

# Death and Taxes: Survivors, Small Businesses, and Estate Planning

When a business owner dies, the tax and planning challenges can be significant. This course examines tax benefits available to surviving family members and explores estate planning strategies designed for small and family-owned businesses. Topics include choosing the right entity for smooth ownership transfer, deferring estate tax payments, and special rules for family farms. Conservation easement donation incentives round out the discussion — making this a practical resource for CPAs guiding business-owning clients through succession planning.

CREDIT HOURS 2 | FIELD OF STUDY TAXES | EXAM QUESTIONS 10

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## LEARNING ASSIGNMENTS AND OBJECTIVES

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### Assignment

- Study the full course materials included here.
- Complete the review questions after each chapter.
- Answer 10 final exam questions.
- Final exam is scored immediately, 70% or better passes.
- Certificate of completion is available in your account.
- Failed exams can be retaken free of charge.

### Course Objectives

- Identify the benefits provided to survivors when filing their own income tax returns.
- Recall some of the estate planning issues that affect small and family businesses.

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## Chapter 1: TAX BENEFITS FOR SURVIVORS

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### *Chapter Objective*

After completing this chapter, you should be able to:

- Identify the benefits provided to survivors when filing their own income tax returns.

### I. INTRODUCTION

Survivors can qualify for certain benefits when filing their own income tax returns, including the following:

- A surviving spouse can file a joint return for the year of death and may qualify for special tax rates for the following two years;
- If the decedent qualified as a taxpayer's dependent for the part of the year before death, a survivor can claim the exemption for the dependent on his or her tax return, regardless of when death occurred during the year; or
- If the decedent was the survivor's qualifying child, the survivor may be able to claim the child tax credit or the earned income credit.

### A. QUALIFYING SURVIVING SPOUSE

If a survivor's spouse dies within the two tax years preceding the year for which his or her return is being filed, the survivor may be eligible to claim the filing status of qualifying surviving spouse and qualify to use the married-filing-jointly tax rates.

#### 1. Requirements

Generally, a surviving spouse can qualify for this special benefit if he or she meets all of the following requirements:

- The surviving spouse was entitled to file a joint return with his or her spouse for the year of death – whether or not he or she actually filed jointly;
- The surviving spouse did not remarry before the end of the current tax year;
- The surviving spouse has a child, stepchild, or foster child who qualifies as his or her dependent for the tax year; and
- The surviving spouse provides more than half the cost of maintaining his or her home, which is the principal residence of that child for the entire year except for temporary absences.

*Example*

William Burns' wife died in 2024. Mr. Burns has not remarried and continued throughout 2025 and 2026 to maintain a home for himself and his dependent child. For 2024 he was entitled to file a joint return for himself and his deceased wife. For 2025 and 2026, he qualifies to file as a qualifying surviving spouse. For later years, he may qualify to file as a head of household.

The last year an individual can file jointly with, or claim an exemption for, his or her deceased spouse is the year of death.

If an individual is the surviving spouse and a personal representative is handling the estate for the decedent, he or she should coordinate filing his or her return for the year of death with this personal representative.

**B. INCOME IN RESPECT OF THE DECEDENT**

All income that the decedent would have received had death not occurred, that was not properly includible on the final return, is income in respect of the decedent. This exclusion does not apply to certain income.

Income in respect of a decedent must be included in the income of one of the following:

- The decedent's estate, if the estate receives it;
- The beneficiary, if the right to income is passed directly to the beneficiary and the beneficiary receives it; or
- Any person to whom the estate properly distributes the right to receive it.

If a taxpayer is required to include income in respect of the decedent in his or her income, he or she may be able to claim a deduction for the estate tax paid on that income.

*Example 1*

Frank Johnson owned and operated an apple orchard. He used the cash method of accounting. He sold and delivered 1,000 bushels of apples to a canning factory for \$2,000, but did not receive payment before his death. The proceeds from the sale are income in respect of the decedent. When the estate was settled, payment had not been made and the estate transferred the right to the payment to his surviving spouse. When Frank's surviving spouse collects the \$2,000, she must include that amount in her return. It is not reported on the final return of the decedent or on the return of the estate.

