

Understanding IRA recharacterization

When it comes to making your annual contribution to a Traditional or Roth IRA, the execution can seem pretty straightforward. You write a check to the institution, make an investment decision, and congratulate yourself for your dedication to saving for your retirement.

So what happens the next April when you are filing your taxes and your CPA explains that you weren't eligible for that annual contribution? Or perhaps you and your tax professional feel your Traditional IRA contribution would be better made to a Roth IRA, or vice-versa?

There's good news. You may be able to recharacterize—or reverse—the contribution. In fact, you don't have to recharacterize the entire amount, as you are able to recharacterize only a portion of the contribution. If you file your federal income taxes by the due date, usually April 15, you have an automatic six-month extension, generally until October 15 of that tax filing year, to complete a recharacterization. If you recharacterize after filing your taxes for the year, you may be required to file an amended tax return.

While the extension and the recharacterization are often welcomed, make sure you understand the specific rules for recharacterization.

Recharacterization rules

- A recharacterization of annual contributions may be transferred from the current IRA to the other type of IRA—either Traditional or Roth—as deemed appropriate.

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- When recharacterizing an annual contribution, it will be considered to have been contributed for the same taxable year that the contribution was originally made.
- SEP and SIMPLE IRA contributions cannot be recharacterized as Roth IRA contributions.
- The net income or loss attributable to the contribution that is being recharacterized must also be transferred when the assets and/or cash are moved and is determined according to the IRS-provided formula. Any earnings or loss are only determined when the recharacterization occurs by the tax filing deadline plus automatic extension.
- Any earnings that are transferred with the recharacterization will not reduce your maximum annual contribution limit, nor will losses increase that limit. For example, Joan is 43 and she recharacterized a \$4,000 contribution along with \$200 in earnings. She still can contribute another \$2,000 because her maximum annual contribution limit is \$6,000, for 2020, and the \$200 in earnings does not count toward her maximum contribution limit.
- A recharacterization can only be completed as a direct transfer with the custodian. It cannot be accomplished as a distribution and then a subsequent rollover.
- Although recharacterizations are nontaxable, they are tax reportable using IRS Forms 1099-R and 5498. The original contribution must also be reported to the IRS.
- **Please be aware that Roth conversions cannot be recharacterized. Before you convert, work with your tax advisor to understand your tax situation and decide if you have the ability to pay any taxes that are a result of the conversion.**