

FATAL ERROR: MISTAKES THAT CANNOT BE FIXED – PART 1

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When a transactional mistake is made with retirement plan or IRA assets, there is oftentimes a mechanism to correct the error. For example, if too much money is contributed to an IRA, a person can leverage the excess contribution withdrawal rules to remove the excess without penalty (assuming the excess is withdrawn prior to the October 15 correction deadline). In another example, if an IRA owner failed to take his required minimum distribution (RMD), there are procedures in place whereby the person can take the missed RMD and formally request a waiver of the missed RMD penalty from the IRS.

On the other hand, some transactional mistakes have no corrective steps. Once the deed is done, there is no going back. Such missteps can create massive tax bills and result in unintended penalties. Many of these “fatal errors” involve rollovers. Here are a few:

Non-Spouse Beneficiary Rollovers. Only a spouse beneficiary can move inherited plan or IRA dollars between custodians via 60-day rollover. Non-spouse beneficiaries can only move inherited dollars via direct transfer. If pre-tax inherited IRA or plan funds are distributed and payable to a non-spouse beneficiary, those dollars are taxable. End of story. If the recipient tries to roll over the funds, the doors at all potential receiving institutions will be closed. There is no transaction a non-spouse beneficiary can do to reverse what has been done. Any taxes due will be due. As such, it is imperative that non-spouse beneficiaries understand the rollover rules and limitations when attempting to move inherited plan or IRA funds. Failure to do so could result in a significant tax bill and eliminate any ability to spread taxable distributions over a multi-year period.

Spousal Rollover. Spouse beneficiaries are the only beneficiaries that can move inherited dollars into their own account. This is called a “spousal rollover.” However, once this common transaction is completed, it cannot be unwound. If a surviving spouse under age 59½ does a spousal rollover, the inherited assets will follow all the normal rules applicable to a person’s own IRA – including the early distribution rules. If the young surviving spouse then takes a withdrawal from the account, a 10% early distribution penalty will apply (unless an exception exists). If a young spouse knows that she will need access to the funds, a better choice is to delay the spousal rollover for now and maintain an inherited IRA. Any withdrawals from the inherited IRA will be penalty-free, and she can always do a spousal rollover later, after she turns age 59½.

Exceeding the One-Rollover-Per-Year Rule. An IRA owner is only allowed to roll over one distribution received within any 12-month period (for IRA-to-IRA or Roth-IRA-to-Roth-IRA rollovers). If more than one rollover is done, that mistake cannot be fixed. The illegal rollover is deemed to be an excess contribution in the receiving IRA and must be removed. Any pre-tax dollars included in the failed rollover will be taxable. Note that the one-rollover-per-year rule also applies to spousal rollovers if done via 60-day rollover. To sidestep the one-rollover-per-year rule, do direct transfers.

In Part 2 (to be published on March 11), we will discuss more fatal errors that cannot be fixed.

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