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RECHARACTERIZATIONS & CONVERSIONS: TAX PLANNING TOOLS FOR IRAS

Self-directed IRAs give account owners unparalleled flexibility in their investment options. That alone makes the self-directed IRA an appealing component of a retirement saving and investing strategy. But for the sophisticated account owner, IRAs can also play a valuable role in tax planning both for the current year and in retirement.

TAX PLANNING TODAY – RECHARACTERIZATIONS

A "recharacterization" moves an IRA contribution from one type of IRA to another type of IRA, typically so the IRA owner can take advantage of the tax benefits provided by the second type of IRA. For example, if an IRA owner contributed to a Traditional IRA for 2019, she could choose to treat that contribution as a Roth IRA contribution for 2019 instead. Alternatively, a Roth IRA contribution can be recharacterized as a Traditional IRA contribution for the same tax year. The investment gain or loss attributable to the amount being recharacterized must be moved to the other type of IRA. There is no IRS tax or penalty associated with a recharacterization, but the IRA owner must treat the contribution appropriately on their tax return. For example, a tax deduction cannot be taken for a Traditional IRA contribution that was recharacterized to a Roth IRA.

RECHARACTERIZATION CANDIDATES

Recharacterizing an IRA contribution could be beneficial to IRA owners in a variety of scenarios:

- **Recently stopped or started participating in a workplace retirement plan**

  Example - An individual who no longer has the opportunity to participate in a 401(k) plan may find a tax deduction for a Traditional IRA contribution more attractive this year than a Roth IRA contribution

  Example - An individual who can make pre-tax deferrals to a 401(k) plan may prefer the tax-diversification benefits of a Roth IRA over a tax deduction for a Traditional IRA contribution

- **Is ineligible for the type of IRA contribution they made this year**

  Example - An individual who is over age 70½ is not eligible to contribute to a traditional IRA but is eligible for a Roth IRA because he has earned income

Example - An individual whose income exceeds the limit allowed for making a Roth IRA contribution is eligible for a traditional IRA if she is under age 70½

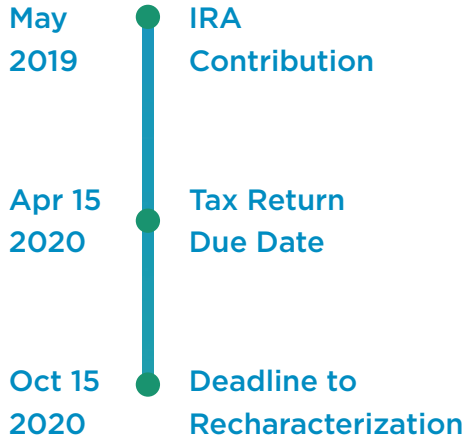
- **Is ineligible to take a deduction for a traditional IRA contribution**

Example - An individual who participates in an employer-sponsored plan and whose income exceeds the limits for taking a deduction (see IRA Deduction Limits[1]) may prefer a Roth contribution over a nondeductible traditional IRA contribution

THE CATCH

A recharacterization must be made by the tax-filing deadline for the year for which the contribution was made. The tax-filing deadline for most filers is April 15, with a possible extension until October 15. So long as the IRA owner files their tax return on time, including extensions, the six-month extension also applies to the recharacterization deadline. A recharacterization may be made up until October 15 even if the tax return has already been filed, but the IRA owner may need to amend the tax return accordingly. Once the tax-filing deadline, including extensions, has passed, recharacterization is no longer an option.

[1] https://www.irs.gov/retirement-plans/ira-deduction-limits



Example:

Carol, age 45, contributed $5,500 to her self-directed Traditional IRA on February 4, 2018, for tax year 2018. By July 2019, her investment had performed so well that she decided she'd rather have the tax-free gain in her Roth IRA than take a tax deduction for the 2018 contribution. On August 15, 2019, Carol instructed her Traditional IRA custodian to recharacterize the 2018 contribution to her Roth IRA at the same institution. Carol's IRA custodian helped her calculate the earnings attributable to the contribution ($2,000 in this example) and transferred $7,500 from Carol's Traditional IRA to her Roth IRA. Carol must amend her 2018 tax return she already filed because she cannot take a tax deduction for the recharacterized 2018 IRA contribution.

