How to Avoid The Top 10 Costly IRA Mistakes

Denise Appleby,
MJ, APA, AKA, CRC, CRPS, CRSP, CISP

Your Presenter

Denise Appleby, **MJ, APA, AKA, CISP, CRC, CRPS, CRSP**

Denise is the author of: **The IRA Quick Reference Guide: A Compilation of IRA Quick Reference Guides**

Denise's consulting practice focuses on protecting retirement savings accounts from costly mistakes.

Denise works with advisors to help ensure that their clients avoid these mistakes, by simplifying the tax code and other governing rules and regulations.

She is the and publisher of www.IRAPublications.com

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This information is for general information purposes only and is not intended to be used as tax or legal advice. You may need additional material to answer some questions related to the course topic.

For legal and compliance reasons, we are unable to answer questions about specific cases, unless we are separately retained for such a consultation.

Learning Objectives

Attendees will learn the following:

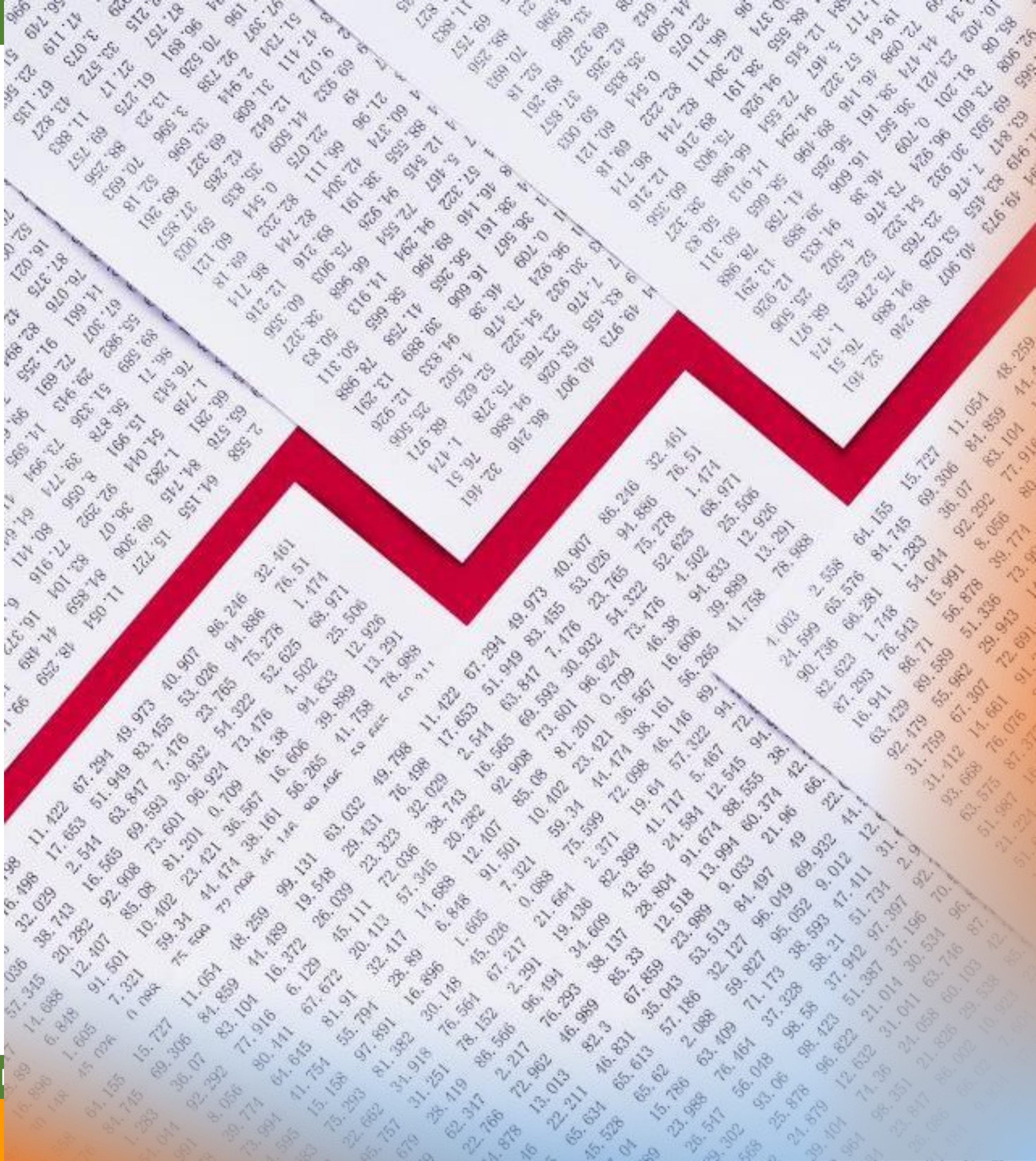
- The 6% excise tax and how to avoid it.
- The 10% additional tax and how to avoid traps for the unwary
- How to avoid or escape the 25% RMD penalty on RMD shortfalls.
- The 100% taxability: How an impermissible portability move could result in 100% loss of tax-deferral and the protective measures that can prevent that.

