

Independent Investor

March 2009

Keeping Up With Your IRA: A Tax Season Checklist

Tax time is an ideal time to evaluate the role that IRAs could play in your retirement and tax management strategies. This checklist offers information to help you make informed decisions and implement a long-term retirement income strategy.

Roth IRA or Traditional IRA?

The primary difference between a traditional IRA and a Roth IRA is the tax treatment of contributions and distributions (withdrawals). Traditional IRAs may allow a tax deduction based on the amount of a contribution, depending on your income level. Any account earnings compound on a tax-deferred basis, and distributions are taxable at the time of withdrawal at then-current income tax rates. Roth IRAs do not allow a deduction for contributions, but account earnings and qualified withdrawals are tax free.¹

In choosing between a traditional and a Roth IRA, you should weigh the immediate tax benefits of a tax deduction this year against the benefits of tax-deferred or tax-free distributions in retirement. If you need the immediate deduction this year — and if you qualify for it (see table below) — then you may wish to opt for a traditional IRA. If you don't qualify for the deduction, then it's almost certainly a better idea to fund a Roth IRA.

On the other hand, if you expect your tax bracket to drop significantly after retirement, you may be better off with a traditional IRA if you qualify for the deduction. You could claim an immediate deduction now and pay taxes at the lower rate later. Nonetheless, if

your anticipated holding period is long, a Roth IRA might still make more sense. That's because a prolonged period of tax-free compounded earnings could more than make up for the lack of a deduction.

Should You Convert to Roth?

The IRS allows individuals to “convert” a traditional IRA to a Roth IRA if you have an adjusted gross income of \$100,000 or less. [Note that after 2009, the income restrictions on a conversion to a Roth IRA will be lifted entirely.]

As part of the conversion, you must pay taxes on any investment earnings and on the deductible contributions previously made to the traditional IRA. The withdrawal from your traditional IRA will not affect your eligibility for a Roth IRA or trigger the 10% penalty normally imposed on early withdrawals.

The decision to convert or not ultimately depends on your timing and tax status. If you are near retirement and find yourself in the top income tax bracket this year, now may not be the time to convert. On the other hand, if your income is low and you still have many years to retirement, you may want to convert.

Maximize Contributions

Try to contribute the maximum amount allowed by the IRS: \$5,000 per individual, plus an additional \$1,000 annually for those aged 50 and older for 2009. Remember though, that those limits are per individual, not per IRA.

Of course, not everyone can afford to contribute the maximum to an IRA, especially if they're also contributing to an employer-sponsored retirement plan. If your workplace retirement plan offers an employer's matching contribution, then that "free" money may be more valuable than the amount of your deduction. As a result, it might make sense to maximize employer plan contributions first, and then try to maximize IRA contributions.

Review Distribution Strategies

If you are ready to start making withdrawals from an IRA, you'll need to choose which distribution strategy to use: a lump-sum distribution, required minimum distributions or periodic distributions.

Don't forget that your distribution strategy may have significant tax time implications if you own a traditional IRA, because taxes will be due at the time of withdrawal. As a result, taking a lump-sum distribution will result in a much heavier tax bill this year than taking a minimum distribution.

Tax day always looms large — so don't hesitate to use the remaining time between now and then to shore up the IRA strategies you will rely on to live comfortably in retirement.

Can You Deduct Contributions?

Your ability to deduct contributions to a traditional IRA is affected by whether you are covered by a workplace retirement plan. If you are covered, your 2009 deduction for contributions to a traditional IRA will be reduced (phased out) if your modified adjusted gross income (MAGI) is:

- Between \$55,000 and \$65,000 for a single individual or head of household.
- Between \$89,000 and \$109,000 for a married couple filing a joint return.

If your MAGI is higher than the range listed above, then you cannot claim the deduction.

¹Early withdrawals (before age 59½) from a traditional IRA may be subject to an additional 10% penalty tax. Early and other nonqualified withdrawals from a Roth IRA may be subject to taxation as well as the 10% penalty. Restrictions, penalties and taxes may apply. Unless certain criteria is met, Roth IRA owners must be 59 1/2 or older and have held the IRA for 5 years before tax-free withdrawals are permitted.

This article is not intended to provide specific investment or tax advice for any individual.

Andrew T. Gardener CFP®
Tanglewood Legacy Advisors, LLC
One Riverway, Suite 1550
Houston, TX 77056
(713) 599-4999

agardener@family-cfo.com

www.family-cfo.com

Securities offered through LPL Financial,
Member FINRA/SIPC