Example:

Ted, age 64, contributed $6,500 to his Roth IRA on May 15, 2018, as a 2018 contribution. While

preparing his 2018 taxes in March 2019, Ted discovered that he was not eligible to make a Roth IRA contribution because his 2018 income exceeded the limits for Roth IRA eligibility. Ted instructed his IRA custodian to recharacterize the $6,500 Roth IRA contribution to his Traditional IRA at the same institution. Ted's IRA custodian helped Ted calculate the earnings attributable to the contribution ($650) and transferred $7,150 from Ted's Roth IRA to his Traditional IRA. Ted may take a tax deduction for the 2018 Traditional IRA contribution since he is eligible for the tax deduction (he is under age 70½, has earned income, and does not participate in an employer's retirement plan).

RECHARACTERIZATION MECHANICS

Although financial advisors are typically removed from the administrative steps involved with a recharacterization, it is helpful to understand the sequence of events IRA owners will follow.

1. **Confirm contribution is eligible to be recharacterized (i.e., before tax-filing deadline plus extensions) and confirm eligibility to contribute to the other IRA**
2. **Request a recharacterization from IRA custodian holding assets to be recharacterized and provide information:**
   a. **Type and amount of original contribution**
   b. **Date on which original contribution was made**
   c. **Name of the receiving IRA custodian and any instructions to accomplish the transaction**
3. **Work with sending IRA custodian to calculate investment gain or loss related to the amount being recharacterized**
4. **Notify receiving custodian of incoming recharacterization if recharacterization is being transferred to another IRA custodian**

Financial advisors may also need to explain to IRA owners how recharacterizations are reported to the IRS. Even though a recharacterization is not taxable, all three money movements (deposit, withdrawal, deposit) must be reported by both the IRA owner and the IRA custodian(s). The IRA owner must explain the recharacterization

with their tax return. The IRS generally uses the information filed by IRA custodians on IRS Form 1099-R[2], and IRS Form 5498[3] each year to confirm the IRA information reported by taxpayers. Depending on the timing of the initial deposit and the recharacterization, the IRS forms may not be available when the IRA owner files their tax return for the year.

CONSIDERATIONS

As an advisor, you can help your IRA clients understand how the IRA rules allow them the flexibility to make their self-directed IRAs work to their greatest tax advantage. For an IRA owner who changes their mind about contributing to one type of IRA or who finds out they were ineligible to contribute, the recharacterization tip could make a difference in their current year tax liability and the tax diversity of their retirement savings. However, you may also want to recommend IRA owners seek tax advice before conducting a recharacterization to make sure they understand all the potential consequences of making the switch.

ROTH IRA DISTRIBUTIONS

There is no tax benefit in the year a Roth contribution is made. Instead, the primary tax benefit occurs when assets are withdrawn from a Roth IRA. Account owners can withdraw the money they contributed at any time tax and penalty free – they paid the tax on those assets when they funded the Roth IRA. If they take a "qualified" distribution, the investment earnings in the Roth IRA will also be tax-free. This could be a significant amount of tax-free money depending on the duration and performance of the investment.

To take a qualified distribution, the Roth IRA owner must

- Have had a Roth IRA for at least five years, and
- Have a qualifying event – age 59½ or older, disabled, deceased, or a first-time homebuyer

TAX PLANNING FOR TOMORROW: CONVERSIONS

A conversion is the taxable movement of assets from a Traditional IRA, SEP IRA or SIMPLE IRA to a Roth IRA. Because assets in the originating IRAs are primarily pre-tax, and Roth IRAs hold after-tax assets, this transaction will be taxable to the IRA owner. Unlike a recharacterization, a conversion will almost always increase the

[2] https://www.irs.gov/pub/irs-pdf/f1099r.pdf
[3] https://www.irs.gov/pub/irs-pdf/f5498.pdf

IRA owner's taxable income for the year the transaction takes place. Whether this means an actual increase in tax liability depends on the amount converted and the individual's tax-filing status, tax bracket, other income and deductions and credits. Even if a conversion does increase the individual's tax liability, many retirement savers find the one-time tax hit worth the ultimate benefits of moving assets into a Roth IRA.

