11 Biggest Rollover Blunders

(and How to Avoid Them)

Rolling over your funds for retirement presents a number of opportunities for error. Having a set of guidelines and preventive touch points is necessary to save yourself from crucial (and often expensive) mistakes.

Here, we'll walk through 11 of the most common blunders associated with rolling over. Tactical or merely careless, committed by individuals or financial institutions, these examples all have the potential to cost you money. They're also easily avoidable.

A SPECIAL RETIREMENT REPORT

By Elaine Floyd, CFP®
Director of Retirement and LIfe Planning, Horsesmouth LLC

Blunder #1: Missing the 60-day Rollover Deadline

You have a 60-day window for moving money from your employer's plan to an IRA rollover account tax-free. The window starts the moment your money leaves the original account. Many people end up whiffing that 60-day window and suffering the consequences.

How it might happen

First of all, you took receipt of the money rather than making a direct "trustee-to-trustee" transfer. The clock starts ticking and minor problems and roadblocks eat up time. The check gets lost in the mail. You're on vacation when it comes in. You lose track of the days. Before you know it, the 60-day window has closed.

Or one of your financial institutions could make a mistake. They might put the money into your taxable account instead of your rollover account, and you don't notice it until after the 60-day window closes.

The consequences

In this case, the price for carelessness is high. The whole distribution will be taxable in one year. And if you're under 59-1/2, you'll pay a 10% penalty on top of it.

How to avoid it

Request a direct transfer of the assets. Open an account with a trustworthy, reputable custodian. Then ask your plan administrator to send the assets to the new custodian. That way, you never touch the money and there's no risk that the check will get lost or you'll lose count of the days. Also, if the assets go straight to the new custodian in a direct transfer, your plan administrator won't have to withhold 20% for taxes.

How to rectify it

Talk to the IRS. If the delay was demonstrably caused by the financial institution, you can get an automatic waiver.

You also might be able to get a discretionary waiver if the error was caused by a hardship circumstance such as a death or disability, or if it was caused by a postal error. But really, you don't need the hassle. The better thing to do is avoid the mistake to begin with and choose a reputable custodian and request a direct, trustee-to-trustee transfer.

Blunder #2: Failing to Name the Right Beneficiary

Naming the wrong beneficiary on your beneficiary designation form is a surprisingly common—and disruptive—mistake.

How it might happen

Most people under ordinary circumstances tend to get this right. But some people with complex financial affairs are advised by their estate planning attorney to name beneficiaries in a very specific way. If their financial institution's standard form won't allow it, all that estate planning can go to waste.

Another problem is neglecting to update the form after a divorce or other major life event. It has happened that an IRA went to the ex-spouse instead of the current spouse because the IRA holder never got around to changing the form after remarrying.

The consequences

The wrong people inherit your money.

Or your beneficiaries end up paying too much in taxes because your estate plan wasn't structured properly. You won't be around to see this, of course, but it can make life difficult for your loved ones.

How to avoid it

Sign a beneficiary designation form when you first set up the account. Then, stay aware of life events—like divorce, marriage, or death of a spouse—that will require the form to be updated.

Even if you don't experience any major life shifts, it's a good idea to review your forms at least once a year.

How to rectify it

You personally can't do much to patch up the situation once you're no longer among the living. Do all you can while you're still alive. Check up on your affairs regularly and stay in touch with your advisors.

Blunder #3: Rolling Over Company Stock

Moving employer stock to your IRA rollover account along with the rest of your retirement assets can potentially set you up to pay more taxes down the road – especially if your stock has appreciated significantly.

How it might happen

This is a very easy mistake to make. At the time of the rollover, you are making a choice on how proceeds from the sale of the company stock should be taxed – whether as a capital gain or ordinary income. Capital gains are taxed at a lower rate than IRA distributions. If you take the employer stock out of your retirement plan and move it to a taxable account, when you eventually sell the stock your net unrealized appreciation—the amount by which the stock has appreciated compared to what you paid for it—will be taxed as a capital gain.

