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Deadline to reconvert Roth IRA at hand

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Taxpayers who converted a traditional individual retirement account to a Roth IRA this year don't have to stick with that decision — even if they've already paid taxes on the conversion — as long as they undo the Roth conversion by the IRS deadline of Oct. 15.

If that sounds like an odd move, financial advisers say there are good reason for investors to change their minds again.

It could be that the value of the investments in the converted Roth IRA went down and they don't want to pay taxes based on the value at the time of conversion. They may not have enough cash on hand to pay the taxes or their taxable income ended up being higher than expected and income from the Roth conversion knocked them into a higher tax bracket.

The good news is the Internal Revenue Service doesn't require any specific reason for undoing or recharacterizing a Roth IRA. It can be done for any reason.

Howard Davis — president of the Downtown accounting firm Davis, Davis & Associates — said the most common reason he has seen clients recharacterize a Roth IRA conversion is due to stock market declines. But he has one client this year who made the switch back so he could use the money that he would have used to pay taxes on the conversion to remodel his kitchen.

"The client wanted to use the money for something else," Mr. Davis said. "They changed their mind about paying taxes and decided to change the account back to a Traditional IRA. That just goes to show you can redo it for any reason and those reasons could be personal."

Roth IRAs are different from traditional IRAs in that withdrawals from traditional individual retirement accounts are taxed as ordinary income when the account owner reaches retirement age. Withdrawals from Roth IRAs are exempt from taxation.

The reason for the different tax treatment is that contributions to a traditional IRA are deducted from the saver's income taxes and are allowed to grow tax-free during the accumulation stage.

Roth IRA owners do not get that tax deduction. All of the contributions that Roth IRA account owners make from their income toward their retirement account have already been taxed.

While the tax code that allows retirement savers to convert traditional IRAs to Roth IRAs makes the change permanent, it also provides an escape hatch. Account owners are allowed to undo it each year for either a portion or the entire amount that was converted.

To avoid paying the taxes on a conversion, the entire recharacterization transaction must be completed by Tuesday, which is the deadline for filing extensions or to refile a prior year tax return.

Recharacterizing a Roth IRA is "a tax planning opportunity to make lemonade out of lemons," said P.J. DiNuzzo, president and chief investment officer at DiNuzzo Index Advisors in Beaver.

"It's a great opportunity if you don't want to pay the taxes or something has changed in your personal financial landscape or your portfolio has underperformed — especially if it has dramatically underperformed."

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