Sample Letter on Nondeductible IRA Contributions

October 22, 2008

Dear ______:

The chances are good that if you participate in an employer sponsored retirement plan, you probably don't qualify to make tax deducible contributions to an individual retirement account (IRA). Although you can always make a contribution to a nondeductible IRA (assuming that you or your spouse has earned income at least equal to the contribution), most people don't bother doing this. Such a contribution doesn't yield a tax deduction and although the earnings inside the account build up tax deferred, they're fully taxable as ordinary income when they're distributed.

Instead, people who want to maximize their retirement savings beyond what they're saving at work typically use a Roth IRA account if they qualify (the Roth IRA also doesn't provide an upfront deduction but it does allow earnings to build up tax-free, rather then tax deferred) or invest in a taxable account – such as tax efficient mutual fund that will yield mostly lightly taxed capital gain income.

Based on a recent law change, the use of a nondeductible IRA now looks more appealing for taxpayers who can't quality to make a Roth IRA. In 2008, the Roth contribution phases out for Single and HOH from $101,000 to $116,000 and for MFJ from $159,000 to $169,000. The new provision allows taxpayers, beginning in 2010, to convert traditional IRAs (such as nondeductible IRA's) to a Roth IRA regardless of the taxpayer's income level. Currently only taxpayers with gross income of no more than $100,000 can convert a traditional IRA to a Roth IRA. At the time of the conversion, ordinary income tax is due on the income portion of the IRA, but future earnings accrue tax-free. In addition, for conversions in 2010, the new law allows the resulting tax to be paid over two years – 2011 and 2012.

A taxpayer who rolls over or converts a traditional IRA to a Roth IRA normally must include in gross income for the year of the distribution or transfer any prior deductible contributions and all the IRA earnings as a percent of the total balance. A strategy to consider is keeping non-deductible IRAs separate from traditional IRAs and rolling the traditional IRA accounts to an individual 401K prior to the Roth conversion. This will minimize the amount of distribution subject to tax.

Why are we telling you this two years in advance of 2010? Because, if you're not yet age 70 1/2 and want to maximize the funds that can go in a Roth IRA, you should be funding nondeductible IRAs now – up to the lesser of your earned income or $5,000 (or $6,000, if you are age 50 or older by the end of the year for which you're making the contribution). It's not too early to fund for 2008 provided you know you'll have enough earned income for the year.

Very truly yours,

Your Name