

Don't Forget About Income Tax Issues in Estate Planning

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In this article, Wood and Brown examine how estate planning and death can affect income tax reporting.

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When most people hear “estate planning,” they don’t think of income taxes. They think of making sure the right people in their lives end up with the right assets and that key issues, such as the guardianship of minor children, are attended to appropriately. But they are likely to think about tax, especially estate tax — sometimes referred to with a political spin as the death tax. This is true even though, for the most part, only especially wealthy people end up having to pay estate taxes.

Today, the gift and estate tax exemption is \$13.99 million per individual and nearly \$28 million for a married couple. But if Congress does not act to amend the law before the end of 2025,

that dollar exemption could plummet to \$7 million as of January 1, 2026. If the law is not amended soon, some estate planners think there will be an explosion of last-minute taxpayers who want to make gifts against their tax-free \$13.99 million exemption in 2025 before it drops to \$7 million.

People also think about probate, the administrative process of collecting a decedent’s assets, paying debts, and effecting transfers. If you don’t have a will, state law imposes rules for who will get what, and those intestate statutes will not necessarily follow what you would have wanted. But even if you do have a will, it must be probated. That is a court proceeding that takes a long time and is public and expensive.

Do people think of income tax considerations in estate planning? Not always, but it can pay to consider whether you want to bear the cost of income taxes or have your children do so. For example, if an asset produces income, such as rental income, do you want to receive it, or would you rather have your children receive the income? Who pays a higher tax rate? On ordinary income, such as rental income, your children’s tax rates may be lower than yours. How about capital gain tax rates? If you are a high-income taxpayer, you might be paying 23.8 percent federal tax on long-term capital gains, plus 13.3 percent California tax. Your kids might be in lower tax brackets for ordinary income and for capital gains. Consider the current federal tax rates for long-term capital gain (see table).

In short, income tax and estate tax can be a kind of yin and yang, and there are many trade-offs to consider. There is also the ever-present obligation to file annual income tax returns, which can continue to be a burden. An individual’s estate planning and death can affect income tax reporting on four (or more) income tax returns.

2025 Capital Gains Tax Rate by Taxable Income and Filing Status

Filing Status	0% Rate	15% Rate	20% Rate
Single	Up to \$48,350	\$48,351-\$533,400	Over \$533,400
Married filing jointly	Up to \$96,700	\$96,701-\$600,050	Over \$600,050
Married filing separately	Up to \$48,350	\$48,351-\$300,000	Over \$300,000
Head of household	Up to \$64,750	\$64,751-\$566,700	Over \$566,700

Decedent's Income Tax Return

When someone dies, their personal representative (that is, executor) must file a final income tax return for the year the individual died. This income tax return includes the income the decedent received from the beginning of the year up until the day they died, and it is due on the usual due date for individual income tax returns for that year.

There is no special tax form for a decedent's final tax return, so a regular Form 1040 is used. However, the word "deceased" should be written at the top of the Form 1040, followed by the decedent's name and date of death. A regular IRS power of attorney, Form 2848, "Power of Attorney and Declaration of Representative," is not sufficient to qualify a personal representative to file a tax return on behalf of a decedent. A Form 2848 generally expires when the taxpayer dies. Instead, the personal representative must file an IRS Form 56, "Notice Concerning Fiduciary Relationship," notifying the IRS that they have been appointed as the decedent's personal representative to file a final tax return on the decedent's behalf.

If the decedent filed a joint income tax return with their surviving spouse, the surviving spouse and personal representative of the decedent can elect for the decedent's final income tax return to be a joint return. The surviving spouse would include their income and deductions for the entire year, but only the decedent's income and deductions for the portion of the year they were still alive would be included. Electing to file a joint return with a deceased spouse can allow a surviving spouse to obtain the benefits that filing jointly usually provides. However, it also has risks, effectively making the surviving spouse and decedent's estate jointly liable for any tax, penalties, and interest on the joint return. That

may not be an issue if the surviving spouse is the sole beneficiary of the estate. However, if there are other beneficiaries besides the surviving spouse (for example, children from a previous marriage), the executor of the estate generally has a fiduciary duty to preserve the assets of the estate for the benefit of the beneficiaries.

