Economic and Market Insights

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Tax Season 2016: How to fight back during a down market

As head of The Commerce Trust Company's East Region tax group, Tom Bassett takes a moment to share his bird's-eye view of various issues that federal tax filers will face as we build toward the April 15 tax deadline.

How many times does life afford you a "do-over?" The ploy you learned as a kid to settle a playground dispute also works in your adulthood on the taxes you could pay during a down market.

When the stock market was flying high in early 2015, you may have converted a traditional Individual Retirement Account (IRA) to a Roth IRA, choosing to pay taxes upfront so you could enjoy future accumulation and appreciation tax-free after the five-year waiting period.

Now that the stock market devalued your Roth IRA by as much as 20% in the first few weeks of 2016, it sure seems unfair you paid all those taxes when the value was much higher at the time of your conversion.

But take heart. This is where the government allows you a legal do-over called a "recharacterization" of the assets in your IRA account, and it could be time to play this card. While the market setback is temporarily bad news, you can use it to your advantage by exercising your right to redo your first conversion to get a smaller tax bill.

So if you converted a traditional IRA to a Roth IRA and now have second thoughts about the move, recharacterization allows you to undo the transaction and move the funds back to a traditional IRA.

The added beauty of this is that you have until Oct. 15, 2016, to make the decision if you think the market will recover or get worse. That gives you a total of 21 months to decide if recharacterization is the right strategy for you.

Most would agree this generous “look-back” period gives you ample time and a lot of runway to make the call, which can possibly save you thousands in taxes.

Check with your professional tax advisor for your circumstances. Depending upon the size of your assets, there may be even more complicated strategies to consider. Some advisors for wealthy clients even divide an IRA into different asset allocation buckets, like large-cap or small-cap investments, and roll them into separate Roths. They use the full benefit of the nearly 21 months of “look-back” to decide which categories have profited or suffered. Then they recharacterize the losers and leave the winners on the table. It’s an expensive paperwork morass, but it can be done.

Finally, one last technique during the recent market drop may help you if you are currently holding onto risky concentrated stock positions to avoid a big capital gains tax bill. This may be your moment in time to trim profitable positions.* As many investors have observed over time, nobody ever went broke taking profits.

**Always consult with your CPA and professional advisor on matters involving income taxes.*