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Recharacterizing IRA Contributions and Roth Conversions

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Introduction

Qualified distributions from Roth IRAs are free from income tax at the federal level. If you convert your traditional individual retirement account (IRA), simplified employee pension (SEP) IRA, or SIMPLE IRA to a Roth IRA, therefore, federal income tax is due for the year of the conversion. You pay tax now on the taxable portion of your traditional (or other) IRA. In return, you enjoy income-tax-free distributions from your Roth IRA in the future. Unfortunately, what may seem like a tax-wise move right now might prove to be an income tax nightmare when it's time to file your federal income tax return for the year. If so, you may be able to reverse or rescind your conversion if circumstances warrant it (and if you meet all of the necessary requirements). Such a rescission is known as a Roth IRA recharacterization.

In addition to reversing Roth IRA conversions, you may be able to "undo" or recharacterize regular (i.e., non-rollover) IRA contributions. In effect, you get to treat a contribution to one IRA as having been made directly to a different IRA.

Caution: State (and local) income tax treatment of Roth IRAs may differ from federal income tax treatment. Consult a tax professional to determine the tax treatment for your state.

Tip: Special rules apply to Roth conversions made in 2010. For these conversions, resulting taxable income will be averaged over the next two years (2011 and 2012).

What is a recharacterization?

A recharacterization is an election to change the nature of your IRA contribution. The opportunity to recharacterize a contribution from one IRA to another type of IRA is designed to help taxpayers who change their minds or are ineligible for one type of IRA and want to switch to another. Generally, you may recharacterize (correct) an IRA contribution or Roth IRA conversion by making a trustee-to-trustee transfer of the contribution (plus any related earnings) from one IRA to another type of IRA within certain deadlines.

Tip: When an individual recharacterizes an IRA contribution, the contribution is treated as though it had never been made to the original IRA; rather, the contribution is treated as having been made (as of the date of the original contribution to the original IRA) to the IRA to which the recharacterized funds are transferred. When an individual recharacterizes a Roth conversion, in effect, it is as though the conversion never occurred, and the funds are treated as having never left the traditional IRA.

Example(s): For instance, assume you converted a traditional IRA to a Roth IRA on August 1, and then recharacterized the conversion on December 1. For federal income tax purposes, you'll be treated as though you never made a contribution to the Roth IRA; it will be as though your funds were in a traditional IRA from August 1 on. Any earnings generated on the funds (or losses suffered) while they were in the Roth IRA will be treated as if they had occurred within the traditional IRA.

How do recharacterized earnings and losses affect normal IRA contribution limits?

The amount recharacterized from one IRA to another must include related earnings or be reduced by any loss. However, earnings that are transferred with a recharacterized contribution don't affect the otherwise maximum IRA contribution limit.

Example(s): Assume John contributes \$1,000 to his traditional IRA for 2008. Before the deadline

for filing his 2008 federal income tax return, John decides to recharacterize his contribution (plus the \$50 in earnings allocable to it) to a Roth IRA. Through a trustee-to-trustee transfer, \$1,050 is switched to his Roth IRA. If John is otherwise eligible, he can contribute an additional \$4,000 (\$5,000 if he is age 50 or older by the end of the tax year) to his Roth IRA for 2008. The \$50 of earnings is treated as having been earned in the Roth IRA.

Similarly, losses attributable to a recharacterized contribution don't increase the contribution limit to the second IRA.

Why might you want to "undo" or rescind a conversion to a Roth IRA?

Your conversion from a traditional IRA to a Roth IRA probably made sense at the time. However, if your income for the year of the conversion exceeds the Roth eligibility limit, you may find that you don't qualify for a conversion after all--in which case you really don't have many options other than recharacterizing. Even if you do qualify for a conversion, if your IRA investments experience a significant decline after the conversion date, you may be able to minimize your tax hit by reversing (recharacterizing) your conversion.

If your income exceeds \$100,000, you may end up with a failed Roth IRA conversion

You might want to undo a Roth IRA conversion if your income for the year of the conversion exceeds the \$100,000 Roth IRA income eligibility limit. If you have funds in a traditional IRA, you can convert all or part of those funds to a Roth IRA only if (among other qualifications) your modified adjusted gross income for the year is less than or equal to \$100,000. If you receive a year-end bonus or an unexpected cash windfall that pushes you over the \$100,000 limit, you'll end up with a failed conversion.

Unless you recharacterize your Roth conversion, the contribution will be treated as a distribution from the traditional IRA and a contribution to the Roth IRA. That means you'll pay income tax on the taxable part of the distribution. A 10 percent premature withdrawal penalty will also apply if you are under age 59½ and do not meet an exception. In addition, a 6 percent (per year) excise tax may apply to any portion of the Roth IRA that represents an excess contribution.

