

The Relationship between Income Taxes and Estate Taxes



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We have told many of our incredulous clients in the past of the relationship

between income taxes and estate taxes.

Many of them remain incredulous so perhaps putting it in writing will convince them.

In 2010, while there is no federal estate tax, the New York State Estate tax and that of most states is very much alive. New York's estate tax is equal to the amount of the federal credit for state death tax paid. That might seem ridiculous given that in 2010, there is no federal credit for state death tax paid; but that is current NYS tax law. Presently, NYS's tax law allows a \$1,000,000.00 exclusion which eliminates the tax on estates of up to \$1,000,000.00 in assets. Most tax experts feel that even the federal estate tax will reappear with either an exclusion of between 3.5 million to 5 million dollars. This means that if a married couple properly plans their estate taxes, they will be able to shelter between \$7,000,000 to \$10,000,000.00 in assets from estate tax. The federal estate tax if it reappears will apply to only about 5,000 estates annually.

So with that as an introduction, how are income and estate taxes related. The first and most obvious way is that the heirs of a decedent get a step up in basis to the fair market values of all assets owned by

the decedent that are included in the Gross estate for federal estate tax purposes. So for example if I inherit my father's IBM stock, which he purchased at \$40.00/share, I can sell it on the day I receive it at its date of death fair market value of \$400.00/share and pay zero income tax on what would otherwise be a substantial capital gain.

It is important to realize that under current 2010 law, the step up in basis is limited. Each decedent's heirs can step up the basis of assets received from him or her to the extent of 1.3 million in assets. A surviving spouse is under 2010 law allowed an additional step up (over the 1.3 million) equal to an additional 3 million in assets. Obviously then it is important to realize the relationship between income taxes and estate taxes and plan both taxes together for maximum possible savings (See IRC Section 1022).

A decedent's assets may also include income owed to him which has not yet been collected at the time of his death. We call this income income in respect of a decedent or IRD. Some examples of IRD are legal fees owed to an attorney but not yet collected, interest on U.S. Savings bonds owned by the decedent which has been earned but not yet collected, pension plan benefits which are vested (legally the decedent's) but have not yet been paid because the decedent has died before reaching retirement age or tax deferred traditional IRA accounts.

Congress recognized that such IRD assets are subject to both income taxes (because the income has not yet been recognized for income tax purposes) and estate taxes (because these IRD assets

belong legally to the decedent. To mitigate this double taxation, Congress enacted an income tax deduction for the percentage of the federal estate tax attributable to the IRD assets. This deduction is taken on your income tax return on Schedule A as an itemized deduction not subject to the 2% of limit on other miscellaneous itemized deductions. The income tax deduction for IRD is the deduction most often missed (not taken) by both taxpayers and tax professionals alike because they simply do not understand it. The IRD deduction can however be very large. Recently, I had a wealthy client get an IRD deduction of \$161,000.00 which resulted in a tax refund to him of \$90,000.00.

The fact that this deduction is so often missed and the fact that the deduction can be so large is a clear reason why it is so important to hire an estate attorney who understands both income taxes and estate taxes to prepare the estate tax returns (Forms 706 and NYS 706), the federal and NYS fiduciary income tax returns (forms 1041 and form IT-205 respectively) and even the personal income tax returns of the beneficiaries and the decedent. **As we have seen income taxes and estate taxes are closely related and to minimize taxes, the client needs to hire an attorney with a comprehensive knowledge of both.**

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