How to correct excess IRA contributions

WELLS FARGO ADVISORS

You may discover that you contributed amounts to your Traditional or Roth IRA in excess of the allowable limits. What can you do? Fortunately, the IRS allows these excess amounts to be corrected without penalty, provided the correction occurs within a certain time frame.

How can an excess contribution happen?

An excess contribution is generally one that exceeds the IRA contribution limit. An excess contribution can occur in an IRA for a variety of reasons including the following:

- Contribution is more than the annual contribution limit
- Contribution is more than your earned income
- Contribution made to a Traditional IRA at age 70½ or older
- Contribution made on behalf of an individual after date of death
- Required minimum distribution (RMD) is rolled over
- Making an ineligible rollover contribution
- Contribution to a Roth IRA and your modified adjusted gross income (MAGI) exceeded the income limit
- Unable to deduct a Traditional IRA contribution; this is truly not an excess contribution because being unable to deduct does not mean that you weren't able to contribute

What is the penalty for not removing the excess contribution?

If you do not remove the excess amount by the deadline, you will owe a 6% IRS excise tax penalty for every year the excess remains in the account.

Ways to correct an excess contribution

There are typically four methods to correct an excess contribution:

1. Timely—Remove excess before the tax filing deadline
2. Recharacterization
3. Remove excess after the tax filing deadline
4. Carry forward

1. **Timely remove excess before the tax filing deadline**—The excess or unwanted IRA contribution amount, plus the net gain or loss, will need to be removed by the tax filing deadline (generally April 15), including an automatic six month extension. This means the excess should generally be distributed by October 15. If you remove the excess contribution *after* you file your taxes, you may need to file an amended tax return. If you remove the excess in a timely manner, you will owe tax and, if under age 59½, the IRS 10% early distribution penalty on any earnings, not on the excess contribution. See the next page for IRS provided formula for calculating the Net Income Attributable (NIA) of either earnings or losses.

2. **Recharacterization**—A recharacterization involves transferring the annual contributions from the current IRA to the other type of IRA—either Traditional or Roth—as deemed appropriate. Note, you can't recharacterize more than your allowable maximum contribution. When recharacterizing an annual contribution, it will be considered to have been contributed for the same taxable year that the contribution was originally made. The earnings or loss attributable to the contribution that is being recharacterized must also be transferred using the NIA formula.

3. **Remove excess after the tax filing deadline**—Only a true excess, not a nondeductible contribution, can be removed after the deadline. You will remove only the amount of the excess; no earnings or loss will be calculated. You will owe the IRS 6% excise penalty for every year the excess remains in the IRA. Additionally, you may not deduct the excess amount when filing your taxes. The excess amount removed will not be taxable if your aggregate contributions for the year do not exceed the annual contribution limit. However, if your aggregate contribution limit for the year exceeded the annual amount, then the excess is taxable and would be subject to the IRS 10% early distribution penalty if you are under age 59½. For example, you made a $5,500 Roth IRA contribution but only qualified to make a $4,500 contribution. The $1,000 excess would not be taxed and penalized because it wasn't more than the annual contribution limit.

4. **Carry forward**—You can offset the excess contribution by limiting your annual contribution for the following year to the maximum minus the excess, as long as you qualify to make a contribution. No distribution from your IRA will occur. For example, if your contribution limit is $5,500 and you exceed it by $1,500, you can offset the excess by limiting your contributions to $4,000 the following year. However, if you use the carry forward method, you are subject to the IRS 6% excise tax because you did not correct the excess by the deadline. You will not owe tax and, if you are under 59½, the IRS 10% early distribution penalty on any earnings. You will not be able to recharacterize the carry forward amount to the other type of IRA. For example, if the carry forward amount is in a Traditional IRA, you cannot recharacterize that amount as a Roth IRA contribution.

How to calculate earnings or losses

The IRS provides a specific formula—Net Income Attributable (NIA)—that must be applied to calculate earnings or losses attributable to an excess contribution.

$$\text{Net Income} = \text{Excess to be removed} \times \frac{\text{Adjusted Closing Balance (ACB)} - \text{Adjusted Opening Balance (AOB)}}{\text{Adjusted Opening Balance}}$$

Here's how to determine the numbers to plug into the NIA formula: To determine the adjusted opening balance, add to the prior month end IRA balance all contributions (including the contribution creating the excess), consolidations, and transfers into the account since the contribution occurred. To determine the adjusted closing balance, subtract from the current value of the IRA all distributions, consolidations, and transfers in since the contribution occurred.

