Motley Fool's *Rule Your Retirement* Newsletter

Everything You Need to Know About IRA Rollover Rules

Adam Levy

March 15, 2019

Rolling over a retirement account into a different type of account can be a savvy financial move. It can open up more investing options or help reduce how much you pay in taxes.

But if you're not careful, you could break some big IRA rollover rules and end up paying a big penalty to the IRS, which can put a serious dent in your retirement savings.

What are the biggest rollover rules?

Here are some of the most important IRA rollover questions to know the answers to:

- What's an IRA rollover?
- Which accounts can you roll over to?
- How do you do an IRA rollover?
- What is the 60-day rollover rule?
- What is the IRA one-rollover-per-year rule?
- What is the same-property rollover rule?
- Which distributions are not eligible to roll over?
- How do you find your IRA rollover options?
- What are the rules for rolling over an inherited IRA?

- Do you have to roll over your entire account balance?
- Can you roll over funds from employer-sponsored retirement plans?
- What is the aggregation rule?

What's an IRA rollover?

A rollover isn't just a trick you can teach your dog. It's a way to take the assets in one type of retirement account and move them to another.

You can often roll over assets "in kind," meaning the mutual funds, bonds, and stocks you own in one brokerage account are transferred directly to the brokerage account you're rolling them into. Sometimes, however, you must liquidate, or sell, your assets first and transfer them in cash.

One of the most common types of rollovers entails taking the funds from a 401(k) or other employer-sponsored retirement plan with a former employer and rolling them over to an IRA. When you leave the workplace, you become eligible to take distributions from your employer-sponsored retirement plan. But if you're under 55, you'll probably have to pay a 10% penalty on those distributions on top of having to pay taxes. One distribution option is to roll over the 401(k) to an IRA or another qualified retirement plan, which will prevent you from paying that penalty.

Additionally, rollover IRAs typically offer lower investment fees and better investing options than 401(k) plans. That's why most people recommend maxing out IRA contributions before maxing out 401(k) contributions (but you should always get the company match on your employer-sponsored retirement plan first). Your situation may be different and your retirement plan may offer lower fees and access to funds IRAs don't. Be sure to check before you decide to roll over your funds.

Another common rollover consists of rolling over funds from a traditional IRA to a Roth IRA. The two types of IRAs have different tax treatments. Traditional IRAs offer a tax deduction the year you contribute, but you pay taxes on your distributions. Roth IRAs require you to pay taxes the year you contribute, but you don't pay any taxes on distributions. Rolling over traditional IRA assets to a Roth IRA requires you to pay taxes on the distribution, but could ultimately save you taxes in the long run.

The traditional-IRA-to-Roth-IRA rollover is a way to make contributions to a Roth IRA if you're not eligible to make direct contributions to a Roth account or for a tax deduction for a traditional IRA. That's called a backdoor Roth.

Which accounts can you roll over to?

There are a whole bunch of different retirement accounts: employer-sponsored retirement plans, self-employed plans, governmental plans, and IRAs. Plus, there are both traditional and Roth versions of many of those plans. You might find yourself with several different types of brokerage accounts during your career, and if you don't know their rollover distribution options, you could make a costly mistake.

The IRS provides a lovely chart detailing which types of brokerage accounts are eligible for rollovers.

From/To	Roth IRA	Traditional IRA	SIMPLE IRA	SEP-IRA	Governmental 457(b)	Qualified Plan (Pre-Tax)	403(b) (Pre-Tax)
Roth IRA	Yes	No	No	No	No	No	No
Traditional IRA	Yes	Yes	Yes, after two years	Yes	Yes	Yes	Yes
SIMPLE IRA	Yes, after two years	Yes, after two years	Yes	Yes, after two years	Yes, after two years	Yes, after two years	Yes, after two years
SEP-IRA	Yes	Yes	Yes, after two years	Yes	Yes	Yes	Yes
Governmental 457(b)	Yes	Yes	Yes, after two years	Yes	Yes	Yes	Yes
Qualified plan (pre-tax)	Yes	Yes	Yes, after two years	Yes	Yes	Yes	Yes
403(b) (pre-tax)	Yes	Yes	Yes, after two years	Yes	Yes	Yes	Yes
Designated Roth account (401(k), 403(b), or 457(b))	Yes	No	No	No	No	No	No

TABLE SOURCE: IRS.

First, you'll notice that tax-deferred accounts can roll over into Roth accounts, but not vice versa. Importantly, such rollovers are now irreversible since the Tax Cuts and Jobs Act went into effect. It used to be possible to recharacterize Roth IRA contributions to traditional IRA contributions if done within the same year, but the new tax law removed that option.

