Daily Mail .com

Rules on inheriting a 401(K) have been revamped - everything you need to know and how to avoid a shock bill

- **Complex rules around inheriting retirement accounts are confusing Americans**
- **READ MORE: Why it is a mistake to put all your retirement savings in your 401(K)**

By TILLY ARMSTRONG ASSISTANT CONSUMER EDITOR FOR DAILYMAIL.COM
PUBLISHED: 09:47 EDT, 9 June 2024 | **UPDATED:** 09:58 EDT, 9 June 2024

Retirement accounts are an important part of the financial assets many Americans plan to pass on to family.

But constantly changing rules mean that many people are confused about what is required of them if they inherit a 401(K) or an IRA.

The regulations around inheriting retirement accounts are complex, and depend on the type of plan and the relationship between the beneficiary and the original owner.

But it is crucial to understand these rules in order to avoid a shock tax bill, experts warn.

The Internal Revenue Service (IRS) requires that Americans who inherit retirement accounts withdraw the savings over a certain time period, in what is known as required minimum distributions (RMDs).

'The rules governing retirement plans - 401(K)s or IRAs - are designed to ensure that when accounts are inherited they do not benefit from tax-deferred growth indefinitely,' Peter Gallagher, managing director of Unified Retirement Planning Group, told DailyMail.com.

'The IRS wants to make sure that they get their money at some point.'

The rules around these withdrawals have changed various times in just the last few years, leaving many people confused where they stand, said Gallagher.

The original SECURE Act, which took effect in 2020, and more recently the SECURE 2.0 Act, have ushered in sweeping changes to those inheriting retirement accounts.

(con't)

Under these rules, most accounts inherited by non-spouse beneficiaries must be cleared out within 10 years of the death of the original owner.

In the past, beneficiaries could 'stretch' the withdrawals over their lifetime, which potentially lowered the tax burden.

For example, people were leaving an IRA to their grandkids and their life expectancy was so long that the IRS was not generating much tax from it, said Gallagher.

The new law did make an exception though, allowing certain 'eligible designated beneficiaries' to continue to be eligible for the stretch IRA rule.

These people include surviving spouses, minor children under the age of 21, and disabled individuals.

In general, IRA owners must take their first RMD by April 1 of the year after they reach the age of 73. That date is called their required beginning date.

Due to **changes to federal law that took effect in 2023**, the age at which Americans must begin taking RMDs can differ depending on the year they were born.
The type of beneficiary of an inherited retirement account, and whether the original owner had begun taking RMDs at the time of their death, will determine the rules around withdrawals, explained Gallagher.

And under new rules introduced this year, if an IRA or a 401(K) holder passes away when they have already begun taking RMDs, then the new owner will have to take annual withdrawals for years one through nine of the 10-year term.

This additional provision has been controversial and caused more confusion, so for the fourth year in a row the IRS announced earlier this year that there would be no penalty for failing to take these RMDs.

The mandatory yearly withdrawal rule also does not apply to inherited Roth IRA accounts, regardless of the deceased's age.

This means these accounts can grow tax-free, and be withdrawn tax-free in the future.

Gallagher recommends speaking to a tax professional to make sure you understand the rules that apply to your specific situation before planning any withdrawal strategy.

'One of the most important things to keep in mind if you're a beneficiary is that when you take withdrawals, these are most likely going to be taxable to you,' he said.

(con’t)

He recommends keeping an eye out for the IRS proposed changes and speaking to a certified public accountant (CPA), a tax advisor or a tax attorney.

This is to make sure that the amount that you need to take in withdrawals - coupled with the other income that you receive - will not push you into a higher tax bracket.

A tax professional may be able to offer strategies to help reduce your taxation each year and ensure that you do not take a big hit, he said.

'It can be mixed feelings for a lot of people because firstly they've lost a loved one, and secondly they have more taxable income. And people don't generally complain about that until they get their tax bill and they realize they had no idea of the implications.

'If you get the wrong advice it could be really catastrophic from a tax perspective.'

Gallagher also warns Americans to make sure that they have someone listed as the beneficiary for their retirement accounts.

Failing to do this can mean that someone's accounts go into their estate when they pass away, causing delays or a lengthy probate process for their family.

'I always tell everybody to just list someone as your beneficiary, and you can always change it,' Gallagher said.

Alongside speaking to a tax professional, he suggests potentially electing 1/10 of the withdrawal each year.

Although it is unknown what could happen to tax brackets in the coming years, he said, leaving it to be taken out in the ninth or tenth year could mean that you are taxed in a higher bracket.

Electing to take out a smaller portion each year would mean spreading out the tax ramifications.

For example, if you inherit a large IRA, you might decide to take out $200,000 a year for 10 years, rather than $2 million on the tenth year.