

# Retirement Weekly

## ■ In this issue

### Your Money

Vanguard has introduced a new Web-based service that enables individuals to compare income annuities from leading insurance companies. (P. 7)

### State of Affairs

Even after describing an annuity-like solution as their ideal financial vehicle, more than half of Americans age 44-75 expressed distaste for the word "annuity", according to an Allianz Life survey. (P. 9)

### HealthWatch

A new report by the Kaiser Family Foundation shows that private Medicare Advantage plans with high quality ratings are concentrated in certain states, leaving beneficiaries in some states with few if any options for choosing a highly-rated plan. (P. 10)

September 10, 2010 (Vol. 8, No. 37)

## Deadline to 'recharacterize' Roth IRA is approaching fast

**30% of those eligible know they can undo Roth IRA conversion**

If you did a Roth IRA conversion last year, in 2009, then the date October 15 should be highlighted in your daily planner. That's the deadline for "recharacterizing" a Roth IRA conversion.

Didn't know about the deadline? Not to worry. You're not alone. A Fidelity Investments study released this week finds that less than a third (30%) of investors who are newly eligible to complete a Roth IRA conversion are aware of the flexibility they have to "undo" the move.

Given that lack of awareness, we asked several retirement experts to put finger to keyboard and pen some thoughts about the potential reasons for considering a recharacterization.

But first some background: According to Fidelity, "the process, known as "recharacterization," allows an investor to reverse amounts converted from a Traditional IRA to a Roth IRA and recover any taxes paid."

In the Fidelity survey, when these investors were asked what circumstances would spur them to recharacterize their Roth IRA, the top reason (54%) cited was an unexpected drop in their taxable income in retirement. Forty-four percent of investors said that they would recharacterize if the additional taxable income from a Roth IRA con-



*(Continued on page 2)*



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### Reason for considering a recharacterization

- An increase in an investor's taxable income that results in a shift to a higher federal income tax bracket.
- A drop in anticipated taxable income in retirement, which could reduce the benefits of a Roth IRA's tax-free distributions.
- A decline in the value of the investments in the converted Roth IRA.
- The inability to pay the taxes that resulted from the Roth IRA conversion.

Source: Viewpoints, [www.fidelity.com/rothconversion](http://www.fidelity.com/rothconversion)

*(Continued from page 1)*

version puts them into a higher federal income tax bracket. Other reasons included not having sufficient cash reserves to cover the tax bill (35%) and a significant drop in the value of investments after converting to a Roth IRA (32%).

## **When a recharacterization makes sense**

*By Denise Appleby*

The option to recharacterize a Roth IRA conversion or an IRA contribution is one of the few chances that taxpayers are allowed to use to reverse a tax-related transaction. A big plus is that one does not even need a reason for performing a recharacterization. You can do it just because you want to. However, there are some circumstances under which a recharacterization may make good tax and/or financial sense.

**Cannot afford the income tax due:** A conversion will likely result in a taxable transaction, and could also cause the individual to be in a higher tax bracket. The question then becomes can the individual afford to pay the income tax that is due as a result of the conversion? If the answer is no, then one solution is to reverse (recharacterize) the conversion. When a conversion is recharacterized, it is treated as if it never occurred for tax purposes. This means that the individual would no longer owe income tax on the amount and any increase in tax bracket as a result of the conversion would be restored to what it would have been had the conversion not occurred.

**Conversion has lost market value:** If an individual converts a taxable amount of \$100,000 to his Roth IRA, he will owe income tax on \$100,000. This applies whether the amount has increased or decreased in market value. This can be disheartening if the \$100,000 has lost market value and is now worth (say) \$60,000; and it is unlikely that the individual will want to pay income tax on \$100,000 when all he has to show of the amount is \$60,000. The good news is that if the \$60,000 is recharacterized, it removes any associated tax liability.

Recharacterizations must be completed by the individual's tax filing due date, for the year in which the conversion occurred. Individuals who filed their tax returns or filed for an extension by their tax filing due date receive an automatic 6-month extension for completing a recharacterization. This means that an individual with a tax filing due date of April 15, has until October 15, 2010 to recharacterize a 2009 conversion, if he filed his tax return or filed for an extension by April 15, 2010.

