IRA UPDATE: AUGUST 2011

Cautions on Roth Recharacterization

2010 was a big year for the Roth IRA Conversion. Anyone regardless of income could do a Roth Conversion and there was the two year deal that allowed you to split the inclusion of income on the 2010 conversion to half in 2011 and the other half in 2012. For some, there are reasons to recharacterize the Roth IRA conversion which means undoing the transaction as if it never happened. If you plan to recharacterize, consider the following:

1. Loss of tax free gains: 2010 and YTD 2011 have been decent in terms of market performance. If the Roth IRA has increased in value and you recharacterize, what would have been tax-free gains will now be taxable at a future date when distributed and/or reconverted.
2. Loss of the two year deal: If a 2010 Roth IRA conversion is recharacterized, then the two-year deal is lost forever because reconverting would be done in 2011 and the deal was only for 2010. While an IRA owner can convert similar amounts in 2011 and 2012, the funds could have been growing tax free. In this case, the gains would have to be added to the conversion either by making larger conversion or spreading it out into 2013.
3. There is still more time: Recharacterization does not need to be completed until October 15^{th} of the year following the year of conversion which works out to be October 17, 2011 for 2010 conversions because the 15^{th} falls on a Saturday. It may be worthwhile to wait a bit longer and see how the investment does. If it grows enough, it may be worthwhile to keep the tax free gains and pay the tax bill. Roth recharacterization must be completed via a trustee-to-trustee transfer.
4. Required Minimum Distributions (RMD) will increase: An RMD is calculated using the balance of the IRA on 12/31 fo the previous year. If a Roth recharacterization occurs, that effectively increases the balance in the IRA for the 12/31 date which will cause the RMD to increase.
5. Entire conversion may not be able to be recharacterized: Ideally the taxes due on a Roth IRA conversion should be paid from funds outside the IRA however this is not a requirement. Some IRA owners who do not have the funds outside the IRA to pay the tax still chose to do the conversion and used some of the IRA money to pay the tax. The problem now is that they cannot recharacterize the amounts withheld for taxes which means there will still be some tax to pay as well as a 10% penalty if under 59 ½.
6. Beware of Partial Recharacterizations: A full recharacterization is easy as the whole account gets moved back to the IRA. However with partial recharacterizations and where monies have been co-mingled, the calculation can get quite complicated due the calculation for net income or loss attributable, and an error can result in the wrong amount being recharacterized and unnecessary taxes paid.

Social Security with Roth IRA to reduce taxes

Up to 85% of Social Security income can be taxable as ordinary income under current tax law depending upon your total taxable income. We also know that deferring receipt of Social Security can boost monthly payments for the recipient and a surviving spouse in many cases. By deferring receipt of Social Security, the payments increase by about 8% which is an excellent return in the current environment.

For those who do not need to take Social Security early because they have other sources of income and low yield assets can consider deferring receipt of Social Security and using that time to convert pre-tax IRAs to Roth IRAs. By executing this strategy:

- Taxes are paid now instead of later. If rates are to rise which is very possible with the state of our country's finances, you reduce or eliminate the risk of higher tax rates in the future;
- Reduce and/or eliminate future Required Minimum Distributions that you may not need allowing the funds to grow tax-free for beneficiaries;
- By eliminating the taxable income now by converting, your overall income will be lower during the years when you begin to collect Social Security thereby possibly reducing or eliminating the taxation on Social Security earnings.
- Future withdrawals from the Roth IRA would not affect taxable income and thus the amount of taxation on Social Security Benefits.

For those who are considering such a strategy, great care should be taken to review if this makes sense, and if so, how much to convert. As always, be sure to ask me any questions if you think this strategy may apply to you.

Sincerely,

Jeremy E. Portnoff

Jeremy E. Portnoff, CFP®, AIF®, CRPS®, CES™, CFS®, CTS™, CAS®
NAPFA Registered Advisor
Ed Slott Master Elite IRA Advisor
HS Dent Master Certified Advisor
Paladin Five-Star Advisor