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IRA

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This Week's Topics:

I am considering converting a traditional IRA, funded with a 401(k) rollover, to a Roth. Are the taxes calculated on the original traditional IRA value or the current value? … I participate in a 401(k) at work. Can my wife have an IRA? … I have money in a former employer's 401(k). I am thinking of either rolling it into an IRA or rolling it into company stock at my current job. What do you think?

Q: After I left my first job in 1998, I did a direct rollover of my 401(k) balance into a traditional IRA. Since then, the IRA has lost approximately 21 percent of its original value. I am considering converting this account to a Roth IRA, as I cannot make deductible IRA contributions. I understand, of course, that I will have to pay taxes at the time of conversion. My question is this: will the basis for taxes be the original value of the IRA (at the time of direct rollover), or the current value (after losses)? How will the losses be treated in terms of taxes?

A: When you convert a traditional IRA to a Roth IRA, you must pay the deferred income taxes on the pretax contributions and all earnings that you convert.

You pay based on the amount you withdraw -- in other words, today's account value, not the IRA's original value.

Ironically, this is one of those rare times when a declining account balance can actually be a good thing.

"This is a positive," said Gayle Buff, a certified financial planner with Buff Capital Management of Newton, Mass. "If you had $100,000 in the account and now it is $50,000, the taxes you owe are based on the $50,000 taxable distribution. The advantage of the loss is it lowers your tax basis."

Technical Terms
- Diversification
- Modified adjusted gross income (MAGI)
- Rollover

Related Reading
- Spousal IRAs: Empowering the Single-income Family
- IRA Losses Can You Deduct Them or Not?
- What's the income lim for getting a tax deduction on my IRA contribution?

More Information
- IRS Publication 590, Individual Retirement Arrangements

Your second question asks if your losses can be deducted. Unfortunately, the answer is probably "no." You are not allowed to deduct investment losses from your IRA.

The only instance in which you may be able to deduct your losses is if you made non-deductible contributions to the traditional IRA and the total value of all of your IRAs, today, are less than your non-deductible contributions. But, the only way to realize these losses is to liquidate this IRA and any other IRAs you may have to determine if you have a loss. Then you have to determine if you qualify to take the loss.

In brief, if you made tax-deductible contributions and/or your IRA contains a rollover from an employer-sponsored retirement plan, such as a 401(k), 403(b) or 457, you probably won't qualify for the deduction.

I wrote extensively about this topic last year. Taking a tax loss on a traditional IRA is complicated and would only apply to a very small number of account holders. A link to that article is provided in the "Related Reading" sidebar.

Q: My wife is a stay-at-home mom, and has no W-2 wage income. However, she does have an IRA. My understanding is that she cannot make contributions to her IRA because of my participation in my company's 401(k) plan. Is my understanding correct?

A: No, and I'm glad you asked. This is a common misconception.

Your spouse can contribute to her IRA even though you participate in a 401(k) at work. The question is whether the contribution will be deductible or nondeductible.

Whether your wife's contribution is deductible depends on your income level. We are going to assume that you are married filing jointly. Based on this assumption here are the IRS limits for making a deductible contribution to your wife's IRA (the non-working spouse):

- Your wife may make a fully tax deductible IRA contribution if your modified adjusted gross income (MAGI) is $149,999 or less.
- She may not make a deductible contribution if your MAGI is $160,000 or more.
- Her contribution will be partially deductible if your MAGI is $150,000 to $159,999.

IRS Publication 590, *Individual Retirement Arrangements*, has a worksheet you can use to calculate how much of her contribution will be deductible.

As the working spouse, you are also allowed to contribute to your own IRA. However, the income limits for you to make a deductible contribution are much lower than the ones listed here. (You can find them in our FAQ section. I have provided a link to that specific question in the "Related Reading" sidebar.)

Remember, if you exceed the income limits, you or your spouse can always make a nondeductible IRA contribution. While you don't get the immediate tax deduction, you can benefit from the tax-deferred growth.

Q: I'm 33 and employed by a large pharmaceutical company. In my previous job I accumulated over $60,000 in my 401(k). Should I roll that over into stock of my new employer where I'm contributing now or put it in an IRA? Right now the money is in my previous employer's 401(k) in a balanced fund. I want to invest this for retirement some 20 years down the road.

A: Let me offer congratulations on building such a nice nest egg so early in life. You are far ahead of many of your peers.

I am assuming that you plan to roll your old 401(k) money into your new employer's 401(k) plan and invest that in company stock offered through the plan.

If not, and you plan to invest it in some other non-tax-advantaged plan, such as buying shares at a discount, you should first consider the tax consequences. If you withdraw the money from your former employer's 401(k) plan to invest in your current employer's stock on an after-tax basis, you will owe income tax on the entire amount and a 10 percent early withdrawal penalty. If this is the case, you can see the argument is pretty strong to roll your money into an IRA, where there are no tax consequences.

If the tax issues don't concern you, then you should consider the investment issues, which we discuss below.

What you don't say in your question is whether you have any other investment alternatives with your current plan.

CFP Gayle Buff said she would likely recommend against rolling your old 401(k) into your new employer's plan if your only investment option is company stock. You "will have too concentrated of a position" in your company's stock, she said.

In that case, she would recommend putting the money in an IRA and diversifying that account.

If you have other investment options available at your current employer's 401(k), and you plan to invest in a diversified portfolio within the 401(k), she would not argue with that strategy.

A diversified portfolio invests in several different asset classes and a number of different companies and industries. Why is this important? "When you have a lack of diversification, you are putting all your eggs in one basket," Buff said.

You have a job at your current employer, which pays your salary. What if you also invested your entire retirement savings at the same company? Even though you probably have the greatest faith in your employer, you have to consider the possibility that things could turn bad. Remember, many folks at Enron thought nothing could go wrong there.

"The more concentrated your investment, the more your risk goes up," Buff said. "Anything that minimizes risk is a good thing, given the uncertainty of life."

Here are some other issues to consider as you make your decision where to roll your old 401(k) money.

If you put it in to your new employer's 401(k) plan, you may be able to borrow against it. And, if you are sued, 401(k) savings are protected against lawsuit and creditors by federal law. With an IRA, such protection depends on the laws in your state of residence.

On the other hand, if you put the money in an IRA, you will likely be able purchase a broader array of investments.

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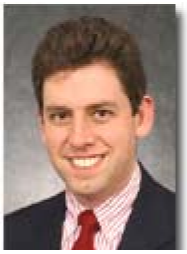

Clifton Linton has been a business writer and reporter for 15 years, most recently specializing in retirement plans as Senior Writer for mPower. Send him a question and he may answer it in this column.