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Excess IRA contributions

In 2007 Michael and Christina Wu sold their home and each deposited $200,000 in an IRA to shelter the proceeds from further taxation. IRAs are a good deal for taxpayers, but they aren't that good. The normal contribution limits for IRAs and Roth IRAs in 2015 is $5,500, plus an extra $1,000 "catch-up" contribution for those 50 and older. One may "roll" money into an IRA from an employer's qualified plan, such as a 401(k) plan, or from another IRA. There is no dollar limit on such rollovers. But there is no provision for rolling the proceeds of a home sale into an IRA. Michael and Christina had each made an excess IRA contribution, which is subject to a 6% excise tax every year until they withdraw the excess from the IRA.

Despite the fact that the U.S. savings rate is generally thought to be too low, the problem of excess IRA contributions is rather large. The Treasury Inspector General for Tax Administration (TIGTA) reported in March that 57,484 taxpayers without eligible compensation potentially made $125 million in the 2011 tax year. That implies $7.5 million owed in excise taxes.

Some of the overfunding of IRAs appears deliberate. TIGTA reported 2,585 cases of IRAs for children under age 10—IRA contributions are not allowed unless an individual has earned income. So a contribution for a child actor is fine, but a contribution by a parent to give a child a head start on retirement is not.

Other funding errors may be inadvertent. For example, taxpayers must take a required minimum distribution (RMD) every year once they reach age 70 ½ or pay a penalty tax. Let's say that someone in this position rolls the IRA from one financial institution into another before taking an RMD for the year. That transfer is treated as a distribution, so the amount of the RMD also will be an excess contribution to the new IRA. The penalty applies even if the RMD is taken later in the year.

One final note. Contributions to traditional IRAs are not allowed for taxpayers who reach age 70 ½, even if they have earned income. Therefore, any contribution by someone that age and up is an excess contribution. Contributions to Roth IRAs are allowed at any age, provided the taxpayer has earned income.

(May 2015)