



Correcting excess contributions to IRAs

By: **Vorris J. Blankenship**

Taxpayers are generally eligible to make regular annual contributions to their IRAs that are limited to fixed dollar amounts established by statute.¹ The contributions are further limited to the amount of the taxpayer's taxable compensation.² Contributions to IRAs in excess of those limits (excess contributions) are generally subject to a 6% excise tax.³

The 6% excise tax may also apply to a failed rollover to a traditional IRA from another traditional IRA or from a qualified retirement plan.⁴ The failed rollover is treated as an ordinary distribution from the plan or traditional IRA, followed by a separate regular contribution to a traditional IRA. The distribution part is taxable to the extent of the earnings portion of the distribution.⁵ The earnings portion may also be subject to the 10% additional tax on early distributions, unless an exception applies.⁶ The contribution part of the failed rollover becomes subject to the 6% excise tax to the extent it exceeds the limitation on regular contributions (i.e., to the extent it is an excess contribution).⁷

A failed Roth conversion from a qualified plan or traditional IRA is similarly treated. The distribution part of the failed Roth conversion is an ordinary distribution and is taxable to the same extent it would have been if the Roth conversion had not failed.⁸ However,

unlike a valid Roth conversion, the earnings portion of the distribution may also be subject to the early-distribution penalty, unless an exception applies.⁹ The contribution part of the failed rollover is subject to the 6% excise tax to the extent it exceeds the statutory limitations on regular contributions to Roth IRAs (i.e., to the extent it is an excess contribution).¹⁰

The most common type of failed rollover is an attempt to roll over a distribution that is not eligible for rollover.¹¹ This includes, for example, an attempt to roll over a required minimum distribution (RMD).¹² Similarly, failure to complete an indirect rollover to an IRA within the required 60-day period is a failed rollover if the taxpayer is unable to self-certify that there is a permissible reason for the delay¹³ and is unable to obtain an IRS waiver of the delay.¹⁴ For some other types of failed rollovers, see Examples 13 through 18.

The 6% excise tax on an excess contribution will continue to apply year after year until mitigated by using the methods described in the remainder of this article. These methods of mitigation are largely the same whether an excess contribution arises from an excessive regular contribution or a failed rollover or whether the excess contribution involves a traditional IRA or a Roth IRA.¹⁵ For that reason, please remember that the term "IRAs" as used in this article includes traditional IRAs (including

SEPs), Roth IRAs, and SIMPLE IRAs, unless the context clearly indicates otherwise.¹⁶

Eliminating excess contributions by making corrective distributions

The 6% excise tax on an excess contribution may be avoided by making a "corrective distribution," provided no deduction has been allowed for the contribution. An IRA makes a corrective distribution by timely distributing the amount of the excess contribution, together with any accumulated net income attributable to the excess contribution.

A corrective distribution is timely if it is made by the extended due date of the taxpayer's tax return for the tax year of the contribution.¹⁷ That date is normally Oct. 15 of the calendar year following the year the taxpayer made the contribution (even if the taxpayer did not need or obtain an extension of time to file his or her return). However, if the taxpayer did not file a timely return for the year of the contribution, the taxpayer must complete the corrective distribution by April 15 of the year following the year of the contribution.¹⁸

If the conditions for a corrective distribution are met, the original contribution is treated as if it had not been made.¹⁹ However, the distribution of income earned by the IRA on the excess contribution is taxable in the year of the contribution and is subject to the

1. Sec. 219(b)(1)(A). They are also inflation-adjusted under Sec. 219(b)(5)(C)(i). The deductible amount for 2019 and 2020 is \$6,000; \$7,000 for taxpayers 50 or older who are eligible for a catch-up contribution (Notice 2018-83 and Notice 2019-59).

2. Sec. 219(b)(1)(B).

3. Sec. 4973. Note, though, that the excise tax may be no more than 6% of the value of the IRA at the close of the tax year in which the taxpayer made the excess contribution (Sec. 4973(a)).

4. For purposes of this article, references to qualified plans include Sec. 403(b) plans (tax-sheltered annuities (TSAs)) and Sec. 457(e)(1)(A) eligible state and local government plans.

5. Regs. Secs. 1.408-1(c) and 1.408A-4, Q&As 3(b) and 6(c); IRS Letter Rulings 9633041 and 201313025.

6. Sec. 72(t); IRS Letter Rulings 9633041 and 201313025.

7. Sec. 4973(b)(1); IRS Letter Rulings 9633041 and 201313025.

8. Regs. Sec. 1.408A-4, Q&As 3(b) and 6(c); IRS Letter Rulings 9633041 and 201313025.

9. Sec. 72(t); IRS Letter Rulings 9633041 and 201313025.

10. Sec. 4973(f)(1).

11. Sec. 402(c)(4); Regs. Sec. 1.402(c)-2, Q&A 4.

12. Secs. 401(a)(9), 402(c)(4)(B), and 408(d)(3)(E).

13. Rev. Proc. 2016-47. Blankenship, "The 60-Day Rollover Rule: Self-Certifying Waiver Eligibility," 49 *The Tax Adviser* 38 (January 2018), available at tinyurl.com/vqnp7eg.

14. Secs. 402(c)(3)(B) and 403(d)(3)(i); Rev. Proc. 2003-16.

15. Secs. 4973(b) and (f); Secs. 408(d)(4) and 219(f)(6).

16. Regs. Sec. 1.408A-8, Q&A 1(a).

17. Sec. 408(d)(4).

18. Sec. 408(d)(4)(A); Regs. Secs. 1.408-4(c)(2)(i) and 301.9100-2(b).

19. Sec. 4973(b) (flush language); Sec. 4973(f) (flush language).

early-distribution penalty, unless an exception applies.²⁰ Determination of the income earned by an IRA on an excess contribution is simple if the excess contribution is the only contribution ever made to the IRA and the IRA did not make any distributions. In that case, the income earned is equal to all the earnings in the IRA. Thus, a taxpayer making a corrective distribution may simply distribute the entire balance (including the income earned).²¹

Otherwise, the taxpayer must distribute a pro rata portion of the income (or loss) earned by the IRA from the date of the original excess contribution to the date of the corrective distribution. The taxpayer computes the allocated income

(or loss) by multiplying the amount of the excess contribution by a fraction. The numerator of the fraction is the adjusted balance of the IRA immediately before the corrective distribution (the “adjusted closing balance”) minus the adjusted balance immediately before the excess contribution (the “adjusted opening balance”). The denominator is the adjusted opening balance.²²

The adjusted opening balance includes the excess contribution. It also includes other contributions and incoming recharacterizations during the computation period. The adjusted closing balance includes distributions, transfers out, and outgoing recharacterizations during the computation period.²³

Example 1: On Feb. 28, 2019, a single, 54-year-old taxpayer made a \$250,000 contribution to her traditional IRA, consisting of a \$7,000 deductible regular contribution, a nontaxable rollover contribution of \$163,000, and an excess contribution of \$80,000. The value of the traditional IRA immediately before the contribution was \$150,000. Thus, the IRA was valued at \$400,000 immediately after the excess contribution. On April 1, 2020, when the IRA was worth \$420,000, the trustee made a corrective distribution to the taxpayer of the \$80,000 excess contribution plus \$4,000 of allocable net income. The trustee computed the allocable income as shown in the chart “Computation of Allocable Income in Example 1.”

Computation of allocable income in Example 1

IRA value before the contribution		\$150,000
Amount of the contribution	a	\$250,000
Adjusted opening balance (AOB)	b	\$400,000
Adjusted closing balance (ACB)		\$420,000
Less the AOB		\$400,000
The income or balance change (ACB – AOB)	c	\$ 20,000
Income as a percentage of the AOB	d = c ÷ b	5%
Income allocable to the corrective distribution	d × 80,000	\$ 4,000

The distributed IRA income of \$4,000 is subject to income tax for 2019 and is subject to the additional 10% tax on premature distributions if no exception applies. At an assumed 30% marginal income tax rate, with an early-distribution penalty of 10%, the total tax and penalty on the distributed income is \$1,600. If the taxpayer had failed to make a corrective distribution before the deadline, she would have instead been

20. Sec. 408(d)(4); Regs. Sec. 1.408A-6, Q&A 1(d); Notice 87-16, Q&A C2.

21. Regs. Sec. 1.408-11(a)(2).

22. Regs. Sec. 1.408-11(a)(1).

23. Regs. Sec. 1.408-11(b).

EXECUTIVE SUMMARY

- Contributions to IRAs are restricted to limits set by statute and subject to inflation adjustments. Currently, the annual limit is \$6,000 with a catch-up contribution of \$1,000 for individuals 50 and older.
- Excess contributions to an IRA are subject to a 6% excise tax,

which applies to the excess contributions each year until they are removed or eliminated from the account. In addition to regular contributions, failed rollover and failed conversion contributions can result in excess contributions to an IRA.

- There are several ways a taxpayer can correct for excess contributions and avoid the

excise tax entirely or for future years. Methods to correct excess contributions include a corrective distribution, a dollar-limited distribution, an ordinary distribution, absorption, and recharacterization.

- The different methods of cure and fact patterns involved are illustrated in several examples.

liable for a 2019 excise tax of \$4,800 (6% of the \$80,000 excess contribution) and would have remained potentially liable for the excise tax in future years.

Although a taxpayer who fails to make a timely corrective distribution generally cannot avoid the excise tax for the year of the excess contribution, he or she may have other ways to avoid or mitigate the excise tax for future years, as described in this article.

