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The Roth Switcheroo

If You've Moved IRA Money Into a Roth, You Can Move It Back

By Kelly Greene

Hundreds of thousands of retirement savers converted their traditional IRAs to Roth accounts last year. It may be time to switch back.

In 2010, the federal government permanently dropped the income limit for moving savings to a Roth IRA from a traditional individual retirement account. Once you have met certain holding requirements, future withdrawals from a Roth are income-tax free—even for your heirs.

But to get that future tax break, you have to pay income tax upfront on the value of the pretax assets you move into a Roth. With market volatility denting many investors' returns, they could get stuck paying tax on investment value that no longer exists.

But there is a fix—if you act fast. The federal government allows the tax-law equivalent of a do-over, says Maria Bruno, an investment analyst at fund giant Vanguard Group, whose customers converted more than 230,000 traditional IRAs to Roths last year, and which has processed 3,900 do-overs this year, as of Monday.

Up until the final tax-return filing deadline for extensions—Oct. 17 this year—investors who transferred traditional IRA holdings to a Roth in 2010 can move them back to a traditional IRA and avoid tax. If you filed your 2010 tax returns already, you can amend them.

Then, if you still want to get your battered assets back into a Roth, the federal rules allow you to "reconvert" them after you sit tight for a bit. For 2010 conversions, the waiting period at this point would be 30 days after you "recharacterize" the account as a traditional IRA. You also would report the amount you move to the Roth again as 2011 income.

Mitchell Starr, an investment adviser in Fort Lauderdale, Fla., moved $66,000 into a Roth from his traditional IRA in January 2010. He invested in health-care and financial-services stocks with high risk but potential for high returns in an effort to maximize his tax-free growth.

Instead, Mr. Starr's account had lost almost half its value by Aug. 1. So he moved the remaining $37,000 back to a traditional IRA. That way, he won't have to report any income when he files his tax return this month.

Mr. Starr's firm is suggesting the same move to clients, and about 70% of them have recharacterized. "If you can find a silver lining to what's been going on in the market, it's the ability to convert to a Roth at lower values—or recharacterize," he says.

There are a few drawbacks to unwinding a 2010 conversion: You lose the one-time option for 2010 conversions of getting to spread the income involved across two tax returns. You also risk missing out on the potential for tax-free earnings if your investments bounce back after all.

People who transferred traditional IRA assets to Roths last year got to choose whether to report the entire amount as income on their 2010 returns or spread it evenly between 2011 and 2012. From this year on, all income created by a Roth conversion has to be reported in the year the assets are moved.

Mr. Starr is planning to make up for losing the two-year income spread by reconverting half of his account value in 2012 and half in 2013, he says. Of course, if his investments recover the next year, he may wind up paying as much tax as he would have owed originally—and tax rates could increase as well.

Even if your account value hasn't dropped drastically, there may be other reasons to undo a Roth conversion. If it bumped you into a higher tax bracket, you may want to undo just enough to get back down to your previous marginal tax rate, says Jean Dorrell, an estate planner in Summerfield, Fla.

And if you have lost your job, you may decide to unwind a Roth conversion for now to lower your tax bill and keep cash on hand. Alternatively, if you have ample savings and anticipate leaving your job in the next few years, you might want to postpone a Roth conversion until your income is lower, she says.

There is a hassle factor to consider as well: You have to complete the process, getting the funds moved back to their original status, by Oct. 17—not just have the paper work in the mail, as with an annual IRA contribution, says Ken Hevert, vice president of personal retirement products at Fidelity Investments.

And this is a transaction that you typically can't do by filling out a form online. Even at Vanguard, you have to work with the call center to complete your do-over, Ms. Bruno says.

It is important to make sure you don't accidentally disqualify your IRA holdings, says Ed Slott, an IRA consultant in Rockville Centre, N.Y. Make sure you use a direct transfer from one account to another. If you make a withdrawal, "you've wiped out the recharacterization option, and you also have to get the money back into the Roth in 60 days" to keep it in place, he says.

One other factor to consider: "Do you really want an amended return out there with the [Internal Revenue Service]?" asks Elda Di Re, a partner at Ernst & Young. "Amended returns, unlike your original filing, are usually looked at by a human being. It could increase your audit risk."