

# Estate Taxation Made Simple (?)

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## I. Types of Tax

### A. Estate Tax

- Assessed on the value of the decedent's estate on the date of death or the alternate valuation date 6 months later
- Currently only applicable if the net estate exceeds \$1 million (\$1.5 million during 2004 and 2005, \$2 million during 2006-2008, and \$3.5 million in 2009)
- **Form 706** must be filed 9 months after the date of death, but can be extended another 6 months
- Tax (assessed at a current maximum rate of 49%) is due 9 months after the date of death
- *Planning Tip:* Request prompt assessment of tax using Form 4810 to limit statute of limitations to 18 months after filing

### B. Gift Tax

- Assessed on any gifts made by the decedent prior to death
- \$11,000 annual exclusion applies
- All gifts in excess of exclusion are reportable on **Form 709** within 9 months after date of gift and taxed at estate tax rates

### C. Inheritance Tax

- Can be assessed to the beneficiary of the estate by the state in which the decedent was domiciled
- California repealed the Inheritance Tax in 1982 and instead imposes an estate tax, sometimes referred to as the Pick-Up Tax (as it is a percentage of the federal estate tax liability)
- This tax is reportable on **Form ET-1** 9 months after the date of death and is payable to the State Controller's Office, not the Franchise Tax Board
- The federal estate tax return currently allows a credit for estate taxes paid to the state, but this credit will be phased out over a 4-year period beginning in January 2002

### D. Income Tax

- Assessed on income earned
- Earned income must be allocated to the decedent for all amounts received prior to the date of death and to the estate thereafter
- The "estate" is created on the date of death and becomes the liability of the fiduciary named or appointed

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- **Form 1040** for the decedent's portion of the income must be filed by April 15<sup>th</sup> of the year following the death
- **Form 1041** for the estate's portion of the income must be filed by April 15<sup>th</sup> of the year following the death and for every year thereafter until the estate is closed
- Tax is assessed to the decedent at ordinary income tax rates:

Filing Status	10%	15%	27%	30%	35%	38.6%
Single	Under 7,000	Under 28,400	Under 68,800	Under 143,500	Under 311,950	Over 311,950
Married Filing Joint (MFJ)	Under 14,000	Under 56,800	Under 114,650	Under 174,700	Under 311,950	Over 311,950

- Tax is assessed to the estate at different rates:

15%	27%	30%	35%	38.6%
Under 1,900	Under 4,500	Under 6,850	Under 9,350	Over 9,350

- *Planning Tip:* Request prompt assessment of tax using Form 4810 to limit statute of limitations to 18 months after filing

## II. Where to Report What

See Table entitled "Income and Expenses Chart for a Decedent"

### A. Retirement Accounts and Annuities

- The value of these accounts on the date of death must be included in the taxable estate on Form 706
- The income received from the payout of these accounts is taxable to the estate on Form 1041 or the beneficiary on his personal tax return
- *Planning Tip:* Consider making a charity the beneficiary of the IRA to avoid income taxation to the estate and beneficiary

### B. Income in Respect of Decedent (IRD)

- All income to which the decedent had a right but which was received after the date of death must be reported on both Forms 706 and 1041
- IRD includes uncollected wages, certain deferred-compensation and stock-option plans, qualified pension plans and IRAs, interest and dividends accrued but unpaid at death, gain from the sale of property if the sale occurred before death but proceeds were not collected until after death, interest accrued through the date of death on Series EE bonds, and annuity payments in excess of the decedent's investment in the contract
- If estate tax was due on this income on Form 706, the estate may claim a deduction on Form 1041 for the tax paid

