Farr Law Firm Newsletter
Big City Solutions. Small Town Values.
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Do You Pay Tax on an Inheritance?

Introduction
Beneficiaries often ask: “Will I have to pay tax on my inheritance?” The taxation of inheritances is not a binary, yes-or-no question. Rather, the analysis depends on a number of factors including the size of the estate, the type of assets comprising the estate and the timing of distributions.

Federal estate and generation-skipping-transfer taxes
The federal estate tax law currently gives each U.S. citizen and permanent resident a $5.49 million exemption that can be left free of federal estate tax. With proper planning, a married couple can leave $10.98 million free of federal estate tax to their beneficiaries.

The generation skipping transfer (GST) tax applies where a decedent benefits someone who is more than one generation removed from the decedent (commonly a grandchild) and is in addition to the estate tax. However, each U.S. citizen and permanent resident has a $5.49 million GST exemption.

The applicable rate for amounts above the estate or GST exemption is 40%. Other deductions such as the marital deduction and charitable deduction may apply.

State estate and inheritance taxes
Many states and foreign jurisdictions levy an estate tax on decedent’s estates and trusts if property is located within its jurisdiction. A few jurisdictions levy an inheritance tax on resident beneficiaries. Each jurisdiction has its own exemption amount, rate, and exceptions for certain types of beneficiaries. Florida does not impose an estate or inheritance tax.

Capital gains tax and basis adjustment on capital assets
The holder of a capital asset pays tax on the difference between the asset’s adjusted basis and its selling price. Basis is generally computed as the amount paid for the asset plus the amount of any improvements.

Capital assets owned by a decedent receive a basis adjustment equal to the fair market value as of date of death, often eliminating built-in capital gain.

For example, decedent owned real property with a cost basis of $10,000 and a fair market value of $100,000. If decedent had sold the property immediately prior to death, decedent would recognize $90,000 in capital gain. However, at death, the basis would be adjusted to $100,000. If the property were sold after death for $100,000 there would be no capital gain on the sale of inherited property.

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Forrest is Board Certified by The Florida Bar in Wills, Trusts and Estates and focuses his practice on estate planning, estate and trust administration, and related tax matters.

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Income Recognized by an Estate or Trust During Administration

Estates and trusts often have ordinary income. Generally, the estate or trust must pay federal income tax. The maximum federal income tax rate of 43.4% applies to income in excess of $12,500. Additionally, some states levy a state fiduciary income tax based on the place of administration of the trust or the fiduciary's state of residence. Florida does not impose a fiduciary income tax.

Estates and trusts may elect to pass the income pre-tax out to the beneficiaries who will bear the tax responsibility.

If the beneficiaries pay the tax on the income, then the income is divided among the beneficiaries and taxed at each beneficiary's personal income tax rate, which may be lower than the federal and state rates applicable to estates and trusts.

Federal tax law allows this approach to be utilized so long as the income was distributed to the beneficiaries within the same calendar year that the income was received by the estate or trust or was distributed within the first 65 days of the following calendar year. Most states recognize this approach as well.

Retirement plans and annuities

Beneficiaries of tax-deferred plans such as traditional IRAs or 401(k) plans pay tax as withdrawals are made. Generally, the beneficiary must take withdrawals and pay tax over the beneficiary's life expectancy, although a beneficiary who receives a tax-deferred account outright may generally withdraw the assets and pay tax more quickly. If an estate or trust is named as beneficiary of a tax-deferred plan, the rules are myriad and require careful consideration.

Similarly, annuities typically accumulate on a tax-deferred basis and some portion of the annuity payment is taxable to the annuitant. Some annuities allow a beneficiary to continue the annuity payments and pay tax incrementally.

Life Insurance

Most life insurance proceeds are not includable as taxable income. However, some of the more sophisticated products have income-generating elements that may be taxable as either ordinary income or capital gain.

Conclusion

In summary inheritances received from an estate or trust may have tax implications that should be carefully reviewed with a qualified tax professional.

Farr Law Firm since 1924

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The Farr Law Firm is honored to be included in the U.S. News – Best Lawyers® 2017 "Best Law Firms" report, receiving a Tier 1 ranking for outstanding work in trusts and estates and real estate law in the Fort Myers metro area.

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