There may be a window open right now for a timely Roth conversion or a recharacterization of a prior Roth conversion made in calendar year 2010. The reason is that doing a conversion now may be far cheaper from a tax standpoint than it was just a few weeks ago. Obviously, converting assets within a traditional IRA into a Roth requires paying taxes on the amount to be converted. Since the market has been hammering assets, including those within traditional IRAs, the tax cost has also been reduced.

An investor in the 33% tax bracket would owe $33,000 on a $100,000 conversion, but if the market reduced those assets to $75,000, the tax burden would fall as well, to $24,750 in this example. For those who have considered a conversion but have decided not to convert, this may be a good time to revisit that decision. Given the volatility of the market, an important factor to keep in mind is that taxpayers have the ability to “change their minds” later and “undo” the Roth conversion.

In addition, those who implemented a Roth conversion in 2010 still have time to “undo”, or re-characterize, even if they have already filed their 2010 tax return and paid the tax. The deadline for doing so is October 17, 2011.

How do you recharacterize an IRA contribution or Roth conversion?

To re-characterize an IRA contribution or Roth conversion, you should take the following steps:

Establish another IRA (if necessary).
Generally, you will either need to establish an IRA or use an existing IRA to accept the withdrawn IRA funds.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.

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.

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, 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 will be allowed to recharacterize the Roth IRA contribution up until October 15 even if you already filed your income tax return on time and did not obtain a filing extension. To take advantage of this rule, you will have to file an amended return (IRS Form 1040-X) and write “Filed Pursuant to Section 301.9100-2” on the return. You will be able to obtain a refund for any tax paid on the conversion. You will also need to include a new or amended Form 8606.

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 on Form 8606 for more information.

How do you allocate the earning 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 earning 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 do not have to make up the loss when you recharacterize the IRA.
Partial Recharacterization
If you are recharacterizing only part of an IRA, you need to
determine how much of the IRA’s earnings are attributable to
the part you are 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)]

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.

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 will have to wait a while
before you can reconvert those funds to a Roth IRA. You
cannot convert and reconvert an amount during the same
taxable year, or if later, during the 30-day period following a
recharacterization. If you convert 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 2011. On August 6, 2011, you recharacterize
that Roth IRA to a traditional IRA. You now want to
reconvert to a Roth IRA. You will not be able to effect a
reconversion until the later of:
January 1, 2012 (the beginning of the year following the year in
which the amount was originally converted to the Roth IRA),
or September 6, 2011 (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 will have to wait until at least January 1, 2012, to
reconvert.

For more information about Roth IRA conversion and
recharacterizations, see IRS Publication 590 or contact:

Carl Loden cloden@kshgs.com,
Jen Flinchum jflinchum@kshgs.com
or your KS professional.

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