BENEFITS OF A ROTH IRA

- Tax-free distribution of contributions at any age (even pre-59½)
- Tax-free distribution of investment earnings with qualified distributions
- Tax diversification of retirement income
- Tax-free distributions do not count as income when determining tax on Social Security benefits
- No age 70½ limit for contributing to a Roth IRA
- No age 70½ required minimum distributions for Roth IRA owners
- Tax-free assets for heirs upon the IRA owner's death

Because Roth IRAs allow IRA owners to create a nontaxable stream of income in retirement, they are a popular component of many retirement income and estate planning strategies.

CONVERSION CANDIDATES

Having the option to convert pre-tax retirement savings to a Roth IRA allows individuals to decide when they want to pay tax on their retirement assets – now or in the future. A Roth IRA and conversions of pre-tax retirement savings may be appealing to individuals who:

- **Are in a low tax bracket today and expect to pay higher tax rates in the future**

  Example: An individual who is new to the workforce or starting a new career, and has the potential to substantially increase their income in future years

- **Have many years to accumulate tax-free earnings on investments they believe will significantly appreciate**

  Example: A self-directed IRA owner investing in an alternative asset over a long term

- **Want to create a tax-free inheritance for their heirs**

  Example: A retired couple planning to leave

IRA assets to their heirs might conduct a series of conversions over several years to spread out the taxation for themselves and create a tax-free inheritance

- **Have not been able to contribute to a Roth IRA because of the income restrictions on Roth IRA eligibility**

  Example: A single individual whose 2019 income exceeds $137,000, or a married individual whose income exceeds $203,000, is not eligible to make an annual contribution to a Roth IRA, but there is no income limit for conversions

- **Do not have a Roth option inside their employer's 401(k) plan**

  Example: An individual who works for a small employer and does not have the opportunity to make Roth 401(k) deferrals may want to diversify their retirement savings

CONVERSION MECHANICS

In a direct conversion transaction, the IRA owner does not have access to the assets during the transaction. In an indirect transaction, the assets are distributed to the IRA owner, who is then responsible for depositing the assets into the Roth IRA within 60 days following the distribution. IRA owners

Example:

Alice, age 49, wants to convert $150,000 of her Traditional IRA assets to a self-directed Roth IRA with another financial organization. She elects to have 10% withheld on her conversion. Alice's Traditional IRA custodian will distribute $150,000 from her Traditional IRA and withhold 10% ($15,000) to send to the IRS as prepayment of her tax liability on this transaction. The custodian then remits $135,000 directly to the trustee of Alice's Roth IRA. Alice's Traditional IRA custodian will generate two Forms 1099-R to report the $15,000 that was withheld and sent to the IRS and the $135,000 that was sent to her Roth IRA. Alice must include $150,000 in her taxable income this year and will owe a 10% early distribution tax on the $15,000 that was sent to the IRS.

Example:

Bob, age 64, retired last year. This year, he decides to convert $75,000 of his 401(k) plan assets to a Roth IRA through a rollover.* He wants to pay tax on a portion of his retirement savings this year when he has no other taxable income and before he begins drawing Social Security benefits. Bob also knows that Roth IRA assets are not subject to the age 70½ required minimum distribution (RMD) rules, so he can extend the period of tax-free growth on his savings beyond age 70½. Bob has requested a direct rollover from his 401(k) account to his Roth IRA to avoid the 20% mandatory withholding that applies to qualified plan distributions eligible for rollover that are paid directly to a plan participant. Bob must include $75,000 in his taxable income this year.

* Plan assets eligible for rollover (and conversion) to a Roth IRA include 401(k) plans, profit sharing plans, 403(b) plans, and governmental 457(b) plans.

may also choose to convert all or just a portion of their IRAs.

The IRA owner must claim the pre-tax amount distributed, including any withholding, as taxable income on their tax return for the year. If an IRA owner has nondeductible contributions in any of their Traditional IRAs, the tax rules require that each IRA withdrawal consists of a pro rata portion of deductible and nondeductible assets held in all non-Roth IRAs. This means that only a portion of each distribution will be tax-free until the nondeductible assets are depleted. It is generally not possible to avoid paying tax on a conversion by converting just nondeductible IRA assets. Although converted amounts are taxable, the 10% early distribution tax does not apply at the time of distribution from the original account.

