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AN ALERT FROM THE BDO COMPENSATION & BENEFITS TAX PRACTICE

BDO KNOWS: COMPENSATION & BENEFITS

SUBJECT

IRA OWNERS AND ADVISORS SHOULD TAKE FINAL LOOK AT ROTH CONVERSIONS BY MID-OCTOBER 2011

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SUMMARY

Many taxpayers who were willing to pay income taxes on their retirement funds at 2010 rates (or under the special installment rules allowed) in exchange for tax-free future earnings, converted their traditional individual retirement account ("IRA") to a Roth IRA. Each of these 2010 conversions should be closely scrutinized to ensure that the taxable amount on the conversion does not exceed the current fair market value of the account.

A market decline gives taxpayers a chance to convert a traditional IRA or investments in a qualified plan to a Roth IRA at a much lower tax cost than would have been possible when stock market values were higher. Taxpayers who have already converted also have the chance to take advantage of the lower tax cost provided they take action on or before October 17, 2011.

RECHARACTERIZING A ROTH CONVERSION BACK TO A REGULAR IRA

If the investments have declined in value since the conversion, the tax bill will be artificially high unless the market recovers quickly. In order to avoid paying income taxes on value that no longer exists, the taxpayer can recharacterize a Roth conversion that took place in 2010 and treat it as if it had never occurred. This process involves transferring the converted amount (plus earnings or minus losses) from the Roth IRA to a traditional IRA via a direct, trustee-to-trustee transfer.

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For example, a taxpayer converts a traditional IRA invested in a stock fund to a Roth IRA invested in the same stock fund in March 2010. At the time of the conversion, the regular IRA had a $50,000 balance, all of which is attributable to deductible contributions and their earnings. The taxpayer's Roth IRA is currently worth only $40,000. To avoid paying tax on the March 2010 conversion value that includes $10,000 of lost value, the Roth IRA can be recharacterized on or before October 17, 2011, as a traditional IRA. (This date is effectively the extended due date for 2010 individual tax returns, as October 15, 2011, is a Saturday.)

The easiest way to make a recharacterization is to do so before filing the income tax return affected by the Roth conversion. Thus, if an individual taxpayer has extended and not yet filed the 2010 return, the return should simply report both the Roth conversion and recharacterization in order to produce a net effect on taxable income of zero. Taxpayers who have already filed their 2010 income tax return and paid taxes on the Roth conversion are not precluded from recharacterizing the conversion by October 17, 2011.[1] If a 2010 conversion is recharacterized after the taxpayer timely filed the 2010 return, an amended return should be filed to reflect the recharacterization[2] and to receive a refund of taxes paid.

RECONVERTING TO A ROTH IRA

If the Roth IRA continues to be the desired retirement vehicle, the recharacterized funds can be returned to a Roth IRA after a specified waiting period.[3] The reconversion cannot be made before the later of:

1. The beginning of the taxable year following the taxable year in which the amount was converted to a Roth IRA; or
2. The end of the 30-day period beginning on the day on which the IRA owner transfers the amount from the Roth IRA back to a traditional IRA by recharacterization.

This limitation applies whether the recharacterization occurs during the taxable year in which the amount was converted to a Roth IRA or the following taxable year.[4] Assuming, for example, that a Roth IRA was recharacterized as a regular IRA on October 17, 2011, the earliest date the funds could be reconverted to a Roth IRA would be November 17, 2011.

[1] Ann. 99-104, 1999-2 C.B. 555; Instructions to Form 8606, Nondeductible IRAs, p.3.
[2] In this case, the notation "Filed pursuant to section 301.9100-2" should be made on the return as indicated in the Instructions to Form 8606, p. 3.
[3] Treas. Reg. § 1.408A-5, Q&A 9(a).
[4] Treas. Reg. § 1.408A-5, Q&A 9(a)(1).