How to Reverse a Roth IRA Conversion

Posted: 12/2/2016 by Fidelity Viewpoints

See how reversing a Roth IRA conversion may help investors save on taxes.

There are good reasons to convert a traditional IRA to a Roth IRA. Among them is a Roth's tax-free growth potential and the ability to take tax-free withdrawals in retirement.[1]

However, there also may be reasons to reverse a Roth IRA conversion. For instance:

- The value of your investments in the converted Roth IRA has declined.
- Your taxable income has ended up being higher than you expected and/or the additional income from the Roth IRA conversion has bumped you into a higher federal income tax bracket.
- You've determined that your taxable income in retirement will likely be lower than you expected, reducing the potential benefits of a Roth IRA's tax-free distributions.
- You don't have enough cash on hand to pay the taxes.

The process of reversing a Roth IRA conversion is known as recharacterization. It needs to be completed by the last date, including extensions, for filing or refiling your prior-year tax return, which is typically on or about October 15. You can generally recharacterize all or a portion of what you converted. And if you change your mind again, assets that you recharacterize to a traditional IRA can be reconverted to a Roth IRA in the next tax year after the conversion or 30 days after the recharacterization, whichever is later.

Potential benefits

Richard, looking to take advantage of the potential benefits of a Roth IRA in retirement, converted $50,000 from his traditional IRA to a Roth IRA on March 1 of year 1. He planned to pay $12,500 in federal income tax on the conversion (he's in the 25% bracket) when he files his taxes.

Richard filed and paid the tax before the usual deadline of April 15 in year 2, but the value of the investments in his Roth IRA were down to $30,000 by the end of July of that year. Because his tax liability would have been less if he had converted then, Richard decided to recharacterize his conversion to a traditional IRA on August 1, before the October deadline. He processed the transaction with his broker and filed an amended tax return to exclude the initial $50,000 conversion from his reported income for year 1.

When he was eligible, on September 1, and with the help of his broker, he reconverted his traditional IRA, which in the interim had increased in value to $35,000, to a Roth IRA. This reconverted value will be included in his tax return, with an estimated tax of $8,750. Even though the account value has risen somewhat from the low point of $30,000, the recharacterization may still save him $3,750, or 30% of the tax cost of his initial conversion.

Undoing a conversion may lower tax cost

	March 1 of year 1	August 1 of year 2	September 1 of year 2	Net tax savings
	Conversion of traditional IRA to Roth IRA	Recharacterization	Reconversion	
Market value	$50,000	–$50,000	$35,000	
Tax rate	25%	25%	25%	
Tax liablility	$12,500	–$12,500	$8,750	$3,750

For illustrative purposes only.

Using recharacterization as a strategy

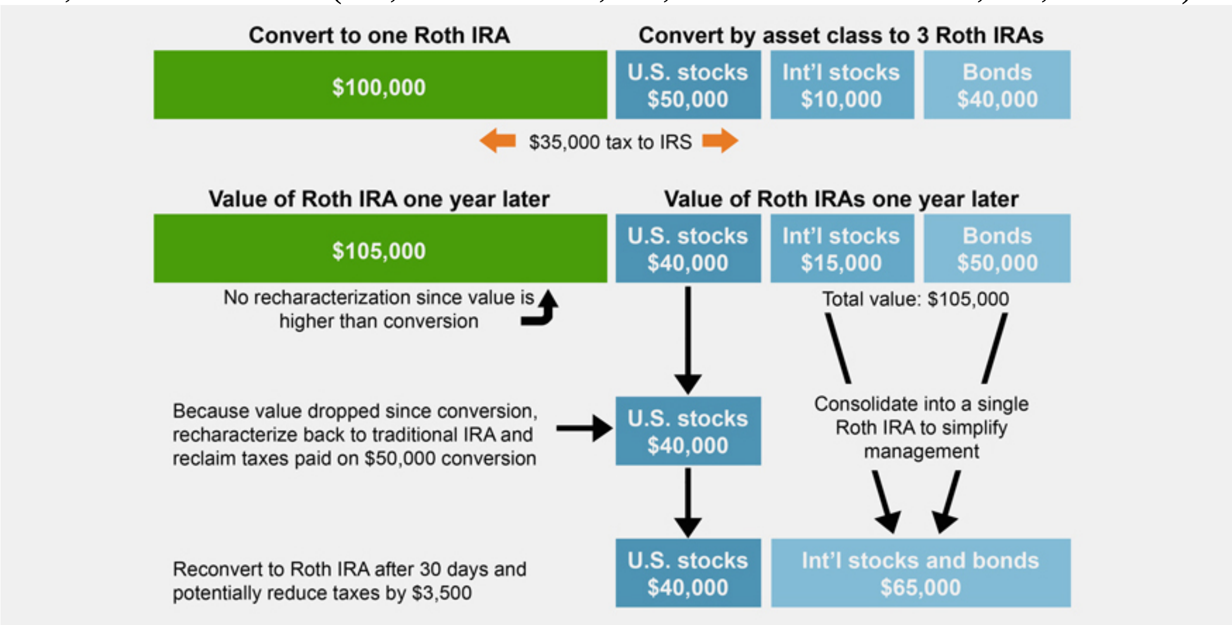
You can manage the tax cost of your conversion by using recharacterization strategically. Instead of just one conversion or multiple conversions into one Roth IRA account, you can make separate conversions into separate Roth IRA accounts. You might do this by asset type or even by individual investments. Then you could later choose to recharacterize only those Roth IRAs that have declined in value. Current rules allow you to recharacterize by account. If you convert into a single account, you will effectively have to recharacterize a pro rata portion of the gains on all your other investments, as well as the losses. In fact, if your portfolio overall gains, you will likely not recharacterize at all, and so potentially miss the opportunity to save on the tax cost of conversion.

Once the recharacterization deadline has passed (usually the following October 15, but if it falls on a weekend, the deadline is the following Monday), you may want to consider consolidating your Roth IRAs into a single account again to make them easier to manage.

Consider this hypothetical example. Caroline, age 55, has $100,000 in a traditional IRA, of which $50,000 is invested in U.S. stocks, $10,000 in international stocks, and $40,000 in bonds and bond funds. By making several separate conversions into separate Roth IRA accounts, she can help manage her tax liability on the conversions. The chart below shows how this could work.

How separate conversions may lower taxes

$100,000 traditional IRA ($50,000 U.S. stocks, $10,000 international stocks, $40,000 bonds)



For illustrative purposes only. This hypothetical assumes a 35% tax rate.

Converting by asset class enables Caroline to keep the Roth IRA accounts that have increased in value and recharacterize those that haven't, which could potentially save her $3,500 on the tax cost of the conversions. She may even want to separate conversions further by individual investments.

This is a sophisticated strategy, and you should discuss such a strategy with your tax adviser to implement it correctly. You should also ensure that by dividing your conversion into multiple accounts, you don't needlessly incur additional fees, such as minimum balance fees or additional tax preparation costs. Keeping track of the paperwork for the multiple conversions and accounts should also be considered.

Think before you act

Recharacterization may enable you to reduce your tax liability on a Roth IRA conversion. The rules can be confusing, so make sure you check with a tax adviser to understand the potential impact on your tax situation. For example, if you choose to recharacterize and then reconvert, the taxable amount may shift from one tax year to another, which may or may not be a good thing.

1. A distribution from a Roth IRA is tax free and penalty free provided that the five-year aging requirement has been satisfied and at least one of the following conditions is met: you reach age 59½, make a qualified first-time home purchase, become disabled, or die.

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