Therefore, when there are non-spouse beneficiaries of an estate who could be negatively affected by making the estate jointly liable for the income tax obligations of the surviving spouse, many executors may insist on filing a separate tax return. This way the estate is only liable for income tax, penalties, or interest that are attributable to the decedent's income and deductions.

Although this may seem simple, many taxpayers who live in community property states and are accustomed to filing joint tax returns may not be aware of how income is supposed to be divided if they file separate tax returns. They may assume that income is divided based on who actually received or earned the income. But it is not that straightforward.

Under section 66, items of community income (generally determined under state community property rules) are supposed to be divided 50-50 by spouses filing separate tax returns. In many community property states, wages are considered community income, so spouses living in community property states filing separate tax returns are often required to report 50 percent of each spouse's wages on each spouse's separate tax return. A Form 8958, "Allocation of Tax Amounts Between Certain Individuals in Community Property States," can be attached to each spouse's separate tax return to identify for the IRS how the couple's income was divided between the two separate tax returns under these rules.

Estate's Income Tax Return

Income received after a decedent's death is considered received by the decedent's estate, which is a separate taxpayer from the decedent. The estate's income is reported on IRS Form 1041, "U.S. Income Tax Return for Estates and Trusts," the same form used by some trusts to report their income. When is the estate's income tax return due? The answer is complicated.

That is because the due date for the estate's income tax return is based on the fiscal tax year the estate chooses to adopt for its income tax reporting. Estates are not required to use a calendar year as their reporting period, though they may if they choose to. The fiscal year chosen must generally end at the end of a month, and the fiscal year must end within one year of the date of death. Therefore, if a decedent dies in January, the estate can choose a fiscal year that ends, at the latest, on December 31 of the same year, but if the decedent died in February, the estate could elect for its first fiscal year to end on January 31 of the following year.

The estate's income tax returns are due on the 15th day of the fourth month after the fiscal year ends. This means April 15 if the estate chooses to report using the calendar year or chooses a fiscal year that ends on December 31. But if the estate chooses a fiscal year that ends at the end of a different month, the filing deadline for the estate's income taxes will be shifted to a different month.

Various types of income could be reported on an estate's income tax returns. The most obvious is any interest, dividends, or other investment income that is earned after the decedent's death while the assets are owned by the estate. If the estate liquidates any estate assets to pay for the liabilities of the decedent or the estate, such as estate tax, it can theoretically generate taxable gain to the estate for income tax purposes.

However, estates are generally entitled to a step-up in basis for assets they inherit from the decedent, so in practice it is rare for a sale of assets by the estate to produce taxable gain, except to the extent the assets appreciated while the estate held them. If the estate pursues a wrongful death action or other litigation on behalf of the decedent, it is the estate that must address any recovery in its tax reporting and pay any resulting income tax.

The most surprising source of income for an estate may be so-called income in respect of a decedent. This occurs when an item of income that would ordinarily be paid directly to the decedent (if they were still alive) is instead paid to their estate or a beneficiary of the estate as a result of the decedent's death. For example, the decedent's employer may pay the estate the decedent's final salary check, bonus, or vacation payout that was earned before the decedent died. The estate could receive annuity payments, interest payments on a loan the decedent made, or mandatory retirement account distributions that were scheduled to be paid to the decedent.

Generally, inheriting funds or assets from the decedent is not taxable to the estate or a beneficiary. Income is usually generated by actions the estate takes or income produced after the estate holds the assets. Income in respect of a decedent is an exception to this rule. A salary payment would have been taxable income to the decedent if they were still alive to receive it, so it is likewise taxable directly to the estate if the employer pays the salary payment to the estate instead. Because the payment was made after the decedent's death, it cannot be included in the decedent's final tax return and must be included in the income tax return of the estate that actually received the payment.

Income Tax Returns for Beneficiaries

The receipt of an inheritance is usually tax free. However, if a beneficiary receives a pretax payment that would have been taxed to the decedent, that payment may be income in respect of a decedent that the beneficiary must include in their income. Another possible exception is if a U.S. beneficiary receives their inheritance through a foreign trust.

