On Personal Finance

IRA Tax Traps

August 2, 2012

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Individual Retirement Arrangements (IRAs) can be a great way to save for retirement because of the tax benefits they may provide. If you're eligible, you can choose a traditional IRA for an up-front tax deduction and defer paying taxes until you take withdrawals in the future. Or if eligible, you might opt for a Roth IRA and contribute after-tax money in exchange for tax-free distributions down the road. (For more details on which account might be best for you, see: Is a Roth IRA Right for You? and Saving for Retirement: IRA vs. 401(k).)

So, what's the catch? Actually, there are a number of them. If you run afoul of some of the IRS rules surrounding these accounts, the penalties can be quite stiff—all the way up to a disqualification and taxation of your entire account if you're not careful. Ignorance of the law is no excuse, and with very few exceptions the IRS isn't forgiving of mistakes. (You could always try the appeal process, but that's like George Bailey asking Old Man Potter for help.) Knowing the rules can help you navigate the many potential IRA tax traps that you might encounter on the way to retirement.

Here we'll cover some of the more common pitfalls, divided into three major categories:

1. Contributions and investments
2. Withdrawals
3. Estate planning

Keep in mind that when we discuss taxes and penalties, we're referring to the federal level. In most states, you will also face ordinary state taxes and may incur additional state penalties as well.

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1. Contributions and investments

Excess contributions

If you contribute more than the law allows in any year based on contribution or income limits for your filing status, or age limitations (you can't contribute to a traditional IRA past age 70½), the penalty is 6% of the excess amount for each year in which you fail to take corrective action. For example, if you contributed $1,000 more than you were allowed, you would owe $60 each year until you corrected the mistake. To correct the excess contribution you need to withdraw the excess amount, plus any earnings specifically tied to the excess contribution, by the due date (plus extension) of your tax return for the year of contribution (generally October 15th of the following year). Alternatively, you could recharacterize the excess contribution before the due date, plus extension, as a contribution to another IRA type (e.g., you're over the limit for a Roth IRA because of income limitations, but you're eligible for a traditional nondeductible IRA). Finally, you could leave the excess contribution alone. You might choose to do this if the amount is so small that the 6% penalty isn't worth the hassle of withdrawal or recharacterization, or if your contribution has increased in value so much that the tax on the earnings (plus 10% penalty if you're under 59½) would be worse than paying the penalty. In that case, you would pay the 6% penalty for one year, and then count the excess as a deemed contribution in the next year, assuming you're eligible to make a contribution at that point.

Prohibited investments

If you personally manage and invest your own retirement money through a self-directed IRA, be aware that IRA rules prohibit investing in collectibles, which include the following:

- Artworks
- Rugs
- Antiques
- Metals
- Gems
- Stamps
- Coins
- Alcoholic beverages
- Certain other tangible personal property

Your IRA *can* invest in one, one-half, one-quarter, or one-tenth ounce US gold coins, or one-ounce silver coins minted by the Treasury Department. It can also invest in certain platinum coins and certain gold, silver, palladium, and platinum bullion. But if you invest directly in collectibles the amount invested will be considered distributed to you in the year invested, subject to applicable tax and 10% penalty if the premature distribution rules apply. Owning real estate directly in an IRA isn't prohibited, but you could find yourself engaged in a prohibited transaction if you buy and sell individual properties and are not extremely careful. If you want to invest in precious metals or real estate in your IRA, then a mutual fund or exchange-traded fund (ETF) would probably be a better choice (although you might be subject to unrelated business taxable income, or UBTI). But if the ETF or mutual fund ever made an in-kind distribution of a prohibited investment such as gold bullion that doesn't meet the Treasury's definition of allowable investments, it would still be subject to prohibited investment rules.

Unrelated business taxable income

Interest income, dividends, capital gains, and profits from options transactions are exempt from UBTI, but an IRA could earn UBTI if it has any of the following characteristics:

- Operates a trade or business
- Has certain types of rental income
- Receives certain types of passive income from a business it controls or from a pass-through entity such as a partnership

that conducts a business, such as master limited partnerships and real estate partnerships
Uses debt to finance investments

Because tax-exempt entities shouldn't have an unfair tax advantage over taxable businesses, an IRA that earns UBTI exceeding $1,000 must pay income taxes on that income. The IRA might have to file Forms 990-T or 990-W and pay estimated income taxes during the year. And in the case of a traditional IRA, UBTI results in double taxation because you have to pay tax on the UBTI in the year it occurs *and* when you ultimately take distributions.

Prohibited transactions

Regardless of what you invest in, you need to avoid prohibited transactions, since they could cause your entire IRA to lose tax-deferred status. Prohibited transactions in your IRA include:

Borrowing money from it (for example, treating your IRA as a margin account)
Selling property to it
Receiving unreasonable compensation for managing it
Using it as security for a loan
Using IRA funds to buy property for personal present or future use

If you engage in a prohibited transaction, your entire account stops being an IRA as of the first day of that year and the account is treated as having made a taxable distribution of all its assets to you based on fair market value on the first day of the year (plus additional excise taxes in some instances). This is as bad as it sounds—engaging in a prohibited transaction could result in the destruction of your IRA.

