Advisor Article

An Overview of the Taxation of Inherited Assets

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Background Information

Whether you are planning for the eventual distribution of your estate upon your death or you are the beneficiary of inherited assets from an estate, understanding how the assets are treated from a taxation perspective is very important. Diligent record-keeping is crucial, and collaboration with someone familiar with the federal and state tax regulations pertaining to estates and inheritances, such as a CPA, estate attorney or financial advisor is recommended.

For those who are planning for the distribution of their estate, understanding the tax ramifications may affect decisions related to gift-giving, Roth conversions, sequence of post-retirement asset use, trust establishment and management of life insurance, annuity and pension policies.

For those who are recipients of inherited assets, such a time is likely to be very emotional with some decisions related to select assets needed within specific timelines. Having a basic understanding of how inherited assets are taxed, trusted contacts to consult with for professional guidance as needed, and a detailed plan for management of the inherited assets will help you make informed decisions and avoid costly mistakes.

As of 2026, the tax landscape has seen significant shifts—including an increased federal estate tax exemption—but the rules for how specific assets are taxed upon receipt remain as nuanced as ever. This guide breaks down the tax ramifications for the most common types of inherited assets.

At times, certain rules will vary based on whether the beneficiary is the deceased person's spouse or not; as a default, the guidelines in this article apply to non-spouse beneficiaries.

Estate Tax vs. Inheritance Tax

An estate tax is a tax on the total value of a taxable estate that's paid out of the estate before assets are distributed to heirs. An inheritance tax is a tax on what each beneficiary actually receives and is paid by the beneficiary rather than by the estate.

The federal government imposes an estate tax but does not impose an inheritance tax. The federal estate tax exemption level and tax rate has varied significantly over the past 30 years – see [3]. As of 2026, the federal estate tax exemption is approximately $15 million per individual. If the total estate is worth less than this, no federal tax is due. In 2026, 12 states and the District of Columbia also impose estate taxes, with varying exemption limits and tax rates – see [4].

Although the federal government does not impose an inheritance tax, several states (currently Kentucky, Maryland, Nebraska, New Jersey, and Pennsylvania) impose inheritance taxes. These taxes vary by state and the relationship of the beneficiary to the decedent.

Taxation of Inherited Assets by Type

1. Cash and Personal Property

For most heirs, the simplest assets to inherit are **cash** (from bank accounts) and **personal property** (like jewelry, vehicles, or furniture).

- **Income Tax:** Generally, there is no federal income tax on the receipt of a cash inheritance. The money is yours to keep, tax-free.

2. Taxable Investment Accounts (Stocks, Bonds, and Real Estate)

One of the most valuable "gifts" the IRS gives to heirs is the **Step-Up in Basis**. This rule can effectively wipe out decades of capital gains taxes.

- **How the Step-Up Works**

  When you inherit an asset like a stock or a home, your "cost basis"—the value used to calculate taxable gain—is "stepped up" to the **fair market value (FMV)** on the date of the original owner's death.

  Example: Your grandmother bought a house in 1970 for $30,000. When she passes away in 2026, she bequeaths the house, now worth $500,000, to you. If you sell it immediately for $500,000, you owe **$0 in capital gains tax**. You are not responsible for the $470,000 of appreciation that occurred during her lifetime.

  As an extension of this example, let's say that your grandmother decided to give the house to you just <u>before</u> she passed away. In that case, you also are "gifted" her cost for the asset, which was $30,000. That means you immediately have a $470,000 capital gain (minus any capital improvements and closing costs that have been recorded) on the "gift".

- **Holding Period**

  All inherited property is automatically treated as being held for **more than one year**. This means that if you sell the asset later for a profit, you will qualify for the lower **long-term capital gains tax rates** (0%, 15%, or 20%), regardless of how long you actually owned it.

3. Annuities

Annuities are often complex and warrant professional analysis and guidance whether you are purchasing one as an investment or inheriting one as a beneficiary. Annuities are often misunderstood because they are structured like life insurance but are taxed like retirement accounts. **Annuities do not receive a step-up in basis.**

The tax treatment of an annuity depends on whether it is **Qualified** or **Non-Qualified**:

- **Qualified Annuities:** These are held inside a retirement plan (like an IRA). Like an inherited IRA, **the entire distribution is taxed as ordinary income**.
- **Non-Qualified Annuities:** These are purchased with after-tax dollars. You will not owe tax on the **principal** (the original investment), but you will owe ordinary income tax on the **earnings** (the growth).

When managing an inherited annuity, it's important to understand the distribution rules that apply to that specific annuity contract. Depending on the type of annuity, the relationship between the original owner and the beneficiary, and whether annuity payments had already started, the inherited amount and required timeline for withdrawing the money will vary.

