Strategic Planning for Roth IRA Conversions, Recharacterizations and Reconversions

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Plan for Recharacterization

- If the assets decline in value, the taxpayer may want to recharacterize so that income taxes are not paid on the inflated value. Strategies to consider are:
  - Multiple Roth IRAs for each asset or asset class – recharacterize those that decline in value
  - Tax effect of separate accounts
- Must be done by October 15th of the year following the year of conversion (assuming extension of income tax return for year of conversion)
- Risk of decline in value after time for recharacterization
- Recharacterization is never treated as a rollover for purposes of the one a year rollover rule

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Recharacterization (cont.)

Example #1 – Net Income (loss) is Considered – Roth IRA Declines in Value

- On 1/4/2010 Jane's traditional IRA is valued at $1,000,000
- Jane converts the entire account to a Roth IRA
- On October 10th, 2011 the account value is $800,000
- Jane recharacterizes $250,000 – the allocated income (loss) is determined as follows:

- $250,000 * $\frac{800{,}000 - 1{,}000{,}000}{\$1{,}000{,}000}$
- $250,000 * (-200,000 ÷ 1,000,000)
- $250,000 * -0.2
- -$50,000

Formula to determine income (loss):

$$R * \frac{ACB - AOB}{AOB}$$

R = Recharacterization Amount

AOB = Adjusted Opening Balance – i.e., the value of Roth IRA at the time of conversion

ACB = Adjusted Closing Balance – i.e., the value of the Roth IRA at the time of recharacterization

For the precise formula see Treas. Reg. §1.408A-5, A-2(c)(1), and examples under section (6).

Amount Originally Converted	Amount Recharacterized	Amount Pulled Out (i.e., after accounting for income (loss))	Income from Conversion
$1,000,000	$250,000	$200,000	$750,000

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Recharacterization (cont.)

Example #2 – Net Income (loss) is Considered – Participant instructs financial institution to distribute $250,000 – What's the amount recharacterized?

- On 1/4/2010 Jane's traditional IRA is valued at $1,000,000
- Jane converts the entire account to a Roth IRA
- On October 10th, 2011 the account value is $800,000

- $\$250{,}000 = R + \left[\left(\frac{800{,}000 - 1{,}000{,}000}{\$1{,}000{,}000}\right) * R\right]$
- $250,000 = R + ((-200,000 ÷ 1,000,000) * R)
- $250,000 = R + (-0.2*R)
- $250,000 = $312,500 + -62,500

Amount Originally Converted	Amount Recharacterized	Amount Pulled Out (i.e., after accounting for income (loss))	Income from Conversion
$1,000,000	**$312,500**	**$250,000**	**$687,500**

Formula to solve for recharacterization amount:

$$P = R + \left[\left(\frac{ACB - AOB}{AOB}\right) * R\right]$$

P = Pull Out Amount

R = Recharacterization Amount

AOB = Adjusted Opening Balance – i.e., the value of Roth IRA at the time of conversion

ACB = Adjusted Closing Balance – i.e., the value of Roth IRA at the time of recharacterization

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Recharacterization (cont.)

Example #3 – Net Income (loss) is Considered – Roth IRA Appreciates in Value

- On 1/4/2010 Jane's traditional IRA is valued at $1,000,000
- Jane converts the entire account to a Roth IRA
- On October 10th, 2011 the account value is $1,200,000
- Jane recharacterizes $250,000 – the allocated income (loss) is determined as follows:

- $\$250{,}000 * \frac{1{,}200{,}000 - 1{,}000{,}000}{\$1{,}000{,}000}$
- $250,000 * (200,000 ÷ 1,000,000)
- $250,000 * .2
- $50,000

Amount Originally Converted	Amount Recharacterized	Amount Pulled Out (i.e., after accounting for income (loss))	Income from Conversion
$1,000,000	**$250,000**	**$300,000**	**$750,000**

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Recharacterization (cont.)

Example #4 – Net Income (loss) is Considered – Participant instructs financial institution to distribute $250,000 – What's the amount recharacterized?

- On 1/4/2010 Jane's traditional IRA is valued at $1,000,000
- Jane converts the entire account to a Roth IRA
- On October 15th, 2011 the account value is $1,200,000

- $\$250,000 = R + \left[\left(\frac{1,200,000 - 1,000,000}{\$1,000,000}\right) * R\right]$
- $250,000 = R + ((200,000÷1,000,000) * R)
- $250,000 = R + (.2*R)
- $250,000 = $208,333 + 41,667

Amount Originally Converted	Amount Recharacterized	Amount Pulled Out (i.e., after accounting for income (loss))	Income from Conversion
$1,000,000	**$208,333**	**$250,000**	**$791,667**

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Recharacterization (cont.)

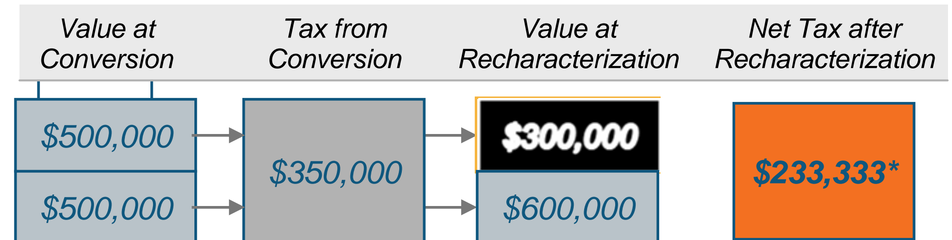
Example #5 – The Value of Separate Accounts[1]

- On 1/5/2010 Kim has $1,000,000 in IRA assets:
  - $500,000 in equities
  - $500,000 in bonds

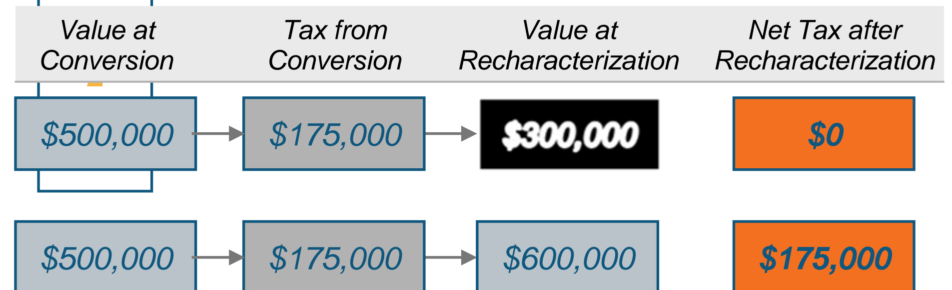
- On April 14, 2010, the assets are worth $900,000:
  - $300,000 in equities
  - $600,000 in bonds