Eliminating excess contributions by making dollar-limited distributions

For tax years after an excess contribution is made to a traditional IRA, a taxpayer may be able to distribute the excess contribution and avoid further impositions of the excise tax if total contributions during the year of the excess contribution did not exceed the statutory dollar limit on regular contributions. The taxpayer also must not have been allowed a deduction for the excess contribution.²⁴ An excess contribution to a traditional IRA might have occurred, for example, because the taxpayer, though mindful of the statutory dollar limit, exceeded the taxable compensation limit on contributions.

The taxpayer may make such a distribution (a “dollar-limited distribution”) of an excess contribution at any time after it is too late to make a corrective distribution (described above).²⁵ Both the amount of the excess contribution and the amount of a later dollar-limited distribution are determined without regard to the phaseout of deductions for IRA contributions applicable to active participants in qualified plans.²⁶

Rather than eliminate an excess contribution with an ordinary distribution, a taxpayer would generally prefer to use a corrective distribution or a dollar-limited distribution.

Example 2: During 2019, a single, 54-year-old taxpayer made a \$7,000 contribution to his traditional IRA (an amount within the dollar limit). The taxpayer was not an active participant in any qualified plan that would prohibit his making deductible IRA contributions. The taxpayer had adjusted gross income of \$75,000 for 2019, but only \$3,000 was taxable compensation. Therefore, the taxpayer may only deduct \$3,000 of the contribution because of the limit on deductible contributions based on taxable compensation. The remaining \$4,000 is an excess contribution. However, the taxpayer may make a dollar-limited distribution of the \$4,000 excess contribution if it is too late to make a corrective distribution (e.g., it is after Oct. 15, 2020).

Alternatively, assume the same taxpayer was an active participant in

a qualified plan. In that case, his IRA deduction was completely phased out based on his gross income, and he was not entitled to a deduction for any of his \$7,000 contribution. Nevertheless, because a taxpayer’s active participation is ignored for purposes of determining both excess contributions and dollar-limited distributions, his excess contribution for 2019 is still only \$4,000 (the excess of his \$7,000 contribution over his \$3,000 taxable compensation). Thus, he may make a dollar-limited distribution of the \$4,000 excess contribution after the allowable period for a corrective distribution has expired. The remaining \$3,000 portion of the original \$7,000 contribution is a nondeductible contribution to the traditional IRA.²⁷

The excise tax does not apply to an excess contribution for the year of a dollar-limited distribution or for any subsequent year.²⁸ Furthermore, the distribution is nontaxable, and it is not necessary to distribute accumulated income earned on the contribution.²⁹ The downside, of course, is that the taxpayer must still pay the 6% excise tax for the year (or years) before the dollar-limited distribution was made.³⁰

Relief in the form of a dollar-limited distribution is also provided for taxpayers who erroneously determined the amount of a rollover contribution to a traditional IRA by reasonably relying on erroneous information supplied under Subtitle F of the Code (e.g., relying on an erroneous information return). In that case, the limit is increased by the amount of any excess contribution resulting from the erroneous information. That is, the taxpayer may make a

24. Secs. 408(d)(5) and 4973(b)(2)(B); Prop. Regs. Sec. 1.408-4(h). The statutory dollar limit is normally determined under Sec. 219(b)(1)(A); however, the statutory dollar limit for SEPs is increased by the lesser of the amount of employer contributions or the dollar limitation under Sec. 415(c)(1)(A). See Sec. 408(d)(5)(A).

25. Sec. 408(d)(5)(A)(i).

26. Secs. 408(d)(5) (flush language), 4973(b)(1)(B), and 4973(b) (flush language).

27. Sec. 408(o). If the taxpayer does not report the nondeductible contribution on a Form 8606, *Nondeductible IRAs*, attached to his or her return, the

taxpayer is liable for a \$50 penalty. If the taxpayer overstates the amount of the nondeductible contribution, he or she is liable for a \$100 penalty (Sec. 6693(b)).

28. Secs. 4973(a), (b), and (f).

29. Sec. 408(d)(5). If the taxpayer nevertheless distributes the accumulated income the IRA earned on the excess contribution, the distributed income is subject to tax and is subject to the early-distribution penalty (if no exception applies) (IRS Letter Rulings 9633041, 9118020, and 7926152).

30. Secs. 4973(a) and (b); Prop. Regs. Sec. 1.408-4(h).

dollar-limited distribution of the excess contribution even though it is more than the normal limit.³¹

Example 3: A single, 54-year-old taxpayer received a \$243,000 distribution from her qualified plan on Dec. 20, 2018. The distribution did not include any investment income. In January 2019, the taxpayer received a Form 1099-R, *Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.*, confirming that the distribution was \$243,000. On Feb. 15, 2019, the taxpayer contributed the entire amount of the distribution to a traditional IRA. Unfortunately, though, the \$243,000 distribution should have been only \$163,000. The remaining \$80,000 was distributed in error. In addition, the taxpayer properly made and deducted a separate regular contribution of \$7,000 to the traditional IRA in 2019.

Only \$163,000 of the \$243,000 attempted rollover contribution to the traditional IRA actually qualifies as a tax-free rollover. This actual permitted rollover amount is equal to the correct portion of the qualified plan distribution. The remaining \$80,000 of the attempted rollover contribution is an excess contribution.

Assume the qualified plan informed the taxpayer of the overpayment in 2020 but too late in the year for the taxpayer to make a timely corrective distribution of the \$80,000 excess contribution. Assume, however, that the taxpayer reasonably relied on the erroneous Form 1099-R when she made her excess IRA contribution of \$80,000. Consequently, the taxpayer may increase the normal regular

Absorption of an excess contribution may be a last resort. That is, it may be too late for a corrective distribution, and the taxpayer may not qualify for a dollar-limited distribution.

contribution limit of \$7,000 for 2019 by an additional \$80,000 for purposes of a dollar-limited distribution. Thus, the taxpayer's traditional IRA may make a timely dollar-limited distribution of the \$80,000 excess contribution in 2020 that falls within the now-augmented regular contribution limit of \$87,000.³²

The dollar-limited distribution from the traditional IRA in 2020 is not taxable. In addition, the 6% excise tax will not apply to the \$80,000 excess contribution for 2020 and later years (though it will still apply for 2019).³³ Unfortunately, though, the \$80,000 erroneously distributed by the qualified plan in 2018 is still taxable in that year and is subject to the early-distribution penalty (unless an exception applies).³⁴

Assume the taxpayer's qualified plan demands return of the \$80,000 overpayment, together with the income earned on the overpayment. To fully comply with that demand, the taxpayer obtains a distribution of the income the traditional IRA earned on the \$80,000 excess contribution (even though the dollar-limited distribution rule does not require distribution of that income). The

distribution of the income is taxable in the same way as any other IRA distribution, and the early-distribution penalty applies in the absence of an exception.³⁵

When the taxpayer returns the \$80,000 overpayment and income earned on it to the qualified plan, the repayment is treated as a miscellaneous itemized deduction.³⁶ Unfortunately, though, miscellaneous itemized deductions are not allowed for the years 2018 through 2025.³⁷ Note that if the plan should instead waive repayment of the overpayment, the waived amount is not taxable as income from the discharge of indebtedness, provided the overpayment was properly reported in prior years.³⁸

The situation becomes more complicated if the taxpayer did not report the qualified plan overpayment as gross income (e.g., because he or she thought it was part of a tax-free rollover to a traditional IRA) and the statute of limitation has run on the distribution year. In that situation, the IRS has ruled that the subsequent distribution of the overpayment amount from the traditional IRA did not qualify as a dollar-limited distribution and was taxable because of the "duty of consistency." The IRS said the IRA's putative dollar-limited distribution of the excess contribution was inconsistent with the taxpayer's treatment of the qualified plan's overpayment as nontaxable in the closed year.

Nevertheless, the IRS also asserted that the 6% excise tax continues to apply to the excess contribution until it is eliminated by distribution or otherwise.³⁹ Arguably, though, it would seem the failed dollar-limited distribution would itself constitute an ordinary distribution that would eliminate the excess contribution in whole or in part. (See the discussion of ordinary distributions below.)

31. Sec. 408(d)(5); Prop. Regs. Sec. 1.408-4(h)(2).

32. IRS Letter Rulings 200337014, 9633041, and 9118020.

33. IRS Letter Ruling 9633041.

34. Rev. Rul. 2002-84; IRS Letter Rulings 9633041 and 201313025.

35. IRS Letter Rulings 9633041 and 9118020.

36. Secs. 67(b) and 165(c)(1); Rev. Rul. 2002-84.

37. Sec. 67(g).

38. IRS Letter Ruling 201743011.

39. IRS Letter Ruling 201313025.

Of course, a taxpayer would normally prefer a corrective distribution (described under the preceding caption) over a dollar-limited distribution. Although neither type of distribution is taxable, the corrective distribution avoids the excise tax for all years, whereas the dollar-limited distribution does not avoid the excise tax for years before the distribution. Even though a dollar-limited distribution does not require the distribution of IRA income earned on the excess contribution, the total tax and penalties imposed on this income under a corrective distribution is normally much less than the excise tax avoided.

