Tax strategies for IRA owners buffeted by the stock market's gyrations

The stock market's roller-coaster performance in recent months has no immediate tax effect on pre-retirement-age taxpayers who invested their traditional or Roth IRAs in stocks and mutual funds. That's because neither losses nor gains are recognized within either type of IRA. However, as this Practice Alert explains, there are some tax strategies for owners of traditional or Roth IRAs to consider, whether they are still in their working years or are retired and taking required minimum distributions (RMDs) from their accounts.

Converting traditional IRA or qualified plan funds to Roth IRA. Taxpayers may convert funds in regular IRAs to Roth IRAs within 60 days, regardless of their income level. Additionally, a distribution from a Code Sec. 401(a) qualified plan can be: (1) contributed to a Roth IRA through a direct rollover; or (2) received by the distributee and contributed (rolled over) to the Roth IRA within 60 days. Similarly, under Code Sec. 402A(c)(4)(B) , for distributions made after Sept. 27, 2010, participants in qualified 401(k) plans and 403(b) annuity plans that maintain a qualified Roth contribution program may make an in-plan Roth rollover (IPRR)—that is, roll over distributions from their 401(k) and 403(b) plans directly to designated Roth accounts maintained for the benefit of the individual to whom the distribution was made. The IPRR may be made regardless of the taxpayer's income level.

Amounts in a SEP-IRA or a SIMPLE IRA also may be converted to a Roth IRA, but under Reg. 1.408A-4 a conversion from a SIMPLE IRA may be made only after the 2-year period beginning on the date on which the taxpayer first participated in any SIMPLE IRA maintained by the taxpayer's employer.

RIA observation: A market decline gives taxpayers a chance to convert a traditional IRA or money in a qualified plan (e.g., profit-sharing plan) to a Roth IRA at a much lower tax cost than would have been possible when stock market values were high.

RIA recommendation: A taxpayer who believes that a Roth IRA is more advantageous than a traditional IRA or qualified plan account, and wants to remain in the market for the long term, should consider converting money in traditional IRAs or qualified plan accounts invested in beaten-down stocks (or mutual funds) into Roth IRAs if eligible to do so.

RIA caution: Individuals considering whether to roll over or convert for 2011 should keep in mind that, unlike the usual IRA rollover, a switch from a traditional IRA or qualified plan to a Roth IRA (as well as an IPRR) is not income tax free. Instead, it is subject to tax as if it were distributed from the traditional IRA or qualified plan and not re-contributed to another IRA (Code Sec. 408A(d)(3)(A)(i)), but generally isn't subject to the 10% premature distribution tax. Even at depressed market levels, a 2011 rollover or conversion still will increase the taxpayer's adjusted gross income (AGI), possibly propelling him into a higher tax bracket and diluting (or eliminating) those tax breaks that have AGI-based phaseouts or “floors.”

Re-characterizing a conversion from regular IRA to Roth IRA. A taxpayer who converted from a traditional IRA (or qualified plan account) invested in stocks to a Roth IRA when the market was higher will wind up with an artificially high tax bill if it doesn't recover quickly and he leaves things as-is. Fortunately, the taxpayer can treat the conversion as if it had never been made by re-characterizing it. This involves transferring the converted amount (plus earnings, or minus losses) from the Roth IRA to a traditional IRA via a direct, trustee-to-trustee transfer.

RIA illustration 1: Earlier in 2011, Jim converted a traditional IRA invested in a stock fund to a Roth IRA invested in the same stock fund. At that time, the regular IRA had a $50,000 balance, all of it attributable to deductible contributions and their earnings. Jim's Roth IRA currently is worth only $40,000. To avoid paying tax on $10,000 of evaporated income, Jim can re-characterize the Roth IRA as a traditional IRA.

If the taxpayer had converted qualified plan account proceeds to a Roth IRA, he can re-characterize all or part of the amount by making a direct, trustee-to-trustee transfer to a regular IRA. (Instructions for Form 8060, Nondeductible IRAs (2010), p. 4)

RIA caution: A contribution to a designated Roth account is irrevocable. Thus, once an employee's elective contribution has been made to a designated Roth account, it cannot be re-characterized and changed into a regular, pre-tax elective contribution to the plan. Also, under Reg. § 1.401(k)-1(f)(4)(ii) , a direct rollover from a designated Roth account under a qualified cash or deferred arrangement may only be made to another designated Roth account under an applicable retirement plan described in Code Sec. 402A(e)(1) (a Code Sec. 401(a) trust exempt under Code Sec. 501(a)) or to a Roth IRA, and only to the extent the direct rollover is permitted under the Code Sec. 402(c) rules.