- By segregating the assets into two IRAs before conversion, Kim can comply with IRS rules governing conversion
- By recharacterizing, Kim's effective tax rate (based on recharacterization values for the 1 IRA account is 38.889% (i.e., $233,333 / $600,000 **). Whereas, the effective tax rate for the 2 IRA approach is 29.00% (i.e., $175,000 / $600,000)

Without IRA Segregation (One Account)



With IRA Segregation (Two Accounts)



Converted to Roth IRA

Recharacterized Assets

* - The conversion amount will be $1,000,000 less $333,334 = $666,666 * 35% = $233,000

** - Pursuant to Treas. Reg. § 1.408-5A Q&A 2, the amount that has to be distributed from the Roth IRA on re-characterization is $300,000. Thus, the value of assets is $600,000 (i.e., $900,000 - $300,000)

Assumptions: Income from conversion places Kim in the 35% tax bracket
Assets that are recharacterized all fall within the 35% tax bracket This is a hypothetical example meant for illustrative purposes only.

[1] Example developed by Lester B. Law, US Trust. Used with Permission.

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Recharacterization (cont.)

Example #5 (cont.) – The Value of Separate Accounts[1]

- On 1/6/2011, Kim converts the re-characterized amount:
  - 1 IRA - $300,000
  - 2 IRAs - $300,000

By using two IRA accounts, versus 1 IRA account, in this case, Kim saves $58,333 in taxes.

Kim's effective tax rate for 1 Roth IRA account is 37.60% (i.e., $338,333 / $900,000), where as the effective tax rate for 2 Roth IRA accounts is 31.00% (i.e., $280,000 / $900,000)

Reconversion after Recharacterization

	Value at Conversion		*Tax from Conversion*
1 IRA	*$300,000*	→	***$105,000***
2 IRAs	*$300,000*	→	***$105,000***

Total Income Tax Comparison

	One Roth IRA Account Income Tax		*Two Roth IRA Accounts Income Tax*
2010 Tax	***$233,000***	→	***$175,000***
2011 Tax	***$105,000***	→	***$105,000***
Total Tax	***$338,333***		***$280,000***

Converted to Roth IRA

Assumptions: Income from conversion places Kim in the 35% tax bracket
Assets that are re-characterized all fall within the 35% tax bracket
This is a hypothetical example meant for illustrative purposes only.

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Recharacterization – The benefits of Separate Accounts

- Let's assume that John has a Traditional IRA valued at $1 million which he converts to a Roth IRA in January 2010. Let's further assume that the assets of the IRA are invested as follows, and :

Asset Class	Value
Large Cap	$250,000
Mid Cap	250,000
Small Cap	250,000
International	250,000
Total	$1,000,000

- Let's further assume that in April, 2011 (i.e., the next year, the value of the Roth IRA increased to $1.1 million, however, the values of the different asset classes have changed, as follows:

Asset Class	Value
Large Cap	$400,000
Mid Cap	450,000
Small Cap	100,000
International	150,000
Total	$1,100,000

- If John only had one IRA, then at the time for making the decision to re-characterize, he would likely not re-characterize (i.e., because the value has increased).
- However, if before conversion, John segregated the Traditional IRA into four (4) separate Traditional IRAs (i.e., one IRA for each asset class), then he converts the four (4) accounts; he could then 'recharacterize' the Small Cap and International IRAs (i.e., the ones that lost value), and simply keep the Large Cap and Mid Cap.
- Recall, that the conversion tax is based on the value at the time of conversion. Thus, the tax on the Large Cap and Mid Cap IRAs will be based on the $250,000 values. Assuming a tax rate of 35%, the tax would be $175,000 (i.e., $500,000 x 35%), even though a year later, the value of the assets is worth $850,000.
- Later (generally 30 days), John could reconvert the Small Cap and International funds (at their lower value).
- Overall Planning Strategy – Look at composition of assets in IRA before conversion, and separate into separate accounts to take advantage of market fluctuations, if any.

This is a hypothetical example meant for illustrative purposes only.

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Planning for Reconversion after Recharacterization

- After a recharacterization, the amount transferred back to the traditional IRA may again be converted into a Roth IRA, but
- Cannot reconvert “that amount” until:
  - (i) the beginning of the taxable year following the taxable year in which the amount was converted into a Roth IRA (referred to in the charts below as the “Date #1”), or, if later,
  - (ii) 30 days after the recharacterization (referred to in the charts below as the “Date #2”). Treas. Reg. §1.408A-5, A-9(a)(1).

Example: Mary converts her traditional IRA to a Roth IRA on January 4, 2010. If Mary recharacterizes the Roth IRA on the following dates, she may reconvert “that amount” on the following dates:

Conversion Date	Recharacterization Date	Date #1	Date #2	Reconversion Possible on or after
January 4th, 2010	May 31, 2010	January 1, 2011	June 30, 2010	January 1, 2011
January 4th, 2010	December 31, 2010	January 1, 2011	January 30, 2011	January 30, 2011
January 4th, 2010	August 31, 2011	N/A	September 30, 2011	September 30, 2011

Reconversion Date	Recharacterization Date	Date #1	Date #2	Re-reconversion Possible on or after
October 1, 2011	October 31, 2011	January 1, 2012	November 30, 2011	January 1, 2012

