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Preview

Second Thoughts

What You Could Do If You Have Roth IRA Conversion Regrets

Sometimes life has surprises in store, a fact that becomes even more apparent during periods of economic uncertainty and financial market volatility. The good news is that Roth IRA owners who experience portfolio losses or significant changes in their financial situations can typically recharacterize a previous Roth IRA conversion — but only if they follow IRS rules and act before the opportunity passes.

> Even if a reversal appears to make sense as the deadline approaches, the decision may not be as simple as it first seems.

When you convert a traditional IRA to a Roth IRA, income tax is typically owed on the value of the converted tax-deferred assets in the tax year of the conversion. The IRS generally allows you to change your mind within a specific time period after conversions are carried out. “Recharacterization” is the technical term for a procedure that reverses a Roth IRA conversion.

Roth IRA conversions may be appealing if you want to create a tax-free income stream for your retirement years. Under current tax law (and if all conditions are met), Roth IRA assets will incur no further income tax liability for the rest of your lifetime or for the lifetimes of your designated beneficiaries, regardless of how much money accumulates in the account. To qualify for the tax-free and penalty-free withdrawal of earnings, a Roth IRA must meet the five-year holding requirement and the distribution must take place after age 59½ or result from the your death, disability, or a first-time home purchase ($10,000 lifetime maximum).

THE BEAUTY OF HINDSIGHT

Unexpected changes in your financial situation — for better or worse — might prompt you to think about whether a conversion carried out in the prior year (with taxes coming due in the current year) still suits your needs.

If you received a financial windfall, underestimated any self-employment income, or simply earned more money than you thought you would in the year of the conversion, you could end up in a higher tax bracket than you anticipated.

You could find yourself in a bind if you owe more in taxes than you planned and can't afford to pay the bill. Exceeding certain income thresholds may also make you ineligible for some tax credits and deductions that might have lowered your taxes.

On the other hand, you may need money to meet short-term living expenses if you lost a job, experienced a costly medical crisis, or had other financial difficulties.

AN OPPORTUNITY TO RECOUP

If your portfolio lost value after it was converted, you may owe taxes on assets you "no longer have." Recharacterizing and then reconverting your IRA later at a lower value could possibly reduce your tax liability.

For example, if an account worth $100,000 is converted and later drops to a value of $80,000, a taxpayer in the 35% bracket would still owe $35,000 in taxes on the $100,000 value. If the Roth IRA was recharacterized and reconverted at the $80,000 value, the bill would be reduced to $28,000 — for a tax savings of $7,000 (or more if the taxpayer falls into a lower tax bracket).

Recharacterizing a portion of your portfolio could help alleviate some of the tax burden. One such strategy involves recharacterizing assets that have lost value and leaving better-performing investments to keep growing tax-free in the Roth account.

DEADLINES AND DETAILS

If you decide to recharacterize, your IRA administrator must transfer funds from the converted Roth IRA back into a traditional IRA without sending any money to you. In order to reduce taxes due this year (for a conversion carried out last year), a recharacterization must be completed and reported on federal tax forms by the October 15 extended filing deadline. If you already filed and paid last year's tax bill, filing an amended return by the deadline could produce a tax refund.

After a recharacterization, you must wait 30 days or until the following calendar year (whichever is longer) to reconvert. If you are still evaluating whether last year's conversion was a wise move in light of your tax situation, this strategy may buy more time to monitor the markets and your portfolio's performance.

Even if a reversal appears to make sense as the deadline approaches, the decision may not be as simple as it first seems. It could backfire if you plan to reconvert later, if tax rates rise after a recharacterization, or if your earnings increase and you land in a higher tax bracket. Before you take any specific action, be sure to consult with your tax professional.

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