## **Does undoing a Roth IRA make financial sense?**

*By Christine G. Russell, QPA, QKA, AIF, RMA*

Few financial decisions we make as investors allow a "do-over", if either our financial situation or market changes shift out of our favor. Roth recharacterization is one of those rare exceptions, so anyone who made new Roth conversion(s) should review their decision to see if undoing the conversion makes financial sense. For example, if I did a Roth conversion, I am going to pay taxes on the amount of assets I converted at that time. But what if that Roth IRA has since lost value? I am still going to pay taxes on that higher amount, and not what my account is worth today. Why pay taxes on money that is no

*(Continued on page 3)*

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*(Continued from page 2)*

longer working for me? Re-characterization would allow me to undo my conversion and avoid paying the taxes. I may not get my lost account value back, but I am avoiding wasting money paying taxes on value I no longer have.

Importantly, investors have the recharacterization “do-over” available for each Roth conversion, thus to preserve the most flexibility investors may split up any year’s Roth conversion into separate Roth IRAs, and even into different investments for each Roth IRA account. They can then review each separate Roth account to determine whether to re-characterize one or more of those accounts. This allows the most planning flexibility. The investor could decide to only do-over the accounts that lost value after they converted. Or an investor might decide to do-over an account because the tax bite on it would put them in a higher bracket than desired. Thus, an investor can more precisely “dial-into” a tax bill they can afford. With these benefits and the potential to save some taxes why not review your conversion?”

### **To recharacterize or not**

*By Dana Anspach, CFP, RMA(sm)*

If you convert an IRA to a Roth IRA, you have until your tax filing deadline, plus extensions, to undo the transaction (the technical term for such a thing is “recharacterization”).

For those who converted an IRA to a Roth IRA in the 2009 tax year, the deadline to recharacterize is Oct 15, 2010, which is the last day, including extensions, to file a 2009 return.

#### **Reasons to recharacterize**

There are two primary situations you may fall into which make recharacterization worth considering:

1. The Roth conversion no longer makes sense from a planning perspective because your financial situation has changed.

A few potential examples are below:

- Roth assets will be needed sooner than anticipated. (For the Roth decision to

*(Continued on page 4)*

### **Time to start thinking about a redo in 2011**

*By Barry C. Picker, CPA/PFS, CFP*

I've had people talk to me about recharacterizations, usually because of a decline in value. My suggestion is that the time to look initially at the recharacterization is in November, since one cannot reconvert those assets before January at the earliest, but at least 31 days after the recharacterization. If one recharacterizes now, they're out of the Roth for almost four months. If values jump, they've lost tax-free growth. So you want to keep that at risk period to the minimum.

One of course could still consider recharacterizing at any point up to next Oct. 15th for their 2010 conversions. But a main point for those unsure about converting, is that you can always undo it by recharacterizing.

Also, for people concerned about the income putting them into a higher bracket, they can do a partial recharacterization, so that they can undo that amount that would be taxed in the higher bracket, while leaving a portion that would be taxed in the lower bracket.

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*(Continued from page 3)*

work in your favor, Roth assets need time to grow tax-free. If assets will need to be used sooner than anticipated, or at the time of use your tax bracket is likely to be low, than the Roth conversion decision should be reconsidered.)

- You no longer have the funds to pay the taxes that resulted from the Roth conversion. (You don't want to have to liquidate some of the Roth assets to pay the tax. In such a case if you are under 59½, a 10% penalty tax would apply in addition to the income taxes.)
- Due to unemployment or other unforeseen circumstances, you need cash. Because of the Roth conversion you paid a substantial amount of tax using after-tax funds. By recharacterizing, it's as if the Roth conversion never happened. Any excess taxes paid would be returned to you.

2. The Roth conversion still makes sense, but the timing of it did not work out because the assets declined in value, or you had more income than anticipated.

Two potential examples are below:

- The assets in the Roth have declined substantially since conversion. By recharac-

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## Question & Answer

*By Aaron Skloff, AIF, CFA, MBA*

**Q:** After evaluating all the pros and cons, we finally decided to convert our Traditional IRAs to Roth IRAs. Can we reverse the conversion and its tax implications if the financial markets drop?

**The Problem:** Values decline after a Roth IRA conversion. After evaluating all the pros and cons, you converted your Traditional IRAs to Roth IRAs. The conversion generated taxable income based on the value of your accounts on the day of the conversion. In less than one year's time, the financial markets drop. Now, you have a tax burden that would have been less had you simply waited until later in the year to convert – hindsight is always 20/20. For example, on March 1, 2010 you convert \$100,000 of assets and generate \$30,000 of taxes. By Dec. 2, 2010, the value of the assets has declined to \$50,000. In retrospect, if you waited until Dec. 2, 2010 to convert the conversion would have only generated \$15,000 of taxes.

