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The IRA Digest

Retirement Account Strategies and Tips

May – June **2022**

The Top 4 IRA Rollover Mistakes and How to Avoid Them

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According to the IRS, over 4.9 million taxpayers rolled over about $534 billion to their IRAs in 2018*. Our review of IRS rulings and court cases shows that many individuals make costly mistakes when attempting rollovers. If you are one of the millions of individuals who will be rolling over a retirement account this year, the following should help you to avoid those mistakes. Due to the complexity of the rollover rules, we recommend that you contact us for assistance before you initiate a rollover.

*IRS, Statistics of Income. SOI Tax Stats: Accumulation and Distribution of Individual Retirement Arrangements (IRA)

Mistake Number 1: Losing Qualification for the 10% Penalty Exception

Taxable distributions taken from your retirement account before you reach age 59 ½ are subject to a 10% additional tax (early distribution penalty). This early distribution penalty is waived if the distribution qualifies for an exception.

The issue: Some of the exceptions apply to IRAs, some apply to employer-sponsored retirement plans (employer plans), and some apply to both.

When rolling over amounts from an employer-sponsored retirement plan (employer plan) to an IRA or vice versa, care must be taken to avoid losing qualification for an exception as a result of the rollover. One example is the age 55 exception which applies to employer plans but does not apply to IRAs. Under the age 55 exception, distributions are exempted from the 10% early distribution penalty if:

a) The participant separates from service (with the employer that provides the employer plan) in the year they reach age 55 or later, and
b) The distributions are taken after the participant separates from service with that employer.

Rolling over these age-55-exception-qualified funds to an IRA will result in a loss of qualification for that exception.

Example 1:
Larry stopped working for AB Widgets & Things at age 56.
Larry requested a withdrawal of $200,000- all pre-tax - from his AB Widgets & Things 401(k) plan a few months after separating from service.

Larry instructed the plan trustee to pay the $200,000 to him. In this case, the $200,000 is exempted from the 10% early distribution penalty.

Example 2:
The facts are the same, except that Larry instructed the plan trustee to move the $200,000 to his traditional IRA as a direct rollover. He then requested a distribution of the $200,000 from the traditional IRA. In this case, Larry cannot use the age 55 exception, as it does not apply to IRAs. Larry will owe the IRS an early distribution penalty of $20,000 unless he qualifies for another exception.

Mistake Number 2: Missing out on the NUA Tax Reduction Strategy

Generally, distributions from your retirement accounts are taxed at your ordinary tax rate. Exceptions apply, one of which is taxation at the capital gains rate for net unrealized appreciation (NUA) on employer securities. This rate reduction is available if you hold employer securities in an account under an employer plan, and you include those securities in a lump-sum distribution from the plan.

The NUA is the gain on employer securities while they are held in your employer plan account. With the NUA strategy, the basis amount is included in income the year the distribution is made, and you may then elect to include the NUA in income when the securities are liquidated.

A distribution must meet specific requirements to qualify as a lump-sum distribution. Please contact us if you are a potential candidate for the NUA strategy. We can help to determine whether you qualify, and explain key factors that should be considered to determine whether the strategy makes good tax sense for you.

Mistake Number 3: Having Mandatory 20% Withholding Because of Choosing the Indirect, Instead of the Direct Rollover Method

When rolling over amounts from an employer plan to an IRA or other eligible retirement plan, there are two options for doing so:

a) A direct rollover where the amounts are paid to the IRA custodian or plan trustee, for the benefit of the participant.
b) An indirect rollover where the amount is paid to the participant who then has 60 days to roll over the amount to an IRA or other eligible retirement plan.

There is no tax withholding under the direct rollover method, which means the entire distribution amount is rolled over to the receiving account.

Under the indirect rollover method, the payor is required to withhold 20% from any taxable amount for federal income taxes. Some also withhold state taxes.

If you choose the indirect rollover method and want to roll over the entire distribution amount, you would need to make up the 20% withholding out of pocket. Any amount that is not rolled over would be included in income and subject to a 10% early distribution penalty unless you qualify for an exception.

Mistake Number 4: Missing the Opportunity for Tax-Free Earnings on After-Tax Rollovers

If you have after-tax amounts in any employer plan, those amounts – if rollover eligible – may be rolled over to your traditional IRA or Roth IRA. Rolling these amounts to a traditional IRA means that the earnings would be tax-deferred and taxable when distributed. Whereas, rolling to a Roth IRA would mean that earnings are tax-deferred but eventually become tax-free once you're eligible for a qualified distribution. Thus, choosing a traditional IRA for a rollover of these amounts is a missed opportunity for tax-free earnings.

Let Us Help You with Your Rollover

A rollover runs the gamut from simple to complex, and the information provided above only touches the surface of the rules discussed. There are many other rollover mistakes to avoid as well. Please contact us before you initiate a rollover for your retirement savings accounts and we will work with you to help ensure that mistakes are avoided.

Important Disclosure

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