Nevertheless, if it is too late to make a corrective distribution to avoid the excise tax for a prior year (or years), a taxpayer will likely choose to make a dollar-limited distribution if available. It is even possible a taxpayer may deliberately choose to wait and make a dollar-limited distribution rather than a corrective distribution if his or her traditional IRA had unusually high income (because of some kind of windfall) while it held the excess contribution. That is, the taxes and penalties on income earned by the traditional IRA on the excess contribution may then be so high that they exceed the 6% excise tax. Then, the taxpayer will want to make a dollar-limited distribution to avoid distributing and paying tax and penalties on the IRA income.

Note that dollar-limited distributions are not available for excess contributions to Roth IRAs.⁴⁰

Eliminating excess contributions by making ordinary distributions

If it is too late to make a corrective distribution, a taxpayer may be able to

eliminate an excess contribution simply by making ordinary distributions.⁴¹ For a traditional IRA, the excess contribution is reduced by an amount equal to the portion of an ordinary distribution that is includible in gross income (but not reduced by the return of investment).⁴² For a Roth IRA, the excess contribution is reduced by the entire amount of the distribution.⁴³ In neither case is there a need to distribute the IRA income earned on the excess contribution.

An ordinary distribution that is used to reduce an excess contribution is taxed in the same way as any other ordinary distribution. The taxpayer includes in gross income the earnings portion of the distribution from a traditional IRA and the earnings portion of a nonqualified distribution from a Roth IRA.⁴⁴ However, to compute the tax-free return of the investment portion of those distributions, the taxpayer may treat the excess contribution as additional investment in the IRA.⁴⁵

Rather than eliminate an excess contribution with an ordinary distribution, a taxpayer would generally prefer to use a corrective distribution or a dollar-limited distribution (both of which automatically override elimination by ordinary distribution).⁴⁶ A corrective distribution avoids the excise tax for all years. And both corrective distributions and dollar-limited distributions, unlike ordinary distributions, are nontaxable. But if it is too late to make a corrective distribution and the taxpayer does not qualify for a dollar-limited distribution, an ordinary distribution may be the only feasible solution.

Example 4: Assume the same facts as in Example 1. That is, on Feb.

15, 2019, the single, 54-year-old taxpayer made a \$250,000 contribution to her traditional IRA, consisting of a \$7,000 deductible regular contribution, a nontaxable rollover contribution of \$163,000 (including no investment), and an excess contribution of \$80,000. In addition, the value of the traditional IRA immediately before the contribution was \$150,000, none of which was taxpayer investment. Unfortunately, the taxpayer failed to make a corrective distribution within the allowable time period and does not qualify for a dollar-limited distribution.

Instead, in 2020, after expiration of the time for a corrective distribution, the taxpayer computes and makes an optimized⁴⁷ ordinary distribution of \$98,814, of which \$18,814 is a tax-free investment. The remaining \$80,000 of distributed earnings, though taxable, reduces the excess contribution to zero. The taxpayer computes the \$18,814 of tax-free investment by multiplying the \$98,814 distribution by the exclusion ratio of 19.04%. The taxpayer computes the exclusion ratio by dividing the \$80,000 investment (attributable to the excess contribution) by the \$420,000 IRA balance.

At an assumed combined rate of 40%, the taxes and early-distribution penalty on the \$80,000 of gross income from the ordinary distribution in 2020 would be \$32,000. The taxpayer would also have already paid a 6% excise tax of \$4,800 for 2019, the year of the \$80,000 excess contribution. The sum of the income tax and excise tax greatly exceeds the \$1,600 total taxes and penalties payable in Example 1 on a corrective distribution.

40. T.D. 8816; Sec. 4973(f)(2).

41. Secs. 4973(b)(2)(A) and (f)(2)(A).

42. Sec. 4973(b)(2)(A).

43. Sec. 4973(f)(2)(A).

44. Secs. 408(d)(1) and 408A(d)(1) and (2).

45. IRS Letter Ruling 200904029.

46. Secs. 408(d)(4) and (5).

47. The optimum distribution may be determined iteratively, or it may be computed as follows: $d = eb \div (b - i)$, where d equals the optimum distribution, e equals the excess contribution, b equals the balance of the traditional IRA, and i equals the investment in the traditional IRA.

As demonstrated by the above examples, a corrective distribution from a traditional IRA will nearly always be substantially more beneficial than an ordinary distribution. Nevertheless, it is theoretically possible (though highly unlikely) that an ordinary distribution could be more beneficial. That is, for a corrective distribution the taxes and penalties on unusually high income earned by the traditional IRA on the excess contribution (due to some kind of windfall) could conceivably exceed the total of (1) the income tax and penalties on an alternative ordinary distribution plus (2) the 6% excise tax on the excess contribution.⁴⁸

For a Roth IRA, the consequences of an ordinary distribution are generally more favorable than they are for a traditional IRA. The entire amount of an ordinary distribution from a Roth IRA (not just the taxable portion) offsets excess contributions,⁴⁹ and a Roth IRA distributes all of its nontaxable investment before taxable earnings.⁵⁰

Example 5: A single, 54-year-old taxpayer is not eligible to contribute to a Roth IRA in 2019 because his modified adjusted gross income exceeds the phaseout limit for those contributions.⁵¹ Nevertheless, the taxpayer mistakenly makes a \$7,000 excess contribution in 2019 to a newly formed Roth IRA. The entire excess contribution constitutes after-tax investment in the Roth IRA.⁵²

In 2020, after the expiration of the time for making a corrective distribution, the Roth IRA's balance has grown to \$7,700. The taxpayer then makes an ordinary distribution of \$7,000 that is composed entirely of nontaxable investment and that eliminates the \$7,000

A corrective distribution is clearly the best way to eliminate an excess contribution to a Roth IRA that is attributable to a regular contribution.

excess contribution. The \$700 of earnings is retained by the Roth IRA and is allowed to compound tax-free in future years. Unfortunately, the taxpayer must still pay excise tax of \$420 for 2019 (6% of the \$7,000 excess contribution).

Note though that, if the taxpayer in Example 5 had not made the excess contribution, he would have personally paid income tax of \$259 on the \$700 of earnings from the funds (at a marginal tax rate of 37%). The \$161 excess of the \$420 excise tax paid over the \$259 of income tax avoided represents the true cost of transferring the \$700 of income to the Roth IRA. However, if the income earned by the Roth IRA were larger than \$700, the cost of shifting the income to the Roth IRA would decline and could even reach zero. For example, if the income earned by the Roth IRA were \$1,135, the taxpayer could have avoided income tax of \$420 (at a 37% marginal tax rate) by retaining the income in the Roth IRA. In that case, the \$420 of income tax avoided would have exactly offset the \$420 of excise tax due.

Thus, after mistakenly making an excess contribution to a Roth IRA, a taxpayer may prefer to wait until the period allowed for a corrective distribution has expired and then eliminate the excess

contribution by making an ordinary distribution. Both types of distributions will eliminate a like amount of excess contributions. For each, distribution of the excess contribution is unlikely to be taxable. Although the excise tax incurred by forgoing a corrective distribution is likely to be higher than the tax and penalty incurred by distributing Roth IRA income as part of a corrective distribution, the retention of the income in the Roth IRA may make the additional cost of an ordinary distribution worthwhile.

Note that the result in Example 5 appears proper if the excess contribution were truly a consequence of the taxpayer's mistake. However, if it were the result of a contrived plan, the IRS would almost certainly seek ways to thwart the plan. Imagine for example that the taxpayer above had deliberately made an excess contribution of \$700,000, resulting in residual earnings of \$70,000 transferred tax-free to the Roth IRA.

Eliminating excess contributions by absorption

If the types of distributions described above do not entirely eliminate excess contributions, the 6% excise tax will continue to apply to the remaining excess contributions in future years. However, for each future year, the taxpayer will be deemed to have contributed the portion of the excess contribution that does not exceed the allowable contribution the taxpayer could have made to the IRA (but did not make) for that year. That is, the excess contribution is automatically "absorbed" by the IRA each year to the extent of the lesser of the dollar limit or the taxable compensation limit, reduced by other actual deductible contributions made for the year.⁵³

For a traditional IRA, the taxpayer may claim a deduction for the deemed

48. Sec. 408(d)(5); Prop. Regs. Sec. 1.408-4(h)(2).

49. Sec. 4973(f)(2)(A).

50. Sec. 408A(d)(4)(B)(i).

51. Sec. 408A(c)(3).

52. IRS Letter Ruling 200904029.

53. Secs. 219(f)(6), 4973(b)(2)(C), and 4973(f)(2)(B); Regs. Sec. 1.408A-3, Q&A 7; Martin, T.C. Memo. 1994-213.

contribution, except to the extent a deduction was claimed for the contribution in a closed year.⁵⁴ No deduction is allowed for a Roth IRA.⁵⁵ But whether for a traditional IRA or a Roth IRA, the excise tax will no longer apply to the portion of the excess contributions deemed contributed (i.e., absorbed).⁵⁶ Note that such a deemed contribution is not an actual contribution that may be recharacterized as made to a different type of IRA (see below for an explanation of recharacterizations).⁵⁷

Absorption of an excess contribution may be a last resort. That is, it may be too late for a corrective distribution, and the taxpayer may not qualify for a dollar-limited distribution. Further, an ordinary distribution from a traditional IRA will normally be taxable, whereas the taxpayer may deduct an excess contribution that is absorbed by a traditional IRA.