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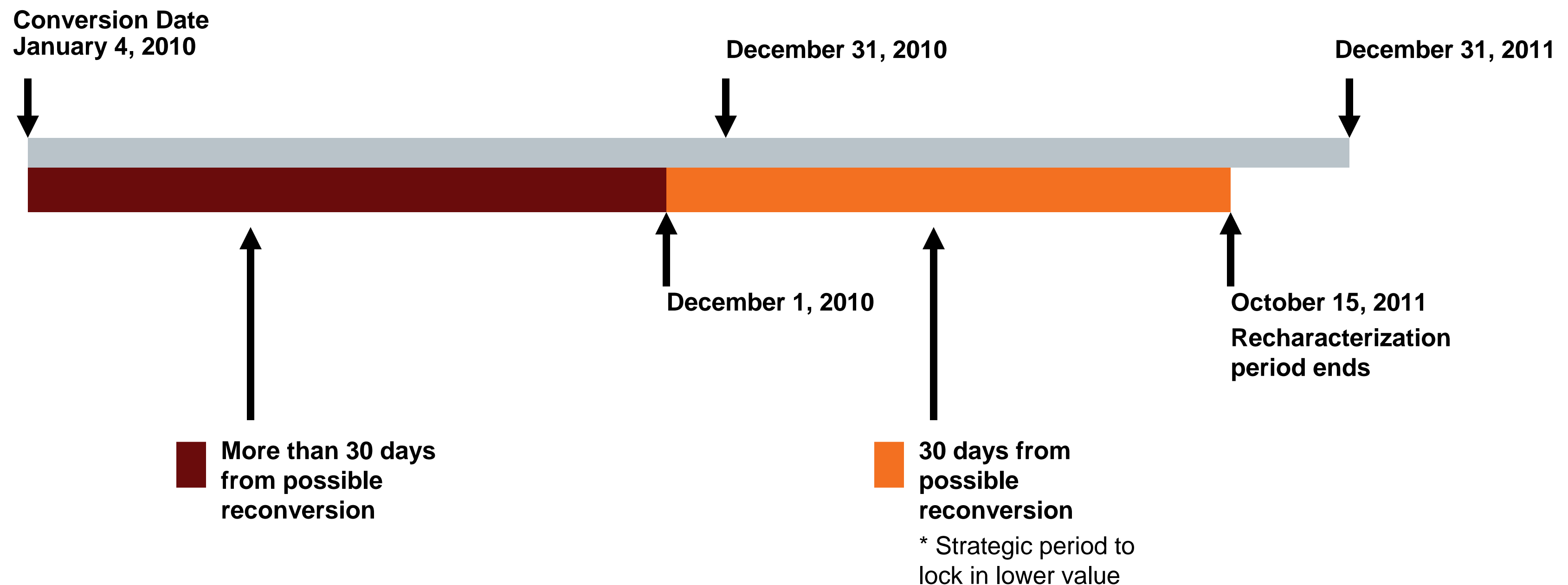
Planning for Reconversion after Recharacterization (cont.)

- Look for the drops in value when recharacterization is possible, particularly when reconversion is possible 30 days thereafter (i.e., lock in lower values for income tax purposes). Of course, consider other factors such as possible higher rates in the reconversion tax year and the impact of deductions and credits.



- **With respect to an account, an amount previously converted must be adjusted for subsequent net income in determining the portion of the account that may be reconverted.** Treas. Reg. §1.408A-5, A-9(c).
- **Consolidate separate accounts after period runs for recharacterization**

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Consider Election to Pay Conversion Taxes in 2010, rather than spread over 2011 and 2012

- For conversions in 2010, Congress provided a special rule for reporting income
- The default rule is that the income is reported one-half in 2011 and 2012
- Have until October 15th of the year following year of conversion to decide
- Interest and penalties will apply if tax is not paid by 4/15/11 if the taxpayer elects to take the income in 2010. If the taxpayer pays the tax by 4/15/11 and then makes a later decision to spread the income, a refund will be applicable
- Can the taxpayer pay part in 2010 and spread part? No. Is it all or nothing or by account? All or nothing. On what form is the election made?
- Estimate tax payments – the taxpayer must pay at least 110% of prior year
- Interaction with recharacterization

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Consider Election to Pay Conversion Taxes in 2010, rather than spread over 2011 and 2012 (cont.)

Example:

- Sue has a Traditional IRA valued at $1 million on January 4, 2010, being the day she converts her Traditional to a Roth IRA.

  Income tax rates for 2010, 2011 and 2012 are as follows:

Year	Tax Rate
2010	35%
2011	39.6%
2012	39.6%

Results:

- If Sue defers, she pays total tax of $396,000 (i.e., $1 million multiplied by 39.6%), over a period of 2 years (i.e., April 15, 2012 and April 15, 2013).
- If Sue opts out of deferral, she pays a total tax of $350,000 in one year (by April 15, 2011).

  Note: An after-tax return of about 8.65% is necessary to consider paying at the 39.6% rate (instead of the 35% rate). So, does conventional wisdom make sense?

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Manage the Timeline

January 4, 2010	-the first business day that conversions can take place -have separate Roth accounts created in anticipation of funding
December 31, 2010	-the last day that conversions can be enacted to take advantage of favorable tax rules
April 15, 2011	-100% of conversion tax if non-deferral is elected -**extend the time for filing the 2010 income tax return**
October 15, 2011	-last day to recharacterize 2010 conversions (includes extensions) -last day for decision to pay taxes in 2010 or allow default spread of income over 2011 and 2012
April 15, 2012	-50% of the resulting tax liability will be due
April 15, 2013	-remaining 50% of conversion tax liability due

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Manage Estate Planning Implications

- **Beneficiary designations –** Roth IRA Almost Begs For Surviving Spouse to Be Sole Beneficiary So That RMDs Are Able To Be Postponed Until SS's passing (In SS's Discretion) - In Order To Do So Spouse Must Treat Roth IRA as His/Her Own and Designate Children and Possibly Grandchildren (Up to GST Exemption Amount) – Measuring Life Can Be 60 – 70 Years
- **Consider using trust as beneficiary**

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Manage Estate Planning Implications (cont.)

- **DPOAs** – consider adding specific power to address conversions and recharacterizations:

  > "My agent shall have the power to convert any retirement plan assets into one or more Roth IRAs and pay any resultant taxes from non-retirement account assets, to re-characterize such Roth IRAs as traditional IRAs and thereafter to reconvert such accounts into one or more Roth IRAs, and in each case to designate the beneficiaries thereof and to make tax elections associated with such conversions and re-characterizations as my Agent deems appropriate."

- **Will/Revocable Trusts** – add provisions to authorize possible recharacterizations and tax elections after the participant's death. Sample provision for a revocable trust:

  > "If I have (or my attorney-in-fact has) converted any qualifying retirement plan assets into one or more Roth IRAs and if such a Roth IRA is payable to my spouse or any descendant of mine, the Trustee may with the consent of the beneficiary of such Roth IRA recharacterize the Roth IRA as a traditional IRA, provided that the same beneficiary is designated as the beneficiary of such traditional IRA, and may make tax elections associated with such recharacterization as my Trustee deems appropriate."

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Manage Estate Planning Implications (cont.)

- **Tax Apportionment** – Income from conversion is reported on the decedent's final income tax return. These taxes will be a debt of the estate. It is best to have identity of beneficiaries under the Roth IRA and those bearing the burden of such taxes.

