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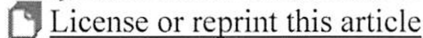
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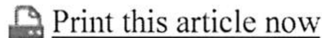
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The Costly Danger of Putting Extra Money in Your IRA

Uncle Sam will sock you with an annual penalty until you fix your mistake.

By Rachel L. Sheedy, From *Kiplinger's Retirement Report*, April 2015
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Saving in an IRA is a good thing. But stashing away too much in a single year can get you in trouble. Put more money into an IRA than the annual contribution limit, and Uncle Sam will sock you with a 6% penalty each year until the extra money is taken out.

See Also: IRAs Special Report

Those most likely to run into the penalty are workers who earn too little to contribute the legal maximum -- and, for Roth IRAs, those who have too much income. Also, new IRS limits on IRA rollovers raise the odds of getting hit with a penalty. With these new rules, "excess contributions will become more of an issue," says Jeffrey Levine, IRA technical consultant for Ed Slott and Co., which provides IRA advice.

Taxpayers younger than 50 can stash up to $5,500 in traditional and Roth IRAs for 2015. Those 50 and older can put in up to $6,500.

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But you can't put more in an IRA than you earn from a job. "The amount is actually capped to your earnings," says Nancy Montanye, a certified public accountant in Williamsport, Pa. Say a 65-year-old retired early in the year and earned $5,500. If he contributed the $6,500 maximum, $1,000 would be excess.

Those with higher incomes who contribute to Roth IRAs also can run into trouble. Roth eligibility in 2015 phases out for joint filers as modified adjusted gross income rises between $183,000 to $193,000, and for single filers between $116,000 to $131,000. If you expect your income to fall below the phase-out range and make the maximum Roth contribution, part or all of the contribution could be excess if your income ends up over the threshold.

Workers who are past typical retirement age could unintentionally make excess contributions, too. While workers of any age can contribute to a Roth IRA, workers can no longer contribute to a traditional IRA starting in the year they reach age 70 1/2. Contributions to a traditional IRA past this age cutoff are considered excess.

The new IRS rules for 60-day IRA rollovers also raise the penalty risk. Previously, you could roll money out and back into an IRA within 60 days tax free every 12 months for each IRA you own. Now you can only do one 60-day rollover every 12 months no matter how many IRAs you own (see IRA Owners: Heed New 60-Day Rollover Rule). If you do more than one rollover, any money that can't count as an annual contribution will be an excess contribution.

Stashing Away Too Much

Because the 6% penalty racks up every year the problem goes unresolved, it's important to address the issue quickly. "The longer you wait, the worse it gets," Levine says. But you do have a couple of options to fix the problem, particularly if you catch it early.

You can avoid the 6% penalty if you withdraw the excess contribution, plus its earnings, by the due date of your tax return, including extensions. However, you must pay ordinary income tax on the earnings. And if you are younger than 59 1/2, you must pay the early-withdrawal penalty of 10%.

Say an account holder had a 2014 excess contribution of $1,000 that earned $200. He would have to take $1,200 out of his IRA by October 15, 2015. He would owe income tax on the $200 earnings; at the 25% rate, his tax tab would be $50. If he's younger than 59 1/2, he would owe an additional $20 on the earnings.

If the investment declined, there's a silver lining: "If the value goes down, there's no tax penalty," says Joe Franklin, president of Franklin Wealth Management, in Hixson, Tenn., because there are no earnings to be taxed.

In some cases, it may make sense just to pay the 6% penalty. For instance, the younger taxpayer above would owe a $60 penalty on his excess contribution. "Earnings are ignored in this situation," Montanye says.

The taxpayer can withdraw the excess amount or leave it in the IRA. If he wants to withdraw the extra money, the taxpayer must do so by December 31 of the tax-filing year. But if the taxpayer wants to

keep the money in his account, he could reduce his IRA contribution for the following year by the amount of the excess contribution.

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