

Helping A father Who Has Inherited His Daughter's 401(k) Account

Raul, age 58, has been a bank customer since 1998. He presently does not have an IRA. He does have a 401(k) account at his employer. His daughter Laura, age 31, died March 2014, in a car accident. Laura had designated her father to be the beneficiary of her 401(k) account. The 401(k) plan administrator had contacted Raul to inform him that he was Laura's beneficiary and that her account balance was approximately \$60,000. He has come into the bank seeking some help.

Raul is fairly sure that he will decide to establish an inherited IRA with your financial institution.

Raul will want to ask the 401(k) administrator to provide him the following information: a copy of the plan's summary plan description, a copy of plan's distribution form and a copy of Laura's most recent participant statement showing her various investment account balances.

The summary plan description will provide a discussion of the rights of a non-spouse beneficiary once he has inherited the 401(k) balance of a deceased beneficiary. The plan could be written to allow him to keep the funds within the 401(k) and then withdraw annual required distributions from such plan. Most likely the plan will be written to require Raul as a non-spouse beneficiary to withdraw the inherited IRA funds within a 3-5 year period. One of his options will be to instruct to directly rollover the inherited 401(k) funds into an inherited traditional IRA and/or an inherited Roth IRA. He then could withdraw annual required distributions from the inherited IRA using the life distribution rule. The 401(k) distribution form must present Raul with the following three options. Sometimes the distribution form does a poor job of explaining that there is the third option.

Option #1. He could elect to withdraw the entire balance of \$60,000. Since he, as any non-spouse beneficiary, does not have the right to rollover this \$60,000, the rule requiring mandatory withholding at the rate of 20% does not apply. The tax rules would require that 10% of the distribution be withheld, but he would have the right to instruct to have no withholding. If he chose to withdraw the \$60,000, it would be prudent for him to have 15-25% withheld since he will need to include the \$60,000 in his income and pay the applicable tax liability. As a beneficiary he does not owe the 10% penalty tax even though he is younger than age 59½.

Option #2. He could elect to directly rollover the \$60,000. He has three (3) sub-options. First, he could elect to directly rollover the \$60,000 into an inherited traditional IRA. Although he is required to commence taking required distributions, he will be deferring taxation on most of the funds until later. Second, he could elect to directly rollover the \$60,000 into an inherited Roth IRA. Such a distribution will require him to include the \$60,000 in his income and pay the applicable taxes. He will also be required to commence annual required distributions from the Roth IRA. Once the 5-year rule has been met all such distributions will be tax-free. Third, he could directly rollover a portion to an inherited traditional IRA and then he could directly rollover the remaining portion into an inherited Roth IRA.

Although the law provides a general rule that if the five-year rule applied to the distributions under the 401(k) plan then this rule is to continue to apply to the inherited IRA, there is a major exception which allows the beneficiary to elect to use the life distribution rule. Two requirements must be met. First, the funds must be directly rolled

over before the end of the year following the year of death. Secondly, the life distribution rule must be determined using the same non-spouse beneficiary.

Option # 3, He would withdraw some of the \$60,000 and then he would directly rollover the remaining balance. For example, he could instruct to withdraw \$10,000 and then he would directly rollover the remaining \$50,000 into an inherited traditional IRA and/or inherited Roth IRA. The withholding rules as discussed under Option #1 would also apply to the withdrawal of the \$10,000.

Raul will complete this 401(k) distribution form and furnish it to the 401(k) administrator. Raul should also furnish a copy of this form to you as the IRA custodian of his new inherited IRA. He will need to execute the inherited IRA plan agreement and instruct you how he wishes to have such funds invested. When the funds are sent to your bank, you will be able to process the direct rollover check as he and the 401(k) administrator have instructed.

The right of a non-spouse beneficiary to set up an inherited IRA for funds arising from decedent with a 401(k) account did not exist until January 1, 2007. There will be mothers, fathers, brothers, sisters, and friends who will wish to establish an inherited IRA. You want to be ready to service these individuals. Almost always, they will be long-term customers, as they will be taking partial distributions over their life expectancy.