- **Creditor Protection** – consider any differences in creditor protection among retirement accounts before converting to a Roth IRA.

- Also, in some states, inherited IRAs are not proteced from creditor claims, even though participate owned IRSs are protected. See generally, Robertson v. Deeb, 16 So.3d 936 (2nd DCA 2009)(F.S. § 222.21 exempting IRAs from claims does not apply to inherited IRAs). "We conclude that section 222.21(2)(a) does not apply to inherited IRAs because the plain language of that section references only the original "fund or account" and the tax consequences of inherited IRAs render them completely separate funds or accounts".

- Consider using a spendthrift conduit trust.

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Strategic Conversions

- Deathbed conversions to save paying estate taxes on the income tax
- Family Foundation – IRA plans for the super wealthy
  - Retirement accounts given to family members are usually subject to both estate taxes at rates of about 50% and income taxes at rates of about 40%. Retirement accounts given to charity, however, avoid both estate and income taxes – they are cheap dollars to give charity. For this reason, estate planners representing very wealthy families have frequently suggested that the retirement accounts be given to the family foundation. With the advent of the Roth conversion (not subject to the MAGI limit), this strategy should be reconsidered. The family's financial position may be improved by converting the account to a Roth IRA, leaving the Roth IRA to the family, and leaving other assets to the family foundation.

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Family Foundation – IRA plans for the super wealthy (cont.)

Example:

Plan #1

	Without Roth/Devise to Foundation		
	Non-Retirement Assets	Retirement Account	Totals
Estate Value	95,000,000	5,000,000	100,000,000
Roth Conversion Tax (@ 35%)	-		-
Remaining Estate	95,000,000	5,000,000	100,000,000
Devise to Foundation	-	5,000,000	5,000,000
Remaining Taxable Estate	95,000,000	-	95,000,000
Estate Taxes (@ 45%)	(42,750,000)		(42,750,000)
Funds for Investment	52,250,000	-	52,250,000

After Estate Tax -- Growth of Estate Assets for 25 Years:			
Year	Assuming 5.92% After Tax Rate of Return (8% @ 28% tax rate)	Assuming 8% Rate of Return (free of taxes)	Totals
1	55,343,200	-	55,343,200
2	58,619,517	-	58,619,517
3	62,089,793	-	62,089,793
4	65,765,509	-	65,765,509
5	69,658,827	-	69,658,827
6	73,782,629	-	73,782,629
7	78,150,561	-	78,150,561
8	82,777,074	-	82,777,074
9	87,677,477	-	87,677,477
10	92,867,984	-	92,867,984
11	98,365,768	-	98,365,768
12	104,189,022	-	104,189,022
13	110,357,012	-	110,357,012
14	116,890,147	-	116,890,147
15	123,810,044	-	123,810,044
16	131,139,598	-	131,139,598
17	138,903,062	-	138,903,062
18	147,126,124	-	147,126,124
19	155,835,990	-	155,835,990
20	165,061,481	-	165,061,481
21	174,833,120	-	174,833,120
22	185,183,241	-	185,183,241
23	196,146,089	-	196,146,089
24	207,757,937	-	207,757,937
25	220,057,207	-	220,057,207

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Family Foundation – IRA plans for the super wealthy (cont.)

Example:

Plan #2

	With Roth/Devise Other Assets to Foundation		
	Non-Retirement Assets	Retirement Account	Totals
Estate Value	95,000,000	5,000,000	100,000,000
Roth Conversion Tax (@ 35%)	(1,750,000)		(1,750,000)
Remaining Estate	93,250,000	5,000,000	98,250,000
Devise to Foundation	5,000,000	-	5,000,000
Remaining Taxable Estate	88,250,000	5,000,000	93,250,000
Estate Taxes (@ 45%)	(41,962,500)		(41,962,500)
Funds for Investment	46,287,500	5,000,000	51,287,500

After Estate Tax -- Growth of Estate Assets for 25 Years:

Distributions are required from the Roth IRA after the owner's death (except in the case of a spousal rollover).

		Roth IRA						
Year	Assuming 5.92% After Tax Rate of Return (8% @ 28% tax rate)	Assuming 8% Rate of Return (free of taxes)	Beneficiary's Age	Distribuiton Divisor	Required Distribution	Distribution Accumulations Assuming 5.92% After Tax Rate of Return (8% @ 28% tax rate)	Totals	Plan # 2 - Better (Worse)
1	49,027,720	5,400,000	50	34.2	157,894.74	157,894.74	54,427,720	(915,480)
2	51,930,161	5,661,474	51	33.2	170,526.32	337,768.42	57,758,877	(860,641)
3	55,004,427	5,930,223	52	32.2	184,168.42	541,932.73	61,292,414	(797,379)
4	58,260,689	6,205,739	53	31.2	198,901.89	772,917.05	65,040,443	(725,066)
5	61,709,721	6,487,384	54	30.2	214,814.05	1,033,487.78	69,015,779	(643,047)
6	65,362,937	6,774,376	55	29.2	231,999.17	1,326,669.43	73,231,983	(550,646)
7	69,232,423	7,065,767	56	28.2	250,559.10	1,655,767.36	77,703,398	(447,163)
8	73,330,982	7,360,424	57	27.2	270,603.83	2,024,392.62	82,445,195	(331,879)
9	77,672,176	7,657,006	58	26.2	292,252.14	2,436,488.80	87,473,419	(204,058)
10	82,270,369	7,953,934	59	25.2	315,632.31	2,896,361.25	92,805,032	(62,951)
11	87,140,775	8,249,366	60	24.2	340,882.89	3,408,708.73	98,457,967	92,199
12	92,299,509	8,541,162	61	23.2	368,153.53	3,978,657.81	104,451,175	262,153
13	97,763,640	8,826,849	62	22.2	397,605.81	4,611,800.16	110,804,683	447,671
14	103,551,247	9,103,583	63	21.2	429,414.27	5,314,233.00	117,539,649	649,502
15	109,681,481	9,368,102	64	20.2	463,767.41	6,092,603.01	124,678,418	868,375
16	116,174,625	9,616,681	65	19.2	500,868.81	6,954,153.92	132,244,591	1,104,993
17	123,052,163	9,845,077	66	18.2	540,938.31	7,906,778.14	140,263,080	1,360,017
18	130,336,851	10,048,470	67	17.2	584,213.38	8,959,072.79	148,760,180	1,634,057
19	138,052,792	10,221,397	68	16.2	630,950.45	10,120,400.34	157,763,639	1,927,649
20	146,225,517	10,357,683	69	15.2	681,426.48	11,400,954.52	167,302,728	2,241,247
21	154,882,068	10,450,357	70	14.2	735,940.60	12,811,831.63	177,408,316	2,575,195
22	164,051,087	10,491,569	71	13.2	794,815.85	14,365,107.92	188,112,948	2,929,707
23	173,762,911	10,472,494	72	12.2	858,401.12	16,073,923.42	199,450,927	3,304,838
24	184,049,675	10,383,220	73	11.2	927,073.21	17,952,572.90	211,458,395	3,700,457
25	194,945,416	10,212,638	74	10.2	1,001,239.06	20,016,604.28	224,173,420	4,116,212

