Roth Recharacterizations

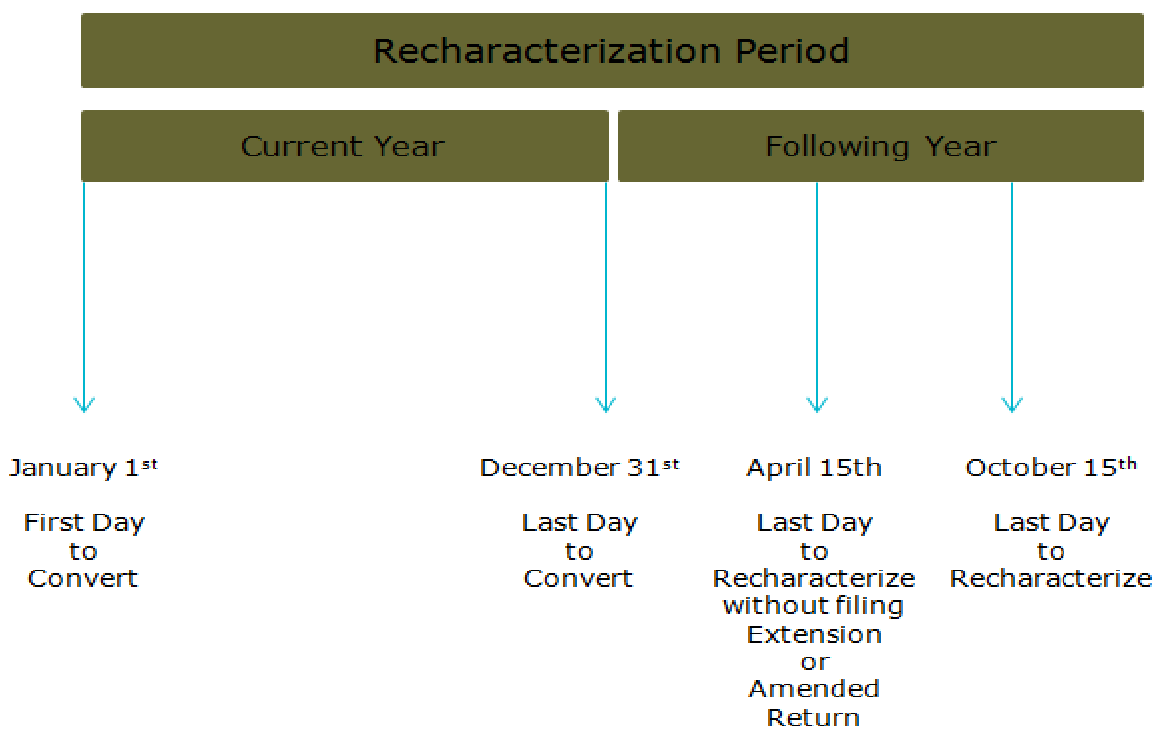
Factors to Consider When Unwinding a Roth Conversion

A Roth Recharacterization is the process of unwinding a Roth contribution, conversion or rollover. Recharacterization provides the taxpayer with the ability to fine tune the conversion amount, in part or whole, long after the initial conversion has been completed.

Taxpayers can recharacterize a conversion from a Traditional IRA or a rollover from a qualified retirement plan by making a trustee-to-trustee transfer from the Roth IRA to a Traditional IRA. Rollovers from a qualified retirement plan must be recharacterized to a Traditional IRA, not back to the original qualified retirement plan. In addition, recharacterizations are not available for Roth conversions from a Traditional qualified retirement plan to a Roth qualified retirement plan, known as "In Plan Conversions".

Recharacterization Period

The recharacterization period starts on the day of conversion and is open through the due date of the tax return for that year, plus extensions – typically October 15th of the year following the year of conversion.



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After a Roth conversion has been recharacterized back to a Traditional IRA, the taxpayer may then reconvert those same dollars back to a Roth IRA after waiting the applicable time period. The taxpayer must wait until the longer of:

- January 1 of the year following the year of the original Roth conversion OR
- 30 days after the recharacterization date.

However, a taxpayer is allowed to convert other assets within an IRA to a Roth IRA, without having to satisfy the waiting period above. For example, assume a taxpayer converts $100,000 from a Traditional IRA to a Roth IRA in May when the Traditional IRA was valued at $400,000. In October, the taxpayer recharacterizes the entire conversion amount back to the Traditional IRA. The recharacterized amount is not eligible to be reconverted to a Roth until January 1st of the following year. However, any portion of the other $300,000 in the Traditional IRA could be converted to a Roth IRA immediately.

