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RETIREMENT PERSPECTIVES

Roth Recharacterization Repealed (Sort of)

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Recharacterization of Roth IRA conversions from traditional IRAs and 401(k)s has been repealed, but recharacterizing Roth contributions is still permitted.

When Congress passed the Tax Reform Act of 1997, what was originally referred to as “IRA Plus” became known as Roth IRA after its primary sponsor, Senator William Roth (Del.). Two decades later, Roth IRAs continue to grow in popularity and assets, especially with younger investors. More than 30% of Roth IRA investors are younger than 40, while cumulative assets have grown to more than $660 billion as of December 31, 2016 (latest available), according to the Investment Company Institute.

Roth IRAs have experienced a number of legislative changes since their inception. For example, in 2002, 401(k) aftertax funds (basis) were first permitted to be rolled into an IRA—which could subsequently be converted into a Roth IRA. Then, in 2008, the rules were loosened again, this time permitting Roth conversions directly from a 401(k), without first rolling over assets into a traditional IRA. In 2006, although not directly affecting Roth IRAs, Congress authorized Roth 401(k) contributions for the first time. Unlike Roth IRAs, an individual did not have to satisfy an income test to meet eligibility requirements. Instead, everyone was eligible to make contributions to a designated Roth 401(k), account so long as it was offered by the plan.

Then, in 2010, Congress repealed the income limit on Roth IRAs. Until then, only individuals whose income was less than $100,000, regardless of marital status, were eligible to convert to a Roth IRA. Now, all investors, regardless of income, are eligible to convert assets to a Roth IRA– commonly referred to as a “Roth conversion.” The repeal spurred a wave of conversions as higher-income taxpayers seized the Roth IRA advantage. Conversions were done for a myriad of reasons, including potential tax-free distributions, eliminating required minimum distributions, and estate and legacy planning. In addition, the change created the popular **“back-door”** Roth strategy.

Do-overs by Recharacterization

Since the inception of this popular retirement vehicle, an investor who converted funds to a Roth IRA could at a later date change his or her mind and reverse the conversion through a technique known as recharacterization. In other words, a recharacterization allowed an individual to unwind or reverse a Roth IRA conversion. A Roth conversion triggers federal income and state (if applicable) income tax liability; by contrast, a recharacterization eliminates the tax liability. In addition, an investor may be eligible for a refund (plus interest) if taxes were previously paid. Anyone could initiate a recharacterization for any reason. It was almost too good to be true.

Under the original Roth rules of 1997, recharacterization offered an investor a method to reverse Roth contributions or conversions for those whose income exceeded the limits as the contribution or conversion shouldn’t have occurred due to being ineligible. At first, the rules required an investor to satisfy an income test for both Roth contributions and conversions. Since 2010, only Roth contributions are subject to an income test, whereas anyone regardless of household income is eligible to convert.

A New Twist on Recharacterization

In 2018, as part of the Tax Cut and Jobs Act, recharacterization of Roth IRA *conversions* from traditional IRAs and qualified plans (e.g., 401(k)) was repealed. As a result, *all* Roth conversions taking place on or after January 1, 2018 are irrevocable. But recharacterizing Roth *contributions* is still permitted. For instance, a traditional IRA contribution can be recharacterized to a Roth IRA contribution and vice-versa.

Prior to January 2018, an investor had four available recharacterization options including: (1) traditional IRA contribution to a Roth IRA, (2) Roth IRA contribution to a traditional IRA, (3) conversion of traditional, SEP, or SIMPLE IRA and (4) qualified plan (e.g., 401(k)-to-Roth IRA conversion to a traditional IRA). Under the new rules, the list of options has been reduced.

How Does the Effective Date Apply to a Roth IRA Conversion Made in 2017?

According to the IRS, a Roth IRA conversion made in 2017 may be recharacterized as a contribution to a traditional IRA if the recharacterization is made by October 15, 2018. A Roth IRA conversion made on or after January 1, 2018, cannot be recharacterized, the IRS says. For details, see “Recharacterizations” in Publication 590-A, “Contributions to Individual Retirement Arrangements (IRAs).”

Why Would Someone Recharacterize a Roth Conversion?

Common reasons to consider recharacterizing a 2017 Roth IRA conversion include: market loss—if the amount of your Roth IRA is valued less today then the fair market value the day it was converted, consider recharacterizing. Why pay income tax on an investment that has lost value? Also, it’s possible you are in a lower marginal tax bracket this year (2018) due to tax reform. Consider recharacterizing and subsequently reconverting. This strategy allows the tax liability to be associated with your 2018 income instead of 2017. Other reasons for recharacterization include the painful discovery that the federal and/or state tax bill is much higher than anticipated.