Example 6: A single, 54-year-old taxpayer made a \$19,000 contribution to his traditional IRA in 2019. The first \$7,000 of the contribution was deductible, and the remaining \$12,000 was an excess contribution. The taxpayer failed to make a timely corrective distribution, and the contribution was too large to qualify for a dollar-limited distribution. The taxpayer made no other contributions to his traditional IRA during the years 2019–2021 and received no distributions from the IRA during those years. Nor was the taxpayer an active participant in a qualified plan during those years.

Assume the taxpayer is nevertheless entitled to make contributions of \$7,000 to his traditional IRA during each of the

years 2020 and 2021 but did not do so. Then, \$7,000 of the excess contribution is “absorbed” and eliminated in 2020, and the remaining \$5,000 is absorbed in 2021. The taxpayer may deduct the amount of the excess contribution absorbed in each year since the amounts were not deducted in a closed year. However, the taxpayer will still pay the 6% excise tax on the \$12,000 excess contribution in 2019 and on the continuing \$5,000 excess contribution for 2020.

Both the amount of an excess contribution to a traditional IRA and the amount of absorption of the excess contribution in a later year are determined without regard to the phaseout of deductions applicable to active participants in qualified plans.⁵⁸

Example 7: Assume the same facts as in Example 6, except that the taxpayer was an active participant in a qualified plan during the years 2019–2021 and his gross income was high enough in those years to reduce his allowable IRA deduction to zero. Thus, the taxpayer does not receive any deduction for his \$19,000 contribution in 2019. Nevertheless, for purposes of determining the excess contribution, the taxpayer’s plan participation is ignored and the excess contribution remains at \$12,000. The remaining \$7,000 portion of the contribution is a nondeductible contribution to the traditional IRA.⁵⁹

Then, since the taxpayer’s active participation in a qualified plan is ignored for absorption purposes, \$7,000 of the excess contribution is “absorbed” and eliminated in 2020, and the remaining \$5,000 is absorbed in 2021. However,

the portions of the excess contribution that are absorbed in 2020 and 2021 are still not deductible in those years due to the phaseout of the deductible contribution limit for an active participant. Instead, the absorbed amounts are non-deductible contributions to the IRA.⁶⁰ In addition, the taxpayer will still have to pay the 6% excise tax on the \$12,000 excess contribution for 2019 and on the remaining \$5,000 of excess contribution for 2020.

Despite the fairly favorable result for the relatively small excess contributions absorbed in Example 6 and Example 7, the outcome might not be so favorable if an excess contribution is very large. In that event, it may take years to absorb it using the relatively small annual limit on absorption. For example, if the excess contribution in the above examples had been \$80,000, it would have taken more than 10 years to absorb it. Meanwhile, the cumulative sum of the annual excise taxes paid could become a large amount. In that case, paying income tax on an ordinary distribution (as described above) may be the only feasible way to avoid the excise tax in future years.

Elimination of an excess contribution with a dollar-limited distribution (if available) is deemed to precede and override elimination by absorption.⁶¹ But absorption may still apply if the taxpayer chooses not to make a dollar-limited distribution. Both methods of elimination avoid the excise tax for the current and future years and avoid the distribution and taxation of income earned by the traditional IRA on the excess contribution. In other respects, though, the two methods are asymmetrical and therefore difficult to compare. A dollar-limited distribution removes funds from

54. Sec. 219(f)(6)(C).

55. T.D. 8816.

56. Secs. 4973(b) and (f).

57. T.D. 8816.

58. Sec. 4973(b) (last sentence); *Dunn*, T.C. Memo. 2015-208.

59. Sec. 408(o). If the taxpayer does not report the nondeductible contribution on a Form 8606 attached to his or her return, the taxpayer is liable for a \$50 penalty. If the taxpayer overstates the amount of the nondeductible contribution, he or she is liable for a \$100 penalty (Sec. 6693(b)).

60. *Id.*

61. Secs. 219(f)(6)(A)(ii) and 4973(b)(2)(C).

Taxpayers may recharacterize regular IRA contributions to traditional IRAs as Roth IRA contributions, and regular contributions to Roth IRAs as traditional IRA contributions.

the traditional IRA, while absorption retains those funds and normally allows a deduction. The choice depends largely on the taxpayer's overall tax situation and on his or her plans for the IRA.

Elimination of an excess contribution using an ordinary distribution also overrides and prevents subsequent elimination by absorption.⁶² Since elimination by absorption (to the extent available) is substantially more favorable for a traditional IRA than using an ordinary distribution, a taxpayer should use an ordinary distribution only to the extent it exceeds the amount that can be currently absorbed.

Absorption of an excess contribution in a Roth IRA is somewhat similar to absorption in a traditional IRA, except that the amount absorbed is not deductible.⁶³ In addition, the absorption may be phased out if the taxpayer's gross income is high enough.⁶⁴ On the other hand, the taxpayer's active participation in a qualified plan is irrelevant.

Example 8: A single, 54-year-old taxpayer made a \$19,000 contribution to his Roth IRA in 2019. Assume that \$7,000 of the contribution was allowable as a contribution to the Roth IRA and the taxpayer's gross income was low enough that the allowable contribution to the Roth IRA was not phased out or reduced. Then, \$7,000 of the contribution was a nondeductible contribution to the Roth IRA, and the remaining \$12,000 was an excess

contribution. Assume the taxpayer failed to make a timely corrective distribution of the excess contribution. Further, the taxpayer made no other contributions to his Roth IRA during the years 2019–2021 and received no distributions from the Roth IRA during those years.

Assume the taxpayer is qualified to make nondeductible contributions of \$7,000 to his Roth IRA during each of the years 2020 and 2021 but did not do so. Then, \$7,000 of the excess contribution is "absorbed" and eliminated in 2020, and the remaining \$5,000 is absorbed in 2021. The excess contributions absorbed are nondeductible contributions. However, the taxpayer must still pay the 6% excise tax on the \$12,000 excess contribution for 2019 and on the remaining \$5,000 excess contribution for 2020.

The result in Example 8 would be very different if the taxpayer's gross income were high enough that some or all of the nondeductible contributions to the Roth IRA were not allowable in the years 2019–2021. More specifically, absorption would not be available at all if nondeductible contributions were completely phased out for those years.

In any event though, elimination of an excess contribution to a Roth IRA by making an ordinary distribution, as observed in the discussion of Roth IRAs in Example 5, will nearly always be at least as favorable as absorption. As with absorption, an ordinary distribution from

a Roth IRA will eliminate the excise tax for the current and future years and will almost always be nontaxable (as a return of investment). But unlike absorption, there are no annual limits on the amount of an excess contribution that can be eliminated with an ordinary distribution.

Superficially, it may appear that absorption has the advantage of retaining funds in a Roth IRA, while an ordinary distribution removes those funds from the IRA. However, since an ordinary distribution does not reduce the amount of the actual current-year contribution that can be made to a Roth IRA (as does absorption), the taxpayer should be able to contribute to the Roth IRA the same amount that could have otherwise been absorbed by the IRA. In fact, this latter alternative may incidentally allow the IRA to retain more earnings.

Example 9: A single, 54-year-old taxpayer made a \$19,000 contribution to his Roth IRA on Jan. 1, 2019. Assume that \$7,000 of the contribution was allowable as a contribution to the Roth IRA, and the taxpayer's gross income was low enough that the allowable contribution to the Roth IRA was not phased out or reduced. The first \$7,000 of the contribution was a nondeductible contribution to the Roth IRA for 2019, and the remaining \$12,000 was an excess contribution. The excess contribution was unintentional, and the taxpayer subsequently overlooked the opportunity to make a timely corrective distribution.

Assume the taxpayer is qualified to make nondeductible contributions of \$7,000 to his Roth IRA during the year 2020 but did not do so. Then, \$7,000 of the excess contribution is eliminated by absorption in 2020. Assume in addition that the taxpayer made an ordinary

62. Id.

63. Sec. 408A(c)(1).

64. Sec. 408A(c)(3).

distribution of \$5,000 on Dec. 31, 2020, that was a nontaxable return of investment that eliminated \$5,000 of the \$12,000 excess contribution. Thus, the taxpayer eliminated the entire \$12,000 excess contribution in 2020 — \$7,000 by absorption and \$5,000 with an ordinary distribution. The Roth IRA retains the income earned on the \$19,000 of funds it held during 2019 and 2020.

Alternatively, assume the taxpayer makes an allowable nondeductible contribution of \$7,000 to the Roth IRA on Jan. 1, 2020. He then makes an ordinary distribution of \$12,000 on Dec. 31, 2020, eliminating the excess contribution. Thus, the taxpayer entirely eliminates the excess contribution by making an ordinary distribution (eliminating none by absorption). Then, the Roth IRA not only retains earnings on the \$19,000 of funds held during 2019, but also retains earnings on \$26,000 of the funds held during 2020. Thus, by rejecting absorption and making only an ordinary distribution, the taxpayer retains earnings in his Roth IRA on an additional \$7,000 of funds for 2020.