Reasons for Recharacterization

Taxpayers are not required to provide the IRS a reason for recharacterizing. However, taxpayers are likely to recharacterize for any number of reasons:

- Probably the most common reason for recharacterizing a Roth conversion is that the converted amount has declined in value since the conversion was completed. For example, assume a taxpayer converts an IRA worth $100,000 to a Roth IRA. In the following months, the new Roth IRA declines in value to $70,000. The taxpayer may decide they don't want to pay tax on the $100,000 conversion while only having $70,000 in the Roth. That taxpayer may choose to recharacterize the $70,000 in the Roth back to the Traditional IRA, wait the applicable time period, and then reconvert the IRA back to a Roth. As long as the value of the Traditional IRA doesn't go back above $100,000 before reconverting, the taxpayer may end up reducing their overall tax cost.
- The taxpayer may realize they are unable or unwilling to pay the income tax liability created by the conversion: For example:
  - The taxpayer's other income was higher than expected, resulting in larger Federal and/or state income taxes than anticipated.
  - The taxpayer unexpectedly became subject to Alternative Minimum Tax, thus increasing the overall tax cost of the conversion.
  - The income from the conversion triggered a loss of other deductions or credits, thereby increasing the tax cost of the conversion.
- The additional income from the conversion may cause an increase in Medicare premiums. Medicare participants with Modified AGI over $170,000 ($85,000 if single) are subject to higher premiums for Medicare Part B, even if that increase is due to a Roth conversion. There is a two-year delay in the premium adjustment, meaning that 2017 income is used to determine 2019 Medicare premiums.

- Not all states tax distributions from retirement plans the same. If the IRA owner is planning a move to a state with a lower tax rate, or one that excludes IRA income from taxation, a Roth conversion may result in a higher tax cost than leaving the Traditional IRA as-is.
    - For example, assume a taxpayer moves from Wisconsin to Florida in the year following a conversion. The taxpayer would be subject to Wisconsin income taxes for the conversion amount. However, if the taxpayer had waited until the move to Florida, which has no state income tax, the total tax cost on the conversion would have been lower.
- If the taxpayer's tax filing status is likely to change, it may provide an opportunity for them to save taxes by deferring the conversion to the year of the change.
    - For example, a taxpayer who is engaged to be married the year following a conversion may discover the married filing joint tax brackets result in a lower tax liability on the conversion than the single brackets.
- If the beneficiary of the Traditional IRA is expected to have a lower tax rate than the IRA owner, the total taxes paid by the beneficiary on the future withdrawals may be less than what the IRA owner has to pay today to convert.
    - For example, the taxpayer names their child as the beneficiary of the Traditional IRA. The parent then converts that IRA to a Roth while in a high tax bracket. If the child is projected to be in a lower tax bracket during their lifetime, their tax on the future IRA withdrawals may be less than what the parent would pay to convert. In this case, recharacterizing and leaving the money in the IRA may be appropriate.
- For taxpayers who have made nondeductible contributions to a Traditional IRA, a pro-rated portion of that IRA can be converted to a Roth IRA tax-free. However, assume that taxpayer also has a qualified plan consisting of all pre-tax money. If the taxpayer rolls over that plan to a Traditional IRA in the same year as the Roth conversion, the pro rata rule will cause the tax-free portion of the Roth conversion to be a smaller portion of the overall conversion, thus increasing the taxable income recognized from the conversion. If the rollover from the employer plan happens in the same year as the conversion, it must be taken into consideration in determining the pro-rata amount of the conversion that is tax free, even if the rollover happens after the conversion or is rolled to a different IRA. An inadvertent rollover of a qualified plan may greatly reduce the tax benefit of converting the IRA, making a recharacterization appropriate.
- The inverse of the last example is also true. Some employers offer qualified plans that allow IRA assets to be rolled into the plan – a "reverse" rollover. However, qualified plans typically do not allow nondeductible contributions to be rolled from an IRA to the plan. This exclusion can enable the taxpayer to separate the nondeductible and deductible portions of the IRA and rollover just the deductible portion to the plan. This would then leave the taxpayer with an IRA consisting of completely nondeductible funds which could then be converted to a Roth IRA income tax free. This strategy would result in a smaller amount in the Roth IRA, but the tax cost of the conversion could be eliminated. If a

reverse rollover if available, it might make sense to undo the Roth conversion and then convert again after moving the Traditional IRA to the qualified plan.

