth conversion could more than pay for themselves, as the 2003 cut in the capital gains tax rate did.

And heaven knows we could use even short-term relief from record budget deficits, giving us the breathing room to figure out how to put the government's budget on a sustainable footing.

Sadly, we expect the powers-that-be will be tempted to simply spend this revenue miracle. What's more, they'll probably demonize "the rich" who made it possible. They'll use tax data to prove that "income inequality" is widening—but it's only because anyone who converts will have to report the converted amount as part of adjusted gross income, even though it's not actual income at all.

Worst of all they'll fail to understand what produced this revenue miracle in the first place. Will they learn that cutting tax rates on the wealthiest Americans can, under the right circumstances, produce more tax revenue when we need it most? Not a chance. Politically, they can never admit the truth: that the hated Bush tax cuts are turning out to be a miraculous gift that keeps on giving.

Mr. Luskin is chief investment officer at Trend Macrolytics LLC.