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Deadline Approaching for Undoing a 2010 Roth IRA Conversion



If you converted a traditional IRA to a Roth IRA in 2010, and your Roth IRA has sustained losses as a result of the recent market downturn, you may want to consider whether it makes sense to undo (recharacterize) your conversion. You have until October 17, 2011, to undo your 2010 conversion. (If you've already filed your federal income tax return for 2010, you'll need to file an amended return if you recharacterize.) A recharacterization can help you avoid paying income tax on the value of IRA assets that have been lost in the downturn. When you recharacterize, your conversion is treated for tax purposes as if it never happened.

For example, assume you converted a fully taxable traditional IRA worth \$100,000 to a Roth IRA in 2010. However, due to the recent market volatility, that Roth IRA is now worth only \$60,000. If you don't undo the conversion you'll pay federal (and possibly state) income tax on \$100,000, even though the current value of those assets is only \$60,000. If you undo the conversion, you'll be treated for tax purposes as if the conversion never happened, and you'll wind up with a traditional IRA worth \$60,000--and no resulting tax bill.

Conversions made in 2010 present special planning issues. A one-time rule gives you the option of including all of the income from your 2010 conversion on your 2010 federal tax return, or reporting half of the income in 2011 and the other half in 2012. If you recharacterize, you'll lose the ability to utilize this special deferral rule.

If you recharacterize your 2010 conversion, you're allowed to convert those dollars (and any earnings) to a Roth IRA again ("reconvert") but you'll have to wait 30 days, starting with the day you transferred the Roth dollars back to a traditional IRA. Keep in mind that even though the amount you recharacterized, and any earnings, is subject to a 30-day waiting period, any additional amounts in your traditional IRAs are not subject to the waiting period, and you can convert all or part of those dollars to a Roth IRA at any time. If you reconvert in 2011, then all taxes due as a result of the conversion will be included on your 2011 federal income tax return.

(You can also recharacterize a 2011 Roth conversion. However, the deadline for doing so isn't until October 17, 2012. If you recharacterize a 2011 conversion, you cannot reconvert those dollars until January 1, 2012, or, if later, 30 days following the recharacterization.)

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Of course, the current market downturn also presents an opportunity to convert additional traditional IRA assets to a Roth at a potentially lower tax cost than just a few months ago.

Whether it makes sense to recharacterize your Roth conversion depends on several factors, including the extent of the losses in your Roth IRA, the potential value of the special 2010 tax deferral rule to you, and your expectations of where the markets may be headed. Your financial professional can help you decide if a recharacterization is right for you.

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