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Income tax considerations in estate planning: Part 1

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When most people hear "estate planning" they do not think of income taxes first. They think of making sure that the right people in their lives end up with the right assets, and that key issues such as guardianship of minor children are attended to appropriately. They are also likely to think of taxes, especially estate taxes, sometimes referred to with a political spin as the "death tax." This is so even though in most cases; only especially wealthy people end up having to pay estate taxes.

Currently, the gift and estate tax exemption is $13,990,000 per person, 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 Jan. 1, 2026. If the law is not amended soon, some estate planners think there will be an explosion of last-minute estate planners who want to make gifts against their tax-free $13,990,000 amount 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, a Will has to be probated. That is a court procedure that takes a long time, is public and is expensive.

Do people think of income tax considerations in estate planning? Not always, but at times, it can pay to consider whether you want to pay income tax personally or rather have your children pay the income taxes. 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, their 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% federal tax on long term capital gains, plus 13.3% California tax. Your kids might be in lower tax brackets for ordinary income, and for capital gain. Consider the current federal tax rates for long-term capital gain:

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

In short, income tax and estate tax can be a kind of ying and yang, and there are many tradeoffs to consider. There is also the ever-present obligation to file annual income tax returns, which can continue to be a burden. When someone dies, their estate planning and death can impact income tax reporting on four (or *more*) income tax returns.

Decedent's income tax return

When someone dies, their personal representative (i.e., executor) must file their final income tax return for the year they died. This income tax return includes the income they 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 the year the taxpayer died.

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. Regular IRS powers of attorney, on a Form 2848, are not sufficient to qualify a personal representative to file a tax return on behalf of the decedent.

Forms 2848 generally expire when the taxpayer dies. Instead, the personal representative must file an IRS Form 56 notifying the IRS that they have been appointed as the decedent's personal representative in order to file a final tax return on behalf of the decedent.

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 tax 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 while they were still alive would be included. Electing to file a joint return with the deceased spouse can allow a surviving spouse to obtain the benefits that filing jointly usually provides.

However, it also has risks. It effectively makes the surviving spouse and the 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 of the estate besides the surviving spouse (e.g., children from a previous marriage), then 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 the estate who could be negatively impacted 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, so that the estate is only liable for any income tax, penalties, or interest that are attributable to the decedent's income and deductions.

Although this may seem simple enough, many taxpayers who live in community property states and who 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 the income or earned it. However, it is not that straightforward.

Under Section 66 of the tax code, items of "community income" (which are 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% of each spouse's wages on each spouse's separate tax return. A Form 8958 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 the decedent's death is considered as received by the decedent's estate, which is a separate taxpayer from the decedent. The estate's income is reported on an IRS Form 1041, the same form used by some trusts to report their income. When is the estate's income tax return due? The answer is complicated.

This 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 can 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 Dec. 31 of the same year, but if the decedent died in February, the estate could elect for its first fiscal year to end on Jan. 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 Dec. 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.

There are various types of income that 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, that can theoretically generate taxable gain to the estate for income tax purposes.

However, estates are generally entitled to a step-up in tax basis for the 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 (or "IRD"). IRD 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 to a beneficiary. Income is usually generated by actions the estate takes, or income produced after the estate holds the assets. IRD 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 pre-tax payment that would have been taxed to the decedent, that payment may be IRD that the beneficiary must include in their income. Another possible exception is if a US beneficiary receives their inheritance through a foreign trust.

If the foreign trust has not been subject to US tax itself, then a distribution to a US beneficiary can trigger the "throwback tax" rules that effectively saddle the beneficiary with the obligation to pay some of the US 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 US beneficiaries who receive distributions.

Milder than the throwback tax is the obligation for US 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 very end of the IRS Form 3520. 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 separately signed and filed with the IRS. Similar to the beneficiary's regular Form 1040 tax return, it is due by April 15 of the following year for any calendar-year taxpayer.

This concludes Part 1 of our two-part series on trust tax returns and estate planning, both of which will be featured in the Daily Journal's May 5 Trust & Estates special issue. In this section, we've covered the basics of living trusts and irrevocable non-grantor trusts, focusing on their income tax implications and how asset transfers to these trusts can affect your overall estate planning strategy. In Part 2, we will delve deeper into advanced estate planning techniques, including how to navigate the potential tax benefits and drawbacks of transferring appreciating assets to trusts, as well as the complexities surrounding foreign trusts and their unique tax reporting requirements. Stay tuned for further insights on how to optimize your estate planning approach.

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