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What a non-spouse should know when inheriting an employer sponsored retirement plan

If you are a non-spouse beneficiary who inherits a qualified employer sponsored retirement plan (QRP) such as a 401(k), 403(b), or governmental 457(b), you should know the rules around claiming these assets. You have several options available to you including a lump-sum distribution, disclaiming the assets, transferring, or perhaps converting that plan balance to an Inherited Individual Retirement Account (IRA).

The distribution options you will have in the Inherited IRA depend on your beneficiary category of either an Eligible Designated Beneficiary (EDB), a Designated Beneficiary (DB) or a Non-Designated Beneficiary (NDB).

A Non-spouse EDB is defined as:

- Disabled or chronically ill individuals
- Individuals not more than 10 years younger, the same age, or older than IRA owner
- Child of the account owner who has not reached age of majority
- Non-spouse individuals who inherited a QRP from a plan participant who died before 2020[1]

A DB is defined as someone who inherits a QRP from a plan participant who dies in 2020 or after and is a:

- Non-spouse more than 10 years younger than IRA owner
- Qualified trust
- Minor that is not the child of the IRA owner
- Child of the IRA owner who has exceeded the age of majority

An NDB is defined as the following:

- Estate
- Non-qualified trust
- Charity

Options for your inherited QRP assets

Before taking any action with your inherited QRP, review your options:

- **Lump-sum distribution** — When you have a check made payable to you it is considered as a lump-sum distribution. This could increase your tax bracket because the taxable distribution of the inherited retirement assets is included as part of all the ordinary income you have for the year. It is important to understand that if you do take a lump-sum distribution, you will not be able to roll it to an Inherited IRA or your own IRA afterwards.
- **Disclaim** — If you want to disclaim the assets, they would need to remain in the plan until the qualified disclaimer is completed. A disclaimer is generally accomplished within nine months of the plan participant's death.
- **Direct rollover to an Inherited Traditional IRA** — A direct rollover from the QRP to an Inherited Traditional IRA will keep the assets and potential growth tax-deferred while taking distributions. This option is available to trusts but not estate and charity QRP beneficiaries.
- **Inherited Roth IRA Conversion** — Making a direct rollover to an Inherited Roth IRA would be considered a conversion from the plan, triggering taxes on any taxable amount. After-tax amounts in the plan might make this

[1] A beneficiary of a participant of a governmental retirement plan [as defined in section 414(d)] who dies after December 31, 2021 will follow the SECURE Act rules. If these participants die on or before December 31, 2021, the pre-SECURE Act death distribution rules apply.

strategy worthwhile because those amounts are not taxable income. Any before-tax amount converted will be included in your gross income for the year. Paying tax on any before-tax dollars converted may not be beneficial if you take distributions soon after the conversion. This option is available to trusts but not estate and charity QRP beneficiaries.

- **Direct rollover to an Inherited Roth IRA** — If you inherit a designated Roth account, you can only directly roll those assets to an Inherited Roth IRA. This option is available to trusts but not estate and charity QRP beneficiaries.

Steps to take to transfer to an Inherited IRA

The below are steps to take if you choose to directly rollover the inherited plan assets to an Inherited IRA:

- Contact your financial advisor to establish an Inherited IRA.
- Contact the deceased's QRP administrator for any paperwork needed.
- Work with your financial advisor to complete the direct rollover of the assets into an Inherited IRA.
- Complete the direct rollover prior to the end of the year following the year of the plan participant's death.

If you are one of multiple beneficiaries you will each be best served by setting up separate Inherited IRAs by December 31 following the plan participant's year of death. This allows each of you to take advantage of the distribution option available to your particular beneficiary category, manage investment decisions, and name successor beneficiaries.

Only direct rollover allowed

It is important to note that you cannot complete an indirect rollover; only a direct rollover is allowed. A **direct rollover** is a non-taxable distribution from the QRP that is sent directly to the new custodian and will be reported to the IRS as a rollover. Failure to employ the direct rollover process could make this transaction fully taxable, ending the tax-deferral available under the Inherited IRA.

In other words, you must never touch the funds and the check should never be issued in your name. If it goes to your own IRA or to another account the distribution is taxable.

Keep in mind

Here are a few things you should know when inheriting a QRP:

- The rollover from the QRP to an Inherited Traditional IRA or from the designated Roth account to an Inherited Roth IRA is not considered a taxable event.
- You will owe tax on the taxable amount converted from the QRP to an Inherited Roth IRA.
- After-tax QRP amounts converted are not subject to tax.
- You will avoid the IRS 10% additional tax for early or pre-59½ distributions (10% additional tax) from the Inherited IRA, no matter your age, because such distributions are coded as a "death distribution."
- You will owe ordinary income tax but not the 10% additional tax on any taxable portion of a QRP distribution that is not directly rolled over.
- You may be able to directly roll assets "in-kind" instead of selling. Ask the plan administrator if this is an option.
- You will need to satisfy, from the QRP, any RMD the plan participant should have taken by December 31 of the year of death.
- You are responsible for only the portion of the deceased's RMD based on the portion of the QRP that you inherited.
- Designated Roth accounts have RMDs, unlike Roth IRAs.
- Check with the sponsor of the QRP about taking any RMD prior to directly rolling the funds to the Inherited IRA. You cannot roll an RMD.
- Any RMD not taken in the year due is subject to an IRS 50% excise tax for every dollar under-distributed.
- Taking annual RMDs beginning the year following the death of the plan participant, no matter how old they were, will allow an EDB to take advantage of the stretch IRA strategy.[2]
- You cannot convert a Traditional IRA you inherit to an Inherited Roth IRA.
- A QRP directly rolled to an Inherited Traditional IRA cannot be converted later to an Inherited Roth IRA; you must make the decision to convert before rolling over.
- You cannot undo or recharacterize a Roth conversion.