Eliminating excess contributions by recharacterization

In some circumstances, a taxpayer who has made a regular contribution or rollover to an IRA may be able to eliminate a resulting excess contribution by recharacterizing the transaction as instead a valid contribution or rollover to a different type of IRA. A taxpayer making

such a recharacterization must transfer the contributed funds in a trustee-to-trustee transfer from the IRA holding the funds (the first IRA) to a different type of IRA (the second IRA). For this purpose, simply redesignating the first IRA as the second IRA (for example, redesignating a Roth IRA as a traditional IRA) is equivalent to a trustee-to-trustee transfer of the entire balance of the first IRA to the second IRA.⁶⁵

The transfer to the second IRA must include any income earned on the funds while held by the first IRA.⁶⁶ The amount of the income is computed in essentially the same way as it is for a corrective distribution, as illustrated in Example 1.⁶⁷

A taxpayer must recharacterize a contribution no later than the extended due date of the taxpayer's timely filed tax return for the tax year of the contribution, which is normally Oct. 15 of the calendar year following the year of the contribution (even if the taxpayer did not need or obtain a filing extension). However, if the taxpayer did not file a timely return for the year of the contribution, the taxpayer must have completed the recharacterization earlier, by April 15 of the calendar year following the year of the contribution.⁶⁸

If a retiree misses the deadline for recharacterization, the IRS may grant additional time to complete it. However, the retiree must show that he or she acted reasonably and in good faith and that the grant of relief would not prejudice the interests of the government.⁶⁹

Taxpayers may recharacterize regular IRA contributions to traditional IRAs as Roth IRA contributions, and regular contributions to Roth IRAs as traditional IRA contributions.⁷⁰ Taxpayers may make those recharacterizations even though the contributions were defective and would have triggered the excise tax on excess contributions.⁷¹

Example 10: A taxpayer makes a regular contribution to her Roth IRA that is an excess contribution because the taxpayer's gross income is too high for Roth IRA contributions.⁷² However, the contribution would have satisfied the requirements for a contribution to a traditional IRA. The taxpayer makes a timely trustee-to-trustee transfer of the original contribution, plus income earned, from her Roth IRA to a traditional IRA. Thus, the taxpayer recharacterizes the contribution as if originally made to the traditional IRA. The contribution is deductible and is no longer an excess contribution.⁷³

Example 11: In 2019, a taxpayer makes a regular contribution to her traditional IRA that is within the normal limitations on regular contributions. However, because the taxpayer is over age 70½ (the maximum contribution age for traditional IRAs in 2019), a deduction for the contribution is not allowed and it becomes an excess contribution.⁷⁴ After

65. Regs. Sec. 1.408A-5, Q&A 1(a).

66. Sec. 408A(d)(6)(B)(i).

67. Regs. Sec. 1.408A-5, Q&A 2(c).

68. Secs. 408A(d)(6)(A) and (d)(7); Regs. Sec. 1.408A-5, Q&A 1(b); Regs. Sec. 301.9100-2(b); IRS Letter Ruling 200352022.

69. Regs. Sec. 301.9100-3(a).

70. Regs. Sec. 1.408A-5, Q&A 10, Examples 2 and 3.

71. In the case of multiple contributions eligible for recharacterization, the taxpayer may choose (by date and dollar amount) which contribution or portion thereof is to be recharacterized (Regs. Sec. 1.408A-5, Q&A 2)(c)(5)).

72. Sec. 408A(c)(3).

73. See IRS Letter Ruling 201930027, in which the taxpayer similarly sought to recharacterize regular contributions made to Roth IRAs in prior years as contributions made to a traditional IRA. Unfortunately, the normal periods allowed for recharacterization had expired. However, the IRS allowed additional time to make the recharacterizations even though the statute of limitation had run on the original contribution years. The taxpayer skirted the statute-of-limitation problem by specifying that the recharacterized contributions to the traditional IRA were nondeductible.

74. Sec. 1411(c)(5); Regs. Sec. 1.1411-8. Note that Section 107 of the Further Consolidated Appropriations Act, 2020, P.L. 116-94, eliminated the maximum age for traditional IRA contributions, effective for contributions made for tax years beginning after Dec. 31, 2019.

discovering her error, the taxpayer makes a timely trustee-to-trustee transfer of the original contribution from her traditional IRA to a Roth IRA. Thus, the taxpayer recharacterizes the contribution as if originally made to the Roth IRA. Because regular contributions may be made to Roth IRAs after age 70½, the contribution is no longer an excess contribution.⁷⁵

Example 12: A taxpayer makes a regular contribution to her SIMPLE IRA that would have satisfied the traditional IRA requirements, if it had been made to one. However, the contribution is an excess contribution because only an employer may contribute to a SIMPLE IRA.⁷⁶ The taxpayer therefore makes a timely trustee-to-trustee transfer of the original contribution from her SIMPLE IRA to a traditional IRA. Thus, the taxpayer recharacterizes the contribution as if originally made to the traditional IRA. Because the contribution is within the normal statutory limitations on regular contributions to traditional IRAs, the contribution is deductible and is no longer an excess contribution.

Properly structured (nondefective) rollovers to IRAs may not be recharacterized. However, failed rollovers generally may be recharacterized.⁷⁷ The tax law treats a failed rollover to an IRA as a normal taxable distribution from a plan or IRA, followed by an excess contribution to the recipient IRA to the extent

The 6% excise tax on an excess contribution will continue to apply year after year until mitigated by using the methods described in this article.

the contribution exceeds the limits on regular contributions.⁷⁸

An excess contribution due to a failed rollover to an IRA most often occurs when a taxpayer attempts to roll over a distribution that is not eligible for rollover. Perhaps the most common example is an attempt to roll over an RMD to an IRA.⁷⁹ Unfortunately, though, any attempt to recharacterize the failed rollover as made to another type of IRA would generally only transfer the excess contribution from one type of IRA to another type of IRA. In most cases, the attempted rollover contribution would remain an excess contribution in the recipient IRA because it would still be an attempt to roll over a distribution ineligible for rollover.

There are, nevertheless, some situations where recharacterization of a failed rollover to a traditional IRA will eliminate an excess contribution. These situations usually involve attempted rollovers to a traditional IRA from other IRAs or plans that are prohibited from making such rollovers but that are allowed to

make rollovers to some other types of IRAs. Some of these situations are illustrated in the following six examples.

Example 13: A taxpayer owns a Roth IRA from which she takes a distribution of all the funds and mistakenly contributes them to a traditional IRA. The transfer is a failed rollover since funds in a Roth IRA may not be rolled over to a traditional IRA. The failed rollover is treated as two transactions. First, the distribution from the Roth IRA is a taxable or nontaxable distribution (depending on the circumstances). Second, the contribution to the traditional IRA is an excess contribution to the traditional IRA to the extent the contribution exceeds the usual limits on regular contributions.⁸⁰

After discovering her mistake, the taxpayer timely transfers the amount of the original contribution from the traditional IRA to a Roth IRA in a trustee-to-trustee transfer. Thus, the taxpayer recharacterizes the contribution as if originally made to a Roth IRA. Thereafter, the transaction is treated as a tax-free rollover from one Roth IRA to another Roth IRA.⁸¹

Example 14: A taxpayer is the owner of two traditional IRAs. The taxpayer takes a distribution from her first traditional IRA and transfers the distributed funds to her second traditional IRA within a 60-day period. Assume, however, that the transfer does not qualify as a tax-free

75. Sec. 219(d)(1).

76. Sec. 408(p)(2)(A)(iv).

77. Regs. Sec. 1.408A-5, Q&A 4. Roth conversions occurring before 2018 could also be recharacterized. After 2017, only failed Roth conversions may be recharacterized (Sec. 408A(d)(6)(B)(iii)).

78. Regs. Sec. 1.408A-4, Q&As 3(b) and 6(c); IRS Letter Rulings 9633041 and 201313025.

79. Secs. 402(c)(4)(B) and 408(d)(3)(E). In addition, a taxpayer may not roll over any of a series of substantially equal annual (or more frequent) periodic payments receivable from a qualified plan for a term of 10 years or more,

the retiree's lifetime (or life expectancy), or the lifetimes (or life expectancies) of the retiree and beneficiary. Nor may a participant in a qualified plan roll over (1) loans treated as deemed distributions because they are not qualified residential loans or qualified five-year loans; (2) hardship distributions; (3) payments of premiums on life insurance; (4) distributions of corporate dividends by an ESOP; (5) certain corrective distributions of excess deferrals and excess contributions; and (6) certain premiums for accident and health insurance (Sec. 402(c)(4); Regs. Sec. 1.402(c)-2, Q&A 4).

80. Regs. Sec. 1.408A-6, Q&A 17.

81. Sec. 408A(e)(1)(A).

The regulations indicate that recharacterizations involving various combinations of traditional IRAs, SIMPLE IRAs, SEPs, and Roth IRAs are allowable if the rules are followed, at least when the same taxpayer is the beneficial owner of each entity.

rollover because it is the second 60-day rollover attempted for a distribution received within a 12-month period.⁸² The transaction is instead treated as a taxable distribution from the first IRA and as a separate excess contribution to the second IRA to the extent the contribution exceeds the usual limits on regular contributions.⁸³

After discovering her mistake, the taxpayer timely transfers the amount of the original contribution from the traditional IRA to a Roth IRA in a trustee-to-trustee transfer. The transfer to the Roth IRA does not count for purposes of the 12-month rule.⁸⁴ Thus, the taxpayer has successfully recharacterized the contribution as originally made to a Roth IRA. Thereafter, the transaction is treated as a Roth conversion of part of a traditional IRA, thus incurring income tax on the conversion but avoiding imposition of the excise tax on excess contributions.

Example 15: A taxpayer is the owner of a traditional IRA. She attempts to roll over a distribution of the balance of her traditional IRA into a SIMPLE IRA within 60 days after the distribution. Assume the transfer

does not qualify as a tax-free rollover because it is a prohibited attempt to roll over funds into a SIMPLE IRA during the two-year period immediately following her first participation in a SIMPLE IRA of her employer.⁸⁵ Thus, the attempted rollover is a failed rollover treated instead as a taxable ordinary distribution from the traditional IRA followed by a separate excess contribution to the taxpayer's SIMPLE IRA.

