

Q 2:25 What methods may be considered when correcting an excess contribution to a Roth IRA?

Generally, four methods may be used to correct an excess contribution to a Roth IRA for 2009:

1. Withdrawing a current year's excess contribution, plus the net income attributable (NIA) to the excess, before the individual's tax filing due date, including extensions, for 2009 (see Qs 2:27, 2:28). The 6 percent excise tax for excess contributions is avoided. The amount withdrawn in a correcting distribution cannot be treated as a qualified distribution. [I.R.C. § 408A(d)(2) (C), referring to I.R.C. § 408(d)(4)]

Note. Current year contributions that are removed, together with NIA, on or before the tax filing due date, are treated as not having been contributed.

2. Treating the prior year's excess contribution as a regular contribution made in a subsequent year in which there is an unused contribution limit. Although the excess contribution does not have to be withdrawn under Method 2, applying it to a later year does not avoid the 6 percent excise tax on the excess contribution.
3. Withdrawing a current year's excess contribution, plus the earnings attributable to the excess, within the six-month period following the return due date (not including extensions). This applies when the individual files his or her return without withdrawing the excess contribution. The 6 percent excise tax for excess contributions is avoided, but amended returns are required (see Q 2:33) to be filed by the owner.

Note. The amount of an excess contribution withdrawn in a correcting distribution that is accompanied by attributable earnings (Methods 1 and 3) cannot be treated as a qualified distribution [I.R.C. § 408A(d)(2)(C), referring to I.R.C. § 408(d)(4)]

4. Withdrawing an excess contribution after the due date of the return (including extensions) without earnings. [I.R.C. § 4973(f)] The 6 percent excise tax for excess contributions is avoided for subsequent years (2010), but not the current year (2009). Under this method, earnings are treated as distributed after all contributions (basis) have been removed (see Q 4:1). If the earnings are subsequently distributed in a qualified distribution (see Q 4:9), the earnings will not be taxable or subject to penalty.

Under method 4, excess contributions for a prior year are treated as deemed Roth IRA contributions for the subsequent year to the extent the owner is allowed to make a Roth IRA contribution for that subsequent year (see Q 2:33).

Example. Thelma, age 40, a qualifying widow, has modified adjusted gross income (MAGI) of \$200,000 for 2009, but only \$30,000 for 2010. For 2009, Thelma is not eligible to make a Roth contribution or conversion contribution because her MAGI exceeds the \$176,000 phaseout limit for contributions (see Q 2:7) and the \$100,000 MAGI limit for conversions (see Q 3:7), but is eligible for 2010. During 2009, Thelma inadvertently converts her only IRA to a Roth

IRA. She had no basis in the IRA and the \$100,000 conversion contribution to the Roth IRA was fully taxable. Thelma does not recharacterize the amount back to a traditional IRA (see Q 3:31), or correct the excess contribution (a “failed conversion”) under Methods 1 or 3, and paid a 6 percent penalty of \$6,000 ($\$100,000 \times .06$) for 2009. Assume the 2010 Roth contribution limit is \$5,000. Because the remaining excess contribution (\$100,000 from prior year) exceeds the \$5,000 amount that Thelma may contribute for 2010 by \$95,000 (\$100,000 reduced by her \$5,000 contribution limit for 2010), it cannot be entirely corrected under Method 2. Only Method 4 is available to correct the remaining \$95,000 excess to avoid the 6 percent penalty for 2010. Assuming Thelma does not want to make a contribution for 2010, the deemed contribution of \$5,000 could be undone by removing the \$5,000 with attributable earnings before the 2010 federal return due date (assume April 15, 2011). In which case, the deemed contribution of \$5,000 for 2010 would be treated as though it was never made. The earnings on the \$5,000 amount if withdrawn are taxable in 2010 (the year the contribution was deemed made), and may be subject to the 10 percent additional tax on distributions if under age 59½. Although it is not entirely clear, it would appear that the earnings attributable to the excess contribution is measured from the date the excess amount was originally contributed in 2009, rather than on April 16, 2011, the day after the 2010 return due date when the \$5,000 excess was treated as a deemed Roth IRA contribution.