Primary Lesson

- When it comes to protecting retirement savings amounts, the focus is usually on investment strategies.
- One mistake can wipe out years of market growth. As such, interested parties must take steps to ensure that the ‘right’ method is used when moving assets to or from retirement accounts.

The Cost of Mistakes

- Erosion of years of savings and growth
- Loss of Tax-Deferred Status
- Double Taxation
- Excise Tax
- Early Distribution Penalty



#1:Being Subject to the 10% Early Distribution Penalty When It Could Have Been Avoided

Early Distribution

- Taken before account owner reaches age 59-½
- Subject to a 10% additional tax (early distribution penalty) unless an exception applies
- Plan trustee/IRA Custodian does not pay/withhold penalty
- Penalty is reported on tax return

Traps: Exception by Account Type

- Some apply to IRAs
- Some apply to employer plans
- Some apply to both

Examples

- The age 55 exception
- Spouse beneficiary treating as own

Case: Exception Confusion on Age 55 Exception

The Case: Young Kim, (CA 7 05/09/2012) 109 AFTR 2d 2012-751

Confusion: Age 55 exception applies to non-IRAs. It does not apply to IRAs.

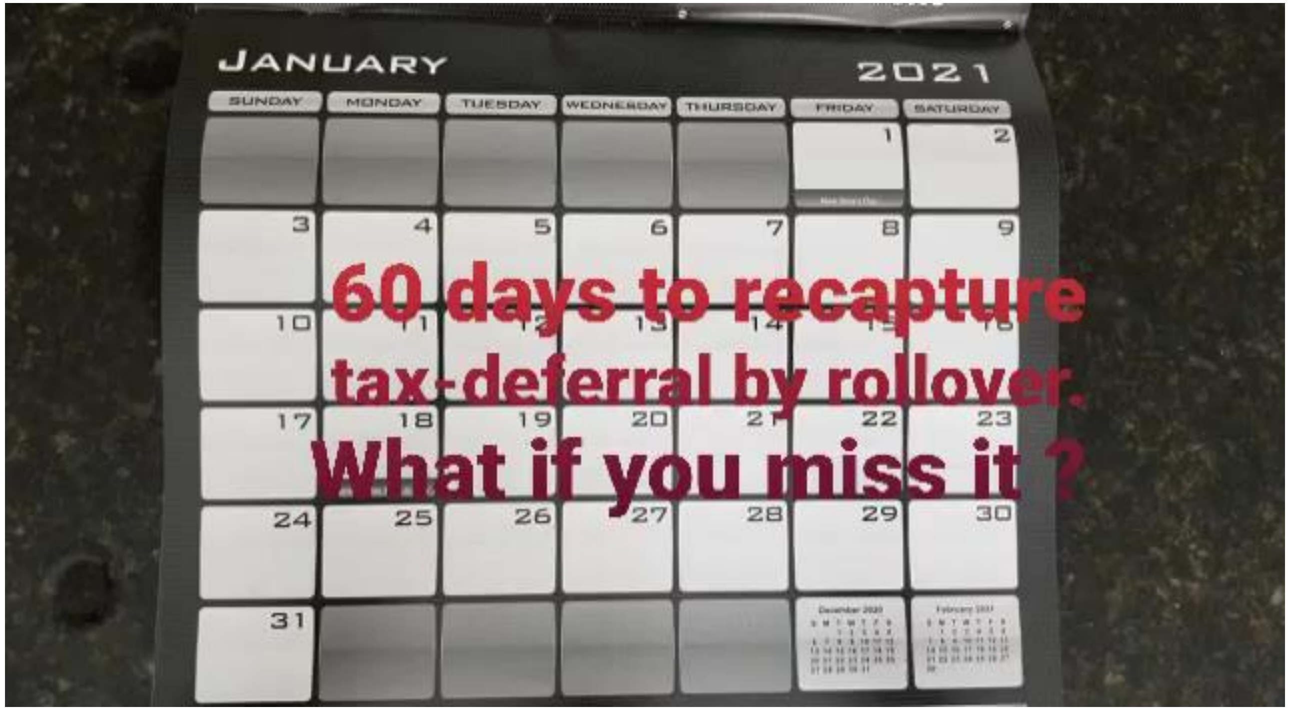
- Participant separated from service at age 56 and rolled over his balance from qualified plan to IRA.
- He withdrew $240,000 from his IRA at age 56.
- The tax court ruled that he was liable for the penalty and owed $20,456.50.

