Steven M. Vogt, CPA, EA

Is an Inheritance Taxable?

Article Highlights:

- Estate Tax
- Estate Tax Exemption
- Fair Market Value at Date of Death
- Step-up in Basis
- Community Property
- Deferred Untaxed Income

A frequent question is whether inheritances are taxable. This is a frequently misunderstood question related to taxation and can be complicated. When someone passes away, all of their assets will be subject to inheritance taxation, and whatever is left over after paying the inheritance tax passes to the decedent's beneficiaries.

Sound bleak? Don't worry, very few decedents' estates ever pay any inheritance tax, primarily because the code exempts a liberal amount of the estate from taxation; thus, only very large estates are subject to inheritance tax. In fact, with the passage of the Tax Cuts & Jobs Act (tax reform), the estate tax deduction has been increased to $11,180,000* for 2018 and is inflation adjusted in future years. That generally means that estates valued at $11,180,000* or less will not pay any federal estate taxes and those in excess of the exemption amount only pay inheritance tax on amounts in excess of the exemption amount. Of interest, there are less than 10,000 deaths each year for which the decedent's estate exceeds the exemption amount, so for most estates, there will be no estate tax and the beneficiaries will generally inherit the entire estate.

** Note that, as with anything tax-related, the exemption is not always a fixed amount. It must be reduced by prior gifts in excess of the annual gift exemption, and it can be increased for a surviving spouse by the decedent's unused exemption amount.*

Because the value of an estate is based upon the fair market value (FMV) of the assets owned by the decedent on the date of their death (or in some cases, an alternative valuation date six months after the decedent's date of death, which is rarely used), the beneficiaries will generally receive the inherited assets, with a basis equal to the same FMV determined for the estate. What this means to a beneficiary is if they sell an inherited asset, they will measure their gain or loss from the inherited basis (FMV and date of death).

> **Example #1:** Joe inherits shares of XYZ Corporation from his father. Because XYZ Corporation is a publically traded stock, the FMV can be determined by what it is trading for on the stock market. Thus, if the inherited basis was $40 per share and the shares are later sold for $50 a share, the beneficiary will have a taxable gain of $10 ($50 - $40) per share. In addition, the gain will be a long-term capital gain, since all inherited assets are treated as being held long-term by the beneficiary. On the flip side, if the shares are sold for $35 a share, the beneficiary would have a loss of $5 per share.

> **Example #2:** Joe inherits his father's home. Like other inherited property, Joe's basis is the FMV of the home on the date of his father's death. However, unlike the stock, whose FMV could be determined from the trading value, the home needs to be appraised to determine its FMV. It is highly recommended that a certified appraiser do the appraisal. This is something that is frequently overlooked and can cause some problems if the IRS challenges the amount used for the basis.

This FMV valuation of inherited assets is frequently referred to as a step-up in basis, which is really a misnomer because the FMV can, under some circumstances, also be a step-down in basis.

If the decedent was married at the time of death and resided in a community property state, and if the property was held by the couple as community property, the beneficiary spouse will generally receive a 100% basis equal to the FMV of the property, even though the spouse will have only inherited the deceased spouse's share.

Not all inherited assets received by the beneficiary fall under the FMV regime. If the decedent held assets that included deferred untaxed income, those assets will be taxable to the beneficiary. Examples of those include inherited:

Traditional IRA Accounts – These are taxable to the beneficiaries, but the special rules generally allow a beneficiary to spread the income over five years or take it over their lifetime.

Roth IRAs – Qualified distributions are not taxable to the beneficiary.

Compensation – Amounts received after the decedent's death as compensation for his or her personal services.

Pension Payments – These are generally taxable to the beneficiary.

Installment Sales - Whoever receives an installment obligation as a result of the seller's death is taxed on the installment payments the same as the seller would have been, had the seller lived to receive the payments.

This is just an overview of issues related to being the beneficiary of an inheritance. If you have questions related to the tax ramifications of a potential or actual inheritance, please give this office a call.