New Law Eases Taxes On Inherited 401(k)s

Heirs Who Aren't Spouses Can Now Roll Over Retirement Accounts Into Their Own IRAs

Congress may have declined to enact sweeping estate-tax cuts, but a new law contains important income-tax relief for many heirs.

Winners under the new legislation, signed Thursday by President Bush, include those who inherit money in an employer-sponsored retirement plan -- such as a 401(k) or a profit-sharing plan -- from someone who wasn't their spouse.

The relevant provision, part of an overhaul of federal pension laws, represents "a major change" in how death benefits are treated for income-tax purposes, says Bill Fleming of PricewaterhouseCoopers in Hartford, Conn. In the past, "we've run into a lot of people who aren't married or who have 'significant others' or who want to leave assets to children, and it was going to create income-tax problems," he says.

Until now, inheriting a retirement plan from someone who wasn't your spouse often created excruciating tax headaches. Even for sophisticated taxpayers, it was remarkably easy to get hit by an unexpectedly big tax bill under the old law.

That's because only a surviving spouse could transfer money inherited from a qualified retirement plan into an individual retirement account. Under the new law, a child or any other non-spouse who inherits money in such a retirement plan can transfer it directly into an IRA. That allows the heir to spread out distributions over numerous years -- and can ease the tax bite considerably.

Most company plans require rapid payment of account balances to heirs after an employee dies, PricewaterhouseCoopers says. In the past, this resulted in some children, grandchildren, "significant others" and other nonspouse beneficiaries getting hit with large amounts of taxes sooner than they had expected.

Congress's Joint Committee on Taxation estimates the change will save taxpayers about $291 million over the next decade alone. But be careful: The new law is effective only for distributions made after the end of this year.

"In my 20 years of practice, I have seen dozens of families and tax advisers who would have benefited" from the new provision, says Robert S. Keebler, a certified public accountant at Virchow Krause & Co. in Green Bay, Wis. In most of those cases, a parent died, leaving retirement-plan money to a child who was forced, under the plan's rules, to withdraw money from the plan within five years -- and, in some cases, immediately, Mr. Keebler says in a new book from CCH, a Riverwoods, Ill., publisher of tax information.

Here's how it works: Suppose a woman dies early next year at age 69 with $1 million in her 401(k) plan. The plan requires that the account balance be distributed to beneficiaries within a year of an employee's death. She had named her 40-year-old son as the sole beneficiary of the plan.

Under the new law, the son can transfer that 401(k) money directly into an "inherited IRA" for his benefit. By doing this, he can stretch out IRA withdrawals over his life expectancy, thus easing his tax hit. If Congress hadn't passed the new provision, the son would have had to withdraw the money within a year, as the company's plan required, and pay tax on the entire amount.

Gay-rights groups and other organizations are hailing the change as a long-overdue victory. "For gay couples and all Americans with nonspouse beneficiaries, death and taxes weren't only certain, but also times of great and unequal financial difficulty," said Joe Solmonese, president of Human Rights Campaign, a Washington-based group. Enactment of the new law "marks an important day for fairness under the law in America."

Congress has been looking into making such a change for at least several years, says Randy Hardock, a former Treasury official and now a lawyer at Davis & Harman in Washington. He says "much of the initial impetus" for the new provision came from the 2001 terrorist attacks, which left some nonspousal heirs with unexpectedly large tax bills. Mr. Hardock says it's likely that "millions of people" will benefit from this new option.

The new law is especially important in view of the huge amounts that people will inherit in coming years. "An unprecedented amount of wealth" is likely to be transferred in coming decades, says a report by Merrill Lynch & Co. and Capgemini. By some estimates, about $45 trillion is expected to be distributed from estates over the next half-century.

For more details, see the technical explanation on the Web site of Congress's Joint Committee on Taxation (www.house.gov/jct).

The Senate voted overwhelmingly in favor of the pension bill earlier this month. But separate legislation containing federal estate-tax cuts and other items, including an increase in the minimum wage, fell just a few votes short of the 60 needed to limit debate. Republican leaders have indicated they hope to revive efforts to overhaul the estate-tax laws when Congress returns next month. This year, the basic federal estate-tax exclusion is $2 million, and the top federal estate-tax rate is 46%.