



## *Inheriting a 401(k) Plan Account*

When you inherit a 401(k) plan account, the options available to you depend on a number of factors, including the terms of the 401(k) plan and your relationship to the deceased 401(k) plan participant. In general, you'll have four options: take an immediate distribution, disclaim all or part of the assets, leave the money in the 401(k) plan (if the plan permits), or roll the funds over to an IRA.

### *Should you take the cash?*

Obviously, if you need the funds immediately, taking a lump-sum distribution from the 401(k) plan may be your only viable alternative. But you'll have to pay ordinary income tax on the distribution (except for the amount of any after-tax contributions and qualified Roth distributions). Special tax rules may apply if the plan participant was born before January 2, 1936--consult a tax professional for details.

A lump sum might also be attractive if you're entitled to a distribution of employer stock. You may be able to pay ordinary income tax on just the participant's basis in the stock, and defer tax on the appreciation (called "net unrealized appreciation," or NUA) until you sell the stock in the future--at capital gain rates.

### *What's a disclaimer?*

When you disclaim (i.e., refuse to accept) 401(k) assets, they pass instead to the plan participant's contingent beneficiary, or estate if there is no contingent beneficiary. In general, you must give the plan written notice of your intent to disclaim the funds within nine months after the participant's death. But be careful not to exercise control over the funds in the meantime (for example, by choos-

ing a distribution option or by exercising investment control), or you may lose your ability to disclaim the funds.

A disclaimer may be an attractive option if you're sure you won't need the funds, and the transfer to the contingent beneficiary makes good economic and estate planning sense.

### *The problem with 401(k) plans*

If you're like most beneficiaries, your goal will be to stretch payments out as long as possible, taking full advantage of the tax deferral offered by retirement plans. This means either leaving the assets in the 401(k) plan, or rolling them over to an IRA.

For most, leaving the funds in the 401(k) plan isn't the best choice for two reasons. First, the investment alternatives available to you in a 401(k) plan are limited to the ones selected by the employer. Second, the distribution options offered by a 401(k) plan typically aren't as flexible as those available in an IRA. In fact, many 401(k) plans require beneficiaries to take distributions shortly after the participant's death.

### *Roll the funds over to an IRA*

Unless the 401(k) plan offers a unique investment alternative, rolling the 401(k) assets over to an IRA will usually be your best choice. IRAs offer virtually limitless investment options. And when it comes time to take distributions from the plan, IRAs offer the most flexible payment provisions. But, before deciding on a rollover, make sure you understand any fees and expenses that may apply.

Unlike annuity payments, a lump-sum distribution from a cash balance plan can be rolled over to an IRA or to another employer's plan that accepts roll-overs. This might be an attractive alternative if you don't immediately need the income when you retire.

If you're a surviving spouse, you'll have to decide between rolling the funds over to your own IRA, or to an IRA that you establish in the participant's name, with you specified as the beneficiary (this is referred to as an "inherited IRA"). Which should you choose?

In most cases, you'll be better off rolling the funds over to your own IRA. Rolling the funds over to an inherited IRA is typically appropriate only if you're not yet age 59½ and you think you'll need the funds before you reach that age. That's because distributions from an inherited IRA aren't subject to the 10% early distribution penalty tax. (In contrast, distributions from your own IRA before age 59½ are subject to the 10% penalty tax unless an exception applies.)

If you're not the surviving spouse, you don't have the option of rolling the 401(k) assets over to your own IRA. But thanks to the Pension Protection Act of 2006, you may be able to make a direct rollover of the 401(k) funds to an inherited IRA. A 401(k) plan isn't required to offer this option, so check with your plan administrator. This new rule applies to distributions you receive after 2006.

The rules governing inherited 401(k) plan accounts are complex. A financial professional can help you sort through the alternatives, and make the decision most appropriate for your individual circumstances.

### ***Estate Tax Appeal: Ramifications and Outlook***

The Economic Growth and Tax Relief Act of 2001 gradually phases out the federal estate tax until its complete repeal in 2010. However, under the same law, the estate tax is scheduled to return in 2011.

Since 2001, there have been a number of failed attempts to make the estate tax repeal permanent. In

fact, there are still several bills in Congress that include provisions to eliminate this tax. While it's clear President Bush would sign such legislation, the recent changes in Congress make it less likely he'll get the chance to do so. The question remains, though: Will permanent repeal become law, and if so, what are the potential ramifications?

### ***Good-bye estate tax, hello capital gains tax***

Repeal does not mean that tax on wealth transfers from one generation to the next will disappear. While currently a tax is imposed on estates, after repeal, a tax will be imposed indirectly on inheritances in the form of capital gains tax. Here's a simplified explanation.

