Vol. 12, No. 1 **Choate's Notes** Spring 2010
**A free newsletter for estate planners, from Natalie B. Choate**

Dear estate planning professional:

Larry Katzenstein, Esq., creator of Tiger Tables software (www.tigertables.com), the estate planning software used by the IRS, tells me there is an **i-Phone** app that for a few bucks enables you to download the entire Internal Revenue Code onto the phone, plus the tax regulations for a few more bucks. That sounds extremely handy. As soon as I figure out how to work my i-Phone I'm going to get those apps.

Have you ever gotten frustrated looking for material on obscure grandfather rules, or trying to compute minimum distributions for years prior to 2001? Sometimes practitioners do need that old stuff, but there's not room for it in the already-overlong newer editions of my book. Problem fixed: I have collected ALL that old material from prior editions, and piled it into one downloadable Special Report called ***Ancient History***. $19.94 at www.ataxplan.com.

*Estate Planning Smarts*, by **Deborah L. Jacobs**, is, as advertised, "a practical user-friendly, action-oriented guide" to estate planning for the nonprofessional reader. Deborah is a former lawyer, now a journalist specializing in estate planning and tax issues, most often for the *New York Times*. She's very smart, knowledgeable, and careful, and writes beautifully. This book will help your clients get right up to speed. $19.95 at www.amazon.com.

Bob Keebler has come up with a terrific 11" x 17" chart summarizing planning considerations and other key info for Roth IRA conversions, the "**Roth IRA Decision Chart**." Order for yourself or your staff. I use the laminated version as a place mat so I never forget the key Roth info it contains. To learn more or order visit www.ultimateiratraining.com.

Find more handy **quick reference guides** at www.applebyconsultinginc.com. Denise Appleby has created charts summarizing Roth vs. traditional IRA, portability (what type of plan can be rolled into what other type of plan), and more. I wish everyone who answers an 800 number at the big financial firms had these charts, so there would be fewer incidents of erroneous advice.

Until the next issue,

Natalie B. Choate

## How to Cure an Excess IRA Contribution

There are three ways to make an excess IRA contribution: Contribute to an IRA you are not eligible to contribute to; put in a larger contribution than is permitted; or roll over a distribution that is not eligible to be rolled over—for example, a minimum required distribution. There are also three ways to fix an excess IRA contribution: Withdrawal, recharacterization, and absorption.

**Recharacterizing:** Making a contribution to an IRA you're not eligible to contribute to can *sometimes* be fixed by recharacterization. For example, if a worker makes a regular contribution to a Roth IRA in a year when his income is too high to permit that, he can recharacterize the contribution as a contribution to a traditional IRA, *if* he's under age 70½. You recharacterize an IRA contribution by transferring the contribution (plus or minus any earnings that the contribution has earned while in the IRA) to the other type of IRA.

**Withdrawal (corrective distribution):** If the individual is not eligible to make a regular contribution to either type of IRA, he should fix the error by withdrawing the contribution.

Similarly, a person who just plain old puts too much money into his IRA—for example, he puts in $8,000, in a year when he's only allowed to contribute $5,000—should also use the remedy of withdrawing the excess IRA contribution. Like recharacterization, a "corrective distribution" requires you to compute the earnings on the contribution; you have to withdraw those earnings along with the contribution.

Another similarity: The deadline for withdrawing an IRA contribution is the same as the deadline for recharacterizing—it's the due date of the tax return for the year in which the contribution is made, "including extensions." That term has a special meaning in the regulations: It means October 15th of the following year if you file your tax return on time, even if you don't actually get an extension. If you don't file your tax return on time, the deadline is April 15th.

Withdrawing an IRA contribution, along with its earnings, by that deadline gives you two benefits. First, the contribution is deemed *not to have been contributed at all* for purposes of the 6% penalty on excess IRA contributions. Second, you pay no income tax on the withdrawn contribution. The bad news is you have to pay income tax on the earnings (if any) on your withdrawn contribution, as well as a 10% early-distributions penalty on those earnings if you are under age 59½ and no exception applies.

The recharacterization and withdrawal remedies can be used by anyone, even if there was no excess contribution. So if you need a few thousand dollars immediately, and the only source you have is your IRA, you may be able to withdraw this year's or last year's contribution with little or no tax or penalty (depending on how profitable your investments inside the IRA have been).

**Absorption:** Suppose you made a small excess IRA contribution, but your investments did extremely well and to correct that excess you would have to withdraw a big chunk of earnings that would be subject to income tax and a 10% penalty. You might want to use the third correction method, absorption. Under this method, you pay the 6% penalty for the excess contribution, and allow the deadline for a corrective distribution to pass. Then your excess contribution is automatically applied to your permitted annual contribution for the *following* year, for purposes of the 6% penalty. If the excess was small, it may be "absorbed" and treated as a legal contribution for the following year, so there will be no penalty for the following year. You don't have to mess with "earnings" under this method.

Absorption doesn't help for a really big excess IRA contribution. That can happen when, for example, a nonspouse beneficiary rolls an inherited retirement plan into *his own* IRA instead of into an *inherited* IRA. He has just generated a taxable distribution of the entire inherited plan, *plus* an excess contribution to his own IRA. If he doesn't withdraw that excess by the corrective distribution deadline he has a real mess. He owes the 6% penalty for the year of the contribution, and *each year thereafter* until the entire contribution is either withdrawn or absorbed. If he withdraws the contribution after the deadline, then the distribution is taxed just like any other IRA distribution (under the "cream in the coffee rule"), so it may be substantially taxable. The only good news is that the excess contribution is considered part of his basis in the account because he paid tax on it.

**Citations:** For meaning of "due date of tax return (including extensions)," see Treas. Reg. § 301.9100-2(b), or explanation in ¶ 5.6.04 of *Life and Death Planning for Retirement Benefits* (6th ed. 2006) or downloadable Special Report, "Roth-Ready for 2010—and Beyond!", both available at www.ataxplan.com. For how to compute the earnings on a returned or recharacterized IRA contribution, see Treas. Reg. § 1.408-11(a)(1), (2).