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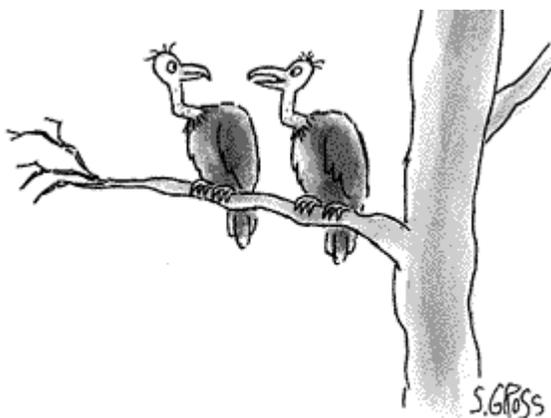
- C. Funeral Expenses
    - Allowable expenses may be deducted on Form 706
  - D. Medical Expenses of the Decedent
    - Medical expenses paid by the decedent before death are deductible as Itemized Deductions on Form 1040, subject to the 7.5% AGI limitation
    - Medical expenses incurred before death but paid by the estate within one year from the date of death may also be deducted on Form 1040 if an election to do so is made
    - Alternatively, medical expenses incurred prior to death but paid by the estate may be deducted on Form 706
  - E. Miscellaneous Itemized Deductions
    - Investment expenses and tax preparation fees incurred after death may be deducted either on Form 1041 subject to the 2% AGI limitation or on Form 706
    - Expenses incurred prior to death but paid by the estate may be deducted on both Forms 706 and 1041
  - F. Charitable Contributions
    - Amounts contributed before death are deductible on the decedent's Form 1040
    - Contributions are deductible only if the decedent's will requires that the contributions to be made
- III. When Things Get Complicated
- A. Married Decedents
    - 1. Marital Deduction
      - Transfers between spouses are typically tax-free upon the death of the 1<sup>st</sup> spouse, but transferred amounts are includible in the estate of the 2<sup>nd</sup> spouse
      - Transfers to non-citizen spouses do not qualify for the marital deduction
    - 2. Surviving Spouse
      - A decedent's IRA funds may be rolled over to the surviving spouse's IRA if that spouse was the designated IRA beneficiary
      - Alternatively, the surviving spouse can leave the funds in the decedent's IRA where distributions do not have to begin until December 31<sup>st</sup> of the year in which the decedent would have turned 70-1/2

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- If distributions had already begun for the decedent, the surviving spouse must either take a lump-sum distribution or continue the payout in the same manner as the decedent or take the payout over the surviving spouse's life expectancy
3. Qualifying Widower
- If all of the following criteria are met, the surviving spouse may file using the more favorable filing status in the two years following the decedent's date of death:
    - a. The taxpayer's spouse died in 2001 or 2002
    - b. The taxpayer was entitled to file a joint return for the year the spouse died
    - c. The taxpayer did not remarry before January 1, 2004
    - d. The taxpayer paid more than half the cost of keeping up his or her home
    - e. The taxpayer's home was the main home for the entire year of the taxpayer's dependent child
- C. A/B Trusts
- The following tax returns may be required upon the death of the 1<sup>st</sup> spouse:
    1. Form 706 if decedent's share of the estate is in excess of \$1 million
    2. Form 1041 for income apportioned to decedent from date of death to year-end (and every year beyond)
    3. Form 1040 for income earned by both spouses prior to date of death and by surviving spouse after date of death to year-end (and every year beyond)—Surviving spouse may file Married-Filing-Jointly
  - The following tax returns may be required upon the death of the 2<sup>nd</sup> spouse:
    1. Form 706 if 2<sup>nd</sup> spouse's share of the estate is in excess of \$1 million
    2. Form 1041 for income apportioned to 2<sup>nd</sup> spouse from date of death to year-end (and every year beyond)
    3. Form 1041 for the income attributable to the trust assets of the 1<sup>st</sup> spouse
    4. Form 1040 for income earned by the 2<sup>nd</sup> spouse's prior to date of death to year-end
- D. Generation-Skipping Tax (GST)
- GST tax imposed on transfers of property to a grandchild at the maximum federal estate tax rate in addition to the regularly computed estate and gift tax
  - Each transferor has a \$1.1 million exemption and the tax is not applied to qualified transfers for medical and tuition payments
- E. Basis
- The heir receives property with a stepped-up basis to the date of death or the value attributed to the asset on Form 706, if filed

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- The holding period of all inherited assets is deemed to be long-term, even if the heir sold the inherited asset less than one year after death
- The decedent's capital loss carryovers from Form 1040 cannot be passed on to heirs other than the surviving spouse, but any unused losses on the fiduciary tax return can be passed through to the beneficiaries upon termination of the estate



*"Only two things are  
certain—death and food."*

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