

The Record, Hackensack, N.J., personal finance column

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Sep. 14--Inheritance can get tricky when it's in a retirement plan

Inheriting money is not always as easy as it looks. When the money is in a retirement plan, tax considerations make the financial planning tricky.

This is becoming more of an issue as the World War II generation dies, leaving their retirement plans to baby-boomer children. In many cases these retirement plans -- the product of decades of saving -- are among the family's largest assets.

There are several steps a family can take to ease the tax burden on inherited retirement accounts. Some must be taken when the account holder is still alive, some after death.

First, for the account holder: If you have a retirement savings plan at work and want to minimize taxes for your heirs, you should move it into a rollover individual retirement account (IRA) when you retire.

That way, your heirs will have the opportunity to stretch out their withdrawals, allowing the money to grow tax-deferred for a longer period. If you leave it in the 401(k), at your death your non-spouse heirs will have to withdraw all the money and pay taxes on it by April 15.

"That's a big mistake we've found a lot of people are making, leaving the 401(k) with the employer," said Shawn Danziger, a broker and retirement planner with Securities America in Englewood Cliffs.

If you want to leave all the money to your spouse, however, things are much simpler. He or she can roll the money over into an IRA after your death.

Another key step: Make sure to list your beneficiaries with the bank, brokerage or mutual fund company that holds your IRA.

No matter what your will says, the money goes to whoever is named with the IRA. So, for example, if your first husband is still listed on the IRA you opened in 1988 -- before the ugly divorce -- he gets the money, not your current spouse.

The same applies to children. If you named your firstborn as a beneficiary but have since had two more kids, the firstborn will get the entire account if you die without updating the information. It doesn't matter if your will splits your estate equally among the three children. The beneficiary designation on an IRA overrides your will.

If you inherit a retirement account: With a traditional IRA, the first thing you need to

check is whether the deceased has taken out his required minimum distribution, which must be withdrawn every year, starting April 1 of the year following the year the account owner reaches 70 1/2.

If not, the beneficiaries must withdraw this money, according to the money management firm T. Rowe Price, which has published a guide to IRA inheritance rules. (The minimum annual distribution is determined by a formula that considers the value of the account and the life expectancy of the owner.)

If you're the spouse of the person who has died, you can simply roll over a 401(k) or IRA into an IRA in your own name, said Ed Slott, a Long Island accountant and author of "Parlay Your IRA Into a Family Fortune" (Viking, \$24.95).

But if you're the child or another heir who was not married to the deceased, it's not so simple.

"The rules are much more rigid for non-spouses," Slott said.

Slott said for non-spouses the account should be retitled as an inherited IRA for the benefit of the heir -- for example, "Joe Smith Individual Retirement Account (deceased Sept. 1, 2005), for the benefit of Joe Smith Jr., beneficiary." The beneficiary's Social Security number must be on the account.

If you do that, the IRA retains its tax-deferred status. That's a great benefit because the heir can stretch out the withdrawals over his life expectancy, allowing the remaining funds in the account to continue to grow without taxation for decades.

Unfortunately, however, many heirs don't understand the need for this step. Worse yet, said Slott, many brokers, advisers and financial institutions don't know these rules, either.

Sometimes brokerages or financial firms will simply hand the money to the heirs -- making it immediately taxable. So, instead of a 40-year-old daughter stretching out withdrawals from her mother's \$300,000 IRA for 40 years, she must pay taxes on the entire amount the next April. And the IRS won't be sympathetic if she says she didn't know better.

"Once the money comes out of the IRA, it's over," said Slott. "You can't put it back. You can't undo it."

Another key step: You should also reevaluate the inherited IRA. Do the investments make sense for you? Are the fees too high? Just because Mom or Dad chose these investments when the account was set up in 1985 doesn't necessarily mean they're right for you 20 years later.

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