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Inheriting a Roth IRA as a non-spouse beneficiary

When you inherit a Roth IRA as a non-spouse beneficiary, you may want to know what the options are for the inherited assets and whether you will owe taxes on distributions from the account. Your options include taking a lump-sum, disclaiming, or opening an Inherited Roth IRA. The distribution options you will have in the Inherited Roth IRA depend on your beneficiary category of either an Eligible Designated Beneficiary (EDB) or a Designated Beneficiary (DB).[1]

A non-spouse Eligible Designated Beneficiary 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 an IRA from an IRA owner who died before 2020
- Qualified trusts that inherited an IRA from an IRA owner who died before 2020

A Designated Beneficiary is defined as someone who inherits an IRA from an IRA owner who dies in 2020 or after, and is a:

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

It is important to remember that for a non-spouse beneficiary who inherits a Roth IRA the rules for distribution from an Inherited IRA apply. This means:

- No IRS 10% additional tax for early or pre-59½ distributions (10% additional tax).
- An EDB can take advantage of the stretch IRA strategy[2] by taking required minimum distributions (RMDs) no later than December 31 following the year the Roth IRA owner died.
- A DB will follow the 10-Year Rule which states that the Inherited IRA must be emptied by the end of the 10th year following the year of the Roth IRA owner's death. No distributions are required before the 10th year.
- You are not permitted to roll over or transfer an IRA you inherit to your own IRA — only spouse beneficiaries have this option.

Roth IRA distribution rules

Whether you will take a lump-sum distribution, disclaim or open an Inherited IRA with the assets, you first should understand the two types of Roth IRA distributions: **qualified** and **non-qualified.**

- ***Qualified*** distributions, which are tax-free and not included in gross income, occur when the account has been open for more than five years **and** the owner is at least age 59½, or the distribution is a result of their death, disability, or using the first-time homebuyer exception.

[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.
[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.

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- If the Roth IRA owner died before the account had been opened for more than five years, you would have a ***non-qualified*** distribution. Non-qualified distributions from Inherited Roth IRAs may be subject to taxes but no 10% additional tax. The five-year clock will continue in the Inherited IRA and until that fifth year has been reached. The Roth distribution ordering rules are outlined below and may help you understand the tax treatment of your distributions.

Contributions come out first — The first dollars distributed are annual contributions. Because Roth contributions are not deductible, they are not subject to tax. Distributions of contributions can be taken at any time.

Converted dollars are next — After you have exhausted all of the contributions, the next amounts distributed are from any conversions that were completed. These conversion amounts are distributed tax-free on a first in, first out basis.

Earnings are last — The last money distributed is from earnings. Earnings taken before the Inherited Roth IRA has been open for more than five years will be taxed.

EDB Inherited Roth IRA ordering rule hypothetical example

Christine is disabled and considered an EDB. She has inherited her mother Ruth's Roth IRA when Ruth died last year. Ruth first funded the Roth IRA three years ago, with a $6,000 contribution and two years ago, converted $100,000 to the Roth IRA. Christine sets up an Inherited Roth IRA and her first RMD is due December 31 of this year. Since Ruth had not had a Roth IRA opened for more than five years, the ordering rules for distributions apply. Christine consulted with her tax advisor and was informed that her RMD for this year would be below $6,000, the contribution amount, therefore, it will be tax-free under the ordering rules. The five-year holding period for a qualified distribution will end on December 31 of next year, and after that, earnings taken will also be tax-free.

DB Inherited Roth IRA ordering rule hypothetical example

Malik, age 34, inherited a Roth IRA from his Uncle Dwayne who was 77 when he died last year. Uncle Dwayne had completed a Roth conversion of $250,000 last year before he died. He did not have a Roth IRA prior to that. Malik could distribute the $250,000 at anytime with no tax due but would owe tax on any earnings until the five-year holding period has been met. The five-year clock will be met at the end of the 4th year following the death of his uncle. If Malik waits to take a distribution until the 10th year, following the year of his uncle's death, when he is required to empty the Inherited Roth IRA, he would owe no tax on the distribution including any potential earnings.

Talk to Wells Fargo Advisors

Please investigate all the options for handling your inheritance of retirement assets with your tax and legal advisors before enacting a strategy. We, at Wells Fargo Advisors, understand your desire to maximize the benefits you can receive from your IRA inheritance. We look forward to helping you and your family with your financial goals and objectives.

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