Recharacterization Process

When a taxpayer decides to recharacterize some or all of a Roth conversion, the amount to actually move to the IRA must be adjusted for any gains or losses in the account attributable to the recharacterized amount.

The attributable gains or losses are known as Net Income, which is calculated as follows:

$$\text{Net Income} = \text{Conversion Amount to be Recharacterized} \times \frac{(\text{Adjusted Closing Balance of Roth} - \text{Adjusted Opening Balance of Roth})}{\text{Adjusted Opening Balance of Roth}}$$

- ***Conversion Amount to be Recharacterized*** could be some or all of the original conversion amount.
- ***Adjusted Closing Balance*** of the Roth IRA is the fair market value of the Roth IRA just prior to the recharacterization plus the amount of any other distributions, transfers or recharacterizations made from the Roth IRA since the conversion.
- ***Adjusted Opening Balance*** of the Roth IRA is the fair market value of the Roth IRA just prior to the original conversion plus any contributions to, or transfers or recharacterizations out of, the Roth since the conversion (including the amount that is being recharacterized itself).

Below are several examples showing how to calculate the recharacterization amount. In each of these examples, assume a taxpayer converted $100,000 from a Traditional IRA to a Roth IRA, all of which was taxable, and that they have no other Roth IRAs.

1. The taxpayer decides to recharacterize the entire Roth conversion when the Roth IRA is valued at $75,000. The amount to be recharacterized is $100,000 +/– Net Income. The Net Income amount is calculated to be $(25,000) as follows:

$$\text{Net Income} = \$100{,}000 \times \frac{(\$75{,}000 - \$100{,}000)}{\$100{,}000} = \$(25{,}000)$$

   Therefore the amount to be recharacterized back to the IRA is $75,000 ($100,000 - $25,000), the net taxable conversion amount is $0 and the Roth is worth $0 after the recharacterization.

2. The taxpayer decides to recharacterize the entire Roth conversion when the Roth IRA is valued at $150,000. The amount to be recharacterized is $100,000 +/– Net Income. The Net Income amount is calculated to be $50,000 as follows:

$$\text{Net Income} = \$100{,}000 \times \frac{(\$150{,}000 - \$100{,}000)}{\$100{,}000} = \$50{,}000$$

Therefore the amount to be recharacterized back to the IRA is $150,000 ($100,000 + $50,000), the net taxable conversion amount is $0 and the Roth is worth $0 after the recharacterization.

3. The taxpayer decides to recharacterize $30,000 of the Roth conversion when the Roth IRA is valued at $75,000. The amount to be recharacterized is $30,000 +/– Net Income. The Net Income amount is calculated to be $(7,500) as follows:

$$\text{Net Income} = \$30{,}000 \times \frac{(\$75{,}000 - \$100{,}000)}{\$100{,}000} = \$(7{,}500)$$

Therefore the amount to be recharacterized back to the IRA is $22,500 ($30,000 – $7,500), the net taxable conversion amount is $70,000 ($100,000 – $30,000) and the Roth is worth $52,500 ($75,000 – $22,500) after the recharacterization.

4. The taxpayer decides to recharacterize $30,000 of the Roth conversion when the Roth IRA is valued at $140,000. The amount to be recharacterized is $30,000 +/– Net Income. The Net Income amount is calculated to be $12,000 as follows:

$$\text{Net Income} = \$30{,}000 \times \frac{(\$140{,}000 - \$100{,}000)}{\$100{,}000} = \$12{,}000$$

Therefore the amount to be recharacterized back to the IRA is $42,000 ($30,000 + $12,000), the net taxable conversion amount is $70,000 ($100,000 – $30,000) and the Roth is worth $108,000 ($150,000 – $42,000) after the recharacterization.

5. In this example, the $100,000 conversion amount went to a Roth IRA that already held $200,000, bringing the total value to $300,000. During the year, the taxpayer took a $20,000 distribution from the Roth. Later, the taxpayer decides to recharacterize $30,000 of the Roth conversion when the Roth IRA is worth $350,000. The amount to be recharacterized is $30,000 +/– Net Income. The Net Income is calculated to be ($7,000) as follows:

$$\text{Net Income} = \$30{,}000 \times \frac{(\$370{,}000^{*} - \$300{,}000^{**})}{\$300{,}000^{**}} = \$(7{,}000)$$

* The Adjusted Closing Balance equals the $350,000 in the Roth at the time of recharacterization plus the $20,000 previously withdrawn.