Timing considerations. The easiest way to make a recharacterization is to do so by the due date (plus extensions) of the taxpayer's return for the affected year, and reflect it on that year's return. Thus, a taxpayer who made a 2011 conversion may recharacterize it on the return he files on or before Apr. 16, 2012 (he has until Oct. 15, 2012, if he gets an automatic extension of six months to file his 2011 return). However, a taxpayer who timely files his 2011 return without having recharacterized a 2011 conversion may do so as late as six months after the original due date for filing the 2011 return, i.e., by Oct. 15, 2012. (Ann. 99-104, 1999-2 CB 555 ; Instructions to Form 8606 (2010), p. 3) If a 2011 conversion is recharacterized after the taxpayer timely files his 2011 return, he should file an amended return for 2011 reflecting the recharacterization (the notation “Filed pursuant to section 301.9100-2” should be made on the return). (Instructions to Form 8606 (2010), p. 3)

If the deadline has passed, IRS may grant the taxpayer additional time to recharacterize a Roth IRA as a traditional IRA if he acted reasonably and in good faith, and granting relief would not prejudice IRS interests. (See, e.g., PLR 200116058)

Reconverting a traditional IRA to a Roth IRA. The IRA regs provide that a person who converted an amount from a traditional IRA to a Roth IRA may not only transfer the amount back to a traditional IRA in a recharacterization, but may later reconvert that amount from the traditional IRA to a Roth IRA. (Reg. § 1.408A-5 , Q&A 9(a))

Timing considerations. The reconversion cannot be made before the later of:
... the beginning of the tax year following the tax year in which the amount was converted to a Roth IRA; or

... the end of the 30-day period beginning on the day on which the IRA owner transfers the amount from the Roth IRA back to a traditional IRA by way of a recharacterization.

This timing rule applies regardless of whether the recharacterization occurs during the tax year in which the amount was converted to a Roth IRA or the following tax year. (Reg. § 1.408A-5 Q&A 9 (a)(1))

RIA recommendation: Determining when to recharacterize a Roth IRA as a traditional IRA and then reconvert depends on how the IRA owner views the stock market. For example, an owner who expects the market to remain low for a while but doesn't expect it to get much lower should recharacterize the Roth IRA now, and then reconvert as soon as eligible if the market is still low.

Losses on investments held by traditional IRAs. Losses on investments held by traditional IRAs aren't recognized when the IRA holdings are sold at a loss. If a taxpayer hasn't made any nondeductible IRA contributions, a loss won't be recognized even when all amounts are distributed from his IRAs. That's because he has a zero basis in the IRA. However, if he has made nondeductible traditional IRA contributions, and liquidates all of his traditional IRAs, a loss is recognized if the amounts distributed are less than his remaining unrecovered basis in his traditional IRAs. (Notice 89-25, Q&A 7, 1989-1 CB 662)

RIA illustration 2: An individual has a single traditional IRA, which was funded with six annual contributions of $2,000 each, none of which was deductible, so the individual's basis in the IRA is $12,000. Because of poor investment results, the IRA contains only $10,000. There were no prior distributions from the IRA. If the individual withdraws the entire $10,000, he recognizes a loss of $2,000 ($12,000 − $10,000) in the year of the withdrawal.

Any loss that's recognized on a traditional IRA is claimed on Schedule A, Form 1040, as a miscellaneous itemized deduction subject to the 2%-of-AGI floor. Any such losses are added back to taxable income for purposes of computing the alternative minimum tax (AMT). (IRS Publication 590, 2009, pg. 41)

Note that for purposes of the distribution rules (including when losses are recognized), only traditional IRAs are aggregated. They are not combined with Roth IRAs. (Code Sec. 408(d)(2) ; Code Sec. 408A(d)(4))

RIA caution: Taxpayers who made substantial nondeductible IRA contributions over the years, and who are thinking of withdrawing the entire amount in all of their traditional IRAs in order to recognize a loss, should be reminded that if they do so, they'll lose the chance of deferring gain if the value of the investments goes up again.

Losses on investments held by Roth IRAs. Under Code Sec. 408A(a) , Roth IRAs are treated the same as traditional IRAs unless otherwise indicated. Because Code Sec. 408A doesn't prescribe rules governing Roth IRA losses, they are subject to the same rules that apply to losses in traditional IRAs. As a result, losses on investments held within a Roth IRA aren't recognized when the losses are incurred. However, if the taxpayer liquidates all of his Roth IRAs, a loss is recognized if the amounts distributed are less than his unrecovered basis, namely his regular and conversion contributions, all of which are nondeductible contributions. The loss is an ordinary loss, but it can only be claimed as a miscellaneous itemized deduction subject to the 2%-of-AGI floor. Any such losses are added back to taxable income for purposes of computing the AMT. (IRS Publication 590, 2009, pg. 68)

RIA illustration 3: Early in 2011, Anne, a single taxpayer who is age 60, converted her traditional IRA with a $50,000 balance into a Roth IRA and invested the money in an aggressive growth fund. The traditional IRA was funded entirely with deductible contributions. Now the Roth IRA is worth only $25,000. A rough estimate for the year shows that Anne will have $100,000 of AGI and taxable income of $80,000 without factoring in the loss, putting her in the 25% tax bracket for 2011. Anne sees little hope for a recovery of the investment in the near future. She has no other Roth IRAs.