Case: Spouse Beneficiary Mistake Cost $$$$

The Case: *Peggy Ann Sears v. Commissioner*, T.C. Memo. 2010-146

Confusion: Whether Death Penalty exception applies when "spouse treats as own"

- The individual inherited her husband’s IRA. Transferred to her "own" IRA.
- She made withdrawals from the IRA while she was under age 59 ½ but did not pay the penalty.
- The IRS amended her tax return to assess the 10% early distribution penalty: $6,093.70.
- The tax court agreed.



#2: Losing Tax Deferred Status by Missing the 60-Day Rollover Deadline

60-Day Rollover Avoids Income Inclusion

- Distributions are usually included in income, unless properly rolled over
- Rollovers of amounts distributed to participants must be completed within 60 days of receipt

Solutions to 60-day rollover

- Automatic waiver
- Self-certification
- Private letter ruling

#3: Losing Tax-Deferred Status by Breaking the One-Per-12-Month Rollover Rule

"Breaking the one-per-12-month rollover rule for IRAs is like breaking an egg. It cannot be put back together." Denise Appleby

The One-Per-12-Month Rollover Rule

- Rule: Only one IRA-to-IRA 60-day rollover may be performed by an individual during a 12-month period

Cost of breaking rule

- Loss of tax-deferred status
- Excess IRA contributions from rollovers
- 6% excise tax if not corrected

Lesson opportunity for clients:

How to Avoid the One-Per-12-Month Rollover Limitation

Case: One-Per-12-Month Rollover Limitation

Bobrow, T.C.M. 2014-21

- The limitation applies on an aggregate basis
- IRS published guidance is not binding precedent
- Publication 590 would not have served as substantial authority

Cost

- Loss of tax-deferred status of amount
- 6% excise tax for every year amount remained in IRA
- Deficiency of $51,298 in income tax for taxable year 2008
- An accuracy-related penalty under §6662 of $10,260

Eligible amounts only

#4: Rolling Over Amounts That Are Ineligible for Rollover

Not All Distributions Are Eligible for Rollover

Cost of breaking rule

- Loss of tax-deferred status
- Excess IRA contributions from rollovers
- 6% excise tax if not corrected

Examples of Ineligible Rollovers

- Required minimum distributions
- Hardship distributions
- Excess contributions
- Rollovers that break the one-per-year IRA-to-IRA rollover rule
- Rollovers that miss the 60-day deadline
- **Employer Plans:** Administrator must inform participants of rollover eligibility of amount

Ineligible Rollover Consequences

Rollovers of ineligible amounts are treated as regular IRA contributions

- Subject to regular IRA contribution limits
- Creates excess contribution that is more than regular IRA contribution limit
- Must be corrected as return-of-excess if results in excess , or will be subject to 6% excise tax for every year it remains in IRA (statute of limitations apply)

#5: Unintentionally Distributing an Inherited Retirement Account by Moving as a Rollover Instead of as a Transfer

Beneficiary Continuing Tax-Deferral

- Beneficiaries of retirement accounts can continue enjoying tax deferral of those assets- except for RMDs - but must take certain precautions in order to do so
- Mistakes made with distributions and portability can result in loss of tax deferral opportunity

Beneficiary Rollovers

IRAs

- Nonspouse beneficiary may **not** roll over distributions from inherited IRAs
- Spouse beneficiary may **not** roll over distributions from inherited IRAs to another inherited IRA, but may rollover to own IRA

Cost Of Wrong Move With Inherited Retirement Accounts

- Unintended distributions
- Loss of tax-deferred status
- Ineligible rollovers resulting in excess contributions

$X × 6% × Years = -$$$

#6: Failing to Correct Errors That Rack Up the 6% Excise Tax

6% Excise Tax on Ineligible Rollovers Not Corrected

- Excess IRA contribution must be corrected by tax filing due date, plus extensions
  - Must include any net income attributable (NIA)
- 6% excise tax applies if not corrected by deadline. Applies for every year excess remains in IRA
- **New**: 6-year statute of limitations with filing tax return