If the foreign trust has not been subject to U.S. tax itself, then a distribution to a U.S. beneficiary can trigger the throwback tax rules that effectively saddle the beneficiary with the obligation to pay some of the U.S. income tax the foreign trust avoided — plus interest. The calculation of the throwback tax is too complicated for this article, but it can be incredibly onerous to the U.S. beneficiaries who receive distributions.

Milder than the throwback tax is the obligation for U.S. beneficiaries to disclose that

they received valuable gifts or inheritances from a foreign person, if they received more than \$100,000 total from the same foreign person in the same year as a gift or inheritance. This does not subject the gift or inheritance to tax, but the gift and inheritance must still be disclosed in the beneficiary's tax return.

This is done by completing Part IV at the end of IRS Form 3520, "Annual Return to Report Transactions With Foreign Trusts and Receipt of Certain Foreign Gifts." Unlike most other tax forms discussed in this article, a Form 3520 is not an attachment to a beneficiary's income tax return. It is a separate form that must be signed and filed with the IRS. Like the beneficiary's regular Form 1040 tax return, it is due by April 15 of the following year for any calendar-year taxpayer.

Trust Tax Returns

Estate planning often involves trusts, which raises the issue of who pays the income tax on income generated within the trust. The most common variety in estate planning is a living trust.

A living trust can often be updated and amended without the formality required for amending a will. A living trust often establishes its own requirements for how it can be amended. Still, perhaps the biggest benefit of holding your assets through a living trust is that in most states, assets held through a trust do not need to be handled through a formal, court-supervised probate procedure or even through a more streamlined probate procedure, regardless of the value of assets owned through the living trust.

With a living trust, you still write a will, just in case there are assets that you neglected or chose not to formally transfer to the living trust while you were alive. Ideally, the value of assets held outside a living trust should be less than the threshold for triggering a requirement to process the estate through probate. But, in this structure, the will provides that everything you own goes to your revocable trust. It's called a pour-over will because it "pours over" all assets you own on your death into your trust.

While you are alive, your living trust has no income tax effect. Living trusts allow you to have complete control over your assets and to amend the trust or revoke it entirely. A transfer of assets

to a revocable trust does not remove the assets from your estate, and therefore, the transfer is not considered a gift. For income tax purposes, these same provisions cause a living trust to be considered a grantor trust.

A grantor trust is invisible for income tax purposes, and assets owned through it are considered directly owned by the trust's owners. Income generated within the trust must be reported on its owners' individual income tax returns. A revocable living trust does not save you taxes. Its purpose is to avoid the time, expense, and complexity of state probate processes.

Some trusts are non-grantor trusts, which are separate taxpayers for income tax purposes. They must report their own income and claim their own deductions on their own tax returns, Form 1041. Non-grantor trusts are created in several ways. In general, when the grantors of a living trust have all died, living trusts are usually designed to become irrevocable non-grantor trusts. When the living trust becomes a non-grantor trust, the trustees must begin to file income tax returns for the trust reporting income and expenses generated within the trust that occur after the trust is no longer a grantor trust.

Other trusts used in estate planning start their existence as irrevocable non-grantor trusts and were never intended to be anything other than that. That typically means that if you transfer assets to an irrevocable non-grantor trust, you can't take your transfer back or even amend the trust without going to court or making a request to a nominally independent trust protector who was appointed in the trust agreement and may have the power to make certain amendments to the trust agreement. Classically, irrevocable trusts are used to move assets out of your estate before the assets can continue to grow in value.

If you own shares of stock worth \$500,000 that are expected to grow in value to \$50 million by the time you die, it may be wise to use your unified credit to absorb a \$500,000 gift now, rather than be at risk of your estate owing estate tax on a \$50 million inheritance later. Transfers to an irrevocable trust can trigger gift taxes in the short term, but they can still save income, gift, or estate taxes in the long run, depending on the facts. Under today's law, individuals and trusts have the

same highest marginal federal income tax rate, 37 percent.

However, for 2025, a couple that is married filing jointly will not reach that highest tax bracket until they have over \$731,200 of taxable income (after factoring in exemptions and deductions). A trust, however, reaches the highest 37 percent tax bracket at only \$15,650 of net taxable income. Therefore, transferring income-producing assets to a non-grantor trust can result in larger income tax liabilities than if the assets were held directly by the trust's settlors or through their living trust.