The deadline to convert assets for a specific tax year is December 31 of that year (although IRA custodians may designate an earlier deadline for submitting year-end conversion requests). The IRA custodian(s) will report the withdrawal on IRS Form 1099-R and the contribution of the converted assets to the Roth IRA on IRS Form 5498.

Assets that are converted to a Roth IRA will be treated as Roth IRA basis going forward. They may be distributed at any time, generally tax-free. The investment earnings that accumulate on conversion assets must meet the Roth IRA qualified distribution requirements to be distributed tax-free. Even if a Roth IRA owner has not met the requirements for a qualified distribution, they may still access a large portion of their Roth IRA assets tax-free because they have already paid tax on all their contributions and conversions.

CONSIDERATIONS

As a financial advisor to IRA clients considering a Roth IRA conversion, you can help them avoid unintended Consequences by making them aware of some potential pitfalls.

5-YEAR CLOCK PRE-AGE 59½

Before converting, IRA owners should evaluate their time frame for taking distributions from the converted assets. If an IRA owner converted taxable assets to a Roth IRA before they reached age 59½ and they withdraw those converted assets within five years of the conversion, they may owe the 10% early distribution tax they avoided at the time of conversion. This tax will be waived if they meet certain exceptions (such as being over age 59½, disabled, or having qualified higher education expenses). A separate five-year period applies for each conversion.

TAX IMPACT

IRA owners who are considering converting their pre-tax retirement assets to a Roth IRA should make certain they have considered all the potential tax consequences before they convert. For example, an increase in taxable income may bump a taxpayer into a higher income tax bracket. Individuals will also want to make sure they have enough assets to pay the tax liability on a conversion, preferably not with other retirement savings. High net worth individuals should evaluate whether the increased income could potentially cause them to become subject to the 3.8% Medicare tax on net investment income.

INELIGIBLE CONVERSION

To avoid an excess contribution and potential excise tax in the Roth IRA, IRA owners should confirm their retirement savings are eligible to be converted. Required minimum distributions (RMDS) and other amounts that are not eligible for rollover may not be converted. SIMPLE IRA assets are not eligible to be converted until two years have passed since the initial contribution under the SIMPLE IRA plan.

NO RETURNS

A conversion cannot be undone or recharacterized back to the original IRA or retirement plan.** This could be problematic, for example, if the value of the investment decreases significantly after the conversion. The amount that must be included in Taxable income is based on the value at the time of distribution from the original IRA or plan.

Conversions can be an important tool for IRA owners who want to purchase investments in their Roth IRA and accumulate tax-gree retirement assets. You can help your clients who might be candidates for Roth IRA conversions evaluate the benefits and considerations of conversions, and remind them to consult with a tax advisor to discuss the potential tax consequences before they convert.

For questions or for more information about recharacterizations or conversions, please contact us. Visit: www.StrataTrust.com

** In 2017 and prior years, IRA owners had the option to "undo" a conversion by recharacterizing the conversion amount into a Traditional IRA. The Tax Cuts and Jobs Act of 2017 eliminated this option. Conversions made in 2018 and later cannot be recharacterized.

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ABOUT US

STRATA Trust Company has quickly catapulted to become a premier national custodian for alternative assets and non-exchange traded investments in self-directed IRAs. STRATA has over $2 billion in assets under custody, and for over a decade has helped over 35,000 investors nationwide use their retirement account funds to invest.

With offices in Waco and Austin, Texas, our team's vast experience in handling the details and complexities that real estate transactions require is unrivaled. Our seasoned team's experience in the custody of alternative assets spans over 350 years. With a well-established reputation for honesty and integrity, STRATA is committed to delivering responsive, flexible and innovative solutions.

At STRATA, we work to ensure that the highest standards for safety and soundness are met. As a subsidiary of Horizon Bank, SSB, STRATA is a Texas-chartered trust company regulated by the Texas Department of Banking, which has long set the benchmark among state banking regulators. Strict controls are in place to ensure the safety of uninvested cash, and independent auditors are retained to conduct regular audits of our operations.

PRWP_312_10_2019I