Remedying Common IRA Contribution and Withdrawal Errors to Avoid IRS Penalties and Plan Disqualification

THURSDAY, JUNE 20, 2019, 1:00-2:50 pm Eastern

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The information contained herein is of a general nature and based on authorities that are subject to change. Applicability of the information to specific situations should be determined through consultation with your tax adviser.

Ways of Avoiding IRA Penalties

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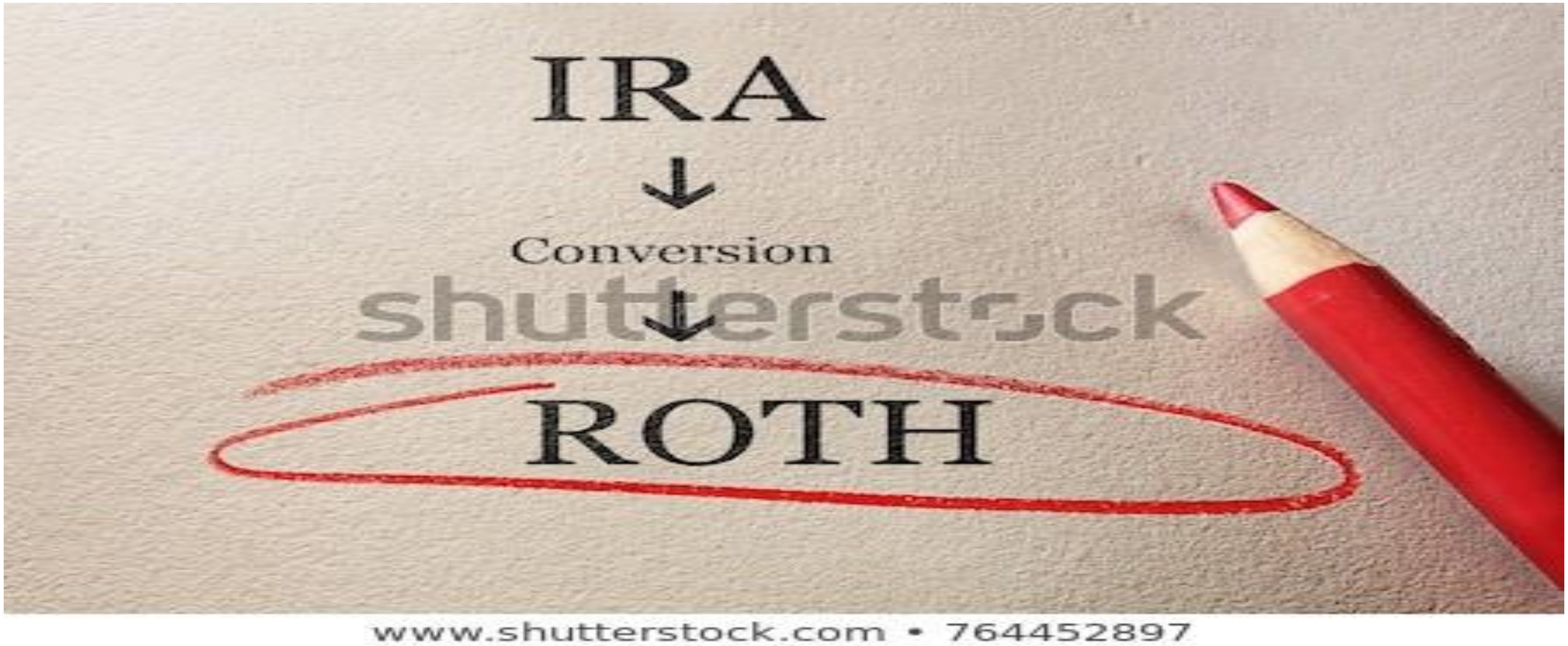
There are different types of IRA including:

- Traditional IRAs. Everyone can contribute to traditional IRAs as long as they are under 72-1/2 years and receive taxable income of up to $71,000 as an individual and $118,000 as a couple. This IRA is tax deferred.
- Roth IRAS. Has the same contribution limits as the traditional IRA and offers tax free growth. This option is suitable for people who suspect they may fall under a higher tax bracket upon retirement or who value flexibility as the plan does not make it mandatory to withdraw when the individual turns 70-1/2.