*Example 2*

Assume the same facts as in Example 1, except that Frank used the accrual method of accounting. The amount accrued from the sale of the apples would be included on his final return. Neither the estate nor the surviving spouse would realize income in respect of the decedent when the money is later paid.

*Example 3*

On February 1, George High, a cash method taxpayer, sold his tractor for \$3,000, payable March 1 of the same year. His adjusted basis in the tractor was \$2,000. Mr. High died on February 15, before receiving payment. The gain to be reported as income in respect of the decedent is the \$1,000 difference between the decedent's basis in the property and the sale proceeds. In other words, the income in respect of the decedent is the gain the decedent would have realized had he lived.

*Example 4*

Cathy O'Neil was entitled to a large salary payment at the date of her death. The amount was to be paid in five annual installments. The estate, after collecting two installments, distributed the right to the remaining installments to Nora, the beneficiary. The payments are income in respect of the decedent. None of the payments were includible on Cathy's final return. The estate must include in its income the two installments it received, and Nora must include in her income each of the three installments as she receives them.

*Example 5*

Clair inherited the right to receive renewal commissions on life insurance sold by her father before his death. She inherited the right from her mother, who acquired it by bequest from her father. Clair's mother died before she received all the commissions she had the right to receive, so Clair received the rest. The commissions are income in respect of the decedent. None of these commissions were includible in her father's final return. The commissions received by Clair's mother were included in her income. The commissions Clair received are not includible in her mother's income, even on her final return. Clair must include them in her income.

## 1. Character of Income

The character of the income received in respect of a decedent is the same as it would be to the decedent if he or she were alive. If the income would have been a capital gain to the decedent, it will be a capital gain to the beneficiary.

## 2. Transfer of Right to Income

If a beneficiary transfers his or her right to income in respect of a decedent, the beneficiary must include in his or her income the greater of:

- The amount he or she received for the right, or
- The fair market value of the right he or she transferred.

If a beneficiary makes a gift of such a right, he or she must include in his or her income the fair market value of the right at the time of the gift. If the right to income from an installment obligation is transferred, the amount he or she must include in income is reduced by the basis of the obligation.

A transfer for this purpose includes a sale, exchange, or other disposition, the satisfaction of an installment obligation at other than face value, or the cancellation of an installment obligation.

## 3. Installment Obligations

If the decedent had sold property using the installment method and a beneficiary collects payments on an installment obligation he or she acquired from the decedent, the beneficiary will use the same gross profit percentage the decedent used to figure the part of each payment that represents profit. The beneficiary should include in his or her income the same profit the decedent would have included had death not occurred.

## 4. Transfer to Obligor

A transfer of a right to income, discussed earlier, has occurred if the decedent (seller) had sold property using the installment method and the installment obligation is transferred to the obligor (buyer or person legally obligated to pay the installments). A transfer also occurs if the obligation is canceled either at death or by the estate or person receiving the obligation from the decedent. An obligation that becomes unenforceable is treated as having been canceled.

If such a transfer occurs, the amount included in the income of the transferor (the estate or beneficiary) is the greater of the amount received or the fair market value of the installment obligation at the time of transfer, reduced by the basis of the obligation. The basis of the obligation is the decedent's basis, adjusted for all installment payments received after the decedent's death and before the transfer.

If the decedent and obligor were related persons, the fair market value of the obligation cannot be less than its face value.

### C. SPECIFIC TYPES OF INCOME IN RESPECT OF A DECEDENT

This section explains and provides examples of some specific types of income in respect of a decedent.

#### 1. Wages

The entire amount of wages or other employee compensation earned by the decedent but unpaid at the time of death is income in respect of the decedent. The income is not reduced by any amounts withheld by the employer. If the income is \$2,000 or more, the employer should report it in box 3 of Form 1099-MISC and give the recipient a copy of the form or a similar statement.

Wages paid as income in respect of a decedent are not subject to federal income tax withholding. However, if paid during the calendar year of death, they are subject to withholding for social security and Medicare taxes. These taxes should be included on the decedent's Form W-2 with the taxes withheld before death. These wages are not included in box 1 of Form W-2.

