Market skid may prompt Roth IRA 'do-overs'

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Oct. 17 may not be known officially as Mulligan Day, but affluent investors who converted their conventional IRA to a Roth last year may want to consider a “do-over” and re-characterize their account by the deadline date.

“Every adviser who does comprehensive tax management should realize they can potentially save clients tens of thousands of dollars” using conversion and re-characterization strategies, said David John Marotta, president of Marotta Wealth Management. “It is part of our annual tax management strategy.”

This year, re-characterization — and attendant strategies to lower taxes paid — is likely to be more prevalent than ever as financial advisers try to determine what is best for clients who converted their individual retirement accounts last year.

As a result of a rule change effective in 2010 that permitted those with more than $100,000 in adjusted gross income to convert from an IRA to a Roth IRA, many affluent investors fearful of higher tax rates in the future took advantage of the opportunity and switched. They paid income taxes on the gains in their conventional IRA and now look forward to tax-free withdrawals for the life of their Roth IRA.

But the roiling stock market, and the possibility of undoing the conversion and receiving a refund for income taxes paid, have advisers and clients rethinking their choices. Some are considering a re-characterization to recover taxes paid and then another conversion later to take advantage of market losses.

In 2010, Mr. Marotta said he converted five times more money than participating clients had intended to keep in their Roth IRAs with the intention of undoing all but the top-performing 20%. In the weeks leading up to this year's Oct. 17 deadline, he will evaluate the investments and choose which to keep. He will repeat the process next year.

Mr. Marotta segregates the IRA conversions into five separate accounts, each devoted to one asset class. Each asset class must clear two hurdles to become “keepers,” he said.

First, the account value must be higher than the amount originally converted; next, it must not push the account holder into a higher tax bracket, although the second hurdle can be waived if results are outstanding, he said.

Acknowledging that taxes could rise if Bush-era tax cuts are allowed to expire in 2013, Mr. Marotta sets the hurdle a little lower than he would if tax rates were sure to remain as they are. But for accounts down significantly since the day of the original conversion, he called it a no-brainer to reconvert the funds back to an IRA and restart the whole process when rules allow — at least 30 days later or Jan. 1 of the year following the year of the original conversion.

Not everyone agrees that re-characterization should be thought of as an active investment strategy.

“It all comes down to trying to time the market,” said tax and retirement expert Ed Slott, president of Ed Slott and Co. LLC. He called the short-term strategy a gamble.

Mr. Slott views conversions as a long-term strategy and doesn't plan to undo his own Roth conversion.

“If you re-characterize 2010's conversion, you can't reconvert those monies for 30 days,” Mr. Slott said. “What if the market goes up in that time and you miss all of that?”

Many advisers who have converted some of their clients' assets to Roth accounts “will let it go” even if it might make sense to reconvert, said David Peterson, founder and president of Peak Capital Investment Services. He uses a strategy similar to Mr. Marotta's.

Mr. Peterson believes that some fee-based advisers have shied away from Roth conversions because the tax bill on the converted assets lowers assets under management.

“You lose money as an adviser by telling your client to do the right thing,” he said, noting that some advisers are reluctant to suggest reconversions, attributing that to “laziness.”

Since he believes that markets tend to go up over the long run, Mr. Peterson said it's a “close call” as to whether accounts that are flat should be switched back to IRAs.

Craig Brimhall, vice president of retirement wealth strategies at Ameriprise Financial Inc., said he is “OK, conceptually” with re-characterizations, which some Ameriprise advisers plan to recommend.

“I'd use it selectively,” he said. “I probably wouldn't do it on a $30,000 account, but on $300,000, maybe.”

Advisers must make sure their clients understand the risks involved in the strategy, which requires a 30-day waiting period before an account can be switched back to a Roth after re-characterization.

“If the market zooms up, you'll be the bad guy,” he said.

He has told Ameriprise advisers to prepare their paperwork for any re-characterizations prior to the official deadline in case there is a backlog of requests. No one has any idea what to expect in terms of volume, though.

“Can you imagine if everyone did this?” he said. “My own Roth account is down, but no way do I want to go through the paperwork.”