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Mechanics of Conversion and Recharacterization

- There is no age limit on who may convert to a Roth IRA. A taxpayer over age 70½ must take his/her RMD first before converting. [Treas. Reg. §1.408A-4, Q&A 6.]
- Beginning 2010 filing status is not relevant (i.e., even married individuals filing separately may convert to a Roth IRA).
- Inherited IRAs may not be converted to Roth IRAs.
- Conversion is accomplished by the following means:
  - A withdrawal from a traditional IRA, followed by a contribution within 60 days to a Roth IRA
  - Trustee to trustee transfer
  - Redesignation of the account to be a Roth IRA at the same custodian. [Treas. Reg. §1.408A-4, Q&A 1(b).]
- Prior to the Pension Protection Act of 2006 (PPA), a rollover from a qualified plan (such as 401(k)) had to pass into a traditional IRA before being converted into a Roth IRA. The PPA changed this rule such that any "eligible rollover distribution" from a qualified plan could be rolled directly (i.e., trustee to trustee transfer) into a Roth IRA without first contributing that amount to a traditional IRA. An example of an "eligible rollover distribution" is a distribution upon termination from service or certain types of in service distributions. Check with the qualified plan provider as to options for in service distributions. *See* Notice 2009-75, IRB 2009-39 (9/28/09) for clarifications on the tax treatment of rollovers from qualified plans to Roth IRAs. [Treas. Reg. §1.408A-4, Q&A 5, which indicates that a rollover directly from a qualified plan, is out of date.]
- Form 8606 is used for reporting Roth conversions.
  - If the converted IRA contains nondeductible contributions, all of the participant's IRAs must be aggregated in determining how much of the converted account is not subject to income taxes.
  - The participant should not roll out of other plans prior to year-end or the fraction will change unfavorably.

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Mechanics of Conversion and Recharacterization

- Recharacterization is accomplished by the following means:
  - Election on or before the date of transfer both the Trustee of the Roth IRA and transferee traditional IRA that the participant is electing to treat the contribution as having been made to the transferee traditional IRA, instead of the Roth IRA, for federal tax purposes. The following information must be provided:
    - The type and amount of the contribution to the Roth IRA that is to be recharacterized;
    - The date on which the contribution was made to the Roth IRA and the year for which it was made;
    - A direction to trustee of the Roth IRA to transfer, in a trustee to trustee transfer, the amount of the contribution and net income allocable to the contribution to the trustee of the transferee traditional IRA; and
    - The name of the trustee of the Roth IRA and the trustee of the transferee traditional IRA and any additional information needed to make the transfer. [Treas. Reg. §1.408A-5, A-6(a).]

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Roth IRA Recharacterizations and Reconversions — 10 Strategies

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Beginning in 2010, taxpayers may convert their retirement accounts to a Roth IRA, income or filing status aside. The article addresses the technical issues and planning opportunities that maximize the benefit of this recharacterization and later conversions.

We know that you are already aware that beginning in 2010 your clients may convert their retirement accounts[1] to a Roth IRA, income or filing status aside.[2] We also know you are aware of the tax benefits that a Roth IRA provides. Your clients are probably asking you to crunch the numbers and help them decide the amount, if any, that should be converted. While you may be familiar with the concept of recharacterizations,[3] you may not be entirely familiar with some of the technical issues and planning opportunities that maximize the benefit of recharacterizations and later conversions.

Let us start at the beginning — with the original conversion.[4] Providing advice on conversion is akin to the marital lawyer advising on an upcoming marriage; the concern and planning should be focused on any potential negative results instead of entirely on a happy ending. If all things go well with the conversion, there would be no need to recharacterize (although when the time comes to actually pay income taxes, we can envision that some clients may change their mind about the conversion). However, when things go wrong (generally as a result of downward market forces on the asset values), recharacterization offers the client an opportunity to take a second look at the original conversion decision.

Some think that the recharacterization provisions allow the client to change his mind with little or no income tax implications. We agree, as long as the original conversion was properly planned (that is, with recharacterization in mind).

Two concepts are important to remember about recharacterizations. First, recharacterizations must be accomplished by the time your client files his income tax return, including extensions (which is generally October 15 of the year following the year of conversion). For example, if your client converts on January 5, 2010, he may recharacterize as late as October 17, 2011.[5] Second, recharacterization only eliminates the risk of decline in value up to the time of recharacterization; it does not eliminate the risk of a decline in the Roth IRA value after the time for recharacterization has passed.

Planning strategy 1: Don't forget to pay the income tax on the conversion by the time for filing the income tax return (without extensions), which is generally April 15 of the year following the year of conversion. If the client is uncertain whether to recharacterize, the client should still pay sufficient income tax to cover the potential liability. If the client decides to recharacterize, he can immediately file for a refund or apply the income tax payment for the following year. If, on the other hand, the client does not recharacterize, and pays sufficient, timely income tax, all is fine. However, if the client did not pay sufficient income tax, he will be subject to late payment penalties and interest charges.

Planning strategy 2: Create multiple, separate Roth IRA accounts before you transfer the assets from the traditional IRA to the Roth IRA.[6] This strategy is illustrated in the following example.

Example 1: John has a traditional IRA that was converted to a single Roth IRA account on January 5, 2010, that is invested as follows:

[1]Retirement accounts include qualified retirement accounts, IRAs (traditional IRAs), and sections 403(b) and 457 accounts.

[2]The $100,000 modified adjusted gross income limit on a conversion of a traditional IRA to a Roth IRA is eliminated beginning in 2010. Also, married taxpayers who file separate income tax returns will be permitted to convert a traditional IRA into a Roth IRA.

