TAX STRATEGIES FOR IRA OWNERS AFFECTED BY THE PRECIPITOUS STOCK MARKET DECLINE

The sharp stock market decline we've experienced has no immediate tax effect on pre-retirement-age taxpayers who invested their traditional IRAs or Roth IRAs in stocks and mutual funds. That's because losses as well as gains are not recognized within either type of IRA. However, 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 to Roth IRA.** A traditional IRA can be converted to a Roth IRA if, for the conversion year, (1) the taxpayer's modified AGI (not counting the taxable amount of the conversion) does not exceed $100,000, and (2) he isn't a married individual filing a separate return (unless he lived apart from his spouse during the entire withdrawal year). The distribution from the traditional IRA is a regular payout for income tax purposes, and the income resulting from the distribution is included on the return for the tax year in which funds are transferred or withdrawn. However, the 10% premature distribution penalty doesn't apply.

  Observation: A market decline gives taxpayers a chance to convert a traditional IRA to a Roth IRA at a much lower tax cost than would have been possible when stock market values were high.

  Recommendation: A taxpayer who believes a Roth IRA is more advantageous than a traditional IRA, and wants to remain in the market for the long term, should convert traditional-IRA money invested in beaten-down stocks (or mutual funds) into Roth IRAs if eligible to do so.

- **Re-characterizing a conversion to Roth IRA.** A taxpayer who earlier this year converted from a traditional IRA invested in stocks to a Roth IRA when the market was much 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 back to a traditional IRA via a trustee-to-trustee transfer.

  Illustration: Early in 2008, 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 $30,000. To avoid paying tax on $20,000 of evaporated income, Jim can re-characterize the Roth IRA as a traditional IRA.

- **Timing considerations.** The easiest way to make a re-characterization 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 2008 conversion may re-characterize it on the return he files on or before April 15, 2009, (he has until October 15, 2009, if he gets an automatic extension of six months to file his 2009 return). However, a taxpayer who timely files his 2008 return without having re-characterized a 2008 conversion may do so as late as six months after the original due date for filing the 2008 return, i.e., by October 15, 2009. If a 2008 conversion is re-characterized after the taxpayer timely files his 2008 return, he should file an amended return for 2008 reflecting the re-characterization (the notation "Filed pursuant to section 301.9100-2" should be made on the return).

- **Reconverting a traditional IRA to a Roth IRA.** 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 re-characterization, but may later reconvert that amount from the traditional IRA to a Roth IRA.

  - **Timing considerations.** The reconversion cannot be made before the later of:

    1. The beginning of the tax year following the tax year in which the amount was converted to a Roth IRA or,

    2. 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 re-characterization.

    This timing rule applies regardless of whether the re-characterization occurs during the tax year in which the amount was converted to a Roth IRA or the following tax year.

  Recommendation: Determining when to re-characterize 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 awhile but doesn't expect it to get much lower should re-characterize 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.

> **Illustration:** 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 $8,000. There were no prior distributions from the IRA. If the individual withdraws the entire $8,000, he recognizes a loss of $4,000 ($12,000 - $8,000) 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.

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.

- **Losses on investments held by Roth IRAs.** Under the Code, Roth IRAs are treated the same as traditional IRAs unless otherwise indicated. Because the Code 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.

> **Illustration:** Early in 2008, 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 a stock 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 28% tax bracket for 2008. Anne sees little hope for a dramatic recovery 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 a $6,440 tax savings for Anne (28% of $23,000). In essence, that cuts her economic loss to $18,560 ($25,000 loss less $6,440 tax savings).

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

- **Unexpected tax trap for Roth IRA owners.** Under the Code, 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 includible in income.

Observation: 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 enough first-time home-buying expenses.

- **Effect of market decline on traditional IRA owners currently receiving RMDs.** Taxpayers must start taking required minimum distributions (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 2008 to account for a drop in their IRAs market value this year. 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.

Illustration: Rose, who attains age 73 in 2008, has a traditional IRA that was worth $500,000 on December 31, 2007. Her RMD for this year is $20,243 ($500,000/24.7, the uniform life expectancy table factor for a 73-year-old). She must withdraw that amount during 2008 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 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.

Illustration: 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 not less than $10,000.

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 or a certificate of deposit that is about to mature to avoid selling at a market low and losing future appreciation potential.

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 an individual holds as an owner. It doesn't apply to IRAs 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 pay-outs.

Observation: Congressional members have been agitating for a relaxation of the rule requiring seniors to take RMDs or face big penalties. As Rep. Frelinghuysen (R-NJ) said in a October 17, 2008, letter to Treasury Secretary Paulsen, in today's stock market environment, by enforcing the RMD rules the "government is essentially mandating significant financial losses on some of our older citizens. We should help seniors by suspending minimum IRA withdrawal rules to spare them from being forced to sell their stocks when the market is low."