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Understanding Excess Traditional and Roth IRA & 401(k) Contributions: Correction, Penalties, and IRS Guidelines

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Retirement accounts like IRAs and 401(k)s offer valuable tax advantages, but exceeding contribution limits can lead to unexpected penalties and tax complications. In this blog, we'll explore how excess contributions happen, the potential penalties, and the steps you can take to correct them.

WHEN CAN YOU CONTRIBUTE TO TRADITIONAL IRA, ROTH IRA OR 401(K)'S?

Traditional & Roth Contributions to IRAs can be made from January 1st of the current tax year until the tax filing deadline, typically April 15th of the following year. *Traditional* IRA contributions may be tax-deductible, reducing taxable income for the contribution year. However, withdrawals in retirement are taxed as ordinary income. *Roth* IRA contributions are made with after-tax dollars, meaning withdrawals in retirement are tax-free if certain conditions are met.

Alternatively, 401(k) Contributions (Traditional & Roth) are deducted directly from payroll and must be made by December 31st of the tax year. *Traditional 401(k)* contributions reduce taxable income in the year they are made but are taxed as ordinary income when withdrawn in retirement. *Roth 401(k)* contributions are made with after-tax dollars, but both growth and withdrawals are tax-free in retirement if conditions are met.

It is important to note that Solo-k's (Self Employed 401(k)'s) and Simplified Employee Pension Plans (SEP-IRAs) have the same contribution deadlines as IRA contributions.

HOW EXCESS CONTRIBUTIONS HAPPEN, WHAT THE PENALTIES ARE, AND HOW TO CORRECT THEM

Excess contributions occur when you contribute more to your retirement accounts than the IRS allows for the given tax year. This can happen for a variety of reasons, like miscalculating your income or contribution limits, errors with your employer's match, or contributing to multiple employer-sponsored plans without coordinating between them. The IRS imposes a 6% excise tax on the excess contributions for each year the excess remains in the account. For 401(k) plans, if you don't withdraw the excess deferrals by April 15th of the following year, they'll be subject to double taxation—meaning you'll pay taxes both in the year you contributed and again when you withdraw in retirement.

If you catch the excess contribution before the tax filing deadline, you can avoid penalties by withdrawing the excess amount and any earnings. Just be aware that the earnings will be taxed in the year you withdraw them. However, if the excess isn't discovered until after the deadline, you'll face the 6% excise tax annually until the issue is corrected.

IRS FORMS YOU'LL NEED

Several IRS forms are involved in correcting excess contributions:

- **Form 5329** reports excess IRA contributions and applies the excise tax if the issue isn't corrected.
- **Form 1099-R** is issued when you withdraw the excess contribution and must be included in your tax returns.
- **Form 1040-X** is used to amend your tax returns if necessary.
- **Form 5498** is an informational form that reports IRA contributions but isn't needed when filing taxes.
- **Form 8606** is required when you have excess IRA contributions to report non-deductible contributions, track after-tax funds, and prevent double taxation on withdrawals.

The deadlines for these forms vary, so it's important to address any excess contributions as soon as possible to prevent penalties from piling up. Working with a tax professional can help ensure everything is handled correctly.

CASE STUDY: SARAH'S EXCESS ROTH IRA CONTRIBUTION & CORRECTION

Sarah, age 45, earns $160,000 in 2024, exceeding the Roth IRA income phase-out limit for full contributions. Unaware of this, she contributes the full $7,000 to her Roth IRA. Later, she realizes her Modified Adjusted Gross Income (MAGI) limits her contribution to only $3,500.

Correction Steps:

1. Sarah contacts her IRA custodian and requests a return of the $3,500 excess contribution plus earnings.
2. Suppose the excess earnings are $200; she must include this in her 2024 taxable income.
3. Her custodian issues her a Form 1099-R reflecting the corrected amount.
4. She files Form 5329 with her tax return to report the correction and avoid the 6% penalty.

If Sarah had discovered the excess after filing her taxes, she would have been subject to a recurring 6% penalty each year until corrected.

CONCLUSION: STAY ON TOP OF YOUR CONTRIBUTIONS

Excess contributions to IRAs and 401(k)s can be costly if not addressed promptly. Regularly reviewing contributions, understanding IRS limits, and working with a tax professional and your Grimes advisor can help prevent these errors and ensure tax-advantaged savings remain compliant.

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