Second, you can always roll over a brokerage account into the same type of account. That's useful if, for example, you get a new employee-sponsored retirement plan that offers significantly better investment options and lower fees than your old retirement plan or your IRA. Or if you find another broker with better investment options than your current broker, you can roll over funds to your new brokerage account.

Finally, you can roll over an IRA into an employer-sponsored retirement plan. While most people usually think of rollover accounts as a rollover from an employer-sponsored retirement plan to an IRA, sometimes going in the opposite direction can be useful. It's good to know what distribution options are available. You never know when it might be handy.

How do you do an IRA rollover?

There are two ways you can execute an IRA rollover. A direct rollover is usually preferable to an indirect rollover because there are fewer steps involved and less liquidity required on your part.

When you roll over the assets from one retirement account to another brokerage account without touching the funds personally, it's called a direct rollover. This can be done with an in-kind transfer or by writing a check payable to the new rollover account. If you're rolling over an employer-sponsored retirement plan, contact the plan administrator for instructions.

In an indirect rollover, you'll receive a distribution check from your retirement plan. The custodian will withhold 20% of your distribution to pay taxes and send that money straight to the IRS. It's the responsibility of the account holder to make up for the taxes paid when rolling over those distributions into a different brokerage account by contributing their own money.

For example, if you left $10,000 in your 401(k) at your old job and did an indirect rollover, you'd receive a check for $8,000. The government receives a payment of $2,000. You'd have to take that $8,000 plus $2,000 of new money and deposit it into your rollover IRA in order complete the rollover. If you only deposited the $8,000 into your brokerage account, you'd owe taxes and a penalty on the $2,000 sent to the IRS.

There's another type of pseudo-rollover called a trustee-to-trustee transfer. You can ask the financial institution holding your IRA to make the payment directly from your IRA to another IRA or to a retirement plan. This is useful if you simply want to switch brokerage accounts or if you want to split a big IRA into smaller accounts. No taxes will be withheld from your transfer amount, and the transfer isn't subject to the one-per-year rule for IRA rollovers (see below).

What is the 60-day rollover rule?

When you execute an indirect rollover, you can't just hang onto your distribution check for as long as you want. You made a deal with the government that you're going to use those funds to save for retirement, so that's what you have to do. The IRS gives you 60 days from the distribution date to roll the funds into another qualified brokerage account.

If you don't complete the rollover within 60 days, the distribution will be treated as a regular withdrawal. That means you'll have to pay taxes on the entire amount and could be subject to an early withdrawal penalty of 10%.

Since you can roll funds from one account to the same type of account, the 60-day rollover rule allows you to borrow funds from your IRA without penalty, interest-free. While many 401(k) plans offer a loan option, in which you can take out funds and then pay yourself back with interest over time, there's no such thing for an IRA -- but if you only need the funds for a few days, you can "roll over" funds from your IRA back into the same brokerage account. Keep in mind that you could face stiff penalties if you don't meet the 60-day rule, though.

What is the IRA one-rollover-per-year rule?

If you're rolling over funds from a traditional IRA, SIMPLE IRA, or SEP-IRA to another one of those types of accounts, you're only eligible to do that once per rolling-12-month period. As of 2015, you can only do one rollover of that kind every 12 months regardless of how many brokerage accounts you own. (Before then, it was limited by the number of IRA brokerage accounts.)

Importantly, the one-IRA-rollover-per-year rule doesn't apply to rollovers from a tax-deferred IRA account to a Roth account. It also doesn't apply to rollovers to or from employer-sponsored retirement plans.

The point of the rule is to close the loophole that made it possible to string together 60-day rollover loans from a bunch of separate IRA brokerage accounts. By doing so, people who timed everything properly could save on taxes by deducting traditional IRA contributions, but still have the money in the IRA available for personal spending.

If you don't follow the once-per-year rule, every rollover after your first could be subject to the 10% early withdrawal penalty, and you'll have to pay taxes on the distribution. You could also face a penalty for overcontributing to your IRA if you put funds that aren't eligible for a rollover back into your brokerage account.

What is the same-property rollover rule?

When you execute a rollover, you have to contribute the same property that you withdrew from your original brokerage account. If you, for example, received a check for an indirect rollover, bought some stock with the distribution proceeds, then tried to transfer that stock to another retirement account, you'd violate the same-property rule.

Violating the same-property rule treats the distribution as a normal withdrawal, which you'll have to pay taxes on and could owe a 10% early withdrawal penalty.

Which distributions are not eligible to roll over?

There are a couple of distribution options that aren't eligible to roll over into another tax-deferred brokerage account.

Required minimum distributions (RMDs) are the biggest. These mandatory distributions start at age 70 1/2 for all tax-deferred accounts like a traditional IRA. They exist because the government wants you to start paying taxes on the funds in your retirement account. If you were able to roll over required minimum distributions into another tax-deferred account, it would completely negate their purpose.