Excess contribution hypothetical examples

Timely removal of excess plus earnings hypothetical

Linda, age 48, contributed $6,500 to her IRA last year. When filing taxes, she discovers she was eligible to contribute only $5,500. She requests to remove the $1,000 excess. Her IRA balance prior to the contribution was $22,000 and is now worth $31,250. She made no additional contributions or distributions. Her ACB is $31,250 and her AOB is $28,500 ($22,000 + $6,500). Linda will remove the $1,096.49 ($1000 excess contribution + $96.49 earnings attributable to the excess contribution).

$$\$1{,}000 \times \frac{(\$31{,}250 - 28{,}500)}{\$28{,}500} = \frac{\$1{,}000 \times \$2{,}750}{\$28{,}500} = \$96.49 \qquad \text{NIA} = \$96.49 \text{ earnings}$$

Timely removal of excess minus earnings hypothetical

Zeke, age 62, contributed $6,500 to his IRA last year. When filing taxes, he discovers that due to his amount of earned income, he was only eligible to contribute $4,000. He requests to remove the $2,500 excess. His IRA balance prior to the contribution was $260,000 and is now worth $250,175. He made no additional contributions or distributions. His ACB is $250,175 and his AOB is $266,500 ($260,000 + $6,500). Zeke will remove $2,346.85 ($2,500 excess contribution - $153.14 loss attributable to the excess contribution).

$$\$2{,}500 \times \frac{(\$250{,}175 - 266{,}500)}{\$266{,}500} = \frac{\$2{,}500 \times -\$16{,}325}{\$266{,}500} = -\$153.14 \qquad \text{NIA} = -\$153.14 \text{ loss}$$

Removal of excess after due date hypothetical

Charlotte, age 36, contributed $6,500 to her IRA, which was $1,000 more than her annual contribution limit. Since the deadline to timely remove the excess has passed, she will remove the $1,000 excess contribution but not remove any earnings or loss. Because her contribution was $1,000 more than her maximum limit, the $1,000 will be subject to ordinary income tax and an IRS 10% early distribution penalty along with the 6% excise tax. If she did not deduct the contribution on her taxes, then she will be paying tax twice on the amount. It may have been better for her to use the carry forward method of correcting an excess. Her tax preparer will file IRS form 5329 to pay the penalties owed.

Carry forward method hypothetical

Again we will use Charlotte, who contributed an excess of $1,000 to her IRA last year. She allowed the due date to remove the excess to expire. Instead of removing the excess, she will chose the carry forward method to correct the excess. Her IRA provider didn't have to do any tax reporting. Instead, her tax preparer will file IRS form 5329 to pay the penalty. She will owe the IRS 6% excise tax on the excess contribution amount of $1,000 and pay the penalty when filing IRS form 5329. This year she will use her excess as a current year contribution and only contribute an additional $4,500 to make her maximum IRA contribution of $5,500.

Keep in mind

- You will remove the excess from the IRA where the contribution was made.
- If you made multiple contributions, the last amount contributed is considered the excess.
- If you contribute to both a Traditional and Roth IRA in the same year, the excess is deemed to have occurred in the Roth IRA.

Talk to Wells Fargo Advisors

As you can see, there are a number of methods to correcting an excess contribution. Your Financial Advisor with Wells Fargo Advisors can provide the education you need to make an informed choice regarding an excess contribution. You should speak with your tax advisor about the one that works best for your situation. We look forward to working with you.

With you every step of the way

Everyone has a different vision of retirement that requires a unique financial strategy. Wells Fargo Advisors can support you in your retirement planning process by providing the guidance needed to make informed choices. We will meet with you and help create a comprehensive plan that takes into account your complete financial picture. Your Financial Advisor will be with you every step of the way to monitor your progress and adapt your plan as needed. Working together, we'll design and implement a retirement plan that will help you live out your unique vision of retirement.