To recharacterize the contribution, you generally must move the amount converted, including earnings, to a traditional IRA by the due date (including extensions) for your tax return for the year during which you made the conversion to the Roth IRA. (For additional details, see [How do you recharacterize an IRA contribution or Roth conversion](#), below.)

Tip: The Tax Increase Prevention and Reconciliation Act of 2009 eliminates the \$100,000 ceiling for converting a traditional IRA to a Roth IRA for tax years after 2009.

If your investments suffer a downturn, you may end up with a disproportionate tax hit

When you convert a traditional IRA to a Roth IRA, you must pay federal income tax on the taxable portion of your traditional IRA for the year of the conversion. The amount of income tax you pay is based on the value of your IRA on the date you converted it. Therefore, you may want to recharacterize your contribution to a Roth IRA if your Roth IRA decreases in value (e.g., through a stock market downturn) after the conversion date.

Example(s): Assume you converted your \$100,000 traditional IRA to a Roth IRA in May. By December, your Roth IRA is worth only \$60,000--it has lost 40 percent of its value. Nevertheless, you'll pay income taxes based on the conversion date value of \$100,000. To get around this, you may be able to undo or recharacterize your Roth conversion. After the appropriate waiting period, you may be able to do a new conversion based on the new account value.

For more information about conversions, see [Converting or Rolling Over Traditional IRAs to Roth IRAs](#).

How do you recharacterize an IRA contribution or Roth conversion?

To recharacterize an IRA contribution or Roth conversion, you should take the following steps:

Establish another IRA (if necessary)

Generally, you'll either need to establish an IRA or use an existing IRA to accept the withdrawn IRA funds. Recharacterizations made with the same IRA trustee can be made by redesignating the first IRA as the second IRA, rather than transferring the account balance to a new account.

Tip: You can't recharacterize employer contributions (including your elective deferrals) under a SEP-IRA or SIMPLE IRA plan as contributions to another IRA. However, if you converted SEP-IRA or SIMPLE IRA contributions to a Roth IRA, you can recharacterize those contributions back to a SEP-IRA or SIMPLE IRA.

Inform both financial institutions that you want to recharacterize

If more than one financial institution is involved, you must notify both financial institutions--the one servicing your present IRA and the one that will accept the recharacterized funds--that you intend to effect a recharacterization. (Only one notification is required if both IRAs are maintained by the same trustee.) Transferring your funds without such a notice may invalidate the recharacterization. You must provide the notice on or before the date of the transfer.

Caution: A valid recharacterization of IRA funds generally must be accomplished through a trustee-to-trustee transfer. You can't withdraw money from your IRA and roll it over to a new IRA within 60 days--the funds must be transferred directly from one IRA to the other.

If your IRA provider doesn't have a standard form for recharacterizations, you should consult a tax professional to create one. Your form should include all required information, including the following:

- An appropriate heading, such as "Notice of Election to Recharacterize IRA Contribution/Conversion."
- Your name, address, telephone number, IRA account number, and Social Security number.
- The name of the first IRA trustee and the name of the second (new) IRA custodian/trustee.
- The type and amount of the contribution to the first IRA that you now want to recharacterize. Inform the first IRA trustee that you want your contribution plus any net income (or net loss) allocable to that contribution to be recharacterized. (See below for more information on calculating net income/loss.)
- The date on which the contribution was made to the first IRA, and the year for which it was made (if applicable)
- A direction to the first IRA custodian/trustee that you want to make a direct, trustee-to-trustee transfer of funds from your present IRA to a new IRA by a specified date. (Include the account number of the new IRA, as well as the name, address, and telephone number of the new IRA custodian/trustee.)

Send a copy of your recharacterization notice to both IRA custodians/trustees. In addition, you should follow up with both of them to ensure that the transfer is accomplished on time.

Meet all applicable deadlines

The deadline for recharacterizing an IRA contribution or Roth IRA conversion is the due date of your federal income tax return, including extensions, for the year of the original contribution. (The year of the original contribution means the year to which the contribution relates--not the year the contribution was actually made.) So, if you file for an automatic extension to August 15 and are then granted a second extension to October 15, you have until October 15 to recharacterize a contribution for the preceding year.

But what if you filed your income tax return on or before April 15 and now want to recharacterize a Roth IRA contribution? In such a case, you would have already paid the conversion tax. If you follow a special procedure, you'll be allowed to recharacterize the Roth IRA contribution up until October 15 even if you already filed your

income tax return on time and didn't obtain a filing extension. To take advantage of this rule, you'll have to file an amended return (IRS Form 1040-X) and write "Filed pursuant to Section 301.9100-2" on the return. You'll be able to obtain a refund for any tax paid on the conversion. You'll also need to include a new or amended Form 8606.