If Anne liquidates her Roth IRA (and has no other miscellaneous itemized deductions), she can claim $23,000 of the loss as a miscellaneous itemized deduction on Schedule A, Form 1040 ($25,000 less $2,000, which is 2% of her $100,000 AGI). The deduction will mean $5,750 in tax savings for Anne (25% of $23,000). In essence, that cuts her economic loss to $19,250 ($25,000 loss less $5,750 tax savings).

RIA caution: Taxpayers who are thinking of liquidating their Roth IRAs should keep in mind that they will be giving up the opportunity to eventually withdraw any future gains tax-free.

Unexpected tax trap for Roth IRA owners. Under Code Sec. 408A(d)(3)(F) , a 10% premature withdrawal penalty tax applies if a taxpayer makes a traditional-IRA-to-Roth-IRA conversion and then withdraws converted amounts (under the sourcing rules) within the five-tax-year-period beginning with the tax year in which the conversion took place. Because the penalty tax applies to a distribution to the extent that the converted amount was taxable when the conversion took place, a taxpayer could wind up paying a penalty tax even though none of the distribution is includable in income.

RIA illustration 4: In 2009, Sam converted his traditional IRA worth $60,000 and funded entirely with deductible dollars into a Roth IRA, and invested the money in a new technology fund. He has no other Roth IRAs. In 2011, when the Roth IRA is worth only $30,000 and he is age 49, Sam withdraws the entire account balance.

Result. Sam will have a $30,000 miscellaneous itemized deduction on Schedule A, subject to the 2%-of-AGI floor. However, he will be hit with a $3,000 penalty tax (10% of $30,000) as a result of the withdrawal.

RIA observation: Under Reg. § 1.408A-6 , Q&A 5(b), the 10% penalty tax doesn't apply if one of the Code Sec. 72(t) exceptions applies. Thus, for example, it doesn't apply if the taxpayer has attained age 59-1/2, has enough qualified higher education expenses, or has enough first-time homebuying expenses.

Effect of market decline on traditional IRA owners currently receiving RMDs. Taxpayers must start taking RMDs from their traditional IRAs by April 1 following the year in which they attain age 70-1/2. These taxpayers can't reduce their RMDs for 2011 to account for a current decline in their IRAs' market value. That's because each year's RMD generally is determined by applying a life-expectancy table factor to the IRA account balance as of the end of the previous year. (Reg. § 1.401(a)(9)-5 , Q&A 3)

RIA illustration 5: Rose, who attains age 73 this year, has a traditional IRA that was worth $500,000 on Dec. 31, 2010. Her RMD for this year is $20,243 ($500,000/24.7, the uniform life expectancy table factor in Reg. § 1.401(a)(9)-9 , Q&A 2, for a 73-year-old). She must withdraw that amount during 2012 even if her IRA currently is worth much less than $500,000. If she doesn't withdraw the minimum amount, she could face a penalty under Code Sec. 4974 equal to 50% of the excess of the amount that should have been withdrawn over the amount that actually is withdrawn.

The amount of each RMD is calculated separately for each IRA. However, the RMD amounts for the separate IRAs may be totaled, and the aggregated RMD amount may be paid out from any one or more of the IRA accounts. (Prop Reg § 1.408-8 , Q&A 9)

RIA illustration 6: Hal has two separate traditional IRAs. The RMD from IRA-A is $6,000 and the RMD from IRA-B is $4,000. Hal may take his total $10,000 RMD from either IRA-A or IRA-B, or take distributions from both, as long as the total IRA payout for the year is $10,000.

RIA observation: This rule gives flexibility to owners of multiple IRAs. For example, if an IRA is invested in stocks or mutual funds shares whose price currently is depressed, the minimum distribution can be made from another IRA invested in a money-market fund to avoid selling at a market low and losing future appreciation potential. **RIA caution**: Many financial institutions automatically place each year's RMD in a separate non-IRA account. This procedure avoids the risk of penalties for insufficient distributions. A taxpayer who wants to take his RMD from another IRA should notify the trustees or custodians of the IRAs from which he does not want to withdraw, otherwise an amount might be automatically withdrawn from those IRAs.

The rule permitting amounts in traditional IRAs to be aggregated for RMD purposes applies only to IRAs that an individual holds as an owner. It doesn't apply to IRAs that an individual holds as a beneficiary. IRAs held by a person as a beneficiary of the same decedent may be aggregated, but can't be aggregated with amounts held in IRAs that the individual holds as the IRA owner or as the beneficiary of another decedent. And no traditional IRA can be aggregated with a qualified retirement plan account or a Roth IRA to determine payouts. (Reg. § 1.408-8 , Q&A 9)