



## Tax woes ease for 401(k) heirs



## Rules ease tax burden for heirs of a 401(k)



## New rules ease tax burden for heirs of a 401(k)

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September 17, 2006

Thanks to the power of payroll deductions, average 401(k) balances now top \$100,000 for people who have had accounts for six years or more. For those who don't live long enough to exhaust their savings in retirement, these accounts are increasingly a valuable asset to be passed on to heirs. The problem with inherited 401(k) assets has been the tax code. The rules governing 401(k) plans are designed to encourage saving for retirement, not to give tax-favored legacies to heirs.

Starting next year, the rules will be changed to ease the tax burden on a person who inherits a 401(k) or other employer-sponsored retirement account.

Here are some questions and answers on the changes, which were included in the Pension Protection Act signed by President Bush last month.

**Question:** Does the law currently allow people to bequeath 401(k) accounts to heirs?

**Answer:** Yes, but there can be a big tax hit if you leave it to anyone besides your spouse.

Under current law, you can leave all your assets -- including your 401(k) -- to your spouse and there will be no tax assessed on that transfer.

People can even roll 401(k) assets inherited from spouses into their own Individual Retirement Accounts and continue getting tax-deferred earnings within the account. But if you leave a 401(k) to anyone besides a spouse, such as your children, the account generally would have to be cashed out, making the money collected subject to income tax. Companies generally require the account to be drained within one to five years.

Non-spousal heirs not only would have to pay tax on the assets but also could be pushed into a higher tax bracket.

**Q:** What does the new law do to change that?

**A:** It will allow non-spousal heirs to roll a deceased person's workplace retirement fund into a special IRA, known as an inherited IRA. The beneficiary must make annual withdrawals from the inherited IRA but is allowed to spread these out over his or her lifetime. (The IRS publishes life span estimates that vary by age but generally presumes people will live into their early 80s.)

**Q:** Does the change apply just to 401(k) accounts?

**A:** No, the rule applies to all workplace retirement accounts, which include 401(k) accounts and 403(b) retirement plans for teachers and other nonprofit workers. Corporate profit-sharing plans and 457 retirement plans for government workers also qualify.

**Q:** What about IRAs?

**A:** IRAs already have this benefit and are not specifically included in this legislation.

**Q:** What kind of tax savings will people see as a result of the new law?

**A:** For an example, consider a non-spouse with no other income who inherits a \$500,000 401(k).

Under current law, this person would be forced to pay \$199,329 in state and federal income taxes in the year the account was cashed out.

Starting next year, that heir could roll the \$500,000 into an inherited IRA and pay taxes only on the portion that is withdrawn each year. Someone who is 33 years old, for example, would have to withdraw only about \$10,000 from the account in that first year and pay just \$180 in income taxes.

Better yet, the remaining assets in the account get to grow on a tax-deferred basis. "You get decades and decades of tax deferral. It's a huge benefit," said Brent Kessel, a Los Angeles planner with Kubera Portfolios.

**Q:** Does the law do anything else to help heirs of retirement assets?

**A:** Yes. It also helps heirs qualify for a special break in the tax law that affects people who have employer stock in their 401(k). This break is complex, but it can save thousands of dollars in tax.

It's worth mentioning because about 10 million workers -- a little more than 20 percent of all active participants in 401(k) plans -- have company stock in their accounts, said David Wray, president of the Profit Sharing/401(k) Council.

**Q:** How does it work?

**A:** In essence, it allows a retiree -- or the heir of an undistributed retirement account -- to split the account into two. One portion would be made up of employer stock. That amount would be taken as a lump-sum distribution -- in stock -- and the employer stock would be placed in a taxable account. The other portion would be taken out and placed in a rollover IRA.

The stock portion that was distributed would be taxable but only on the cost of the stock. In other words, if the stock was purchased for a total of \$50,000 but is now worth \$250,000, the heir pays ordinary income tax on just the \$50,000 cost. The remaining \$200,000 in value would not be taxable until the stock is sold. And then, it would be taxed at capital gains rates, which max out at 15 percent versus the 35 percent ordinary income tax rate.

The bottom line: This transaction could save an heir 20 percentage points in tax on \$200,000. That's a saving of \$40,000.

**Q:** Is there anything else I should know about retirement plan distribution rules and the new law?

**A:** Whether you are inheriting a retirement plan or retiring yourself, it makes sense to consult a specialist in retirement distribution rules before tapping the account. A retirement plan may well be your biggest liquid asset. False moves in tapping that asset could cost you thousands of dollars in tax. That's money that could be spent on better things, like you.

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