#7: Failing to take RMDs and Racking up the 25% Excess Accumulation Penalty

Required Minimum Distributions

- A minimum amount that must be withdrawn from a retirement account, by applicable deadline
- For owners- must begin by required beginning date (RBD)
- For beneficiary accounts- determined by DOD of owner, relationship to owner and beneficiary status
- Subject to a 25% excise tax if not withdrawn by deadline
- Excise tax can be waived under certain circumstances

Caution:
1959 falls into two categories

Year/date of birth	Attained age relevant to RMDs	Applicable age (age at which RMDs begin)
June 30, 1949, and earlier	• Attained age 70½ before 2020	The year the participant/IRA owner attained age 70½
July 1, 1949–December 31, 1950	• Attained age 70½ after 2019. • Attained age 72 before 2023	The year the participant/IRA owner attained age 72 © Denise Appleby 2024
January 1, 1951–December 31, 1959	• Will attain age 72 after 2022. • Will attain age 73 before 2033	The year the participant/IRA owner attains age 73
January 1, 1959, and after	• Will attain age 74 after 2032	The year the participant/IRA owner attains age 75

Excess Accumulation Penalty

- 50% before 2023
- 25% as of 2023
- Reduced to 10% if corrected timely
- **Observation**: Waiver option not repealed
- The IRS may waive the penalty, if the failure to meet the deadline was due to reasonable cause

Tax Return Preparer Handles Penalty Reporting/Waiver

- Reported on IRS Form 5329
- Information about procedures available in instructions for Form 5329 at www.irs.gov

#8: Failing to Get the Proper Documentation for Splitting a Retirement Account Due to Divorce

Transfer Due to Divorce

General Requirements

- Spouse/former spouse awarded IRA
- Must “transfer” to receiving spouse’s IRA
- Require divorce decree or legal separation agreement

Transfer Method Should Be Used

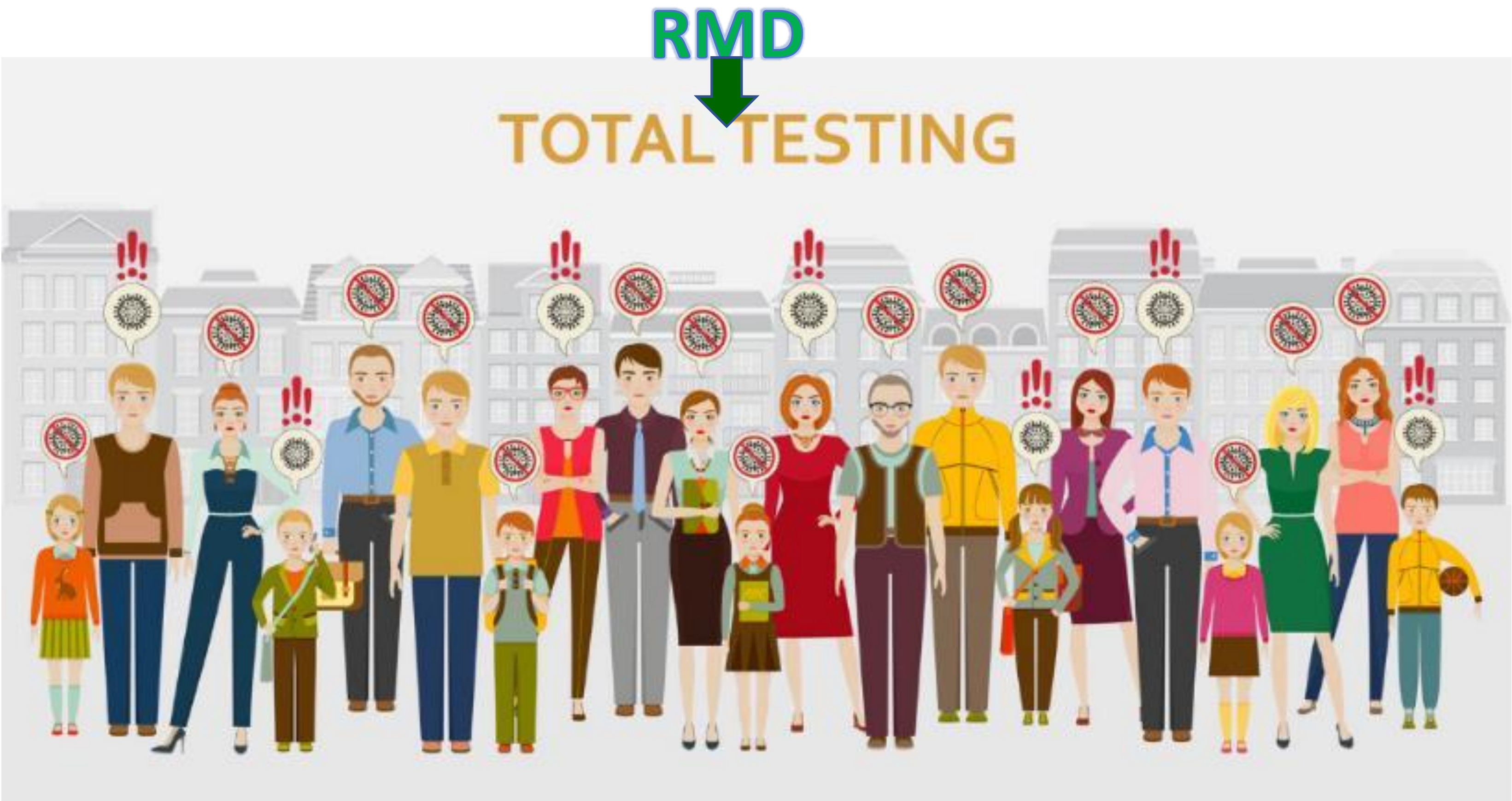
If distributed to former spouse, not treated as transfer due to divorce