**The Solution:** Recharacterize your Roth IRA Conversion. The same way the IRS permits you to convert all or a portion of your Traditional IRAs to Roth IRAs, the IRS also permits you to reverse all or a portion of the conversion through a "recharacterization". When you recharacterize you reverse the conversion and its full tax implications. Using the example above, the recharacterization would reverse the full \$30,000 tax obligation and the assets would be moved from the new Roth IRAs to the original Traditional IRAs.

The deadline for recharacterizing is the extended due date of your tax return for the year of the contribution or conversion. In the example above, this would be April 15, 2011 or October 15, 2011 with an extension.

**Re-Converting to a Roth IRA.** Ideally, you would reconvert the assets again at their depressed valuation. If only it were that simple. Remember, we are talking about the IRS. You cannot convert, recharacterize, and then reconvert to a Roth IRA within the same tax year. If you convert and then recharacterize, you may not reconvert back to a

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terizing the funds, you can avoid paying tax on the higher value that was stated at the time of the conversion, and instead take the chance that the asset will remain at a depressed value until the next tax year, at which time you can decide to reconvert the funds into a Roth again.

- Your 2009 income was higher than anticipated, and thus you are no longer eligible to convert the IRA to a Roth. (For 2009, only tax payers with modified AGIs of less than \$100,000 were eligible to convert their IRA to a Roth.)

#### **A reason not to recharacterize**

If your 2009 Roth conversion took place because you were in a situation where you had little 2009 income, and plenty of deductions, and thus you were able to convert some assets to a Roth and pay no tax (or pay tax at a very low rate) then there would be no benefit to recharacterization.

Many of you have already filed your 2009 return, which means undoing your Roth conversion would require amending your return. Considering the hassle, the pros of recharacterization would need to be verified to consider doing so.

#### **How to decide**

If you think you might be a good candidate for recharacterization, make sure you run an income tax projection both with and without the ROTH conversion to see what impact your decision would have.

Your accountant or CPA can run such a projection, or you can use an online tax calculator (<http://www.dinkytown.net/java/Tax10402009.html>) to run your own projections.

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Roth IRA before the later of:

- 1) The taxable year following the taxable year in which the amount was initially converted to a Roth IRA or
- 2) The end of the 30-day period, beginning on the day you recharacterized from the Roth IRA to the Traditional IRA

For example, if you recharacterized a conversion contribution on Dec. 2, 2010, you would not be able to reconvert until Jan. 2, 2011. If you reconvert prior to these limit dates, the reconversion will be classified as a failed conversion by the IRS. If the failure is not corrected it may result in an excess contribution to the Roth IRA.

**Reduce Your Headaches.** If your Traditional IRA holds very volatile securities, consider converting just those securities into their own Roth IRAs. In the event those securities decline in value it will reduce your headaches if you choose to recharacterize just those Roth IRAs. In the event those securities increase in value you do not have to do anything.

For example, let's say you have a Traditional IRA that holds one stock, Google. As Google is a very volatile stock, consider converting that Traditional IRA into its own Roth IRA. If Google drops, recharacterize the Roth IRA that holds solely Google. If it rises, do nothing.

**Action Step:** Work closely with your CPA and Financial Advisor, when considering Roth IRA conversions and/or recharacterizations. Conversions and recharacterizations can have significant impacts on your income and your estate's taxes. **RW**

(Continued from page 5)

## Make sure it's trustee-to-trustee

By Beverly DeVeney

This is the last year that some individuals MUST recharacterize. Those who have no choice are individuals whose converted in 2009 and whose modified adjusted gross income exceeded \$100,000 or who were married filing separate.

Other reasons for recharacterizing have been spelled out already - account values have dropped, income taxes were higher than expected due to the conversion, a shortage of funds to pay the income tax or an unwillingness to pay the income tax.

The guidelines for doing a recharacterization are outlined in IRS Publication 590. The recharacterization must be done as a trustee-to-trustee transfer. Both institutions must be notified of the recharacterization. The recharacterization request is for an amount that is all or part of the original converted amount and then a net income calculation is done. Gain or loss is attributed to the recharacterization amount and a net amount is then transferred to the IRA.

The recharacterization must be done by October 15th of the year after the conversion. There is no extension of that date. IRS has allowed late recharacterizations through the private letter ruling process. For 2010, that fee has been reduced to \$4,000. Requests are approved when there are circumstances beyond the control of the taxpayer such as an IRS audit that increases income, incorrect advice from advisors, etc. No late recharacterization requests have been approved for taxpayers who simply changed their minds about doing the conversion so it is important not to miss that date. **RW**

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