InvestmentNews
The Leading News Source for Financial Advisers

Last chance to re-characterize

For those with losses in converted Roth IRAs, the deadline for undoing 2010 conversions is Oct 17

By Robert N. Gordon

September 25, 2011

Much has been written about the opportunity to undo, or re-characterize, a Roth IRA conversion if the assets in the account depreciate. In fact, we have recommended converting early in the year to maximize this look-back period and noted that it makes good sense to have multiple Roths so that the investor can choose which Roth to keep and which to undo.

If a client's Roth accounts are invested in equities, there is a good chance that the accounts have declined in value since the conversion and that it might make sense to re-characterize those Roth accounts back into conventional individual retirement accounts. If, as suggested, the investor has multiple Roths invested in various asset classes, it is likely that a few of these accounts have appreciated and are worth keeping.

All 2010 Roth converters have until Oct. 17 to undo their accounts, whether they filed their tax returns on time or filed for an extension.

This is because the decision to re-characterize a Roth is an “election” that the taxpayer is making. Elections can be made within six months of the date a final tax return originally is due.

If your clients are going to re-characterize, make sure that their Roth is turned back into a traditional IRA. An investor can't take Roth funds into their own hands and then make an IRA contribution.

The switch must be a trustee-to-trustee transfer, and both trustees must be notified of the re-characterization, which must be completed by Oct. 17. Those interested in the technicalities should see Internal Revenue Service Publication 590, Pages 29-31.

Those undoing a 2010 Roth conversion this year must wait 30 days before being able to reconvert to a Roth. Of course, an investor also may wait until next year to re-Roth.

Investors who converted to a Roth last year were given the choice of taking all the income (and paying all the tax) in 2010 or deferring half the income (and tax) into 2011 the other half into 2012.

If a new Roth is established this year, all the income generated by the new depreciated Roth conversion will be taxable as 2011 income. If the new Roth isn't established until next year, all the income triggered from the Roth redo will be treated as 2012 taxable income.

Investors are allowed serial conversions and re-characterizations without limit, giving them many opportunities to maximize the conversion and possible re-characterization experience. Theoretically, it is best to convert to a Roth early in the year to maximize the period of time during which assets may decline.

Again, if the plan includes the possibility of going back and forth between conventional and Roth IRAs, it makes sense to establish multiple regular IRAs that could be cherry-picked for re-characterization into Roth IRAs until October 2013. This approach works even if an investor converted only one conventional IRA to a Roth last year.

Clients who re-characterize only some of their Roth accounts must be careful to re-characterize in amounts that correspond to the value of the original Roth conversion, not the current value.
Let's assume that an investor converted $500,000 of conventional IRA assets into a newly created Roth. Today, it is worth just $300,000.

If the investor moves $150,000 to a traditional IRA, the trustee will report a re-characterization of $250,000 of previously converted Roth income, not $150,000. The change in value of the assets in the Roth since conversion is taken into account in determining the amount of the re-characterization.

Amounts are reported on Forms 1099-R and 5498. Two Form 5498s will be generated, one related to the Roth conversion and the other covering the re-characterization contribution to the traditional IRA. The 1099-R should reflect that there was a re-characterization and that the amount isn't taxable.

IRS Form 8606 will be issued only when partial re-characterizations take place.

To my mind, if a client's Roth assets have declined, it probably makes sense to re-characterize and re-Roth. The bigger decision is whether to re-Roth this year or wait until early next year.

If your client waits, he or she will defer the payment of the tax from April 15, 2012, to April 15, 2013. In addition, waiting until the beginning of 2012 to re-Roth allows more time to see how the investments perform and to determine whether to re-characterize again.

Robert N. Gordon is chief executive of Twenty-First Securities Corp. and an adjunct professor at New York University's Leonard N. Stern School of Business. He can be reached at bob@twenty-first.com.