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Tax Questions When a Parent Dies

Many people are confused about the tax consequences when a parent dies and the children inherit property or other assets. This brief summary will address the most common questions. More complex questions will likely require an individual consultation.

What is the estate tax, and who has to pay it?

The federal government levies an estate tax if the total value of assets in the decedent's estate at the time of death is more than the estate tax exemption. The estate tax is levied against the excess over the estate tax exemption. The estate tax exemption for 2009 is $3.5 million. The taxes are paid by the estate, before distributions to the beneficiaries.

Under current law, there is no estate tax in place for 2010, and then the estate tax returns with an exemption of only $1,000,000 in 2011 and thereafter. However, President Obama's proposal, and the most likely result, is for the $3.5 million to remain in effect.

How much tax has to be paid?

The tax rate begins at 45 percent, but only applies to assets owned by the decedent in excess of the estate tax exemption ($3,500,000 in 2009). Bequests by a decedent to charities or to a surviving spouse operate as a deduction, and effectively do not count as part of the exemption.

Do assets in a Revocable Living Trust "count" for estate tax purposes?

Yes, any assets owned or controlled by a decedent are countable in the estate tax calculation. This includes assets in a Revocable Living Trust, IRA and 401(k) accounts, joint tenancy real estate, POD bank accounts or brokerage accounts, and most life insurance policies. Even though these assets are not typically subject to probate, they are taxed exactly the same as assets which pass pursuant to the terms of a decedent's Will. These all must be reported on the Estate Tax Return, IRS Form 706, which is due nine months after the date of death, if the individual owned more than $3.5 million.

Keep in mind that if an individual had an interest in a trust established by someone else, including a Decedent's Trust or Trust

B from a surviving spouse, that trust may be excluded from the value of his or her estate.

Will I have to pay income taxes on the money I inherit from my parent?

No, not usually. If you receive a $100,000 distribution from an individual's Estate or Trust, or you receive proceeds from a life insurance policy, or a POD bank account, this is typically not income and does not need to be reported. However, there are two exceptions:

1. A portion of your distribution may have been income (interest or dividends) earned by the decedent's estate while it was open. This small portion of your distribution will be taxable income to you, and will be shown on a K-1 form sent to you by the estate or trust.

2. If your inheritance is an IRA, 401(k), tax-sheltered annuity, or other tax deferred account, you will have to pay income taxes on any amounts you remove from the account (with the exception of a Roth IRA). You may or may not be able to defer how quickly you withdraw the money and incur the tax. This is because taxes were never paid on this money (again, with the exception of Roth IRA funds). If the decedent had withdrawn it they would have had to pay taxes, and the same applies to you.

What about capital gains taxes?

Assume the decedent had real estate or securities which have greatly appreciated in value since purchased. If they had sold them, they would have had to pay capital gains tax on the difference between the purchase price (known as the basis) and the sales price. However, when you inherit these assets, you receive a step-up in the basis to the fair market value of the assets at the time of death. If you turn around and sell the assets quickly, there will be little or no gain and no capital gains tax to pay. If you hold on to the assets for a number of years, you only pay capital gains tax on the difference between the value of the assets at the time of death (the stepped-up basis) and the ultimate sales price.

Do I need to file final income tax returns (1040/140) for the decedent?

Probably. Income earned or received between January 1 and the date of death is reportable under her Social Security Number. If that amount is sufficient to meet the minimum filing requirements (which change each year), you will need to file a return. Also, if any taxes were withheld (e.g. from a pension, or from estimated payments), you will certainly want to file to claim a refund. However, if the decedent's income was low and they had not been filing returns, you won’t have to unless there was some special circumstance such as selling stock or a house, cashing in an IRA, or winning the lottery.

Does Arizona have any estate, income, or inheritance taxes in addition to the federal taxes?

No. Arizona receives a portion of the estate tax payable to the federal government, but no additional amounts are due to the state of Arizona. Also, Arizona does not have an inheritance tax as some states do. Finally, the income tax situation in Arizona is parallel to the federal income tax with regard to inheritances, IRAs, etc.