[3]Section 408A(d)(6) and reg. section 1.408A-5 provide the rules and guidance on recharacterizations.

[4]For purposes of this article, we call the original conversion the "conversion," and a conversion after a recharacterization a "reconversion."

[5]Because October 15, 2011, falls on a Saturday, the time for filing is extended to the following Monday, which is October 17.

[6]You may have as many Roth IRA accounts as you like.

Asset Class	Value
Large cap	$250,000
Mid cap	$250,000
Small cap	$250,000
International	$250,000
Total	**$1,000,000**

John opts to recognize income in 2010, and on April 11, 2011, the Roth assets were valued as follows:

Asset Class	Value
Large cap	$450,000
Mid cap	$450,000
Small cap	$100,000
International	$100,000
Total	**$1,100,000**

Based on the foregoing, John would not likely recharacterize the single Roth account, because the value of the assets from date of conversion ($1 million) would be less than the value at the time when John is ready to file his income taxes ($1.1 million).

Had John created multiple accounts (in this case four accounts, one for each separate asset class), he could have recharacterized the accounts that decreased in value (that is, the small-cap and international asset classes), thus recognizing income only on the ones that had increased in value since the date of conversion. Later, John could reconvert the recharacterized amounts, thus recognizing less income in the future.

Recognized Income With One Account	
Conversion value	$1,000,000
Recognized Income With Multiple Accounts	
Original Conversion	
Conversion value	$500,000
Reconversion	
Conversion value	$200,000
Total	
Conversion value	$700,000

It is important to understand what happens on recharacterization and reconversion if only a single account is used. Understanding this concept will give you greater appreciation for why it is critical to use multiple accounts, especially with larger IRAs.

If the entire Roth IRA account is recharacterized (and no distributions or additional contributions have been made from or to the account since conversion), any net income or net loss is automatically accounted for, as the entire account is moved back to the traditional IRA.[7] However, if only a portion of a Roth IRA is recharacterized, accounting for any net income or net loss is more complicated. A formula must be applied to determine the net income or loss attributable to the portion being recharacterized. Example 2 shows the formula and illustrates an example of a 20 percent decline in value of the Roth IRA from the time of conversion to the time of recharacterization.

Example 2: Net income (loss) is considered — Roth IRA declines in value:

- On January 4, 2010, Jane's traditional IRA is valued at $1 million.
- Jane converts the entire account to a Roth IRA.
- On October 10, 2011, the account is valued at $800,000. Jane recharacterizes $250,000.
- $\$250,000 * \frac{\$800,000 - \$1,000,000}{\$1,000,000}$
- $250,000 * (-200,000/1,000,000)
- $250,000 * -0.2
- -$50,000

Formula to determine income (loss):

$$R * \frac{ACB - AOB}{AOB}$$

R = Recharacterization amount

AOB = Adjusted opening balance — that is, the value of the Roth IRA at the time of coversion

ACB = Adjusted closing balance — that is, the value of the Roth IRA at the time of recharacterization

For the precise formula, see reg. section 1.408A-5, A-2(c)(1), and examples under section (6).

Amount originally converted	$1,000,000
Assuming no after-tax contributions, this is the amount Jane includes in income on conversion.	
Amount recharacterized	$250,000
This is the portion of the Roth IRA conversion that Jane undoes by recharacterization.	
Amount pulled out (that is, after accounting for income (loss))	$200,000
This is the amount transferred from the Roth IRA to the traditional IRA (that is, the recharacterization amount, plus attributable gain or loss).	
Income from conversion after recharacterization	$750,000
After the recharacterization, this is the amount Jane includes in income from the conversion.	

Planning strategy 3: Do not assume that the client understands the terms 'recharacterized amounts' and 'pullout amounts.' Rather, assume that the client may speak in terms of "transfer" or "withdraw." The following example may highlight this issue:

Example 3: Recharacterized amounts and pullout amounts — the facts are the same as in Example 2; however, on October 10, 2011, when the account is valued at $800,000, Jane calls her account representative and says that she wants to "undo" the transfer of $250,000 from her new Roth IRA to her traditional IRA account. And then she asks him to "transfer" $250,000 back to the traditional IRA.

[7]Reg. section 1.408A-5, Q&A 9.

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When Jane called her account representative and asked him to move $250,000 from her Roth IRA to her traditional IRA, Jane also believes that she is recharacterizing $250,000 of her Roth IRA. It is likely that she does not appreciate the difference between the pullout amount and recharacterized amount. Let's assume that her account representative simply follows Jane's instructions and transfers (that is, ''pulls out'') $250,000 from the account.

In this case, we know the pullout amount and need to adjust the foregoing formula (that solved for the income or loss) to solve for the recharacterization amount as follows:

Formula to solve for recharacterization amount:

$$P = R + [(R * \frac{ACB - AOB}{AOB}) * R]$$

- $\$250,000 = R + [(\frac{\$800,000 - \$1,000,000}{\$1,000,000}) * R]$
- $250,000 = R + ((-200,000/1,000,000) * R)
- $250,000 = R + (-0.2*R)
- $250,000 = $312,500 + -62,500

Amount originally converted	$1,000,000
Amount recharacterized	$312,500
Amount pulled out (that is, after accounting for income (loss))	$250,000
Income from conversion after recharacterization	$687,500

Jane may be surprised (perhaps pleasantly) by the results, because she may have thought that the $250,000 she transferred from the Roth IRA back to the traditional IRA reduced the $1 million originally converted. Jane may have thought she would recognize $750,000 of income (that is, $1 million less $250,000). In this case, she actually recognizes $687,500 of income (that is, $1 million less $312,500 that she recharacterized). There would be a worse result if she simply told her CPA that she recharacterized $250,000, and relying on Jane's advice the CPA reported $750,000 of recognized converted income, instead of the lesser amount of $687,500.

Examples 4 and 5 follow the same fact pattern of examples 2 and 3, except that rather than having a loss of $200,000, the Roth IRA experiences a gain in value of $200,000.