- SEP IRAs. SEP IRAs are for self-employed individuals and small business people. As such, the plan is usually taken by employers with one or more employees.
- For this plan, contributions are tax-deductible for those who choose the plan and go into the traditional IRA of the employee. However, it is the business or employer that contributes, and the amount contributed must be the same for all employees.
- Simple IRAs. This is a traditional IRA for self-employed people and small businesses. The contributions are tax-deductible, and the tax is deferred until you begin to withdraw after retirement.

- It is easy to contribute an excess to your IRA but you can correct the excess contribution.
- Timely removal of the excess before the tax filing deadline. The tax deadline comes around April 15, but there is an extension of six months after the tax period. If the excess is removed after the tax period, you will have to file an amended tax return.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- Recharacterization. Recharacterization is the transferring of your entire year's contribution from one type of IRA to another, for instance, from traditional to Roth IRA. You cannot, however, recharacterize an amount beyond your maximum allowable contribution. The recharacterized contribution will be counted as having been made for the same taxable year.

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- Removal of excess after the tax filing deadline. The excess can be removed after the tax deadline only if it is true excess. No loss or earning will be calculated except the amount in excess, and there is a 6% IRA excise penalty for each year the amount remains in the IRA.
- The amount is also not deductible when you file taxes and will not be taxable if the aggregate contribution does not exceed the contribution limit for the year. If the entire contribution limit exceeds the annual amount, the excess will be subject to a 10% early distribution penalty if the contributor is under 59-1/2.

- Carry forward. This involves offsetting the excess contribution by limiting your contribution in the next year to the maximum minus the excess. However, you will still be subjected to a 6 % excise tax by the IRS for failing to correct the excess by the deadline.
- If you are under 59-1/2 you will not owe the IRS 10% early distribution penalty nor tax but cannot recharacterize the amount.


RETIREMENT

People often make contributions even though they earn beyond the contribution limit.

These contributions are considered ineligible and are subject to tax penalty. Some of the reasons why people make ineligible contributions include:

- An increase of income pushing them out of the qualifying bracket
- Making contributions from income from other approved sources
- Forgetting about earlier contributions to IRA.

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- It is possible to make ineligible contributions but that does not make the contribution exempt from fines. In fact, you will be fined up to 6% of the amount for every year that it stays uncorrected.
- You can move the ineligible contribution and the net income attributable from the Roth to traditional IRA before the tax deadline or withdraw the funds and invest them elsewhere before the tax deadline.

RMDs stands for Required Minimum Distribution taken from IRA accounts or a qualified retirement plan. There are many errors related to taking RMDs including:

- Failing to take the RMD on time
- Forgetting to take the RMD completely
- Taking the RMD from the wrong account
- Taking the RMD from your spouse's IRA
- Taking the wrong RMD amount

To handle RMD errors, you will have to

- Involve the IRS.
- Calculate the amount of money that should have been withdrawn as RMD for the number of years you have not withdrawn.
- Withdraw the amount
- File form 5329 for all the RMDs you missed
- Wait for feedback from the IRS

There are some important pointers to remember when filing form 5329 as the form will help you get a waiver from IRS. They include:

- In lines 52 and 53, fill the amount that should have been withdrawn as RMD.
- Note down reasonable cause and the amount you want waived on line 54
- Do not forget to add a note that explains that your fund company or employer omitted the RMD but you withdrew it immediately after you found out.

- There is a probability that if you wait, you will get a response especially if you withdrew the amount right after you discovered and filed the form 5329.
- It is not necessary to let the employer or fund company send a letter to the IRS about the missed RMD but you can have them write the letter and file it for reference.

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“Financial illiteracy is not an issue unique to any one population. It affects everyone: men and women, young and old, across all racial and socioeconomic lines. No longer can we stand by and ignore this problem. The economic future of the United States depends on it.”