** The Adjusted Opening Balance equals the $200,000 balance in the Roth IRA prior to the conversion plus the $100,000 conversion amount.

Therefore the amount to be recharacterized back to the IRA is $37,000 ($30,000 + $7,000), the net taxable conversion amount is $70,000 ($100,000 – $30,000) and the Roth is worth $313,000 ($350,000 - $37,000) after the recharacterization.

Tax rules allow recharacterizations to be completed by moving specific positions rather than just cash. However, it does not allow a taxpayer to only consider the change in value of a specific investment in a Roth IRA that holds other investments when determining the recharacterization amount. Ideally, the taxpayer would recharacterize the assets with the biggest losses and keep the assets with the largest gains in the Roth. However, the IRS prohibits "cherry picking" assets, instead requiring that all gains and losses be prorated within the entire Roth IRA instead of an asset-by-asset attribution.

6. Taxpayer A converts $100,000 of Stock A and $100,000 of Stock B to one Roth IRA. Stock A declines in value to $75,000, but Stock B increases in value to $150,000, making the Roth now worth $225,000, or $25,000 more than at the time of conversion. The taxpayer would like to recharacterize only Stock A back to the IRA, but leave Stock B in the Roth, thereby reducing the taxable conversion from $200,000 to $100,000. However, the anti-cherry picking rules prevent this approach. The change in the entire value of the Roth must be considered when figuring the net income attributed to the recharacterized amount, not just the change in value of a specific asset in the Roth. If the taxpayer wanted to recharacterize Stock A, which was worth $100,000 of the initial conversion amount, the amount to be recharacterized would be $100,000 +/– a portion of the net income of the entire Roth IRA:

$$\text{Net Income} = \$100{,}000 \times \frac{(\$225{,}000 - \$200{,}000)}{\$200{,}000} = \$12{,}500$$

   Therefore the amount to be recharacterized is $100,000 + $12,500, or $112,500. In other words, the loss from Stock A is offset by part of the gain from Stock B.

However, if Stocks A and B had been converted to their own individual Roth IRAs, the taxpayer could have ignored Stock B when figuring the net income attributed to Stock A. The proration of gains and losses only applies to the specific Roth IRA being recharacterized, not all Roth IRAs. By segregating the Roth conversion, the taxpayer could achieve their goal of recharacterizing the full loss on Stock A (see Example 1 above) while keeping the gains from Stock B in the Roth IRA.

Tax Reporting by IRA Custodian

IRA Custodians are required to issue a Form 1099-R to the IRA owner and the IRS upon any withdrawal from either a Traditional or Roth IRA. Any contribution to a Traditional or Roth IRA, including one resulting from a Roth conversion, must also be reported to both parties on Form 5498. As a result, a Roth conversion will cause two tax forms to be issued by the IRA custodian, and a recharacterization of a conversion will result in two additional tax forms. The 1099-R is typically issued in January following the year of withdrawal, while Form 5498 is usually issued in May following the year of the recharacterization.

The IRA custodian is required to report the Roth conversion even if the converted amount is later recharacterized. This means that if a taxpayer recharacterizes, the taxpayer will receive two Form 1099-Rs and two Form 5498s; one of each for both the Traditional and Roth IRAs. The reporting requirements for the IRA trustee and the taxpayer are summarized below:

Tax Documents Issued by IRA Trustee				
Event	**Form**	**Box #**	**Code #**	**Issue Date**
Roth Conversion	1099-R	Box 1 – Total conversion amount Box 2A – Total conversion amount Box 7 – Code 2 or 7	Code 2 – Under 59 ½ penalty exception applies* Code 7 – Normal distribution, no penalty *No penalty applies to IRA distributions converted to a Roth IRA	January of the year following the year of conversion
	5498	Box 3 – Conversion amount		May of the year following the year of conversion
Roth Recharacterization	1099-R	Box 1 – Recharacterization Amount +/ - Earnings Box 2A – $0 Box 7 – Code N or R	Code N – Indicates recharacterization occurred in the same year as conversion Code R – Indicates recharacterization occurred in the year following the year of conversion	January of the year following the year of recharacterization
	5498	Box 4 – Recharacterization Amount +/- Earnings		May of the year following the year of recharacterization

* All line references are for tax forms issued for the 2016 tax filing year