Step-Up in Basis on Death

Placing appreciating assets in an irrevocable trust for future estate tax savings can also have income tax consequences down the line. A hallmark of our income tax system for generations has been that everybody gets a stepped-up basis on death for income tax purposes. If you hold assets on your death, your estate and your heirs will get a step-up in basis for income tax purposes on your death. That way, if your heirs sell the assets they inherit, they do not have to pay all the capital gain tax that they would otherwise owe.

If the rule were otherwise, someone selling a farm passed down through a family since the 1880s would have to reconstruct and substantiate over 140 years of investments, improvements, repairs, depreciation, and so on, mostly done by people who are now dead, to calculate the current adjusted tax basis in the farm. This is avoided by having the basis step up to the property's fair market value at death, since the seller will only need to substantiate what the FMV of the property was when they inherited the property and what they did with the property after inheriting it to arrive at the property's adjusted tax basis.

If your parents bought a house in the 1950s for \$50,000 that is worth \$5 million when they die, their estate, and subsequently you, will inherit the house with an adjusted tax basis of \$5 million. Therefore, if the estate or you choose to sell the house for \$5 million, you would not owe any income tax on the sale because there is no gain. The built-in gain that existed in the home while your parents owned it is essentially wiped clean by their death.

However, a step-up in basis only occurs for assets that are considered part of your estate for calculating estate tax. With the current unified credit amounts at historic highs, very few taxpayers actually owe estate tax. Therefore, for most taxpayers, holding assets at death means no estate tax and a step-up in basis for income tax purposes — all upside and no downside. This step-up in basis provides tax benefits for everyone passing down appreciated assets, including real estate, stock, family companies, and more. Small businesses count on this.

Say you have a family business worth \$20 million that you started from scratch. How is it taxed if you and your spouse die? If both parents die, the nearly \$28 million estate tax exemption should mean no estate tax for that \$20 million business. And the equity in the business passed down to the kids gets a step-up in basis for income taxes, too.

Say Mom and Dad die, and Junior gets the stock in the family company. No matter how small Mom and Dad's tax basis was in the stock, the stock gets stepped up to market value on death, \$20 million. That way, Junior can run the business or sell it for \$20 million and should pay no income tax. After all, the parents wanted Junior to inherit the business, not their income tax bill.

Junior could try running the business for a year or two — it might even be worth \$22 million then — but if he sells it, he has that \$20 million date of death value basis. Of course, this example is simplistic and ignores the fact that the business itself might make the sale by selling its assets. Assets held within the business do not necessarily get a step-up in basis (unless the business was treated as a disregarded entity while the parents owned it). Therefore, built-in gain in assets held by a business can be passed down to the next generation, triggering income tax if the business later sells its assets. In this situation, heirs have a particular incentive to structure sales as equity sales rather than asset sales, to get the benefit of their stepped-up basis in the equity they inherit.

The purpose of transferring appreciating assets to irrevocable trusts is to get the assets out of your estate before they appreciate more in value and are subject to estate tax. When assets are gifted, including gratuitous transfers to irrevocable trusts, the recipient does not obtain a

step-up in basis as a result of the gift but instead takes the gifted asset with the donor's adjusted tax basis. Moreover, because assets transferred to irrevocable trusts are not included in the decedent's estate when they die, the assets do not receive a step-up in basis when the donor later dies. Therefore, when the trust or its beneficiaries later sell the assets held in trust, they must calculate the resulting gain for income tax based on the decedent's adjusted tax basis, adjusted for any transactions entered into by the trust regarding the assets that might require subsequent adjustments.

For example, imagine an unmarried taxpayer who owns equity that has a \$2 million basis and is worth about \$7 million but is expected to increase in value significantly. Worried about future estate tax, the taxpayer is considering whether to transfer the equity to an irrevocable trust to lock in the current \$7 million value, which his unified credit against gift and estate tax can fully absorb. The best choice for the taxpayer may be ambiguous.

When the taxpayer dies, the equity is worth \$20 million. Therefore, for estate tax purposes, transferring the shares to the irrevocable trust when they were worth \$7 million shielded \$13 million of future appreciation from potential estate tax. At a 40 percent tax rate, this is a potential estate tax savings of approximately \$5.2 million, though the savings could be less than \$5.2 million if some of the \$13 million in appreciation would have been shielded from estate tax using the taxpayer's remaining unified credit.