After discovering her mistake, the taxpayer timely transfers the excess contribution from the SIMPLE IRA back to a traditional IRA in a trustee-to-trustee transfer. Thus, the taxpayer recharacterizes the contribution as if originally made to a traditional IRA.⁸⁶ Consequently, the transaction is deemed to be a tax-free rollover from one traditional IRA to another traditional IRA. Similarly, a prohibited trustee-to-trustee transfer from a Roth IRA to a SIMPLE IRA may be recharacterized as a rollover from one Roth IRA to another Roth IRA.

Example 16: A taxpayer takes a distribution of all the funds in her SIMPLE IRA and contributes the distributed funds to her traditional

IRA within a 60-day period. Assume the transfer does not qualify as a tax-free rollover because it is a prohibited attempt to roll over funds from a SIMPLE IRA during the two-year period immediately following the taxpayer's first participation in a SIMPLE IRA of her employer.⁸⁷ The transaction is instead treated as a taxable distribution from the SIMPLE IRA and as a separate excess contribution to the traditional IRA to the extent the contribution exceeds the usual statutory limits on regular contributions.⁸⁸

After discovering her mistake, the taxpayer timely transfers the amount of the original contribution from the traditional IRA to a SIMPLE IRA in a trustee-to-trustee transfer. Thus, the taxpayer successfully recharacterizes the contribution as if originally made to a SIMPLE IRA. Thereafter, the transaction is treated as a permissible nontaxable rollover between SIMPLE IRAs. Similarly, a prohibited rollover from a SIMPLE IRA to a Roth IRA during the two-year period may be recharacterized as a tax-free rollover from one SIMPLE IRA to another SIMPLE IRA.⁸⁹

Example 17: A taxpayer is the non-spouse beneficiary of a traditional IRA that is an "inherited IRA" in the taxpayer's hands. The taxpayer attempts to use a trustee-to-trustee transfer to transfer the balance in the inherited IRA to a traditional IRA in the taxpayer's own name. However, funds in an inherited IRA may be so transferred only to another inherited IRA.⁹⁰ Thus, the transfer for tax purposes is a failed rollover treated

82. Sec. 408(d)(3)(B); *Martin*, T.C. Memo. 1994-213.

83. Regs. Secs. 1.408-1(c) and 1.408A-4, Q&As 3(b) and 6(c).

84. Sec. 408A(e)(1).

85. Sec. 408(p)(1)(B).

86. Regs. Sec. 1.408A-5, Q&A 1.

87. Sec. 408(d)(3)(G); Regs. Sec. 1.408A-4, Q&A 4(b).

88. Regs. Secs. 1.408-1(c) and 1.408A-4, Q&As 3(b) and 6(c).

89. Regs. Sec. 1.408A-5, Q&A 5.

90. Sec. 408(d)(3)(C)(i); IRS Letter Ruling 200717023; IRS Letter Ruling 201128036.

instead as a taxable ordinary distribution from the inherited IRA followed by a separate regular contribution to the taxpayer's traditional IRA.⁹¹

After discovering his mistake, the taxpayer timely transfers the contribution from the traditional IRA to an inherited IRA, in a trustee-to-trustee transfer. Thus, the taxpayer recharacterizes the transfer as originally made from one inherited IRA to another inherited IRA. Consequently, the trustee-to-trustee transfer from one inherited IRA to another inherited IRA is deemed to be a mere substitution of trustees.⁹² Similarly, a prohibited trustee-to-trustee transfer from an inherited IRA to a Roth IRA may be recharacterized as a mere substitution of trustees of an inherited IRA.

Example 18: A taxpayer is the nonspouse designated beneficiary of a qualified plan. The beneficiary attempts to use a trustee-to-trustee transfer to roll over the balance of his funds in the qualified plan to a traditional IRA in the beneficiary's own name. However, funds in a qualified plan held by a nonspouse designated beneficiary may be rolled over only to a newly formed inherited IRA.⁹³ Thus, the rollover is, for tax purposes, a failed rollover treated instead as a taxable ordinary distribution from the qualified plan, followed by a separate regular contribution to the beneficiary's traditional IRA.⁹⁴

After discovering his mistake, the taxpayer timely transfers the excess contribution from the traditional IRA to a newly formed inherited IRA in a trustee-to-trustee transfer. Thus, the taxpayer recharacterizes the contribution as originally made to an inherited IRA in a trustee-to-trustee transfer. Consequently, the transaction is deemed to be a valid tax-free rollover from a qualified plan to an inherited IRA. Similarly, a prohibited trustee-to-trustee transfer by a nonspouse designated beneficiary from a qualified plan to his own Roth IRA may be recharacterized as a trustee-to-trustee transfer from the qualified plan to a newly formed inherited Roth IRA.

Note that, in Examples 17 and 18, a recharacterization would not have solved the problem if the nonspouse designated beneficiary had originally attempted to make a prohibited *indirect 60-day rollover* to a traditional IRA (rather than a trustee-to-trustee rollover). The failed indirect rollover would consist of an actual ordinary distribution to the nonspouse beneficiary from the plan or IRA, followed by a regular contribution by the beneficiary to the traditional IRA. However, the beneficiary's contribution could only be recharacterized as a contribution to an inherited IRA *by the beneficiary* (and not by a trustee-to-trustee transfer from a plan or IRA). Unfortunately, a nonspouse beneficiary who actually receives a distribution from a plan or inherited IRA may not contribute it to an inherited IRA, by recharacterization or otherwise.⁹⁵

It is similarly true that, as indicated in Examples 17 and 18, the regulations provide that a failed *trustee-to-trustee rollover* by a nonspouse beneficiary to a traditional IRA, from a qualified plan or inherited IRA, is treated as an ordinary distribution to the beneficiary followed by a regular contribution to the traditional IRA.⁹⁶ However, the regulations also provide that, after recharacterization as a proper contribution to an inherited IRA, the original contribution to the traditional IRA is instead "treated as having been contributed to" the inherited IRA,⁹⁷ thus eliminating all traces of the actual original contribution to the traditional IRA. Consequently, if the original contribution was in the form of a trustee-to-trustee transfer, it should still be a trustee-to-trustee transfer, and thus a valid rollover to the inherited IRA, after the recharacterization.

The regulations indicate that recharacterizations involving various combinations of traditional IRAs, SIMPLE IRAs, SEPs, and Roth IRAs are allowable if the rules are followed, at least when the same taxpayer is the beneficial owner of each entity.⁹⁸ See Examples 13, 15, and 16. Thus, the same should be true of recharacterizations between inherited IRAs and other plans and IRAs owned by the same taxpayer, as in Examples 17 and 18.

However, whether a taxpayer may use a recharacterization to correct a mistaken attempt to roll over an amount from the taxpayer's own plan or IRA into an IRA owned by another

91. Regs. Secs. 1.408-1(c) and 1.408A-4, Q&As 3(b) and 6(c).

92. Rev. Rul. 78-406. On the other hand, where an IRA trustee transfers funds directly to the trustee of an entity governed by different tax rules, the IRS and the tax law generally treat the transfer as in substance an actual distribution to the taxpayer and a transfer by the taxpayer to the other entity. For example, the IRS has treated a trustee-to-trustee transfer from a SIMPLE IRA to a traditional IRA as an actual distribution to the taxpayer and a transfer by the taxpayer to the traditional IRA (Notice 98-4, Q&A I-4). In addition, the tax law treats a trustee-to-trustee transfer from a traditional IRA to a Roth IRA as the equivalent of an actual distribution from the traditional IRA and a contribution by the owner to the Roth IRA (Secs. 408A(d)(3)(C) and 408(d)(3); Regs. Sec.

1.408A-4, Q&A 1(b)). See also Rev. Rul. 71-541, in which the IRS stated that certain direct trustee-to-trustee transfers (not intended to be distributions) between plans qualified under Sec. 401(a) will nevertheless be treated as distributions if the recipient plan is not made subject to the same restrictions imposed by the tax law on the transferring plan.

93. Sec. 402(c)(11).

94. Regs. Sec. 1.408A-4, Q&As 3(b) and 6(c).

95. See Notice 2007-7, Q&A 15.

96. Regs. Sec. 1.408A-4, Q&A 6(c).

97. Regs. Sec. 1.408A-4, Q&A 3(a).

98. Regs. Sec. 1.408A-5, Q&As 4 and 5.

taxpayer is an open question. For example, can a recharacterization be used to cure an attempted but mistaken rollover from a taxpayer's own qualified plan to his wife's IRA? Or to cure a post-death attempted trustee-to-trustee rollover from the decedent's qualified plan to an inherited IRA of the wrong beneficiary? There does not appear to be any specific authority or guidance allowing a recharacterization in those cases; nor does there appear to be any authority forbidding it.

Synopsis: Excess contributions attributable to regular contributions to traditional IRAs

Depending on the circumstances, a taxpayer may be able to eliminate an excess contribution attributable to a regular contribution to a traditional IRA by using either a corrective distribution, a dollar-limited distribution, an ordinary distribution, absorption, or recharacterization.

