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Deadline looms: Should you re-characterize a Roth IRA?

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Lawyers and their clients who chose to convert a traditional IRA into a Roth IRA last year face a deadline in the coming weeks.

Those who wish to re-characterize their Roth IRA back into a traditional IRA have until Oct. 17 to take action.

Last year, lawyers and their clients had **a unique opportunity** to convert a traditional IRA into a Roth IRA, deferring the tax over a two-year period.

Now, for those who wish to undo their decision, they must make a choice in the next 10 days.

Estate planning attorney Bernard A. Krooks, a partner at Littman Krooks in Manhattan and White Plains, N.Y., said he had received "several inquiries" about re-characterization.

"I don't think anybody expected the market would be down about 10 percent," Krooks said. Re-characterizing for those whose investment lost a great deal is "a win-win and in my experience, there are very few win-wins in tax planning."

But think twice before making the switch, advised Ed Slott, a CPA in Rockville Centre, N.Y., who publishes "Ed Slott's IRA Advisor."

"Look at the situation long-term," he stressed. "Too many people are reacting to the ups and down of the market, and it is unfortunate that the market has been so volatile right before the deadline."

The ability to convert and re-characterize "shouldn't be used as a swinging door," Slott cautioned. "Don't lose sight of the long-term plan."

A 'tanked' Roth

Lawyers and their clients should think through the option of re-characterizing and consider their overall estate plan, Slott said.

"These days a retirement account is often larger than the value of a house and a key part of an estate plan," he said. "A big part of that plan is minimizing or reducing taxes and the Roth fits into that plan."

The intent of a Roth IRA is to have tax-free income in retirement or to pass on to loved ones in an estate plan, Slott said. Therefore, to respond to short-term market swings by re-characterizing can be short-sighted.

"If your real plan is to be in a Roth and you plan to re-convert at some point, the market could be even higher," he said, which would result in even greater taxes when switching back to a Roth. "You will have to pay taxes on all those gains when you could have just stayed in a Roth."

Robert Keebler, a CPA with Keebler & Associates in Green Bay, Wis., pointed out that for those who converted to a Roth IRA in early 2010, the Dow Jones Industrial Average is roughly unchanged – despite the turbulent months in between.

Attempting to play the market is a dangerous game, Slott noted. "It's hard to predict peaks and valleys."

However, re-characterizing could be a good option for some.

"If you converted $100,000 and it jumped to $125,000, you are a very happy camper," Keebler said. "But if you converted $100,000 and it fell to $80,000, you are almost certainly going to re-characterize."

Slott agreed.

"If your Roth IRA really tanked, then it might pay to re-characterize and stay out for a little while," Slott said. Because taxes are based on the amount of money that was originally converted, "you don't want to get stuck paying tax on value that no longer exists," he explained.

For those who separated their funds into multiple accounts when they converted to Roth IRAs, the choice to re-characterize could be simple, Slott noted. For example, he converted all of his own IRAs into six different Roth accounts.

With separate Roth accounts, "you can cherry-pick the losers and re-characterize the investments that tanked," he said.

As a general rule, "the more money that is at stake, the more sense it makes to [re-characterize]," Keebler said. "You don't want to utilize this strategy over an account with $50,000."

Those who re-characterize into a traditional IRA do have the option to re-convert again into a Roth, although they must wait 30 days or until the next calendar year, whichever is longer. For those who choose to re-characterize by this month's deadline, that means waiting until Jan. 1, 2012.

Effect of estate tax, GST

The tax-free nature of a Roth IRA account is often part of an estate plan, and the impact of the current estate tax and generation-skipping tax should not be forgotten, Slott said.

"Now with the much bigger estate tax and GST exemptions, this is the first time in history that people can leave that much tax-free to children or grandchildren," he said. "Keeping it tax-free over time [in a Roth IRA] removes the uncertainty of future tax rates."

Slott said he doesn't plan to re-characterize any of his own plans.

"I have to believe that over time the market will go up, as it always has," he said. "And if I pulled my money out, that's when the market would rebound magically. Chasing market timing is not for me."

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