Tax Strategies for IRA Owners Affected by the Precipitous Stock Market Decline

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In view of the precipitous decline in the stock market, there are some tax strategies for owners of traditional or Roth IRAs to consider.

Converting a traditional IRA to a Roth IRA

A traditional IRA can be converted to a Roth IRA if, for the conversion year, (1) the taxpayer's modified AGI (not counting the taxable amount of the conversion) does not exceed $100,000, and (2) the taxpayer's not a married individual filing a separate return (unless he lived apart from his spouse during the entire withdrawal year). The amount withdrawn from the traditional IRA and put in the Roth IRA is 100% taxable as ordinary income in the year of the conversion. The 10% penalty for premature withdrawals before age 59-1/2 does not apply.

If your traditional IRA has declined in value because of the current stock market debacle, and you otherwise qualify; now would be a great time to do a Roth conversion while its value is low and, thus, the amount subject to income tax would be low.

The advantage of a Roth IRA is that, if you qualify, the entire value of the account plus its earnings are income tax free when you or your beneficiary withdraw them. Plus there are no requirements to take minimum distributions beginning at age 70-1/2. The Roth IRA can continue to grow tax-free.

Recharacterizing an Underwater Roth Conversion

If you converted a traditional IRA to a Roth IRA ealier this year when the market was much higher, you can treat the conversion as if it never happend by recharacterizing it. Transfer the amount converted to the Roth IRA (plus earnings or minus losses) back to a traditional IRA by a trustee-to-trustee transfer.

Here's an example: You converted a traditional IRA to a Roth IRA in February 2008 when it was worth $40,000. Currently, the Roth IRA is worth only $25,000 due to market decline. To avoid paying tax on $15,000 ($40,000-$25,000) of evaporated or phantom income, you can recharacterize the Roth IRA back to a traditional IRA.

How do you recharacterize? You must do two things: (1) Contact the financial institution that administers your IRA and have them make a direct transfer from the Roth back to a traditional IRA. The transfer to the traditional IRA is treated as if it were the original recipient of the rollover, so the tax consequences of the initial conversion to the Roth IRA are avoided (i.e., the taxpayer does not recognize the income that would have been recognized with the initial Roth conversion). Note that the transfer must include the earnings (or losses) allocable to the converted amount. You cannot withdraw funds from a ROTH and redeposit them to a traditional IRA - that won't work. The transfer has to be trustee-to-trustee. (2) The easiest way to make a recharacterization of a 2008 conversion is to reflect it on your 2008 Form 1040 due on or before April 15, 2009 (or Oct. 15, 2009, if the taxpayer gets an automatic extension of six months to file his 2008 return). However, a taxpayer who timely files his 2008 return without having recharacterized a 2008 conversion may do so as late as six months after the original due date for filing the 2008 return, i.e., by Oct. 15, 2009. If a 2008 conversion is recharacterized after the taxpayer timely files his 2008 return, he should file an amended return for 2008 reflecting the recharacterization (the notation "Filed pursuant to section 301.9100-2" should be made on the return).

Going back to a Roth Again

Since you wanted a Roth IRA in the first place and only recharacterized back to a traditional IRA becuase of the market decline and the evaporated taxable income, when can you go back to a Roth again? The reconversion cannot be made before the later of (1) the beginning of the tax year following the tax year in which the amount was converted to a Roth IRA (January 1, 2009 for 2008 conversions) or (2) the end of the 30-day period beginning on the day on which the IRA owner transfers the amount from the Roth IRA back to a traditional IRA by way of a recharacterization. It is best to go back to Roth when the market is low to minimize the tax impact.

Remember, PA treats IRAs completely differently than the feds. There is no PA deduction for contributions to a traditional IRA. Earnings in an IRA account are not subject to tax if withdrawals are taken from the IRA as retirement benefits. If premature withdrawals are taken from an IRA, PA taxes the withdrawals to the extent they were not previously taxed (e.g. on account earnings since contributions were previously taxed). No PA tax is due on a Roth recharacterization.