- Regular distribution to IRA owner
- Not eligible to be credited to former spouse's IRA

Court Case: No Divorce Decree

***Summers v. Comm'r*, T.C. Memo. 2017-125, 2 (U.S.T.C. Jun. 26, 2017)**

- Jeremy Ray Summers (age 35)- paid of his ex-wife’s, Karie Rae Summers, credit card bills.
- No transfer due to divorce



#9: Misapplying the RMD Aggregation Rules & Being Blindsided by the 50% Penalty

RMD Aggregation

Impermissible RMD Aggregation leads to shortfall

Multiple Traditional IRAs

- RMDs must be calculated separately
- Can be totaled and taken from one or more IRAs

Multiple 403(b)s

- RMDs must be calculated separately
- Can be totaled and taken from one or more 403(b)s

Multiple Employer Plans [pension, 401(k), etc]

- RMDs must be calculated separately
- Must be taken from each plan (cannot be combined)

RMDs: Multiple Inherited Accounts

Multiple Inherited IRAs

- RMDs must be calculated separately
  - Can be totaled and taken from one or more IRAs, providing the IRAs were inherited from the same person
- RMDs for inherited traditional IRAs cannot be taken from inherited Roth IRAs and vice versa
- RMDs for an individual's "own" IRA cannot be taken from Inherited IRAs and vice versa
- RMDs for inherited qualified plan, 403(b), and 457(b) plan/accounts cannot be taken from IRAs and vice versa

#10: Failing to Claim Available Tax Reduction Benefits

Net Unrealized Appreciation

- NUA is the growth on employer stocks, while being held in a qualified retirement plan
- NUA eligible for special tax treatment if part of a lump-sum distribution
  - When employer stock is distributed, basis is taxed as ordinary income
  - NUA is taxed at long-term capital gains rate
  - NUA taxed when stock is sold
- Special tax treatment is lost if stocks are rolled over

Cost of missing out

- Missed opportunity for tax reduction strategy

Check for Net Unrealized Appreciation

- Review client's statement before distribution is requested
- Check for employer securities
- Ensure lump-sum distribution if NUA is desired

Failing to Track Basis in IRAs

Sources

- Nondeductible IRA Contributions
- Rollover of after-tax amounts from employer-sponsored retirement plan

Overriding Custodians Report To Claim the 10% Penalty when Eligible

- IRA custodians and plan trustees are required to report exception in Box 7 of Form 1099-R, but only for certain distributions
- Examples include:
  - First time homebuyer
  - Health insurance medical expenses exception
- IRS Form 5329 must be filed to claim exception, when not reported by issuer of 1099-R

Can Mistakes Be Fixed?

Can Mistakes be Fixed?

- Solutions might depend on:
  - The type mistake,
  - Who made the mistake
- Look for available remedies
- Work with IRA Custodian to correct mistakes made by advisor/custodian
- Where applicable, seek PLR

Takeaways for Advisors

- IRAs are complex. Always double-check when there is not 100% certainty
- Using the ‘wrong’ method to move an IRA could be disastrous
- Look for fixes before giving up
- Make corrections timely

Contact Information

Denise@ApplebyconsultingInc.com

Questions?

Denise@ApplebyconsultingInc.com