Had Thelma timely recharacterized (see Q 2:7) her failed 2009 conversion on or before the due date of her 2009 return (including extensions), she would have qualified to make a conversion contribution in 2010 or after 2011. [The \$100,000 MAGI conversion limit does not apply after 2010 (see Q 3:16).]

It can be argued that if a Roth owner is not eligible for a Roth IRA contribution in an excess contribution carryover year, the owner should be able to remove the deemed Roth IRA contribution portion of the excess contribution (plus net income attributable) by the due date of the federal income tax return for that subsequent year (see Q 2:33). Only actual contributions can be recharacterized. If prior years’ excess contributions are treated as current year’s contributions, they can be recharacterized only if the recharacterization would still be timely with respect to the tax year for which the applied contribution were actually made.

Note 1. The rules under Code Section 408(d)(5) regarding corrections after the due date of a tax return for the tax-free distribution of certain excess contributions to traditional IRAs do not apply to a Roth IRA because Roth IRA contributions are always tax free on distribution (except to the extent that they accelerate income inclusion under the four-year spread (which was possible during 1998 through 2001, see Q 3:15) and under the two-year rule for amounts converted in 2010 and distributed before 2012 (see Qs 3: 12, 3:17). [Treas. Reg. § 1.408A-3, Q&A 7] Although Code Section 408(d)(5) regarding traditional IRA contributions returned before the due date of the

return does not apply to a Roth IRA, Method 4 is similar to the correction of excess traditional IRA contributions under that section. [I.R.C. § 4973(f)]

Note 2. The IRS has not published any guidance regarding the correction of excess Roth contributions after the due date of the return, except as provided in Method 3. This is because of the contribution first recovery rules that apply to Roth IRAs (see Q 4:1). [The contribution first recovery rules for excess contributions to a designated Roth account (DRA) are treated differently, subject to double taxation, and with no exclusion from income for amounts attributable to basis, if not distributed (with earnings) by April 15th of the year following the year of the excess (see Q 10:68).]

Q 2:26 How are the earnings on an excess or unwanted contribution to a Roth IRA calculated?

Treasury Regulations Section 1.408-4 prescribes a rather complicated formula for determining the earnings attributable to an excess or unwanted contribution that is being corrected by withdrawing that contribution, plus the earnings attributable to the excess, before the year's tax filing due date (including extensions). It sets up a ratio comparing the unwanted contribution to the total Roth IRA (all investments held under the Roth IRA agreement) and the earnings attributable to the unwanted contribution to the total income earned by the total Roth IRA account during the computation period (see Qs 2:27, 2:29). [Treas. Reg. §§ 1.408-4(c)(2)(ii), 1.408-4(e)(2)(iii)] Earnings are deemed to be received for federal income tax purposes in the taxable year *in which* the contribution is made. [I.R.C. 408(d)(4)]

Note. On May 5, 2003, the IRS finalized the proposed regulations that were issued on July 23, 2002. [T.D. 9056, 68 Fed. Reg. 23586–23590 (May 5, 2003); REG-124256-02 (67 Fed. Reg. 48067–48070), as corrected at 67 Fed. Reg. 53644 (Aug. 16, 2002)] The final regulations retain the rule that net income calculations must be based on the overall value of an IRA and the dollar amounts contributed, distributed, or recharacterized from the IRA. The regulations do not permit the calculation of net income on the basis of the return on specific assets, even when recharacterizing an amount converted to a Roth IRA.

The final regulations apply to income calculations of IRA contributions made on or after January 1, 2004. The final regulations generally utilize the “new” method announced in Notice 2000-39 [2000-30 I.R.B. 132] for calculating the net income attributable to IRA contributions that are distributed as an excess or unwanted recharacterization (see Qs 2:28, 2:29). Notice 2000-39 allows earnings to be positive or negative and does not produce irregular results for contributions made late in the year. [Treas. Reg. § 1.408A-5, A-2(c); Treas. Reg. § 1.408-11, 68 Fed. Reg. 23586–23590 (May 5, 2003)]

The *computation period* extends from January 1 of the year for which the excess contribution is made until the date of the corrective distribution.