If you move the employer stock to an IRA rollover account, all distributions are taxed at ordinary income tax rates, which are higher than the capital gains rate under current rules.

Many people don't realize the significance of rolling over company stock and so give their plan administrator a blanket instruction to roll over everything into the rollover IRA. It also happens that they may give the proper instructions, but the administrator or financial institution makes a mistake.

The consequences

You end up paying taxes at ordinary income tax rates (28-39.6%) instead of capital gains (15-20%) rates.

How to avoid it

First of all, check with your tax advisor if you have employer stock in your retirement plan. This is a complicated issue and specific rules apply, so get qualified tax guidance before issuing instructions to your plan administrator. There might be circumstances when you would want to move employer stock – for example, if the net unrealized appreciation doesn't amount to much.

If you decide to move the stock to a taxable account, give explicit instructions to your plan administrator for holding out the company stock from the rest of the rollover.

How to rectify it

You can't. This is one mistake you can't fix. If your company stock goes into your IRA rollover account, the only way to get it out is to take a distribution and pay taxes at ordinary income tax rates. The only way to take advantage of capital gains tax rates on employer stock is to keep it from going into the IRA in the first place.

Blunder #4: Not Paying Off Loans Before Rolling Over

Failing to pay off loans before rolling over your retirement money means that any loans outstanding when you leave the company will be considered a distribution – fully taxable and subject to penalties if you're under 59-1/2.

How it might happen

This can easily happen if you borrow from your 401k plan and forget—or don't have the money—to pay off the loan.

The consequences

The loan is considered a retirement distribution, subject to taxes and penalties.

How to avoid it

Pay off your loans before you do the rollover. Borrow the money from somewhere else if you have to.

How to rectify it

If you request an IRA rollover while you have a loan outstanding, your plan administrator will subtract the loan amount from the rollover amount.

For example, if your account is worth $100,000 and you have $20,000 in outstanding loans, the rollover amount will be $80,000, and you'll be taxed on $20,000. To avoid taxes, pay back the $20,000 (with outside money) by depositing it into the IRA rollover account within 60 days. Technically, you will have rolled over the full $100,000, therefore avoiding any taxes or penalties on your outstanding loan(s).

Blunder #5:

Cashing Out or Taking an Indirect Rollover

Cashing out your retirement account or taking cash in the form of an "indirect rollover" can subject you to taxes, penalties, and lost growth.

How it might happen

It's tempting to take some or all of the money out of your retirement accounts because you want to pay off debts or buy a RV or vacation home to kick off your retirement. Or maybe you just want to use the money for short time, with the intention of replacing it before the 60-day deadline.

The consequences

Anytime you get your hands on your retirement money, you face the risk of paying taxes and possible penalties on the amounts withdrawn. Any cash you take out to pay off loans or make purchases will count as a taxable distribution, reportable on your tax return. Any amount you use and fail to replace within 60 days will also count as a taxable distribution.

How to avoid it

The safest choice is not to touch the money at all. Request a direct transfer of the assets and make sure it's done right.

How to rectify it

If you do take receipt of the money, make sure you replace the funds within the 60-day deadline. Sometimes the IRS will be lenient in case of hardship or if there's a death or disability. But don't count on it. It's far easier to avoid this mistake than to try to rectify it.

Blunder #6:

Failing to Compare Fees

You have several options when you leave a company. You can roll your retirement funds to an IRA, leave the funds in your old employer's plan, or even move them to a new plan. One thing to consider when evaluating these options is the fees you will pay to manage your money.

How it might happen

There are two reasons for failing to compare fees. One is that you simply fail to notice. The other is that you have a hard time understanding what the fees are. Sometimes fees aren't clearly disclosed, so you have to ask a lot of questions to find out exactly how much you are paying in fees.

The consequences

The consequence of paying excessive fees is that it gradually erodes your retirement savings. The fees may not seem like much on an annual basis, but they do add up over time.

