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## Should You Recharacterize Your 2010 Roth IRA Conversion? *It Could Save You Taxes Now, But You Must Act Soon*



In 2010, many high-income taxpayers converted their traditional IRAs to Roth IRAs. An added incentive for *only* 2010 conversions was the ability to defer income on the conversions.

If you made a conversion in 2010, recent market volatility may have caused you to rethink the wisdom of that decision. Your Roth IRA may have lost value since the conversion, causing you to owe tax on income that has since “disappeared”. Or changes in the rest of your portfolio or your financial situation as a whole may have made the tax less affordable. In either situation, it may make sense to “recharacterize” (that is, undo) your conversion. But you must act soon, the deadline for most taxpayers is October 17, 2011. (Certain taxpayers affected by Hurricane Irene have until October 31, 2011.)

### **Conversions Come with Both Benefits and Taxes**

Roth IRAs offer an attractive advantage over traditional IRAs. Qualified Roth IRA distributions are tax-free; whereas traditional IRA distributions are subject to tax — at ordinary-income rates. The trade-off is that Roth IRAs are funded with after-tax dollars; whereas traditional IRAs may be funded with deductible contributions or rollovers from employer-sponsored plans that were funded with pre-tax dollars.

Another Roth IRA advantage is that the accounts aren’t subject to the required minimum distribution (RMD) rules that apply to traditional IRAs. That means you can let your Roth IRA grow tax-free over your lifetime, which potentially provides an estate planning benefit. Although the beneficiaries you name will be subject to RMDs, the RMDs will be income-tax-free and spread over their lifetimes. This can allow substantial opportunity for tax-free compounding.

For these and other reasons, converting a traditional IRA to a Roth IRA can be a good idea — especially for high-income taxpayers who are ineligible to contribute to Roth IRAs because of the limits on income.

However, when converting a traditional IRA to a Roth IRA, the conversion is treated as a taxable distribution. This means the account balance on the date of conversion — less your basis, if any, in the account — is included in your taxable income for the year. (You’d have basis if, for instance, you’d made nondeductible contributions to your traditional IRA.) But for 2010 conversions, half the taxable income could be deferred to 2011 and the other half to 2012.

### **Recharacterization Eliminates Unanticipated Negatives**

If you made a Roth IRA conversion in 2010, you may have elected to report the entire balance on your 2010 return. Otherwise, you must report half the balance on your 2011 return and half on your 2012 return. Either way, these tax consequences may be producing unanticipated negatives that you can eliminate with a recharacterization.

***You paid tax or will owe tax on value that has been lost.*** By undoing the conversion, you can avoid tax on the conversion-date balance, including the lost value. If a conversion is otherwise desirable, you can wait 30 days and then reconvert. The tax you’ll owe will be based on the account’s potentially lower value on the date of the new conversion.

However, keep in mind that income deferral was allowed only for 2010 conversions. So you’ll need to report the entire amount of the new conversion on your 2011 tax return.

***The tax has become less affordable.*** Again, by undoing the conversion, you can avoid tax on the conversion-date balance. If you elected to report the income on your 2010 return and already paid the tax, you can receive a refund, which can produce a helpful cash flow boost.

### **How to Recharacterize a Conversion**

If your Roth IRA contains only assets from the 2010 conversion (and growth on them, if any), the simplest option is to ask the trustee to change the account from a Roth IRA to a traditional IRA. You also must inform the trustee of the original traditional IRA (if different) of the recharacterization.

If there are additional assets in the Roth IRA (such as from a previous conversion or from contributions) or you'd like to consolidate the recharacterized assets with assets remaining in the original traditional IRA, you can ask the Roth IRA trustee to transfer the 2010 converted amount (plus growth on that amount, if any) to the trustee of the traditional IRA.

There are also IRS filing requirements:

- To be eligible for a recharacterization, you must have filed your 2010 tax return by April 18, 2011 or have timely requested an extension.
- If you already filed your 2010 return, you must file an *amended* return reflecting the recharacterization.
- If you requested an extension, you must file your extended return, reflecting the recharacterization, by October 17, 2011 — or later, if applicable.

These filing requirements must be met even if you were going to report the 2010 conversion income on your 2011 and 2012 tax returns.

### **Determining if Recharacterization is Right for You**

Whether you should recharacterize a 2010 Roth IRA conversion depends on the current value of your Roth IRA compared with the value on the date of conversion as well as whether you can afford to pay the tax without harming your overall financial position. We'd be happy to help you evaluate these considerations.

If you decide a recharacterization is right for you, we also can help you ensure you file the necessary tax returns. But remember, you must act soon to meet the deadline.

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We hope this information is helpful. If you would like more details, please contact a Kerkering Barberio professional tax advisor at 941-365-4617.