Fiduciary Trust International

Inheriting Wealth: When Will Inheritance Result in Income Tax?

INSIGHTS

Receiving an inheritance can come with a number of questions. One of the first questions many people ask is whether the inheritance will result in income tax to them.

The simple answer is no. While federal estate taxes and state-level estate or inheritance taxes may apply to estates that exceed the applicable thresholds (for example, in 2019 the federal estate tax exemption amount is $11.4 million for an individual), receipt of an inheritance does not result in taxable income for federal or state income tax purposes.

Nevertheless, all assets you inherit carry with them eventual, and sometimes very immediate, income tax concerns. To make well-informed decisions and handle an inheritance prudently, it is important to understand the type of assets you're receiving, and the income tax concerns for each.

In general, you can think of inherited assets in six general categories:

1. Cash and Securities
2. Retirement Accounts
3. Real Estate
4. Art and Collectibles
5. Life Insurance and Annuities
6. Interests in Trust

Income Tax Treatment for the Six Most Common Types of Inherited Assets

The following are the most common types of inherited assets and their potential income tax consequences.

1. Cash and Securities

In general, you do not owe income tax on cash you receive as an inheritance—but there is a caveat. If what you receive is not simply cash, but rather is the right to receive money due to the person you're inheriting from, it's possible you could owe income tax when you receive the amounts. This typically involves items like salaries, bonuses, and promissory note payments, which would have been taxable income to the decedent (i.e., the person you're inheriting from) but never were reported on the decedent's or their estate's income tax returns. The amounts don't escape income tax because of the decedent's death. Instead, you end up paying the income tax as the recipient.

Step-up in Cost Basis

When you inherit securities, your receipt of them does not result in income tax. In fact, you receive the added tax benefit in that the income tax basis of the securities gets updated to the fair market value of the securities on the decedent's date of death (or six months later, if elected). This is referred to as the "step up" in basis and can be a tremendous benefit, especially if the securities were purchased at a low price and have increased significantly in value. This applies to publicly traded stock and bonds. It also applies to interests in private businesses, whether partnerships, limited liability companies or corporations.

For example, if you inherit shares in a company that were originally purchased for $100,000 and the value as of the decedent's date death was $1 million your income tax basis in the shares would be $1 million not $100,000. And you could sell the shares for $1 million with no capital gains tax. You would have capital gains if the shares continued to appreciate and you sold them for more than $1 million. What's more, gains from the sale would be classified as long-term capital gains, even if you sell the shares shortly after obtaining them.

2. Retirement Accounts

Retirement accounts, such as IRAs or 401Ks, are typically the most income tax sensitive assets you will inherit. If they are traditional accounts (and not Roth's), the account holdings have not yet been taxed. The accounts were likely funded by non-taxed income or employer contributions, and earnings and appreciation in an account also will not have been subject to tax.

As a result, your withdrawals from the account will be considered income and you will need to pay income tax. In addition, depending on your relationship to the decedent and how you receive your interest in the account, IRS rules will require you to take withdrawals from the account over a certain period.

Your options for inheriting an IRA will depend on a handful of factors:
Spouse. If you are the beneficiary of your spouse's traditional IRA, your options for how you handle the account will depend on whether your spouse was required to take distributions from the account before their death. Assuming they were, you generally will need to evaluate two options:

1. **Rollover into your own IRA.** As a surviving spouse, you can roll your spouse's IRA into your existing IRA or elect to be treated as if you are the owner of the IRA. The IRS will treat the assets as if they had been your IRA all along, and you'll pay income taxes on the withdrawals as you make them. You will be required to take withdrawals starting at age 70½ just as you would with your own IRA. This is often the preferred choice since it provides greater flexibility in the deferral of withdrawals (and resulting income tax) and how you can leave the IRA when you die.
2. **Transfer assets into an Inherited IRA.** Alternatively, you can establish a so-called "Inherited IRA" for your benefit (the account is typically titled, "Inherited IRA for the benefit of [Your Name]"). The main advantage of this approach is that it enables to you to withdraw funds from the account before you reach age 59½ without the normal 10% early withdrawal penalty. It also can make sense if you're over 59½ and your spouse was younger than you, since you'll be able to extend distributions over a longer period.

Non-Spouse. If you inherit a traditional IRA from someone other than a spouse, you can't roll the assets into your existing IRA or elect to treat the IRA as your own. Instead, you will generally want to open an Inherited IRA. While you can take a lump sum distribution from the IRA, that distribution will be fully taxable to you for the year of receipt, so it usually doesn't make sense.

