EXCESS IRA CONTRIBUTIONS – GAMING THE SYSTEM?

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An IRA owner can contribute only so much to a Traditional and/or Roth IRA annually. The IRA owner must also have earned income. The contribution limit for 2021 is $6,000, with a catch-up provision of another $1,000 for those age 50 and over. If a person does not have earned income, he is ineligible to contribute (not counting spousal contributions). If he makes too much, he will be ineligible to make a Roth IRA contribution. (Roth IRA income phase-outs for 2021 are $198,000 - $208,000 for those married, filing joint; $125,000 - $140,000 for single filers)

Nothing exciting here. These are basic regulations.

If a person violates these hard-and-fast rules, then we have an excess contribution that must be addressed. There are a handful of remedies. One could recharacterize (change) a Roth IRA contribution to a Traditional IRA contribution, or vice-versa. (This option is only available up to the cutoff date of October 15 of the year after when the excess contribution was made.)

Another fix prior to the October 15 deadline is to withdraw the excess contribution plus "net income attributable" (NIA). There will be taxes due on the NIA, and a 10% early withdrawal penalty on those earnings if the IRA owner is under 59 ½ years old. Still another fix is to leave the excess in the account, pay a 6% penalty on that excess, and carry forward the excess amount to the next year (or future year) when the IRA owner is eligible to contribute.

But what about fixing an excess contribution after the October 15 deadline? We must remove the excess, but believe it or not, we can leave the earnings on that excess in the account. It's true. The IRA owner will still have to pay a 6% penalty on the excess amount for every year it remains, but with a weird quirk in the rules, the earnings on the excess can remain in the IRA.

My guess is the 6% penalty amount was chosen to wipe out a nominal gain based on a typical and conservative investment return. But what if the markets have been roaring for years? What if some annual returns were 20%, 30%, or more? (Based on recent market activity, these are not unreasonable numbers.) Could someone leverage high returns to intentionally abuse the excess contribution rules?

Example: In 2010, Bernie started contributing $2,000 annually to a Roth IRA for his 8-year-old son Billy. He did this for 10 years. Son Billy had no income and was totally ineligible for an IRA. Bernie invested in an S&P 500 ETF. The 10-year average annual return on the S&P 500 over the decade was 13.6%. In 2020, the account was worth nearly $38,000. Bernie withdrew the $20,000 excess and paid the annual 6% penalties that had accumulated to $6,600. Since the earnings could remain, son Billy keeps the Roth IRA with the remaining $18,000.

Bernie got lucky with a bull market, but did he game the system? Was the penalty worth getting $18,000 into a Roth IRA for his teenage son? When Billy is 59 ½, at 6% average annual growth, that's nearly $200,000 in a Roth IRA that should not exist. However, when it comes to tax-free Roth IRA earnings, excess contributions alone won't help. Tax rules dictate that an ineligible contribution to a Roth IRA does not start the 5-year clock for qualified earnings. That requires an eligible Roth IRA contribution…which Billy could make on his own. A valid and minimal Roth IRA contribution could fully legitimize Billy's somewhat bogus Roth IRA.