Inheriting a Loved One's Retirement Assets

Financial Planning provided by

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While earlier articles in this column have discussed ways to prepare for our own retirement, this month's article introduces some things to be aware of if we should happen to inherit retirement assets from someone else. If you find yourself in this situation, it is important to get professional help to avoid running afoul of IRS regulations.

If you recently inherited retirement assets from a deceased loved one, it is important to pay attention to IRS rules that govern this type of bequest. Your options in managing this money typically depend on your relationship to the deceased and the type of retirement account (401(k) or 403(b) plan, IRA, or annuity) that you inherited.

Employer-Sponsored Plans

When inheriting a deceased spouse's assets within an employer-sponsored plan, you are not required to pay federal estate or income taxes if the assets are left intact within the estate. After age 70½, you must begin required minimum distributions (RMDs) based on your life expectancy. The formula for calculating the RMDs, which are taxed as ordinary income, is available in IRS Publication 590. This withdrawal schedule typically is preferred to cashing out the entire bequest at once, which is likely to trigger higher tax payments.

If the deceased was not your spouse, the plan's rules generally determine your course of action. Depending on the plan, you may have one or more of the following options: Leave the money in the plan, transfer the money to an IRA created for this purpose, or elect a cash distribution.

Some employer plans offer nonspousal beneficiaries the option of completing a trustee-to-trustee transfer from an employer-sponsored plan to an IRA established for this purpose. The nonspousal beneficiary is required to take annual distributions based on the beneficiary's life expectancy. Note that in this type of scenario, the IRA is opened in the decedent's name for the beneficiary's benefit, and assets transferred to the IRA cannot be comingled with other IRAs that the beneficiary may have established.

In other instances, employer plans can default to a five-year payout rule and require nonspousal beneficiaries to empty the account within five years of the death of the deceased. Distributions taken by nonspousal heirs are taxed as ordinary income.

Before taking any action, it is critical to determine the rules of the deceased's retirement plan and consult a financial advisor or a tax advisor to make sure that you avoid unnecessary taxes.

IRAs

When inheriting a traditional IRA from a deceased spouse, you may designate yourself as the account owner and treat an inherited IRA as your own. This means you can transfer the assets to an existing IRA. These transfers typically do not trigger tax payments as long as you follow the rules for trustee-to-trustee transfers. You may also begin taking distributions, which are taxed as ordinary income. With a traditional IRA, after age 70½, you are mandated to take annual RMDs, which are based on your life expectancy and are taxed as ordinary income.

If the deceased was not your spouse, you cannot transfer assets within an inherited IRA to your own existing IRA. Instead, you have two options: You may take all distributions within five years of the decedent's death or take annual distributions determined by the life expectancy of you or the decedent, whichever is longer.

Annuities

If you receive a survivor annuity, the tax status of periodic payments to you is determined by how much the decedent paid for the annuity contract, which is known as the cost basis.1 If the decedent did not pay for the contract (for example, if it was provided by an employer), periodic payments to you are taxable. Assuming the deceased had a cost basis, the amount up to the cost of the contract is not taxable, but amounts in excess of the deceased's cost are taxed as ordinary income.

Because determining the tax status of annuities and other inherited retirement assets can be complicated, you may want to consult an estate planning attorney or a financial advisor to answer any questions you may have.

Source/Disclaimer:

1An annuity is a long-term, tax-deferred investment vehicle designed for investment purposes and contains both an investment and an insurance component. They are sold only by prospectus. Guarantees are based on the claims-paying ability of the issuer and do not apply to an annuity's separate account or its underlying investments. The investment returns and principal value of the available sub-portfolios will fluctuate so that the value of an investor's unit, when redeemed, may be worth more or less than their original value. Gains from tax-deferred investments are taxable as ordinary income upon withdrawal.