President’s Advisory Council on Financial Literacy

Beneficiary

- A beneficiary is any person designated by the owner of the IRA to receive the benefits of the IRA after he/she passes away.
- Beneficiaries are expected to include any taxable distributions to their gross income. Beneficiaries can be spouses in which case they can choose to treat the IRA as their own by declaring themselves the owner, rolling it over to a traditional IRA or treating themselves as beneficiaries.
- Other beneficiaries cannot use the IRA just like the owner as their own but will not owe tax when receiving distributions.


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Prohibited Transactions

Prohibited transactions are those that involve the improper use of the assets of your IRA by either you, the people set to benefit from the IRA, your IRA manager or representative or any trustee or custodian.

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- Borrowing money from your plan. Some plans provide loans to participants. They are required to pay the loans with an interest over a certain period. IRAs, however, are prohibited from making loans to IRA owners or disqualified parties. For instance, if your spouse wants to start a business, you can use your savings to invest in the business but cannot use your IRA assets to fund your spouse's business.
- Paying excess fees for the management of your plan. The asset manager that manages your IRA asset should be compensated the same as he is for other customer's whose assets are of similar balance.

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- Selling property to your plan. Sales to your IRA are a prohibited transaction.
- Using the IRA as collateral for a loan. You are not allowed to use your IRA as security when taking a loan.
- Purchasing property for personal use. IRA assets should not be used to buy property intended for personal use. Misusing your IRA for such purposes results in the IRA's disqualification.

“There is a secret psychology of money. Most people don’t know about it. That’s why most people never become financially successful. A lack of money is not the problem; it is merely a symptom of what’s going on inside of you.” **T. Harve Eker**

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- It pays to be vigilant when dealing with IRA investments as ignorance may lead to serious consequences such as disqualification of your IRA assets.
- Using your IRA assets for any illegal transactions can result in dire consequences. You should, therefore, ensure you check for information regarding prohibited transactions in the IRA disclosure statement.


TIMEX

- It is conventional wisdom on IRA that if you withdraw before you are 59-1/2 years old, you will be liable to pay a 10% tax for the money withdrawn from the IRA.
- The amount can become more, depending on the state because there is a state tax penalty that varies by state and a federal state tax penalty of 10% to pay as well.
- However, there are some cases that are exempt from the law in which an individual may withdraw without paying the 10% penalty. For this to happen, the amount for the qualified expense must usually exceed the IRA distribution.

Some of the circumstances exempted include:

- IRA withdrawal for medical expenses. If you use your IRA distributions to pay for medical expenses and are not reimbursed by health insurance, and the amount exceeds 10% of your adjusted gross income, you will not be subjected to an early withdrawal penalty.
- IRA withdrawal for health insurance. If a person loses his/her job and collects unemployment compensation for three months, they can take IRA distributions and use them as health insurance for themselves, their spouses or dependants without suffering a 10% penalty. To qualify, the person has to take the distribution in the same year the unemployment compensation was received or on the year after.

- IRA withdrawal for college. You can take an IRA distribution to pay for college and expenses such as books, supplies, fees, and tuition. You can also pay for room and board for a student attending college as a half-time student. However, it is important to realize that IRA distributions could reduce eligibility for financial aid.
- IRA withdrawal for purchasing a first home. An individual can withdraw up to $10,000 while a couple can withdraw up to $2,000 to build or buy their first home penalty-free. It is considered a first time home if you have not owned or purchased a home for the two years before the purchase in question. If the purchase or constriction does not proceed as planned, it is wise to put the money back in 120 days to avoid the penalty.

- IRA withdrawal for disability. If you have a severe physical or mental disability that prevents you from working, you can take IRA withdrawals without penalties as long as your physician signs it off.
- IRA for military service. If you are a member of the military reserves and take an IRA distribution when on duty for more than 179 days, you will not accrue the 10% penalty.

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- IRA withdrawal as annuity payments. If you take a series of IRA withdrawals as annuity payments, you will not be subject to penalties. However, you must use an IRS approved distribution method and withdraw at least once a year to avoid the penalty.
- The payments you get, however, have to be calculated based on factors such as your life expectancy or yours and that of your beneficiary and may require professional help to determine. Consistently withdrawing incorrect amounts over years could, however, still attract penalties.


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