How to avoid it

You can avoid this mistake by asking about fees and understanding what you are getting for your money.

How to rectify it

If you find out that you are paying too much in fees, consider moving your account to an institution that charges lower fees. Note that IRA accounts often have lower fees than 401(k) plans.

Blunder #7: Mismanaging Required Minimum Distributions

When you are 70-1/2, you are required to take annual minimum distributions from your IRA and pay taxes on them, even if you don't need the money. It's very easy to forget to take these distributions – especially if you don't need the money.

How it might happen

It's actually quite easy for this error to occur. Maybe no one ever told you about the rules for taking required minimum distributions. Financial institutions often send reminders, but they cannot be responsible for forcing you to take out the required amount because you might have IRAs in different places. Maybe you want to take your entire distribution from the IRA you have in Bank A. Bank B would be presumptuous to send you a distribution from the IRA you have with them. Taking the required distribution on time and in the right amounts is your responsibility.

The consequences

The consequence of not taking your required distribution is a 50% penalty on the amount that should have been withdrawn. Say you have a $250,000 IRA and the required minimum distribution is $9,000. If you fail to take it, you'll owe a penalty tax of $4,500 when you file your tax return.

How to avoid it

You can avoid this mistake by making sure you start taking your required minimum distributions when you turn 70-1/2. Determine the value of the IRA on the last day of the previous year and divide by your life expectancy as shown on the IRS tables. Then take out that amount by December 31. The first year you have a grace period to April 1, but it's better not to take advantage of the grace period because your next distribution must be taken before December 31, which means you'll report two distributions in one year. Get professional advice if you need it.

How to rectify it

If you didn't take your required minimum distribution by the deadline, take it as soon after as possible. Then, if the oversight was due to a reasonable error, you can file Form 5329 with your tax return and ask to have the penalty waived.

Blunder #8: Target Account Isn't Ready to Receive Funds

If the rollover account isn't ready to receive funds, the administrator will be forced to send the check to you.

How it might happen

This mistake can happen if you fail to open an IRA rollover account at your new financial institution before requesting the transfer of assets. Or there could be a clerical error — your plan administrator might not receive or heed your instructions.

The consequences

You'll get a check in the mail with 20% withheld for taxes. If you fail to open an IRA rollover account with the institution that will be accepting the assets, your plan administrator will send the check to you where you then have 60 days to roll it into your IRA account. You will also have to come up with outside funds to replace the missing 20% from your account to avoid a tax hit.

How to avoid it

Open your IRA rollover account with a reputable custodian and make sure your current plan administrator knows where to send the assets.

How to rectify it

If you miss the 60-day deadline because of a reasonable error like this, you can ask the IRS to waive the taxes and penalties. If it is clearly not your fault, you may get a waiver. But the best course of action is to make sure your rollover account is ready to be funded when you give your plan administrator your instructions.

Blunder #9:

Failing to Consider a Roth IRA Rollover

Tax deferral is great, but at some point you're going to have to pay taxes on your retirement plan contributions and investment earnings. If you roll your retirement assets to a Roth IRA, you will have to pay taxes on the distribution in the year you do it, but future investment earnings will be tax free. After you've gotten the tax hit out of the way, you will never again have to worry about paying taxes on your IRA distributions.

How it might happen

Lots of people don't even consider a Roth IRA for their rollover, either because they're too focused on deferring taxes or because no one ever told them how Roth IRAs work.

The consequences

The consequences come later. There are plenty of older retirees with large IRAs who are now paying huge amounts of taxes on their required minimum distributions. And there are stealth taxes involved as well. If your income is too high, you may pay taxes on your Social Security benefits or pay a surcharge on your Medicare premiums. Or your beneficiaries could end up paying more in taxes. The point is to think very long term. No one knows what tax rates will be in the future, but it can't hurt to try to save yourself some taxes in retirement.

How to avoid it

You can avoid this mistake by asking a financial advisor to do a Roth analysis for you before you do your rollover. Find out if it makes sense in your case.

