FINANCIAL PLANNING ASSOCIATION

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Tip of the Week

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Should You Undo Your Roth Conversion?

Prior to 2010, there were income limits on who was allowed to convert a Traditional Individual Retirement Account (IRA) to a Roth IRA. At the start of 2010, those income limits were eliminated, allowing anyone to complete a Roth conversion. Thus, the floodgates were opened and Roth conversions became one of the hot topics among investors and financial planners.

When you convert a Traditional IRA to a Roth IRA all future gains become tax free and you will not be subject to required distributions on the converted amount. The full value of the IRA converted to a Roth IRA is reported as taxable income. In addition to being the first year many investors were allowed to do a Roth conversion, there was an extra kicker in 2010. Instead of reporting the entire conversion amount on your 2010 tax returns, you were allowed to split the conversion amount and report half in 2011 and the other half in 2012.

Many investors considered this a no-brainer, as you were given a mulligan. If you decide that you are better off to not have completed the Roth conversion, you can undo it (called a recharacterization) without consequence. Here's the kicker, if you did a Roth conversion in 2010, you have until you file your 2010 taxes to undo it. If you filed in April, the question is moot. However, if you filed an extension, you may still have time to undo the conversion. But why would you want to?

Reasons to Consider Un-doing the Conversion:

1. **Recent Markets Decline.** There's a possibility that the value of your Roth IRA is less than the amount that you converted. If this is the case, you should consider a recharacterization. Remember that the benefit to the Roth conversion is future tax free growth, but the cost is owing taxes on the value of that conversion. You don't want to pay taxes on an amount larger than the current value.
2. **Ability to Redo.** You not only can undo your conversion, but you can still redo it. Consider this: If you completed a Roth conversion in 2010 for $100,000 and the value of the account has declined to $80,000, you are better off undoing the conversion then, once again, converting the same account. Your end result is the same; you have a Roth IRA with a value of $80,000 (sadly, this does not have the power to wipe out any market losses), but you will owe taxes on $80,000 rather than $100,000.

Other Factors in Roth Conversion Recharacterizations:

1. **You will no longer be able to split the conversion value into two separate tax years.** That offer was only available in 2010. This could bump you into a higher tax bracket, or even cause the loss of some deductions — many of which are based on your Adjusted Gross Income.
2. **You cannot reconvert the same funds right away.** You have to wait until one year after the initial conversion or 30 days after the recharacterization, whichever comes later, essentially mandating a waiting period. The risk is that the value of the account may skyrocket during this waiting period. By the time you reconvert the IRA, you may be converting the same or more as the initial conversion, but will have lost the ability to split the income over two tax years.

This is a complicated situation with significant tax and financial planning considerations. You should consult a financial planner or a tax professional for advice specific to your situation.

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