The advantage of establishing an Inherited IRA is the ability to stretch out distributions, and the resulting income tax liability, over a longer period. You will need to take distributions starting the year after the year of the decedent's death, but under current rules you can have the opportunity to stretch those distributions over your remaining life expectancy.

Important Note: The SECURE Act, which passed the House by a vote on May 23, 2019, and is pending action in the Senate would generally restrict that timeframe to 10 years as well as make other changes to the rules on retirement accounts.

Trusts and Other Complicating Factors
If you receive an interest in a retirement account as the beneficiary of a trust or you are one of multiple beneficiaries, the analysis of your options in handling the account and your interests is likely to get complicated. When the beneficiaries of an IRA are not individuals, the IRA generally needs to be paid out within five years of the participant's death—with the resulting tax liability.

There are ways to "see-through" a trust and segregate off charities and other non-individual beneficiaries, but this typically will require tax or legal counsel and a weighing of costs and benefits (especially if the SECURE Act passes and the maximum deferral is limited to 10 years). It is also important to note that if the decedent didn't take their full required distribution from a retirement account in the year of the death, that distribution requirement and the resulting tax liability will pass to their successor.

Special Rules for Roth IRAs
The rules are different when dealing with a Roth IRA or 401k. Since assets in Roth accounts have already been taxed, you generally won't need to pay any income tax when you withdraw funds from the

account. This makes Roth accounts better to inherit, but that's because the decedent saved you the tax hit by already taking it during their lifetime.

3. Real Estate

Like securities, when you inherit real property the income tax basis is stepped up to the value of the property at the time of death (or if elected, six months later). If you decide to sell the property, you only pay capital gains tax on any appreciation over your stepped-up basis. In fact, it's often the case that you will realize a loss when sell real property shortly after it's inherited which can offset other gains. That's because the expenses of sale can be added to the basis of the property, which is already "stepped-up" to current value that presumably you are selling the property for.

In addition, if the property is a personal residence and it does appreciate significantly after you inherit it, it is important to remember you can exclude $250,000 ($500,000 for married couples) of gain on the sale from taxes, as long as you own the house and use it as your principal residence for two of the five years before the sale. If you inherit the property from a spouse, you can use their period of residence to qualify for the two years.

Finally, if you decide to retain the property, of course, any rental income will be taxable, but if you are renting the property, it also can be possible deduct your expenses related to the property as well as depreciation of the house. When inheriting real property, it's important to consider what you plan to do with the property as it can impact both the tax consequences stemming directly from the property as well as how you plan with your other assets to maximize your tax benefits.

4. Art and Collectibles

Again, like securities and real property (and any other appreciated property), the income tax basis of inherited artwork and other collectibles is stepped up to the fair market value at the time of death (or six months later, if elected). For these items, which may include anything from paintings, sculpture, clothing, furniture, books, jewelry, silver or other tangible items with potential for value, it is important to obtain a professional appraisal to document the value. An appraisal may be necessary for estate or inheritance tax purposes and is useful to make sure you insure and care for items that have value appropriately. From a tax perspective, it is important to have appraised values if items are being donated to charity, so you document your deductions appropriately. It can also be relevant when items are divided among family members, both to ensure fairness, and avoid claims of de facto sales.

5. Life Insurance and Annuities

From a tax perspective, the great benefit of life insurance is that life insurance proceeds are not counted as taxable income, so beneficiaries do not pay income tax on them. However, if you take your benefits in installments over time rather than in a lump sum, the balance of the account may earn interest over that time, which would be taxable.

With annuities, the situation is different. If an annuity provides for a death benefit, it typically will be treated like life insurance and not be subject to income tax. However, if you receive a survivorship right to a continuing annuity, the annuity payments you receive would likely be subject to income tax, like the other cash receivable mentioned previously.

6. Interests in Trusts

In addition to receiving assets directly from a decedent or their estate, you may also become the beneficiary of a trust as a result of a decedent's death. For income taxes, it's important to realize that assets in a trust will not receive a step-up in income tax basis if they were not included in the decedent's estate for estate tax purposes. The assets and legal requirements of a trust also can vary, so communication with the trustee, or with legal and tax counsel if you are the trustee, is key.

The good news is inheritance is generally income tax-free. But that doesn't mean you don't need to be attentive to income tax when you inherit. In many cases, there are opportunities to capture; in others, there may be pitfalls to avoid. Your Fiduciary Trust wealth advisor can help you work through the concerns and make the most out of what you inherit.

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