Rollovers

You can make unlimited direct trustee-to-trustee transfers of your IRA funds in any given year. BUT, when you take receipt of the money yourself, you face a number of restrictions. First, you have 60 days to redeposit it into the same or another IRA or it counts as a taxable distribution (plus penalty if you're under age 59½). Moreover, you are only allowed one such "rollover" per year. If you deposit the funds into another IRA and then attempt another rollover with the same funds in the same year, then the withdrawal is immediately taxable. One other thing to keep in mind is that when you take receipt of the money it's subject to 20% withholding. You'll get the withholding back when you file your tax return (assuming you don't violate the rollover rules), but in the meantime you have to come up with 100% of the money in 60 days. Bottom line: If you need to switch custodians, play it safe and stick to the direct trustee-to-trustee transfer method.

Roth conversion

Converting from a traditional IRA to a Roth IRA might make sense if you're sure you'll be in a higher tax bracket when you take future withdrawals, can pay the conversion tax from outside sources now, and have a reasonably long time horizon. However, even if you meet these three basic criteria you should consider the following potential conversion traps:

Hidden taxes. A Roth conversion analysis shouldn't just look at the marginal ordinary income tax impact. Depending on your modified adjusted gross income (MAGI) before converting, the additional conversion income could trigger increased taxation due to any or all of the following factors:
- Taxability of Social Security benefits
- Triggering alternative minimum tax (AMT)
- Phase-out of exemptions, deductions, or eligibility for other tax breaks.

Potential financial aid loss because of a higher AGI.
Aggregation rule for partial conversions involving after-tax money. If you have made nondeductible contributions to your traditional IRA in the past (hopefully, tracked all along on IRS Form 8606), you can't pick and choose which portion of the

traditional IRA money you want to convert to a Roth. The IRS looks at all traditional IRAs as one when it comes to distributions, including Roth conversions. Traditional IRA balances are aggregated so that the amount converted consists of a prorated portion of taxable and nontaxable money (see discussion in section 2 below).

Failing to first take RMDs, if applicable. You can't avoid taking required minimum distributions by converting funds.

Premature withdrawal penalty. If you're under 59½ you'll pay a 10% penalty if you withdraw funds to pay the conversion tax (a bad idea anyway). Also, even though withdrawals of regular contributions made to a Roth IRA are normally penalty free, you can't convert from a traditional IRA to a Roth in order to avoid the premature withdrawal penalty (unless you wait at least five years or to age 59½, whichever is less).

For more, see Roth Conversion: Look Before You Leap.

2. Withdrawals

Premature withdrawals

If you withdraw money from your IRA before age 59½, you will incur a 10% penalty plus ordinary income tax on the amount attributable to previously deductible contributions and earnings. There are some exceptions to this rule under Internal Revenue Code (IRC) section 72 (see IRS Publication 590), including:

- Disability or death of the IRA owner
- Withdrawals that constitute a series of "substantially equal periodic payments" made over the life expectancy of the IRA owner
- Withdrawals used to pay for unreimbursed medical expenses that exceed 7½% of AGI
- Withdrawals used for a first-time home purchase (subject to a lifetime limit of $10,000)
- Withdrawals used to pay for the qualified higher-education expenses of the IRA owner and eligible family members

Even if you can avoid the 10% penalty, you will still pay tax. More importantly, you will be leaving less money to work for your retirement account because you will lose out on any future potential deferred compounding. Remember, you can only contribute so much to these accounts annually, so you may never be able to make up for the lost ground.

Required minimum distributions

If you're age 70½ or older then you're required to take minimum distributions (RMDs) from your traditional IRA. (Original owners of Roth IRAs are exempt from RMD rules, but non-spousal beneficiaries who inherit a Roth IRA must take distributions over their life expectancies.) You need to take your RMD before December 31st each year. The one exception is for the year you turn 70½, in which you have the option of waiting until April 1st of the following year. Waiting, however, means you will have to take two distributions in that next year, which may not be a good idea if it bumps you into a higher tax bracket. The penalty for failing to take your RMD is a 50% excise tax on the amount you were required to take, but didn't (plus ordinary income tax, of course).

The IRS requires that you calculate the RMD for each IRA separately, based on the value of the account at the end of the prior year divided by your life expectancy factor (taken from the appropriate table in IRS Publication 590). However, once you've calculated your RMD for each traditional IRA account, you can aggregate the total and take it from one or multiple IRAs in any combination, as long as you withdraw the total amount required.

