Money and You: Questions still pouring in about IRAs, taxes, refunds

by Lynn O'Shaughnessy

Individual Retirement Accounts may be simple, but they continue to befuddle investors. My recent column on IRAs prompted lots of questions. In fact, I get almost as many e-mails from IRA columns as when I trash annuities.

Here are some more IRA questions:

Q: What are the tax consequences for moving cash from a nondeductible IRA to a Roth IRA?

A: Before reading last week's column, I'm sure most readers had never spent even a nanosecond contemplating the merits of a nondeductible IRA. Until the Roth IRA came along, my husband and I used to feel like freaks for investing in a nondeductible IRA, which had been our only option. Our accountant used to tell us that we were his only clients who owned one of these IRAs.

But as I mentioned previously, the nondeductible IRA is enjoying sudden attention from those who make too much money to qualify for the more attractive Roth IRA. Thanks to recent legislation, these high-income earners will be able to move money that has accumulated in a nondeductible IRA into a Roth beginning in 2010. So now is an excellent time for these folks to start stockpiling money in nondeductible IRAs.

People who invest in a nondeductible IRA will have to pay tax when they eventually convert their account into a Roth. The tax hit, however, won't be as punitive as you might assume. In paying the tax, you exclude the nondeductible contributions that you've made.

If a 50-year-old puts $5,000 into a nondeductible IRA for four years for a total of $20,000 - and the account grows to $25,000, he or she would only owe income taxes on the $5,000. The math will be different, however, if you have more than one nondeductible IRA.

Suppose you also have an old nondeductible IRA that you haven't touched in years that has generated a lot of growth. Even if you only want to convert your newer IRA to a Roth, you must still average in the earnings of any nondeductible IRA accounts. So if earnings represent 20 percent of the new IRA and 60 percent of the old one, you'd have to pay taxes on 40 percent of the account.

Nobody asked about the tax consequences of inheriting a nondeductible IRA - an even more obscure topic - but it's important to understand the handling directions so you can shrink that looming tax bill. When you inherit a traditional IRA, you should determine if it's a deductible or a nondeductible account. Figuring this out isn't an easy as you might think, but it's worth the hassle.

If you inherit a nondeductible IRA, you won't have to pay federal taxes on the cost basis, which represents all the prior contributions. Suppose a father, for instance, plowed $30,000 into a nondeductible IRA and it ultimately grew to $45,000. The son or daughter would owe taxes only on the $15,000. In contrast, if Dad had left a deductible IRA, the heir would face a tax liability on $45,000.

You, however, can't expect the IRS to alert you to this, and even most tax preparers don't think about it. So how can you tell if you've inherited a nondeductible IRA? One way is to see if the benefactor filed IRS Form 8606 with his or her federal taxes, which shows the amount of a nondeductible IRA contribution. You can also check IRA statements and old federal tax returns to see if tax deductions were claimed for contributions. If they were, the money was intended for a deductible IRA. FYI, one reason why Roth IRAs are so wonderful is because those who inherit these accounts will pay zero taxes on any withdrawals.

Q: I've been told that my wife must stop contributing to her IRA because she's no longer working. Is this true?

A: It's hard enough being a stay-at-home mom - I've been one for 16 years - without facing the galling prospects of passing up the opportunity to save for your own retirement. Luckily, a stay-at-home mother or father can contribute to an IRA as long as the spouse is earning a paycheck that at least equals the IRA contributions.

A mom who's raising the kids can kick in a maximum of $4,000 into an IRA this year or $5,000 if she has already reached the 50-year mark or will this year. The contribution limits are the same as for those who are employed outside the home. To be eligible to make these contributions, however, a couple must file their taxes jointly.

Q: I heard you can have a federal tax refund go directly into an IRA. Is that true?

A: Yes, it is. This is the first year that taxpayers with anticipated refunds will be able to instruct the IRS to deposit their money directly into IRAs. While this sounds likes a great time-saver, you need to anticipate what could go haywire. For instance, what if your refund amount was wrong?

Suppose the IRS ended up adjusting your tax return for math errors or for other reasons and the amount is now different. If your refund is increased - hey, it does happen - the cash going directly to your IRA could bust through the contribution ceiling. This would create problems with the IRS.

If you choose the direct-deposit route, make sure you give the IRS plenty of time to channel the money to the right account. You're stuck if the IRS deposits to your IRA after the deadline.

Q: What's the deadline for contributing to an IRA?

A: The federal government is very eager to turn us all into IRA converts, so it has always offered very generous deadlines. This year, you have until April 17 to deposit money into an IRA for 2006. If you haven't already opened an account, you can contact just about any financial institution to obtain the paperwork. To save time, you can also download these forms off the Web sites of most brokerage and mutual-fund firms.

If you've already maxed out your contributions for 2006, go ahead and start on 2007. Bottom line: It's always a good day to feed your IRA.

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