Caution: You can use this special procedure only if you filed your income tax return on time (i.e., either by April 15, or within the extension period if you filed for an extension in a timely manner).

Don't confuse the amended return date with the recharacterization due date. An amended return can be filed as late as three years after the original return was filed. However, the deadline for recharacterization of your Roth IRA funds (i.e., for transferring the funds) is the October 15 following your April 15 tax-return-filing deadline for the prior tax year.

Report the recharacterization

If you elect to recharacterize a contribution (either on your federal income tax return or on an amended return), you may have to attach Form 8606 and a statement explaining the recharacterization. You must report the recharacterization on the tax return for the tax year in which you made the original contribution or Roth conversion. See the instructions to Form 8606 for more information.

How do you allocate the earnings when you recharacterize a contribution?

When you recharacterize an IRA contribution, you must transfer the contribution plus any earnings allocable to that contribution to a new IRA.

Full recharacterization

If your IRA is comprised only of the contribution and earnings that you want to recharacterize, you can simply recharacterize (transfer) the entire IRA. If your IRA has suffered a loss since the time of the original conversion, you don't have to make up the loss when you recharacterize the IRA.

Partial recharacterization

If you're recharacterizing only part of an IRA, you need to determine how much of the IRA's earnings are attributable to the part you're transferring and how much belong to the portion of the IRA that remains. Here's the formula (note that net income can be negative):

Net income = Contribution x [(Adjusted closing balance - Adjusted opening balance) / Adjusted opening balance]

The opening balance for this computation is the IRA's fair market value (FMV) immediately before the contribution was made to the account, and the closing balance is the FMV of the account right before the contribution is removed. The "adjusted opening balance" is the opening balance plus any contributions or transfers (including the amount being recharacterized) made to the account during the computation period. The "adjusted closing balance" is the closing balance plus any distributions (including recharacterizations) made from the account during the computation period.

Example(s): Assume John has a Roth IRA that is worth \$50,000 on February 1, 2008. On that same date, John decides to convert \$100,000 from a traditional IRA to his existing Roth IRA. Before he files his federal income tax return for 2008, John learns that his income level will render him ineligible to make a Roth conversion contribution. So, on February 1, 2009, he requests that the \$100,000 be recharacterized to his traditional IRA. On that date, when his Roth IRA is worth \$135,000, the Roth IRA trustee transfers to John's traditional IRA the \$100,000 contribution plus allocable net income.

Example(s): Here's how the allocable net income is calculated. The adjusted opening balance of the account is \$150,000 (\$50,000 + \$100,000), and the adjusted closing balance is \$135,000. Therefore, the net income (actually, the net loss) allocable to the \$100,000 contribution is -\$10,000 [$\$100,000 \times (\$135,000 - \$150,000) / \$150,000$]. To recharacterize John's \$100,000 conversion

contribution, the Roth IRA trustee must transfer \$90,000 (\$100,000 - \$10,000) from his Roth IRA to his traditional IRA.

Tip: If more than one contribution is being recharacterized, different rules may apply. If multiple contributions for a particular year are eligible for recharacterization, the IRA owner chooses which contribution to recharacterize. And if a series of regular contributions had been made, and consecutive contributions in that series were being recharacterized, the computation period would be determined using a single computation period (based on the first contribution in the series). For more information, consult a tax professional.

Technical Note: Your IRA provider may calculate for you the amount of net income to be transferred. If your provider is unable to do so, direct him or her to IRS Notice 2000-39 and IRS Reg. Section 1.408A-5.

How long must you wait before you can convert or roll over your funds back to a Roth IRA?

If you convert funds to a Roth IRA and then switch the funds back to a traditional IRA through a recharacterization, you'll have to wait awhile before you can reconvert those funds to a Roth IRA. You can't convert and reconvert an amount during the same taxable year, or if later, during the 30-day period following a recharacterization. If you reconvert during either of these periods, the conversion will be a failed one.

For example, assume you convert a traditional IRA to a Roth IRA in May of 2008. On August 6, 2008, you recharacterize that Roth IRA to a traditional IRA. You now want to reconvert to a Roth IRA. You won't be able to effect a reconversion until the later of:

- January 1, 2009 (the beginning of the year following the year in which the amount was originally converted to the Roth IRA), or
- September 6, 2008 (the end of the 30-day period following the day on which you recharacterized the Roth IRA to a traditional IRA)

Because the later of the two dates is what matters, you'll have to wait until at least January 1, 2009, to reconvert.

For more information about Roth IRA conversions and recharacterizations, see IRS Publication 590.

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