The other ineligible distribution option in IRAs is any distribution of excess contributions and related earnings. These funds accumulate when you put in more than the contribution limit for your IRA. These funds were never eligible for the preferential tax treatment, so allowing people to roll that money to another tax-advantaged account doesn't make sense.

Employer-sponsored retirement plans have even more restrictions on rollover distribution options. Here's a list of what's not eligible:

- Required minimum distributions
- Loans treated as a distribution
- Hardship distributions
- Distributions of excess contributions and related earnings
- A distribution that is one of a series of substantially equal payments
- Withdrawals electing out of automatic contribution arrangements
- Distributions to pay for accident, health, or life insurance
- Dividends on employer securities
- S-corporation allocations treated as deemed distributions

How do you find your IRA rollover options?

If you don't make an election to roll over your employer-sponsored retirement plan to another retirement account when you leave the workplace, the plan administrator must give you a written explanation of your rollover distribution options.

The plan administrator may deposit an amount between $1,000 and $5,000 into an IRA in your name if you don't make an election. If you have less than $1,000 in your employer-sponsored retirement plan, the administrator may send you a check with 20% taxes withheld. You'll have 60 days to complete a rollover without penalty from the time you receive the distribution.

What are the rules for rolling over an inherited IRA?

If you inherit an IRA, your best option is usually to set yourself up as the beneficiary of an inherited IRA account and take the required minimum distributions (RMDs). You'll owe whatever taxes you'd regularly owe on that type of account distribution, but you won't receive a penalty even if you're under 59 1/2.

The big exception is if you're inheriting your spouse's IRA, in which case you can roll over the assets of the inherited IRA into a brokerage account in your name and treat the assets as your own. That gives you greater control over the distribution options and the taxes you owe.

Do you have to roll over your entire account balance?

When you execute a rollover, you don't have to transfer the entire brokerage account balance from one account to another. That's an important thing to note if you're interested in making a rollover from your traditional IRA to a Roth IRA.

If you have a year of low income, it might make sense to roll over some funds from a traditional IRA to a Roth IRA. It would be quite a tax burden if it were an all-or-nothing option. But by selecting an appropriate amount to roll over to a Roth that year, you can save on taxes in the long run.

Can you roll over funds from employer-sponsored retirement plans?

Typically, you must separate from service in order to become eligible to take a distribution from an employer-sponsored retirement plan and roll it over into an IRA or an account of your choice. There are exceptions, however.

If your employer plan offers in-service withdrawals, you could roll over your employer-sponsored retirement plan funds to an IRA. That's especially useful if the investment options in your 401(k) are subpar. (That said, plans that offer in-service withdrawals usually have some of the best investment options.) In-service withdrawals combined with the option for after-tax contributions would enable you to execute the mega-backdoor Roth IRA.

What is the aggregation rule?

One last rule to consider when rolling over a retirement account is the aggregation rule, which comes into effect when you mix tax-deferred funds and after-tax funds together.

If you're not eligible for a tax deduction on your traditional IRA contributions, you may be taking advantage of the backdoor Roth IRA. That works because the funds you contribute are all after-tax funds.

But if you roll over another retirement account with tax-deferred funds into a traditional IRA, then you suddenly have both tax-deferred and after-tax funds in your IRAs when you go to make your backdoor Roth conversion. The aggregation rule says that you must treat any distribution from an IRA, including a rollover to a Roth account, as a blend of the types of funds (tax-deferred and after-tax) in the original account.

For example, if you have a 401(k) with $95,000 in it and roll that over into an IRA when you leave your job, you now have an IRA with $95,000 in tax-deferred funds. If you make an after-tax contribution to your IRA that year of $5,000 with the intention of doing a backdoor Roth, you'll end up with quite a surprise come tax time. Of the funds in your IRA, 95% are tax-deferred, so when you make a $5,000 distribution to roll over to a Roth IRA, you'll owe tax on 95% of that $5,000, or $4,750.

That's on top of paying taxes on the original $5,000 after-tax contribution.

Note that the aggregation rule applies to all of your IRAs, so even rolling over your old 401(k) to an IRA at a separate brokerage account won't protect you. The best course of action is to roll over tax-deferred funds into a non-IRA retirement account first (or keep them in your old 401(k)), do your backdoor Roth, and then roll them back over to the IRA if you desire.

Know the rollover rules

When it comes to moving your retirement funds around, there are quite a few rules to follow. But if you stick to the guidelines, you shouldn't have any problems getting your money where you need it to go.

Things can get tricky when you try to get creative with your money, and if you don't know the rules or miss a deadline by even just a day, you could pay dearly. Be careful out there!