[2] Stretching an IRA simply refers to the ability to take RMDs over the beneficiary's single life expectancy (using the term-certain calculation method) rather than over the life expectancy of the original IRA owner.

Understanding your options

You have a few decisions to make if you have been named as the beneficiary of a QRP. It is important to understand each option because certain distribution methods preserve the account's tax-advantaged status while others do not. Keep in mind that after a distribution is taken from retirement assets you inherit, you are not able to put it back.

- **Open an Inherited IRA** — An Inherited IRA allows you to keep the funds growing tax-advantaged, in an IRA, while taking distributions. The account titling will always refer to the deceased plan participant along with you listed as the beneficiary. Since you aren't the owner, you may not make contributions including a 60-day rollover deposit to this account. The benefit of this arrangement is that you have the option to distribute the funds over time and are taxed only on the amount included in gross income.

Inherited IRA distribution options are:

- **Designated beneficiary**

  Under the SECURE Act, these beneficiaries will now be subject to the 10-Year Rule.

  10-Year Rule – This option is available for Inherited Roth and Inherited Traditional IRAs. The Inherited IRA must be emptied by the 10th year following the year of the plan participant's death. No distributions are required before the 10th year. Depending on the size of the account, you may want to spread distributions over the 10-year period.

- **Eligible designated beneficiary**

  – **Life expectancy:** This option is available for Inherited Roth and Inherited Traditional IRAs. The Wells Fargo Clearing Services, (WFCS) LLC IRA Custodial Agreement default is the Life Expectancy option. You may be subject to an IRS 50% excise tax for every dollar under-distributed. You will take annual RMDs but you can always take more than that amount. RMDs are based on your life expectancy using a divisor from the IRS Single Life Table and the prior year-end IRA value, on a term-certain basis. Term-certain means that one is subtracted from the original divisor in each subsequent year. These RMDs will begin the year following the death of the plan participant.

- **Non-designated beneficiary**

  The option available to the the non-qualified trust depend on if the plan participant died before or after their RBD. If the plan participant died on or after their RBD, RMDs are based on their age in the year of death and the divisor is reduced by one in each subsequent year. If the plan participant dies before their RBD, the 5-year rule is followed.

  5-year rule — Empty the Inherited IRA by December 31 of the year containing the fifth anniversary of your death.

- **Other option**

  This choice is available to all beneficiaries no matter the plan participant's year of death.

  – **Lump-sum:** This strategy will exhaust the entire account in one distribution, with retirement assets losing their tax-advantaged status. Taxes will be due on the taxable portion of the distribution in the year received and may place you in a higher tax bracket. Once a non-spouse beneficiary chooses to take a lump-sum distribution, it cannot be undone.

It is important to note that for EDBs if you have both an Inherited Traditional and Inherited Roth IRA, annual RMDs should be taken from both accounts beginning the year following the death of the plan participant, to take advantage of the stretch IRA strategy.[2]

Naming beneficiaries on an Inherited IRA

Remember you can designate a "successor" beneficiary on the Inherited IRA.

Successor beneficiary of an EDB: It is important to note that the Internal Revenue Code (IRC) does not let a successor beneficiary of an EDB start over and stretch inherited assets out over their own lifetime. Instead, they will use the 10-Year Rule.

Successor beneficiary of a DB: If a DB dies before the end of the 10th year and the account is still funded, their successor beneficiary will have the remaining years of the DB's 10-Year Rule to empty the Inherited IRA.

Beneficiary distribution options when a plan participant dies on or after 1/1/2020[1]

The following table summarizes the options you have depending on your beneficiary type.

	Open an Inherited IRA		
Beneficiary category	**Life expectancy**	**Five-year rule**	**Ten-year rule**
Designated beneficiary:			
- Non-spouse			X
- Qualified trust			X
Eligible designated beneficiary:			
- Disabled or chronically ill individuals	X		X
- Individuals not more than 10 years younger, the same age as, or older than IRA owner	X		X
- Child of the account owner or their qualified trust who has not reached age of majority[3]	X		X
Non-designated beneficiary (owner died before RBD):			
- Non-qualified trust		X	
Non-designated beneficiary (owner died after RBD):			
- Non-qualified trust	X[4]		

[3] The age of majority has not been defined yet

[4] RMDs based on owner's age in year of death

Talk with Wells Fargo Advisors

It is always wise to discuss your options on how to handle your retirement plan inheritance with your financial advisor as well as your tax and legal advisors before executing any strategy. Please contact your financial advisor with any questions you may have. We look forward to working with you today and in the future.

With you every step of the way

Everyone has a different vision of retirement that requires a unique financial strategy. Wells Fargo Advisors can support you in your retirement planning process by providing the guidance needed to make informed choices. We will meet with you and help create a comprehensive plan that takes into account your complete financial picture. Your financial advisor will be with you every step of the way to meet to review your progress and adapt your plan as needed. Working together, we'll design and implement an investment plan that can help you live out your unique vision of retirement.

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