How much of your withdrawal will be subject to ordinary income tax depends on whether you made any nondeductible contributions in the past. If you made nondeductible (and therefore nontaxable) contributions to your traditional IRA, you have to treat each distribution (including a conversion to a Roth IRA, if applicable) as one part nontaxable return of cost basis (your nondeductible contributions) and one part taxable earnings. When you compute the nontaxable portions, all traditional IRA

distributions made during the taxable year are treated as one distribution, using this formula:

$$\text{Nontaxable portion of distributions} = \frac{\text{nondeductible contributions}}{\text{traditional IRA balances at year-end} + \text{distributions during year}} \times \text{total distributions during year}$$

Consider the hypothetical contributions made by Mr. Jones below:

Years	Hypothetical contributions to a traditional IRA	
	Deductible	Nondeductible
2005–2007	$3,000 each year	$0
2008	$2,000	$2,000
2009–2010	$0	$4,000 each year
2011	$0	$5,000
Total contributions	$11,000	$15,000

On October 15, 2012, Mr. Jones takes a distribution of $3,000. At the end of the year, his total traditional IRA account balance is $30,000. So the nontaxable portion of Mr. Jones' distribution is as follows:

$$\frac{\$15,000}{30,000 + 3,000} \times 3,000 = \$1,364$$

Hopefully, Mr. Jones filed IRS Form 8606, "Nondeductible IRAs," with his tax return for each year he made nondeductible contributions to his traditional IRA. Form 8606 is also required for years when a distribution takes place (including a Roth conversion).

Note: The IRA aggregation rule does not apply to qualified employer plans, such as 401(k)s, where the RMD must be calculated and distributed separately.

Finally, the RMDs for inherited IRAs are a bit more complex (see "Beneficiaries" below).

3. Estate planning

You should designate your IRA beneficiaries with care because, as is the case with employer plans and life insurance, your beneficiary will have control over and access to your account no matter what your will or revocable living trust might say. Beyond that, beneficiaries need to be careful about how and when they access IRA funds. Ideally, you want to defer

withdrawals for as long as the law allows, in most cases, but the rules surrounding inherited retirement account balances can get complex, depending on whether the recipient is a spouse or non-spouse and whether the original account holder had begun taking required minimum distributions (RMDs) at the time of death. Given the right set of circumstances, a beneficiary may be able to "stretch out" the IRA distributions over his or her lifetime and, potentially, the lives of successive beneficiaries (see the table below).

Your Options for an Inherited IRA

Choices	Who qualifies	When the money is available	Other considerations
Lump-sum distribution	Spouse or non-spouse	All at once.	Income taxes are paid all at once. No 10% early withdrawal penalty. Your tax bracket may change.
Transfer to an inherited IRA[1] held in the name of the original account holder for your benefit (distribution based on original account holder's age at decease)	Spouse or non-spouse	You can access your funds at any time and are taxed on each distribution. If account holder was under age 70½ : You can begin taking annual required minimum distributions (RMDs) no later than December 31 following the year of the original account holder's death, or you may delay distributions until the end of the fifth year after the year in which the original account holder died, at which time all assets need to be fully distributed. If account holder was over age 70½ : Your annual distributions are spread over the longer of the original account holder's or your expected lifetime. If you intend to take an RMD, you must begin no later than December 31 following the original account holder's death. If the original account holder did not take an RMD in the year he or she died, you must take the distribution by	Each distribution is taxed. No 10% early withdrawal penalty. Undistributed assets continue growing tax-deferred. You can designate your own beneficiary.

		the end of that year.	
Transfer into an existing or new IRA in your name	Spouse	At any time.	Available only if spouse is sole beneficiary. Penalty applies to withdrawals made before you reach age 59½ . IRA assets continue to grow tax-deferred. You can designate your own beneficiary. If deceased was over 70½ , you must take an RMD for the year of death (if account holder did not already take it).

Source: "You've just inherited a retirement account. Now what?" Schwab brochure, 2010.

For more information on inherited IRAs, see Heir Economics and Schwab's step-by-step decision guide for retirement account beneficiaries. Also, see IRS Publication 590, Individual Retirement Arrangements (IRAs) .

Naming a trust as your IRA beneficiary

In the vast majority of cases, naming your spouse as primary beneficiary provides the greatest flexibility. The next best route is to name a non-spouse beneficiary such as a child, grandchild, or even a favorite charity. In very few cases, where there are concerns over the capacity or maturity of a beneficiary, or some other situation in which you want to put controls and restrictions in place, it might make sense to name a trust as your IRA beneficiary.

Naming a trust as beneficiary can lead to all kinds of unintended consequences if you're not very careful. For example, naming a trust instead of a spouse as beneficiary removes the surviving spouse's ability to roll over the IRA into his or her name to take advantage of the IRA ownership rules. In contrast, a trust is not a natural person and must make RMDs over the life expectancy of the oldest trust beneficiary.

Another pitfall arises if a charity is named as a co-beneficiary of an IRA trust, in which case the entire IRA would need to be distributed within five years of the date of death of the IRA owner (if death occurs before age 70½), or over the remaining life expectancy of the IRA owner if the owner had reached the age of 70½.

Bottom line: Be sure you have a legitimate reason to name a trust as beneficiary, and then only do so after you consult with an independent and objective tax and estate expert working in conjunction with your financial advisors and account providers.

Important Disclosures

1. An inherited IRA allows a spouse or non-spouse beneficiary to keep inherited IRA assets tax-deferred—until the IRS requires the funds in the inherited IRA to be distributed.

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