Corrective distributions from traditional IRAs

A corrective distribution is clearly the best way to eliminate an excess contribution to a traditional IRA that is attributable to a regular contribution (i.e., that is not part of a failed rollover). The corrective distribution is not taxable, and it eliminates the 6% excise tax entirely. Although income earned by the traditional IRA on the excess contribution is distributable and is taxable, the income on the funds would presumably have been taxed outside the traditional IRA anyway if the owner had not made the excess contribution. Unfortunately, though, the early-distribution penalty may be imposed on the distributed earnings if no exceptions apply. Nevertheless, under the circumstances, the tax and penalty on the distributed income is generally a small price to pay for avoiding the excise tax on the excess contribution. (See Example 1.)

Dollar-limited distributions from traditional IRAs

Unfortunately, a taxpayer will often not discover that he or she has made an excess contribution to a traditional IRA until after the expiration of the period allowed for a corrective distribution. In that case, a taxpayer should first consider the potential availability of a dollar-limited distribution. The dollar-limited distribution is generally available only if regular contributions for the year of the excess contributions are greater than the taxpayer's taxable compensation but no greater than the statutory dollar limit on IRA contributions for that year. The dollar-limited distribution is not taxed, and the traditional IRA need not distribute income earned by the IRA on the excess contribution. Furthermore, a dollar-limited distribution avoids the 6% excise tax for the year of distribution and all future years. (See Example 2.)

Of course, if the taxpayer has a choice, he or she would normally prefer to make a corrective distribution rather than a dollar-limited distribution. It is true the amount of the excess contribution is not taxable under either type of distribution. However, the corrective distribution avoids the excise tax for all years, whereas the dollar-limited distribution does not avoid the excise tax for years before the distribution. Although a dollar-limited distribution does not require the distribution of IRA income earned on the excess contribution, the total tax and penalties imposed on this income under a corrective distribution is normally much less than the excise tax avoided.

Nevertheless, it is possible that a qualifying taxpayer would deliberately choose a dollar-limited distribution over a corrective distribution in the unlikely event his or her traditional IRA had unusually high income while it held the excess contribution. That is, with a corrective distribution, the taxes and penalties on income earned by the traditional IRA on the excess contribution

may be so high (because of some kind of windfall) that they exceed the 6% excise tax that is avoided. Then, the taxpayer may want to avoid a corrective distribution and instead make a dollar-limited distribution, thus paying the excise tax for the year of contribution to avoid distributing and paying tax and penalties on the inflated IRA income.

Absorption by traditional IRAs

If it is too late to make a corrective distribution and a dollar-limited distribution is not available, an excess contribution might be automatically eliminated by "absorption." That is, for each year after the excess contribution, the taxpayer is automatically deemed to contribute to the traditional IRA the portion of the excess contributions that does not exceed the allowable contribution the taxpayer could have made (but did not make) for that year.

One apparent advantage of absorption is that the traditional IRA retains both the absorbed amount and the IRA income earned thereon. In addition, the amount of the excess contribution that is absorbed is generally deductible. To the extent the absorbed excess contribution is not deductible (e.g., because the taxpayer is an active participant in a qualified plan), the amount absorbed is considered a nondeductible contribution to the traditional IRA. (See Examples 6 and 7.)

The excise tax will not apply in future years to the amount absorbed. Unfortunately, though, the taxpayer cannot avoid the 6% excise tax for the year (or years) before the absorption or for future years on amounts not yet absorbed. Consequently, it may not be practical to rely on absorption to eliminate an excess contribution if it is very large. In that event, it may take years to absorb it given the relatively small annual limit on absorption. Meanwhile, the sum of the annual excise taxes could become very large. In such a case, an immediate ordinary distribution of the entire amount of the excess contribution, though itself

somewhat onerous, may be the only feasible alternative. See the immediately following caption for an explanation of the effects of an ordinary distribution.

Ordinary distributions from traditional IRAs

A taxpayer may have to resort to an ordinary distribution to eliminate an excess contribution in a traditional IRA if it is too late to make a corrective distribution and the excess contribution is too large to be eliminated by a dollar-limited distribution or by absorption. Such an ordinary distribution is taxed in the same way as other ordinary distributions. That is, only the earnings portion of the distribution is taxed (not the investment portion). In addition, only the earnings portion of the distribution reduces excess contributions. If the earnings portion of an ordinary distribution is large enough to eliminate all excess contributions, the excise tax will not apply in the current or future years. (See Example 4.)

It is apparent then that a corrective distribution from a traditional IRA, if available, will nearly always be substantially more beneficial than an ordinary distribution. Nevertheless, it is possible, though highly unlikely, that a taxpayer might deliberately choose an ordinary distribution over a corrective distribution. That is, for a corrective distribution the taxes and penalties on the distribution of unusually high income earned by the traditional IRA on the excess contribution (due to some kind of windfall) might potentially exceed the total of (1) the tax and penalties on an ordinary distribution plus (2) the 6% excise tax for the year of contribution.

Absorption of an excess contribution is deemed to occur at the end of a tax year. Thus, elimination of an excess contribution using an ordinary distribution overrides elimination by absorption in the current and future years. Since elimination by absorption to the extent available is normally substantially more favorable than using an ordinary

distribution, a taxpayer should eliminate an excess contribution with an ordinary distribution only to the extent the excess contribution exceeds the amount that can be absorbed in the same tax year.

Recharacterizations out of traditional IRAs

Recharacterization of an excess contribution made to a traditional IRA (that is not part of a failed rollover) would very rarely eliminate the excess contribution. For example, if the excess contribution were recharacterized as made to a Roth IRA, the recharacterization would generally only transfer the excess contribution from one type of IRA to another type of IRA. In most cases, it would still remain an excess contribution in the recipient IRA because it would still normally exceed the overall statutory limit applicable to regular IRA contributions. However, there are rare exceptions. (See Examples 11 and 12, above.)

Synopsis: Excess contributions attributable to failed rollovers to traditional IRAs

A failed rollover to a traditional IRA is treated as an ordinary distribution from the distributing plan or traditional IRA, followed by a separate regular contribution to the recipient traditional IRA. The distribution part of the rollover is taxable to the extent of the earnings portion of the distribution and may be subject to the early-distribution penalty if no exception applies. The contribution part of the failed rollover usually results in an excess contribution in whole or in part.

The techniques for eliminating the excess contribution part of a failed rollover are generally the same as those discussed above for excess contributions not involving a rollover. However, most of those techniques do not solve the problem of the taxability of the distribution part of a failed rollover. In fact, in most cases, taxation of the distribution

simply cannot be avoided (e.g., because the distribution was originally not eligible for rollover).

Nevertheless, under certain limited circumstances, a dollar-limited distribution may be particularly useful in eliminating the excess contribution part of a failed rollover. In addition, for a few types of failed rollovers, recharacterizations may be particularly effective at both eliminating excess contributions and making the distribution part of the failed rollover nontaxable. See the following discussion.

Dollar-limited distributions from traditional IRAs

If a timely corrective distribution or recharacterization is not available, a dollar-limited distribution may provide substantial relief for a taxpayer who erroneously determined the amount of a rollover contribution to his or her traditional IRA. However, the taxpayer must have reasonably relied on erroneous information supplied under Subtitle F of the Code.

For example, the taxpayer may have relied on a qualified plan information return that erroneously overstated the amount of an eligible rollover distribution. In that case, for purposes of a dollar-limited distribution, the dollar limit is increased by the amount of any excess contribution resulting from the erroneous information. That is, the taxpayer may make a dollar-limited distribution of the excess contribution even though it exceeds the normal statutory dollar limitation. (See Example 3.)

The 6% excise tax will still apply to the excess contribution for prior years but will not apply for the year of the dollar-limited distribution and subsequent years. Unfortunately, though, the amount erroneously distributed by the qualified plan remains taxable and subject to the early-distribution penalty (unless an exception applies).

Furthermore, the taxpayer's qualified plan will likely demand return

of the overpayment, together with any income earned on the overpayment. Consequently, the taxpayer may seek a distribution of the income the traditional IRA earned on the excess contribution (even though that is not otherwise required for a dollar-limited distribution). A distribution of that income is taxable the same as any other IRA distribution (i.e., by separating the nontaxable investment and the taxable earnings portions of the distribution), and the early-distribution penalty applies in the absence of an exception.

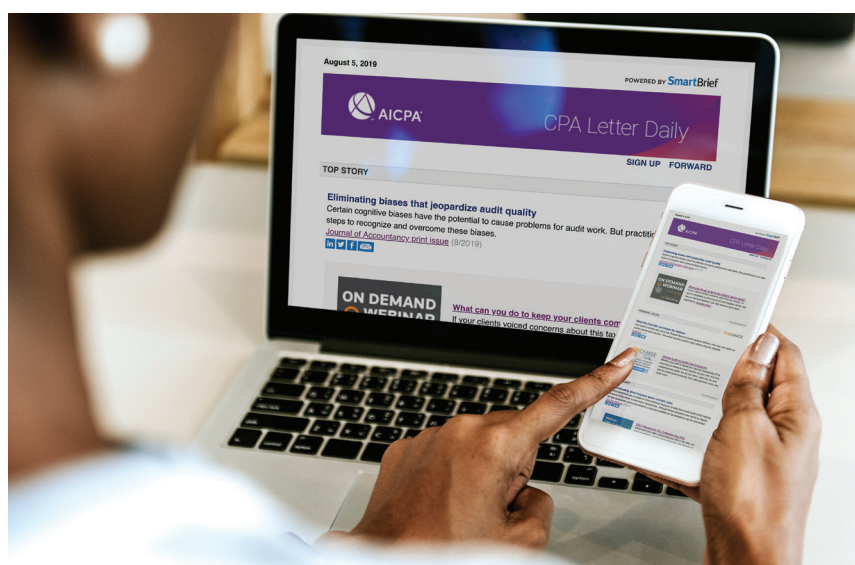
When the taxpayer returns the qualified plan overpayment and the income earned on it, the repayment is treated as a miscellaneous itemized deduction. Unfortunately, miscellaneous itemized deductions are not allowed for the years 2018 through 2025. Since the taxpayer will have paid tax on the overpayment without an offsetting deduction for the repayment, he or she might try to persuade the plan to waive part or all of the repayment. If so, the amount waived is not taxable as income from the discharge of indebtedness, provided the overpayment was properly reported in prior years.

