

Understand the Flexibility of Roth Conversions

Fidelity Viewpoints

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There are many reasons that investors convert traditional IRAs to Roth IRAs, including the ability to take tax-free distributions once you have reached 59 ½, provided certain conditions are met. Sometimes there are reasons why you may want to undo a conversion. If you converted in 2008, for instance, you may be wondering if it would have been better to wait. Why? Because with stock market valuations still significantly below early 2008 levels, the taxes on converting today may be significantly lower.

Also, if you're thinking about taking advantage of tax law changes in 2010, which will allow many previously ineligible investors to convert traditional IRAs to Roth IRAs, it's important to know about undoing a conversion.

Fortunately, the IRS does offer an opportunity to press the "undo" button on a Roth IRA conversion. The process is known as "recharacterization" and it allows you to reverse amounts converted from a traditional IRA to a Roth IRA and recover any taxes you paid. If you could benefit from this option based on a 2008 Roth IRA conversion, the time to act is now, as the October 15 deadline for recharacterizing is approaching (assuming you met the 2008 federal tax filing deadline in April).

The rationale

In addition to recapturing all or a portion of the tax cost of a Roth IRA conversion, there are other reasons why you might consider a recharacterization, including:

- Your taxable income was higher than expected and/or the additional income from the Roth conversion puts you into a higher federal income tax bracket.
- Your taxable income in retirement will be lower than you expected, reducing the anticipated benefit of tax-free income from a Roth IRA.
- Your modified adjusted gross income exceeded \$100,000 or you filed your taxes as married-filing separately, resulting in a "failed conversion."
- You do not have sufficient cash reserves to cover the tax bill.

After you complete a recharacterization, you do have the option of re-converting to a Roth IRA. The only requirement is that you wait one year from the original conversion date or 30 days after the recharacterization, whichever is later.

The following hypothetical example illustrates a recharacterization. Richard was looking to reduce the amount of taxes he would pay in retirement and converted \$100,000 from his traditional IRA to a Roth IRA in March 2008. He incurred a federal tax of approximately \$25,000 (25% marginal tax rate), which he paid from other savings.

Like many investors, the value of Richard's Roth IRA fell in 2009, eventually bottoming out at \$60,000. Realizing that he would have incurred a much smaller tax bill if he had waited to convert, Richard decided to recharacterize the conversion back to the traditional IRA. He completed the recharacterization when his account was valued at \$70,000. He then waited the prescribed period of time and re-converted the \$75,000 in his traditional IRA (his investments had increased in value since he recharacterized) to a Roth IRA. Richard completed his recharacterization by first contacting his financial provider and asking them to move \$75,000 from his Roth IRA back to his IRA and

then filing an amended tax return excluding the \$100,000 conversion. He will include \$75,000 as income on his 2009 tax return with an estimated tax of \$18,750. By recharacterizing and reconverting, Richard was able to save \$6,250 in taxes and reclaim 25% of his original tax cost.

By The Numbers (hypothetical illustration)					
	Mar 1 '08	Apr 15 '09	Oct 1 '09	Nov 15 '09	Apr 15 '10
	Converted Traditional IRA to Roth	Paid taxes on conversion (\$25K)	Recharacterize File forms with IRS	Convert back to Roth	File taxes, claim credit of \$6,250 (\$25K - \$18,750)
Pre-conversion Market Value	\$100,000		\$70,000	\$75,000	
Tax Rate	25%		25%	25%	
Estimated tax on conversion	\$25,000		\$17,500	\$18,750	
Potential tax saving					\$6,250

As this example shows, recharacterization may be a valuable way to reduce some of the guesswork involved with Roth IRA conversions. The rules can be confusing, so make sure you -- or your financial or tax advisor -- are aware of the following provisions:

- Recharacterizations must be completed through a trustee-to-trustee transfer.
- The deadline for completing a recharacterization is the last date to file your prior year taxes, inclusive of extensions -- usually on or about October 15th.
- All or a portion of the amount you converted can be recharacterized.
- Traditional IRA balances can be reconverted back to a Roth IRA one year after the original conversion or 30 days after the recharacterization, whichever is later.

Think before you act

Decisions about recharacterizing Roth IRAs are complicated and you should understand what the impact is on your specific 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 desirable to your situation.

- Learn more in IRS Publication 590.
- Learn how to recharacterize, convert, or reconvert at Fidelity.
- Speak to a Fidelity Retirement Specialist at 800-544-5373.

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