How to rectify it

Fortunately, this is one mistake that is easy to rectify. You don't have to do the Roth conversion at the time you do your IRA rollover. It can be done at any time.

Blunder #10: Failing to Properly Report Your Rollover

While you won't owe any taxes if you roll over the entire distribution by direct transfer, you'll want to make sure it's reported properly. In January you'll get a 1099-R showing the total amount of your retirement fund. It will also show the taxable amount. This will be zero if you did a direct transfer. When you file your taxes you'll need to show these two amounts on your tax return. Otherwise, when the IRS checks the 1099 against your tax return, it will raise a red flag.

How it might happen

It is very easy to make this mistake. You followed the instructions for a direct transfer and then put it out of your mind because you know that the rollover won't be taxable. So when your 1099 comes in January you ignore it or throw it away.

The situation gets more complicated when you do something other than a direct or "trustee-to-trustee" transfer. Maybe you did an indirect rollover, which means 20% was withheld for taxes. In this case you'll want to be sure you report the rollover so you can get that 20% back. Or maybe you did a partial rollover and held out some money or company stock. In this case you will owe some taxes, and you'll need to make sure you report it properly.

The consequences

The consequence of not matching your tax return to your 1099 is a friendly letter from the IRS asking you to pay any taxes they think you owe based on the 1099 they got.

How to avoid it

You can avoid this mistake by watching for your 1099 in January, checking it for accuracy, and reporting it properly.

How to rectify it

If you do make this or any other tax mistake, try to rectify it immediately. Don't wait for the letter from the IRS. Go ahead and file an amended return.

Blunder #11: Missing a Signature

Believe it or not, a missing signature can mess up your IRA rollover. Your assets cannot be moved without your signature, so make sure you sign where indicated.

How it might happen

Sometimes this is not your fault. Maybe you were never asked to sign and the paperwork went through without your signature and it wasn't caught until too late.

The consequences

If the missing signature is caught too late, you may miss the 60-day deadline and incur taxes and penalties.

How to avoid it

Pay attention to detail and hire competent people to handle your rollover.

How to rectify it

Watch your mail, talk to the plan administrator, and check your accounts until you are satisfied that the right amount of money has been moved.

Actual Blunders

Often, during the rollover process, tricky rules are inadvertently bungled by individuals with the best of intentions. Here are a few examples of actual tax-court cases:

- A woman transferred her IRA to her husband's IRA, thinking that doing so constituted a tax-free rollover. Instead, it was a taxable distribution to her.
- A man took cash out of an IRA, bought stock, and put the stock into another IRA within 60 days. This violated the rule that the same property must be rolled over, adding $480,414 to his taxable income that year. Had he simply rolled over the cash and bought the stock in the new IRA, he could have avoided the error.
- A man received a check from his IRA and immediately deposited it into a new IRA. Three months later, he did it again—which violates a new rule (as of 2014) that an individual can perform only one IRA-to-IRA rollover in any 12-month period. To avoid risking a taxable event, he could have done a direct trustee-to-trustee transfer, on which there are no limits, and continued to grow his retirement savings tax-deferred.

In many cases, financial institutions are responsible for errors. That doesn't mean that their clients are exempt from paying the taxes, however.

- One man asked to have his retirement income deposited into his IRA; unfortunately, the corporation put it into a regular brokerage account instead. Nine months later, the man discovered the error and asked the corporation to correct it.

  In a private letter ruling, the IRS said the income was taxable and also subject to excess contribution penalties. It made no difference to the IRS who made the mistake or why it occurred.

Elaine Floyd, CFP®, is the Director of Retirement and Life Planning, Horsesmouth, LLC, where she focuses on helping people understand the practical and technical aspects of retirement income planning. Horsesmouth is an independent organization providing unique, unbiased insight into the most critical issues facing financial advisors and their clients. Horsesmouth was founded in 1996 and is located in New York City.