White Lighthouse
Investment Management

How to Correct Roth RIA Contribution Errors

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Imagine the following situation: As you do every year, you made your 2014 Roth IRA contribution in April 2014, right after receiving your 2013 tax refund. Now it's March 2015 and you are getting ready to file your 2014 tax return. When you get home from work, you find a voice mail from your accountant:

> "Thank you for forwarding your tax documents to my office. I have some good news and some bad news to share. First, the good news: Congratulations, you made more money this year and your income is up! Now the bad news: unfortunately Congress thinks you made too much money to make a Roth IRA contribution, so you need to fix this ASAP or you will have to pay a penalty."

Fix the problem? How? Pay a penalty? You don't want to pay any penalties! You are utterly confused because you thought you were doing the "right thing" by saving early for retirement...

First, let's understand what happened. Roth IRAs allow workers to contribute a portion of their after tax earnings into an account that grows tax free and can be distributed tax free at retirement, as long as the required Roth account conditions are met. However, contributions to Roth IRAs are not unlimited. There are two limitations:

- **Contribution Limitations**: Roth IRA contributions are limited to the lower of your earned income of $5,500/year (or $6500 if you are older than 50)
- **Income Limitations**: The ability to contribution to a Roth IRA is phased-out after certain Adjusted Gross Income levels. For 2015, the phase-out range is $183,000 - $193,000 for

married couples filing joint returns and $116,000 to $131,000 for singles and heads of households ($0 - $10,000 for married couples filing separately)

If you make an excess contribution to a Roth IRA, either because you contributed more than the maximum allowed amount, or because you made a contribution when your income was over the phase-out range, the excess contribution will be subject to an excise tax of 6%. This excise tax will apply every year until the excess contribution is withdrawn.

Now that we understand what happened, how do you fix this problem? There are two options:

Withdrawal: You simply distribute your excess contribution (adjusted for related earnings or losses) by filing deadline of your return, including extensions, usually April 15th or October 15th respectively. If you are unsure how to calculate how much you need to withdraw, you should ask your brokerage firm or investment adviser to help you with the calculation. Any earnings accrued between the time you made the contribution and the funds are withdrawn will be taxed as ordinary income. If you are younger than 59 ½, the earnings will also be subject to a 10% penalty. The original contribution amount itself and related losses (if any) can be withdrawn tax free.

Alternatively, there is a get-out-of-jail-free-card:

- **Re-characterization:** A re-characterization is a "correction" of an improper IRA contribution. Re-characterization is achieved by making a trustee-to-trustee transfer from one IRA to another type of IRA, in this case, from a Roth IRA to a Traditional IRA. Trustee-to-trustee transfers are made directly between financial institutions or within the same financial institution. As above, the re-characterization needs to take place by the filing deadline of the return, including extensions, ie, April 15th or October 15th.

The advantage of re-characterizing an excess contribution over withdrawing it is that it avoids any penalties and taxes for earnings accrued. Any re-characterization contribution and related earnings will be treated as having been originally contributed to the second IRA, not the first IRA. For that reason, it is important to enlist the assistance of your brokerage firm or investment advisor with the calculation of the correct amount that needs to be re-characterized in the trustee-to-trustee transfer.

What is the difference between a Roth IRA and a Traditional IRA?

If you re-characterize your Roth IRA contributions to Traditional IRA contributions, there are two possibilities:

- The re-characterized Traditional IRA contributions will be tax deductible in the year the contribution was made. This will be the case if neither you nor your spouse (if you are married and filing a joint return) are active participants in a qualified retirement plan such as 401(k), 403(b), SEP IRA, defined benefit plan, Keogh plan, etc. This situation will be more

common for foreign resident taxpayers who participate in foreign retirement plans and not US retirement plans, as foreign retirement plans are generally* not qualified retirement plans.

- The re-characterized Traditional IRA contributions will NOT be tax deductible because either you or your spouse are active participants in a qualified retirement plan. If this is the case, earnings will accrue tax deferred in the account but will be taxed at ordinary tax rates when withdrawn at retirement. The contributions are withdrawn tax-free. This is a disadvantage of non-deductible traditional IRAs over Roth IRAs.

More good news: you can convert your Traditional IRA back into a Roth IRA. This is usually referred to as a "back-door Roth Conversion". Unlike Roth contributions, there are no income limitations for Roth Conversion. A Roth Conversion is a trustee-to-trustee transfer from a Traditional IRA to a Roth IRA. Non-deductible IRA contributions can be converted to a Roth IRA tax-free. Converted gains accrued in a traditional IRA are taxed at ordinary rates but there is no early withdrawal penalty. So, as you can see, you can end up where you began even if your income exceeded the phase out range by re-characterizing your Roth IRA contributions to a Traditional IRA and then converting the Traditional IRA back into a Roth IRA! This will require some administrative work, but will save you unnecessary taxes and penalties.

Caveats to "Back Door" Roth Conversions:

- If you have other deductible Traditional IRAs, the taxable portion of the conversion is calculated proportionately in the aggregate of your deductible and non-deductible IRAs. For example: if you have a balance of $94,500 in a deductible IRA and a non-deductible $5,500 IRA, for a total of $100,000 IRA balance, 94.5% of the conversion will be taxable.

- Some analysts have pointed out that the IRS may disallow such a conversion by applying the substance over form doctrine: although the form of the transaction is a Roth conversion, the actual substance is a disguised Roth contribution by a person whose income is too high. However, to date, and in spite of this being a well-known and widely applied practice, we are not aware of any IRS challenge to Roth conversions by taxpayers with incomes above the Roth contribution limits.

In conclusion, if you have made an excess Roth IRA contribution, there is no need to panic. There are mechanisms to correct this mistake with no penalties, depending on the circumstances, there is even the possibility of ending back with the contribution in a Roth IRA, as originally intended, through a Roth conversion.

Timing is important though. Waiting to the last minute to file your tax return and finding out, say on October 14th, that you have a Roth IRA excess contribution problem, is probably not going to give you enough time to correct it before the October 15th filing deadline. If you find out that you made an excess Roth IRA contribution on April 15th, do not file your tax return. File a request for an

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extension of time to file instead and call your brokerage firm or investment advisor to help you re-characterize the excess contribution.