The situation is more complicated if the taxpayer did not report the qualified plan overpayment as gross income and the statute of limitation has run on the year of the distribution from the qualified plan. In that situation, the IRS has ruled that the subsequent distribution of the excess contribution that was made to the IRA is taxable because it does not qualify as a dollar-limited distribution, due to the taxpayer's failure to satisfy his or her "duty of consistency." The IRS also asserts that the 6% excise tax continues to apply to the excess contribution until it is eliminated by distribution or otherwise. Arguably, though, the failed dollar-limited distribution would itself constitute an ordinary distribution that would eliminate the excess contribution in whole or in part.

Recharacterizations of failed rollovers to traditional IRAs

An excess contribution due to a failed rollover to a traditional IRA most often occurs when a taxpayer attempts to roll over a distribution that is not eligible for rollover. Perhaps the most common

example of such an excess contribution occurs when a taxpayer attempts to roll over an RMD to a traditional IRA. Any attempt to recharacterize the failed rollover as made to another type of IRA (e.g., a Roth IRA) will generally only transfer the excess contribution from



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one type of IRA to another type of IRA. In most cases, the failed rollover amount will remain an excess contribution in the recipient IRA because a rollover would still be a forbidden attempt to roll over a distribution not eligible for rollover.

There are, nevertheless, a few situations where recharacterization of a rollover contribution to a traditional IRA will not only eliminate an excess contribution but also make the rollover tax-free. These situations usually involve attempted rollovers to a traditional IRA from other plans or IRAs that are prohibited from making such rollovers but that are allowed to make nontaxable rollovers to some other types of IRAs. (See Example 13 and Examples 15–18. Similarly, for a situation in which a taxpayer may recharacterize a failed rollover to a traditional IRA as instead a *taxable* Roth conversion, see Example 14.)

Synopsis: Excess contributions attributable to regular contributions to Roth IRAs

Depending on the circumstances, a taxpayer may be able to eliminate an excess contribution attributable to a regular contribution to a Roth IRA by using either a corrective distribution, an ordinary distribution, absorption, or recharacterization.

Corrective distributions from Roth IRAs

A corrective distribution is clearly the best way to eliminate an excess contribution to a Roth IRA that is attributable to a regular contribution (i.e., that is not part of a failed Roth conversion). The corrective distribution is not taxable, and it eliminates the 6% excise tax entirely. Although income earned by the Roth IRA on the excess contribution is also distributable and is taxable, the income on the funds would presumably have been taxable outside the traditional IRA anyway if the owner had not made the excess contribution. Unfortunately,

though, the early-distribution penalty may be imposed on the distributed earnings if no exceptions apply. In any event, the tax and penalty on the distributed income is generally a small price to pay for avoiding the excise tax on the excess contribution.

Dollar-limited distributions

Dollar-limited distributions are not available for excess contributions to Roth IRAs.

Ordinary distributions from Roth IRAs

A taxpayer may use an ordinary distribution to eliminate an excess contribution to a Roth IRA if it is too late to make a corrective distribution. Specifically, the entire amount of the ordinary distribution (including both the earnings and investment portions) reduces excess contributions. If the distribution is large enough to eliminate all excess contributions, the excise tax will not apply in the current or future years (only in the prior year or years).

The ordinary distribution is taxable or nontaxable under the usual Roth IRA rules. That is, a qualified distribution is not taxable, and only the earnings portion of a nonqualified distribution is taxable (not the investment portion). Since a Roth IRA is deemed to distribute investment before earnings, even a nonqualified distribution will normally consist of nontaxable investment, particularly since the entire amount of the original excess contribution is added to investment in the Roth IRA. (See Example 5.)

Thus, after mistakenly making an excess contribution to a Roth IRA, a taxpayer may prefer to eliminate the excess contribution by making an ordinary distribution rather than a corrective distribution. Both types of distributions will eliminate a like amount of excess contributions. For each, distribution of the excess contribution is unlikely to be taxable. Although the excise tax incurred

by forgoing a corrective distribution is likely to be higher than the tax and penalty incurred by distributing Roth IRA income as part of a corrective distribution, the retention of the income by the Roth IRA may make the additional cost of an ordinary distribution worthwhile.

Absorption by Roth IRAs

If it is too late to make a corrective distribution, and in the unlikely event an ordinary distribution would be too costly or otherwise undesirable, a taxpayer may be able to eliminate an excess contribution to a Roth IRA through absorption. That is, for each year after the excess contribution, the taxpayer is deemed to contribute to the Roth IRA that portion of the excess contribution that does not exceed the allowable Roth IRA contribution the taxpayer could have made (but did not make) for that year. However, the amount of the excess contribution that is absorbed is not deductible. (See Example 8.)

The excise tax will not apply in future years to the amount absorbed. Unfortunately, though, the taxpayer cannot avoid the excise tax for the year (or years) before the absorption or for future years on amounts not absorbed. Consequently, it may not be practical to rely on absorption to eliminate an excess contribution if it is very large. In that event, it may take years to absorb the excess contribution using the relatively small annual limits on absorption.

Fortunately, though, elimination of an excess contribution to a Roth IRA by making an ordinary distribution, as discussed under the preceding caption, will nearly always be at least as favorable as absorption. As with absorption, an ordinary distribution will almost always be nontaxable and will eliminate the excise tax for the current and future years. But unlike absorption, there are no annual limits on the amount of an excess contribution that can be eliminated with an ordinary distribution. Note that elimination of an excess contribution in

a Roth IRA using an ordinary distribution automatically forecloses elimination by absorption.

Superficially, it may appear that absorption has the advantage of retaining funds in a Roth IRA while an ordinary distribution removes those funds from the Roth IRA. However, since an ordinary distribution does not reduce the allowable contribution to a Roth IRA (as does absorption), the taxpayer may contribute the amount that otherwise would have been absorbed back into the Roth IRA (and in a way that may maximize tax-free earnings of the Roth IRA). (See Example 9.)

Recharacterizations out of Roth IRAs

A recharacterization of an excess contribution made to a Roth IRA (that is not part of a failed Roth conversion) would very rarely eliminate the excess contribution. If the excess contribution were recharacterized as made to a traditional IRA, the recharacterization would generally only transfer the excess contribution from one type of IRA to another type of IRA. In most cases, it would remain an excess contribution in the recipient IRA because it would still normally exceed the overall limit applicable to most IRA contributions. However, there are rare exceptions. One of those exceptions is illustrated in Example 10, which recharacterizes an entirely forbidden taxpayer contribution to a Roth IRA as instead a deductible contribution to a traditional IRA.

Synopsis: Excess contributions attributable to failed Roth conversions

A failed Roth conversion is treated as an ordinary distribution from a plan or traditional IRA, followed by a separate regular contribution to a Roth IRA. The distribution part of the failed conversion is taxable to the extent of the earnings portion of the distribution and may be subject to the early-distribution penalty if no exception applies. The contribution part of the failed conversion usually results in an excess contribution in whole or in part. The techniques for eliminating the excess contribution are basically the same as those discussed above for an excess contribution to a Roth IRA not involving a Roth conversion. However, most of those techniques do not change the continuing taxability of the distribution part of a failed Roth conversion. That is where recharacterizations might play a more significant role.

Recharacterizations of failed Roth conversions

An excess contribution due to a failed Roth conversion most often occurs when a taxpayer attempts to roll over a distribution that is not eligible for rollover. Perhaps the most common example of such an excess contribution occurs when a taxpayer attempts to roll over an RMD to a Roth IRA. Any attempt to recharacterize the failed Roth conversion as a rollover to another type of IRA could generally only transfer the excess contribution from one type of IRA to

another type of IRA. In most cases, it would remain an excess contribution in the recipient IRA because it would still be an attempt to roll over a distribution that is not eligible for rollover.

There are, nevertheless, a few situations where recharacterization of a failed Roth conversion as instead a rollover to another type of IRA will not only eliminate an excess contribution but also make the rollover tax-free. These situations usually involve attempted rollovers to a Roth IRA from other plans or IRAs that are prohibited from making those rollovers, but that are allowed to make nontaxable rollovers to some other types of IRAs. (See Examples 16–18, particularly the last sentence of each example.)

As this article illustrates with its many examples, depending on the circumstances, a taxpayer may be able to eliminate an excess contribution attributable to a regular contribution to a traditional IRA or a Roth IRA by using either a corrective distribution, a dollar-limited distribution, an ordinary distribution, absorption, or recharacterization. ■

Contributor

Vorris J. Blankenship is a retired attorney and CPA. He is the author of *Tax Planning for Retirees*, published by LexisNexis. For more information about this article, please contact thetaxadviser@aicpa.org.

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