Example 4: Net income (loss) is considered — Roth IRA appreciates in value:

- On January 4, 2010, Jane's traditional IRA is valued at $1 million.
- Jane converts the entire account to a Roth IRA.
- On October 10, 2011, the account value is $1.2 million.
- Janes recharacterizes $250,000 — the allocated income (loss) is determined as follows:
  - $\$250,000 * \frac{\$1,200,000 - \$1,000,000}{\$1,000,000}$
  - $250,000 * (200,000/1,000,000)
  - $250,000 * 0.2
  - $50,000

Amount originally converted	$1,000,000
Amount recharacterized	$250,000
Amount pulled out (that is, after accounting for income (loss))	$300,000
Income from conversion after recharacterization	$750,000

Example 5: Recharacterized amounts and pullout amounts — the facts are the same as in Example 4; however, on October 10, 2011, when the account is valued at $1,200,000, Jane calls her account representative and says to ''transfer'' $250,000 back to the traditional IRA. In this case, we know the pullout amount and need to solve for the recharacterization amount as follows:

- $\$250,000 = R + [(\frac{\$1,200,000 - \$1,000,000}{\$1,000,000}) * R]$
- $250,000 = R + ((200,000/1,000,000) * R)
- $250,000 = R + (0.2*R)
- $250,000 = $208,333 + 41,667

Amount originally converted	$1,000,000
Amount recharacterized	$208,333
Amount pulled out (that is, after accounting for income (loss))	$250,000
Income from conversion after recharacterization	$791,667

Why is the pullout amount so significant? It is because this is the amount that is distributed from the Roth IRA, and can be reconverted in the future.

Planning strategy 4: Use multiple Roth IRA accounts to save your clients money if the client has to recharacterize. With the foregoing understanding of the principles of recharacterized and pullout amounts, we now focus on how separate accounts actually save your client money.

Example 6: Kim has $500,000 of equities and $500,000 of fixed income in her traditional IRA on January 5, 2010, and converts all of the traditional IRA. Kim elects to recognize conversion income in 2010 when the tax rate is 35 percent. On April 14, 2011, the Roth IRA is valued at $900,000, in which the equities are valued at $300,000 and the fixed-income portfolio is at $600,000. Kim wishes to recharacterize an amount sufficient to allow her to pullout the entire $300,000 of equities.

If Kim used one account, her income recognized in 2010 would be $666,666 (that is, $1 million minus $333,334 recharacterized). (Note: The pullout amount would be $300,000 or 10 percent less than the recharacterized amount of $333,334.)

If Kim used two accounts, one for equities and one for fixed income, and if Kim recharacterized the equity account, she would only recognize the income on the fixed income account (of $500,000 valued at the date of conversion).

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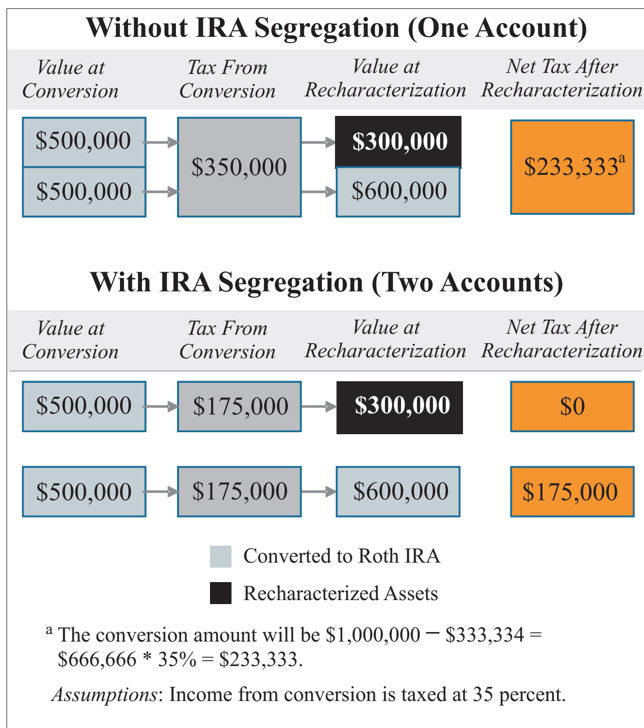


Kim's best strategy would be to recharacterize only the asset that declined in value (the equities), thereby eliminating half of her income tax liability from the conversion. But the IRS forbids cherry-picking of assets for the purposes of recharacterization. So, if Kim only uses one Roth IRA account, moving the equities that have declined in value back to a traditional IRA will be a partial recharacterization. Kim must prorate her gains and losses, which reduces her tax bill to only $233,333.

Alternatively, if Kim converts her equities into one Roth IRA and the bonds into a separate Roth IRA, the result is dramatically improved. Kim could recharacterize only the Roth IRA account owning the equities. Provided she recharacterizes the entire balance held in the equities account, she will not owe any income tax on the conversion of the assets in that account. By using separate accounts, Kim can undo all the taxes due on the equity conversion, leaving only $175,000 in taxes on the conversion of the account owning the bonds.

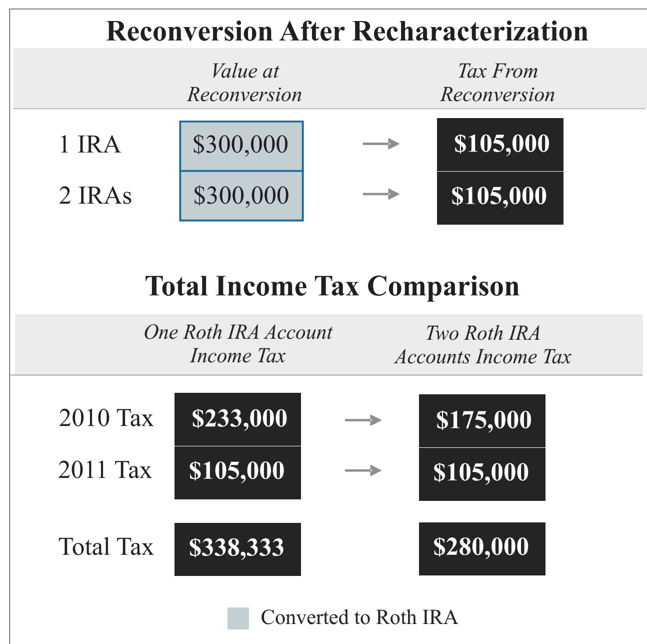
Kim still wants the $300,000 in equities to be owned by a Roth IRA. Therefore, the recharacterization strategy is helpful if Kim can reconvert the equities into a Roth IRA at the lower value and pay income tax on $300,000 rather than the original $500,000. To prevent taxpayers from abusing the rules, a waiting period exists before a reconversion can take place. After a recharacterization, the amount transferred back to the traditional IRA may again be converted into a Roth IRA, but not until the beginning of the tax year following the tax year in which the amount was converted into a Roth IRA, or, if later, 30 days after the recharacterization. We will call this the waiting period.