Estate Tax vs. Income Tax Trade-Offs

Of course, \$5.2 million of estate tax savings seems like an obvious tax planning success, and it is, at least from an estate tax perspective. But for income tax purposes, the irrevocable trust — or the taxpayer's heirs, if the equity is later distributed to them — may still have only the taxpayer's original \$2 million basis. Because the equity was removed from the taxpayer's estate by the transfer to the trust, the equity does not get a step-up in basis upon his death.

If the trust or its beneficiaries immediately sell the equity for its \$20 million value, they will recognize \$18 million in taxable gain. At a 23.8 percent capital gains tax rate with net investment

income tax added, this means additional federal income tax owed, which could have been avoided, of nearly \$4.3 million. Therefore, the net federal tax savings from the transfer were only about \$900,000, not \$5.3 million.

Other expenses may make the comparison even closer. State income taxes can create an additional cost when the basis step-up is sacrificed. One might assume that state estate tax savings could help counteract those costs. However, today only 12 states and the District of Columbia have a state-level estate tax, but 41 states and the District of Columbia have state-level income tax. If you live where there is no state estate tax but there is a state income tax, there are no state-level estate tax savings to offset the additional state income tax the estate planning may have created.

This is not a negligible consideration. California does not have an estate tax, so the hypothetical taxpayer's transferring of the equity to an irrevocable trust did not produce any California estate tax savings. However, California's income tax can tax the gain on the sale of assets at rates of up to 13.3 percent. Therefore, at the 13.3 percent tax rate, the \$18 million of taxable gain could generate nearly \$2.4 million of additional California income tax that could have been avoided if the equity had received a step-up in basis. This hypothetical additional state income tax significantly exceeds the \$900,000 federal net tax benefit from using the irrevocable trust structure.

Transferring real estate to an irrevocable trust can trigger property tax reassessment, which can create higher property tax liabilities relative to if you continue to own the real estate until your death, delaying the timing of the change in ownership. There are costs of maintaining an irrevocable trust, including trustee fees and accounting fees, which would not have to be incurred if an asset is kept in a living trust. As mentioned earlier, there is also the possibility of additional income tax from any income generated within the trust (such as dividends produced by the equity) resulting from steeper tax brackets than would have applied if the taxpayer had retained direct ownership of the equity, including through a living trust.

There are situations in which it is advantageous to freeze estate values by transferring appreciating assets to an irrevocable trust. Irrevocable trusts are a useful arrow in an estate planner's quiver. But it is often a mistake to assume there is always a net benefit to transferring appreciating assets into irrevocable trusts. No estate planning on this topic should fail to account for the offsetting income tax consequences.

Foreign Trusts

Foreign trusts have special and much more complex tax rules and tax reporting requirements than we can cover in this article. As a general encapsulation, if a U.S. person forms a foreign trust, it is generally much more difficult to avoid the foreign trust being treated as a grantor trust for U.S. tax purposes, with its income immediately taxable to the U.S. settlor. If a U.S. taxpayer is a beneficiary of a non-grantor foreign trust (for example, a trust established by a non-U.S. relative as part of their estate planning), they may be subject to the onerous throwback-tax rules mentioned earlier that can subject the

distributions they receive to U.S. income tax plus interest.

Foreign trusts can also trigger heightened and complex reporting requirements, either as a foreign grantor trust or a foreign non-grantor trust. At a minimum, these heightened reporting obligations can include the frequently audited Forms 3520 and Forms 3520-A, which are in addition to the more typical foreign reporting obligations that can be triggered by foreign assets, such as foreign bank account reports; Forms 8938, "Statement of Specified Foreign Financial Assets"; Forms 5471, "Information Return of U.S. Persons With Respect to Certain Foreign Corporations"; Forms 8865, "Return of U.S. Persons With Respect to Certain Foreign Partnerships"; and others.

Conclusion

Estate planning is complex, and income taxes on the surface may seem low on the list of considerations. But the inherent trade-offs between income and estate taxes can be worth a second look. ■