Tip: An individual is permitted to reconvert after recharacterizing. But certain timing rules must be followed: you are required to wait until the calendar year following the original conversion or more than 30 days, whichever is longer.

Does the End of Recharacterization Mean Roth Conversions Are No Longer Viable?

Absolutely not, although it does place a greater emphasis on planning, especially in the face of a market loss, an inability to pay the associated tax liability, etc. Other reasons for thorough due diligence include: the potential of increased Medicare premiums (Part B and D); Social Security benefit taxation; the 3.8% net investment income surtax; and phasing out of means-tested government programs, as well as tax deductions and credits. Again, you must do your homework prior to converting because the decision is irrevocable, which could cause a tax “domino effect” that affects other benefits.

Partial Roth Conversions

A popular strategy over the years consisted of annual partial Roth conversion known as “fill the bracket”—converting just enough to remain in their current marginal tax bracket. An investor working with a tax professional would need to be extra cautious now that a conversion is irrevocable. Why? Because if you accidently convert too much, you may inadvertently be bumped to a higher bracket (federal and/or state)—without an option to unwind the conversion, thus incurring a higher tax liability than expected. Having a solid understanding of what a client’s Roth conversion will do to their income (and by association, his or her taxes), prior to converting, is crucial. This is easier said than done. Unfortunately, predicting a client’s annual household income is difficult, for most, if not all, clients, especially for those who are thinking about converting early in the year. This may very well lead to a change in Roth IRA conversion planning. Instead, it will probably be beneficial to wait until later in the year to get a better feel for your total household income.

What Else Do I Need to Know About Recharacterization?

- Effective January 1, 2018, recharacterization of Roth conversions has been eliminated. However, Roth contributions can continue to be recharacterized. The recharacterization deadline is tax filing plus extension of the year following the contribution tax year.

- The IRS announced 2017 Roth conversions can be recharacterized until tax filing plus extension (October 15, 2018).

- Check with your IRA custodian(s) regarding the paperwork and process required to recharacterize.

- Recharacterization is required to be processed via "trustee-to-trustee" transfers.

- October 15, 2018 is a firm deadline, which means the entire recharacterization process must be completed by then. So check with your custodian on the length of time needed to recharacterize. If you wait until October 15 to submit for processing, it may be too late.

- If you're not sure about the amount, remember that a full or partial recharacterization is allowed.

- Amounts recharacterized do not need to be recharacterized to the same IRA they came from. Any traditional IRA would be permitted.

- A Roth conversion started from a qualified plan like a 401(k) cannot be recharacterized back to the plan. Instead, the recharacterization funds would need to be transferred to a traditional IRA.

- Concerned about paperwork? Partner with an experienced accountant or tax professional, because reporting a recharacterization involves multiple tax forms.

- IRS Form 8606 is required filing for all Roth IRA conversions.

- For more on recharacterization see IRS Publication 590-A "Contributions to IRAs".

If you have any questions about this or another retirement topic, please e-mail me at **roadtoretirement@lordabbett.com**.

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Traditional IRA contributions plus earnings, interest, dividends, and capital gains may compound tax-deferred until you withdraw them as retirement income. Amounts withdrawn from traditional IRA plans are generally included as taxable income in the year received and may be subject to 10% federal tax penalties if withdrawn prior to age 59½, unless an exception applies.

A **Roth IRA** is a tax-deferred and potentially tax-free savings plan available to all working individuals and their spouses who meet the IRS income requirements. Distributions, including accumulated earnings, may be made tax-free if the account has been held at least five years and the individual is at least 59½, or if any of the IRS exceptions apply. Contributions to a Roth IRA are not tax deductible, but withdrawals during retirement are generally tax-free.

A **SIMPLE IRA** plan is an IRA-based plan that gives small-business employers a simplified method to make contributions toward their employees' retirement and their own retirement. Under a SIMPLE IRA plan, employees may choose to make salary reduction contributions and the employer makes matching or nonelective contributions. All contributions are made directly to an individual retirement account (IRA) set up for each employee (a SIMPLE IRA). SIMPLE IRA plans are maintained on a calendar-year basis.

A **simplified employee pension plan (SEP IRA)** is a retirement plan specifically designed for self-employed people and small-business owners. When establishing a SEP-IRA plan for your business, you and any eligible employees establish your own separate SEP-IRA; employer contributions are then made into each eligible employee's SEP IRA.

A **401(k)** is a qualified plan established by employers to which eligible employees may make salary deferral (salary reduction) contributions on an aftertax and/or pretax basis. Employers offering a 401(k) plan may make matching or nonelective contributions to the plan on behalf of eligible employees and may also add a profit-sharing feature to the plan. Earnings accrue on a tax-deferred basis.

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