Under the current tax system, property that is transferred to heirs at the owner's death typically gets a "step-up" in tax basis. Generally, tax basis refers to the cost the owner paid to acquire the property, and is used to compute capital gains tax when the property is sold. For example, let's say Mr. Smith buys property for \$50,000, which becomes his tax basis, and sometime later sells the property for \$60,000. Mr. Smith's computed capital gain for tax purposes is \$10,000.

When property is transferred by gift, the recipient receives a "carryover" basis; the tax basis in the hands of the person making the gift generally becomes the recipient's tax basis. So, let's say that Mr. Smith gives the property in the above example to his son, John. Mr. Smith's \$50,000 tax basis carries over to John, and when John subsequently sells the property for \$60,000, John recognizes the \$10,000 capital gain.

However, when property is transferred because of the owner's death, the tax basis is stepped up to its current fair market value. Again using the first example, let's say that John receives the property through his father's will. John's tax basis is stepped up to \$60,000, the property's fair market value. When John subsequently sells the property for \$60,000, John recognizes no capital gain on the transaction.

One of the consequences of estate tax repeal in 2010 will be that the step-up in tax basis will be lost. Heirs will receive a carryover basis on inherited property,

## *Estate Tax Repeal (cont)*

and will recognize the capital gain (or loss) when the property is sold at some point in the future.

What will this change in the tax system mean for American families? According to the IRS, estate tax affects only 2% of the most wealthy Americans. Capital gains tax, though, can affect anyone who owns capital assets. Therefore, unless the step-up in basis remains, estate tax repeal is likely to result in creating a higher tax bill for a greater percentage of less wealthy Americans. Further, repeal will create a paperwork headache for heirs who will have to determine the decedent's tax basis in the property they've inherited.

### *Pros and cons of permanent repeal*

Proponents of permanent repeal regard the estate tax as morally unfair and an obstacle to family business continuity and growth. Critics call permanent repeal a boon to the mega-rich and fiscal suicide in a time of budget deficits, a Social Security and Medicare crisis, and war. The confusing reality is that there is statistical evidence both for and against the arguments presented by each side.

One thing is certain, however: Dealing with the uncertainties of the current state of the estate tax is a burden on Americans and their financial planning professionals who must re-evaluate estate planning options every year. For many on both sides of the issue, sensible reform is a preferable alternative to the success or failure of permanent repeal.

### *Outlook*

In 2007, the Democrats regained power in Congress after 12 years of Republican control. The new Congress has been pursuing a fresh agenda, putting estate tax relief on the back burner. When the issue does resurface, it's likely that Congress will support reform over full and permanent repeal. Reforms such as lowering the estate tax rates to match capital gains tax rates and/or increasing the exemption amount have been proposed. Other options that have been discussed include doubling the exemption amount for married taxpayers, phasing out the tax over a five- or ten-year period, and replacing the estate tax with an inheritance tax (which would

merely move the tax burden to the heirs). It remains to be seen what will be done, if anything.

If your policy limits have not increased since you purchased your home, there's a good chance that you're now underinsured. However, it's not necessarily because the market value of your home has risen, but rather because construction costs have gone up.

***Ask the Experts: My home is worth a lot more than I originally paid for it. Does this affect my homeowner's insurance?***

For insurance purposes, the cost to rebuild your home is what counts, and that's probably very different than what you paid for your home, or how much you would pocket if you sold it today. For example, while the market value of your home includes the land it's built on, the rebuilding cost does not. On the other hand, if your home has features that would be expensive to replicate, is built of materials whose cost has skyrocketed, or is located in an area where labor costs are high, the market value of your home may actually be lower than the cost to rebuild it.

It's important to review your homeowners coverage with your insurer at least once a year. You should also call your insurance representative whenever you remodel your home or buy expensive items.

Although it's ultimately up to you to make sure you have adequate homeowners insurance, your insurance representative can help you estimate the cost of rebuilding your home, using information about construction costs in your area. Be prepared to answer questions about your home's features and square footage to help determine proper coverage limits.

*Material provided by Forefield Inc.*

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### NEWS

**Catherine Friend White** was honored on November 9<sup>th</sup> at the 10th Annual Women's Leadership Conference hosted by Babson College. The college recognized her leadership as an early member of Babson Women in Business (BWIB).

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FinArc's got talent! **Arlene Chaplin** announces her third art show in the last year. She has exhibited at the Danforth Museum, Natick Center for the Arts, and at her studio at the Holliston Mill Open Studios . She works in acrylics and mixed media.

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**Catherine Friend White** has been invited to serve on the Graduate Advisory Board of Babson College. The board assists the Dean of the MBA program in curriculum development, recruitment, and outreach to the business community.

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