Roth Recharacterization, Hindsight can be 20/20

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I've been a CPA for over twenty years. Recharacterizing a Roth is one of only a few instances that I can think of where the IRS allows you to make a decision (convert from Traditional IRA to a Roth IRA), wait what could be well over a year to see how your newly converted Roth IRA performs, and if you don't like your decision, change it back (recharacterize). As an Administrator of Self Directed IRAs, we had a number of clients who rushed to take advantage of the special rules regarding Roth conversions completed in 2010.

To review, beginning in 2010, the $100k income limitation for conversions was permanently eliminated. This enables taxpayers (whether married or single) to convert traditional IRAs to Roth IRAs without worrying about whether they will qualify by staying under the now eliminated income limitation. As an added incentive, for conversions completed in 2010 only, taxpayers are able to make an election to defer the tax on these conversions and pay tax on half of the converted amount in 2011 and the other half in tax year 2012. Many taxpayers enter into complicated transactions like this not fully understanding all the ramifications and then suffer a form of 'buyer's remorse."

Fortunately, with Roth Conversions, there is an opportunity to 'undo' the transaction. Simply stated, there is an opportunity to evaluate the tax treatment of your account AND THEN, decide whether you really wanted to convert to Roth or not.

Let's look at an example. Suppose you had an IRA account here at MidAtlantic IRA with a value at the time of conversion of $150k (this is the amount you'll pay tax on). Further, let's say that you purchase a property for $90k and put $40k of additional improvements into the property. When the improvements are complete, you put the property on the market for $225k.

If the property sells in a reasonable amount of time for $225k, your decision to convert your IRA was a good one. The only question that remains is whether you want to pay the tax on the $150k (the amount converted) in 2010 or defer the tax and pay half in 2011 and the other half in 2012.

If on the other hand, let's say you put the property on the market for $225k and it doesn't sell. In fact, let's say the likelihood is low that you'll be able to recoup your investment. What can you do? Simple, you recharactorize your Roth back to a Traditional IRA. This is one of only a few instances in tax law where hind sight can be 20/20. When you recharacterize, you will not pay tax on the conversion. The account is returned to its pre Roth status. Better still, you have until October 15, 2011 to recharactorize your 2010 conversion.

In the self directed IRA world, this can be a real planning tool. We have many clients who, thinking that they have found an extremely good piece of property, convert first and then purchase the property. The challenge becomes, with illiquid assets, does the transaction turn out to be as profitable as was originally thought. If it was, the client is happy to pay the tax on the conversion knowing that his account is worth quite a bit more and the income never will be taxed. If the deal turned out not to be a good one, then the client can recharactorize and not pay any tax.

The rules on conversions and recharactorizations are complex and confusing. We encourage you to contact us or your tax advisor to help explain the rules regarding these transactions. Happy investing!!

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Jack Kiley brings to the table over 25 years of experience in public accounting. He has extensive knowledge in developing tax, retirement and financial planning strategies for high net worth individuals along with closely held businesses and has a reputation for "speaking in plain English" regarding complex concepts. Groups regularly engage him to speak about these topics especially "How to Self-Direct Your IRA." His specialty knowledge makes him the expert to turn to particularly when a complex scenario is needed for the purchase of real estate, mortgages, leases and other cash flows that the IRS allows in an individual retirement plan. Jack Kiley a *Certified Public Accountant* (CPA) is also credentialed as a *Personal Financial Specialist* (PFS) and a *Certified IRA Services Professional* (CISP).

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