Keeping Up With Your IRA: Tax Season Checklist

If you're one of the millions of American households who owns either a Traditional individual retirement account (IRA) or a Roth IRA, then the onset of tax season should serve as a reminder to review your retirement savings strategies and make any changes that will enhance your prospects for long-term financial security. It's also a good time to start an IRA if you don't already have one. The IRS allows you to contribute to an IRA up to April 15, 2010, for the 2009 tax year.

In either case, this checklist will provide you with information to help you make informed decisions and implement a long-term retirement income strategy.

Which Account: Roth IRA or Traditional IRA?

There are two types of IRAs available: the Traditional IRA and the Roth IRA. The primary difference between them 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 — 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.

Case in point: Your ability to deduct Traditional IRA contributions may be limited not only by income, but by your participation in an employer-sponsored retirement plan. (See callout box below.) If that's the case, a Roth IRA is likely to be the best solution.

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 you to "convert" — or change the designation of — a Traditional IRA to a Roth IRA if you have an adjusted gross income of $100,000 or less. As part of the conversion, you must pay taxes on any investment growth in — and on the amount of any 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 unusually low and you still have many years to retirement, you may want to convert.

Maximize Contributions

If possible, 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. 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 plan contributions first, and then try to maximize IRA contributions.

Review Distribution Strategies

If you're 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 heftier tax bill this year than taking a minimum distribution.

April 15 is never that far away — so don't hesitate to use the remaining time between now and then to shore up the IRA strategies you'll rely on to live comfortably in retirement.

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 by a retirement plan at work, your 2009 deduction for

contributions to a Traditional IRA will be reduced (phased out) if your modified adjusted gross income (MAGI) is:

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

If your MAGI is higher than the phase-out ceilings listed above for your filing status, then you cannot claim the deduction.

[1] *Early withdrawals (before age 59 ½) 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.*

Points to Remember

1. Opening and contributing to either a Traditional IRA or Roth IRA is an important way to lay the groundwork for financial security in retirement.
2. As tax time approaches, keep in mind that your decision to fund either a Traditional IRA or a Roth IRA should be based on which type of account will provide you with the most money in retirement.
3. You have the option of "converting" a Traditional IRA to a Roth IRA, although some taxes may be due at the time of conversion. You should only convert if the move is likely to increase the amount of after-tax income you'll have in retirement.
4. The maximum annual contribution you can make to all IRAs combined is $5,000 in 2009. If you are at least 50 years old, you can contribute an additional $1,000.
5. Your three options for withdrawing money from an IRA are: a lump sum distribution, required minimum distributions, or periodic distributions. In general, the larger your distribution from a Traditional IRA is, the larger your tax bill will be.

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