In Kim's case, if she recharacterized the equities on April 14, 2010, she would have to wait until January 1, 2011, to reconvert the equities into a Roth IRA. On reconversion, the separate accounts strategy saves Kim $58,333 in taxes. It is important to remember, however, if Kim's equities increase in value during the waiting period (usually a good thing) it could wipe out the anticipated savings of the recharacterization and reconversion.

Example 7: If Kim used two Roth IRA accounts (that is, one for equities and one for fixed-income), her reconverted value would be $300,000 (that is, the values of the equities).

Her combined income for 2010 and 2011 would be $500,000 and $300,000, respectively, totaling $800,000.

The use of multiple accounts reduces the income by $166,666. If tax rates were the same in 2010 and 2011, the savings would be the reduction of income multiplied by the tax rate. If we assume a 35 percent tax rate, tax savings would be $58,333.



If we have different tax rates from one year to the next, as we anticipate will be the case (as of the time of this writing), the tax savings could be less. This would be true, if the income tax rates increase. The following example illustrates the point.

Example 8: Same as Example 7, except income tax rates will be 35 percent in 2010 and 40 percent in 2011. In this case the tax liability for 2010 and 2011 will be as follows:

	Single Account		Multiple Accounts	
	Income	Income Tax	Income	Income Tax
2010	$666,666	$233,333	$500,000	$175,000
2011	$300,000	$120,000	$300,000	$120,000
Total	**$966,666**	**$353,333**	**$800,000**	**$295,000**

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Thus, the use of multiple accounts reduces the income by $170,000 and tax liability by $58,333. Without separate accounts, the increased tax rates for the year of reconversion causes the recharacterization/reconversion strategy to result in Kim paying more in taxes!

Planning strategy 5: Don't rush to recharacterize. If there is a decrease in asset values inside the newly created Roth IRA, your clients should not automatically recharacterize. That is true even if they have multiple Roth IRA accounts, because it may cost more to recharacterize. Example 8 illustrates this in the single account scenario.

Example 9: Same as Example 8, except income tax rates will be 35 percent in 2010 and 45 percent in 2011. In this case the tax liability for 2010 and 2011 will be as follows:

	Multiple Accounts — Recharacterization		Multiple Accounts — No Recharacterization	
	Income	Income Tax	Income	Income Tax
2010	$500,000	$175,000	$1,000,000	$350,000
2011	$300,000	$135,000		
Total	**$800,000**	**$310,000**	**$1,000,000**	**$350,000**

In this case, by using multiple accounts, it is still economical to recharacterize even with a substantially higher tax rate in the year of reconversion.

However, Example 10 illustrates that it may not always be favorable to recharacterize.

Example 10: Same as Example 9, except that the value of the equities only decreased to $450,000 and the fixed income portfolio remained at $500,000.

	Multiple Accounts — Recharacterization		Multiple Accounts — No Recharacterization	
	Income	Income Tax	Income	Income Tax
2010	$500,000	$175,000	$1,000,000	$350,000
2011	$450,000	$180,000		
Total	**$950,000**	**$355,000**	**$1,000,000**	**$350,000**

In this case, even though values decreased by $50,000, the total tax paid increased by $5,000.

Planning strategy 6: During the possible recharacterization period, watch for drops in value. The strategic time for recharacterization is when the participant only has to wait 30 days to reconvert. (See Figure 1.) Just waiting until October 15 of the year following the year of conversion to see if the Roth IRA has dropped in value is insufficient. Suppose that in February of the year following the year of conversion, the value of the Roth IRA is down by 50 percent. The client may miss the opportunity to lock in the lower value for income tax purposes by waiting until October 15, at which time the value may have recovered.

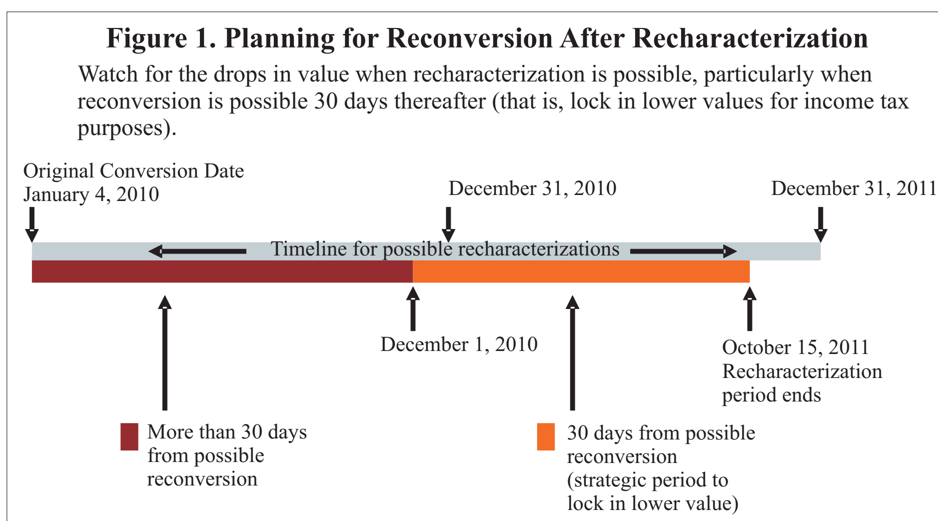

Figure 1. Planning for Reconversion After Recharacterization

Watch for the drops in value when recharacterization is possible, particularly when reconversion is possible 30 days thereafter (that is, lock in lower values for income tax purposes).

Planning strategy 7: Don't transfer the recharacterized amounts back to the original traditional IRA. Stated differently, any amounts being recharacterized should be transferred to a separate traditional IRA and not consolidated into an existing traditional IRA. This is because for purposes of applying the waiting period before reconversion can take place, an amount previously converted must be adjusted for subsequent net income and loss in determining the portion of the consolidated account that may be reconverted.[8] Using separate accounts makes it easier too.

Planning strategy 8: Consolidate the Roth IRA accounts after the period for recharacterization has passed. That will simplify administration and investments of the accounts.

Planning strategy 9: Consolidate the traditional IRA accounts once all reconversion waiting periods have passed. Again, it will simplify the administration of the accounts.

Planning strategy 10: Develop a conversion, recharacterization, and reconversion strategy and monitoring plan in coordination with the client's financial planning and tax accounting advisers. That gives the client the best chance of successfully navigating the process and achieving the optimum result.

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[8] *Id.*

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