The Annuity Tax Trap

The IRS uses a "Last-In, First-Out" (LIFO) rule for non-qualified annuity withdrawals. This means the first dollars you take out are considered the taxable earnings. Only after all earnings are exhausted can the tax-free principal be withdrawn.

To manage this, heirs often choose to **annuitize** the contract (turning it into a stream of payments), which allows them to use an “exclusion ratio” to spread the tax-free principal and taxable earnings over many years.

4. Retirement Accounts (IRAs and 401(k)s)

Like qualified annuities, retirement accounts do **not** receive a step-up on cost basis. These assets are considered "Income in Respect of a Decedent" (IRD).

The 10-Year Rule

Under current 2026 regulations (following the SECURE Act 2.0), most non-spouse beneficiaries must fully distribute the retirement account balance by the **end of the 10th year** following the year of the owner's death.

Traditional IRAs and 401(k)s: Every withdrawal is taxed as **ordinary income**. This is an important factor to consider if you plan to bequeath such accounts to grown children who may be in their peak earning years when they inherit this asset and thus will sacrifice a significant portion of the inherited asset to federal and state income taxes.

Roth IRAs and 401(k)s: While you must still empty the account within 10 years, the withdrawals are **tax-free**, provided the account met the five-year holding rule.

For more details on the rules governing inherited retirement accounts, please refer to the first resource listed below [1].

5. Life Insurance Proceeds

Life insurance is designed to provide immediate liquidity, and its tax treatment reflects that goal.

- **Income Tax:** Death benefits paid to a beneficiary are generally **income tax-free**.
- **Interest Income:** If you choose to have the insurance company hold the funds and pay you in installments, any **interest earned** on that principal is taxable as ordinary income.

Recap: Income Tax Treatment by Inherited Asset Type

Asset Type	**Step-Up on Basis?**	**Income Tax Due on Inheritance?**	**Potential Future Income Tax**
Cash	N/A	No	None on inherited amount; interest earned on the inherited amount is taxable.
Stocks	Yes	No	Long-term Capital Gain taxes will apply on the change in asset value *after* death.
Real Estate	Yes	No	Long-term Capital Gain taxes will apply on the change in value *after* death. Based on how the real estate was used after inheritance (personal or business) a loss in value may NOT be deductible.
Traditional IRA or 401(k)	No	Based on distribution timing.	If the inherited IRA is rolled over, there is no immediate taxation. All distributions, when taken, will be taxed as ordinary income.
Annuity (Non-Qualified)	No	Based on distribution timing.	Ordinary income tax is applied only to earnings received on initial policy and subsequent earnings after inheritance. Original contributions and premiums were paid with after-tax dollars and are thus not taxed when distributed.
Annuity (Qualified)	No	Based on distribution timing.	All distributions, when taken, will be taxed as ordinary income.
Roth IRA or 401(k)	No	No	None (if 5-year holding rule is met).
Life Insurance	N/A	No	If the proceeds are taken in a series of payments, any interest/dividends earned on the death benefit with be taxed.

Summary

Inherited assets can create meaningful financial opportunities, but the tax outcome depends heavily on the asset type, applicable federal and state rules, distribution timing, and the beneficiary's relationship to the decedent. The most important planning steps are to identify each asset's tax treatment early, consider taxation factors when defining beneficiaries, document fair market values as of the date of death, understand any required withdrawal or payout deadlines, and coordinate decisions with qualified tax, legal, and financial professionals before acting.

The key takeaway: do not treat an inheritance as "tax-free" until you know how each asset is classified. Careful planning on the part of the asset donor and prompt action on the part of the beneficiary — especially for retirement accounts, annuities, and appreciated property — can help preserve more of the inherited value, avoid unintended tax consequences, and give beneficiaries a clear path for managing the inherited assets with confidence.

Resources

1. https://www.eustaceadvisors.com/files/eustace_advisors_article_20250421_new_rules_for_inherited_iras.pdf.
2. https://www.eustaceadvisors.com/files/eustace_advisors_article_how_to_manage_a_financial_windfall.pdf.
3. https://www.financialsamurai.com/historical-estate-tax-exemption-amounts-and-tax-rates/.
4. https://creativeplanning.com/insights/taxes/state-estate-inheritance-taxes/.
5. https://dwcadvisors.com/minimizing-taxes-on-inherited-assets-how-the-step-up-in-basis-works/.
6. https://www.empower.com/the-currency/life/taxes-on-inheritance-how-to-avoid.
7. https://www.annuity.org/annuities/inheriting-an-annuity/.
8. https://www.westernsouthern.com/retirement/claiming-your-inheritance-annuity.