Last Chance to Undo a Roth Conversion

(Contributed by Justin Fundalinski)

As a client of ours, a radio show listener, or someone who just happens to get our newsletter, it is very likely that you have heard many appealing reasons to convert your Traditional IRA to a Roth IRA. Considering that the October 15th IRS deadline to "undo" Roth conversions is upon us (technically the IRS calls it "Recharacterization" of Roth Conversions") this month's newsletter will review some reasons why you may want to reverse some of your Roth Conversion as well as discuss a few mistakes that are often made.

Reasons to Recharacterize

You don't want to pay the taxes:

Often, when one initially converts from a Traditional IRA to a Roth IRA, the exact amount that should be converted is unknown because tax implications are not yet clear. So you may end up converting too much, causing a tax impact that is more than you can handle. Tax impacts could include not only more taxes paid, but could also cause your adjustable gross income to crest above thresholds for certain tax credits and/or financial aid. Other times one may just decide they don't want to pay the taxes that are caused by the conversion. In either case you can undo a Roth Conversion and save on taxes for the current year.

Your account value dropped:

Another common reason to recharacterize is because your account value has dropped significantly since the conversion. A quick downturn in the markets can cause an account value to drop markedly. Such an event will cause you to pay taxes on a converted value that is significantly higher than the current actual value of the assets. For example, if you converted $15,000, but after a market drop your account value is now $10,000 you will have paid taxes on $15,000 for something that is now only worth $10,000.

Recharacterization Mistakes

The amount your recharacterize is not the amount you transfer back:

When you decide to recharacterize a certain dollar amount for tax purposes, the actual amount that you transfer back to a Traditional IRA will be different. Why? Well, there will most likely be gains or losses on the holdings that you originally converted to a Roth IRA and the IRS treats a recharacterization as if the conversion never took place. So, any gains or losses must be reflected in the amount that is transferred back to an IRA. Continuing the example above, if you converted $15,000 that is now worth $10,000 you would recharacterize $15,000 but only transfer $10,000 back to a Traditional IRA. Seems simple enough, but when you have multiple assets that have gains and losses this simple math can get rather complicated.

You cannot flip flop:

If you're feeling savvy, after reading the last paragraph you may be thinking that it would be beneficial to recharacterize so you don't pay taxes on the $15,000 and then immediately turn around and convert the $10,000 back to a Roth IRA. Well unfortunately you cannot do this without waiting a specific period of time.

The IRS says that you cannot reconvert the amount that you recharacterized until the later of 30 days after the recharacterization, or the year following the year of the original conversion. For the most part, people tend to recharacterize in the year after the original conversion so generally the *30 day rule* will be what applies. However, if you happen to be recharacterizing in the same year that you converted then the *year following rule* will apply. On a sidebar, this rule applies only to the amounts that you recharacterize; you are free to convert other amounts without meeting this rule.

It is not a DIY project:

The recharacterization has to be via a Trustee to Trustee transfer. You cannot do it yourself by using the 60 day rollover rule to recharacterize your IRA. Simply put, the Traditional IRA Custodian has to request the transfer of funds on your behalf.

In summary, you can see that there are sometimes reasons to convert back to a Traditional IRA and plenty of traps along the way. We recommend that you work with a professional that has experience and working knowledge of recharacterizations. More often than not, a CPA can help you figure out how much to recharacterize and a financial planner can help you with the actual action of getting it done correctly. As always, if you have any questions on this topic we are here to help. Questions and comments can be set to Justin@jimhelps.com.