Wages paid as income in respect of a decedent after the year of death generally are not subject to withholding for any federal taxes.

#### 2. Farm Income

A farmer's growing crops and livestock at the date of death normally would not give rise to income in respect of a decedent or income to be included in the final return. However, when a cash method farmer receives rent in the form of crop shares or livestock and owns the crop shares or livestock at the time of death, the rent is income in respect of a decedent and is reported in the year in which the crop shares or livestock are sold or otherwise disposed of. The same treatment applies to crop shares or livestock the decedent had a right to receive as rent at the time of death for economic activities that occurred before death.

If the individual died during a rental period, only the proceeds from the portion of the rental period ending with death are income in respect of a decedent. The proceeds from the portion of the rental period from the day after death to the end of the rental period are income to the estate. Cash rent or crop shares and livestock received as rent and reduced to cash by the decedent are includible in the final return even though the rental period did not end until after death.

*Example*

Alonzo Roberts, who used the cash method of accounting, leased part of his farm for a 1-year period beginning March 1. The rental was one-third of the crop, payable in cash when the crop share is sold at the direction of Roberts. Roberts died on June 30 and was alive during 122 days of the rental period. Seven months later, Roberts' personal representative ordered the crop to be sold and was paid \$1,500. Of the \$1,500,  $122/365$ , or \$501, is income in respect of a decedent. The balance of the \$1,500 received by the estate, \$999, is income to the estate.

### 3. Partnership Income

If the partner who died had been receiving payments representing a distributive share or guaranteed payment in liquidation of the partner's interest in a partnership, the remaining payments made to the estate or other successor in interest are income in respect of the decedent. The estate or the successor receiving the payments must include them in income when received. Similarly, the estate or other successor in interest receives income in respect of a decedent if amounts are paid by a third person in exchange for the successor's right to the future payments.

### 4. U.S. Savings Bonds Acquired from Decedent

If series EE or series I U.S. savings bonds that were owned by a cash method individual who had chosen to report the interest each year (or by an accrual method individual) are transferred because of death, the increase in value of the bonds (interest earned) in the year of death up to the date of death must be reported on the decedent's final return. The transferee (estate or beneficiary) reports on its return only the interest earned after the date of death.

The redemption values of U.S. savings bonds generally are available from local banks, savings and loan institutions, or the Federal Reserve Bank, or online at <http://www.TreasuryDirect.gov>.

If the bonds transferred because of death were owned by a cash method individual who had not chosen to report the interest each year and had purchased the bonds entirely with personal funds, interest earned before death must be reported in one of the following ways:

- 1) The person (executor, administrator, etc.) who must file the final income tax return of the decedent can elect to include in it all of the interest earned on the bonds before the decedent's death. The transferee (estate or beneficiary) then includes in its return only the interest earned after the date of death.
- 2) If the election in 1), above, was not made, the interest earned to the date of death is income in respect of the decedent and is not included in the decedent's final return. In this case, all of the interest earned before and after the decedent's death is income to the transferee (estate or beneficiary). A transferee who uses the cash method of

accounting and who has not chosen to report the interest annually may defer reporting any of it until the bonds are cashed or the date of maturity, whichever is earlier. In the year the interest is reported, the transferee may claim a deduction for any federal estate tax paid that arose because of the part of interest (if any) included in the decedent's estate.

### *Example 1*

Will's uncle, a cash method taxpayer, died and left him a \$1,000 series EE bond. He had bought the bond for \$500 and had not chosen to report the increase in value each year. At the date of death, interest of \$94 had accrued on the bond, and its value of \$594 at date of death was included in Will's uncle's estate. Will's uncle's personal representative did not choose to include the \$94 accrued interest in the decedent's final income tax return. Will is a cash method taxpayer and does not choose to report the increase in value each year as it is earned. Assuming he cashes it when it reaches maturity value of \$1,000, Will would report \$500 interest income (the difference between maturity value of \$1,000 and the original cost of \$500) in that year.

Will is also entitled to claim, in that year, a deduction for any federal estate tax resulting from the inclusion in his uncle's estate of the \$94 increase in value.

### *Example 2*

If, in Example 1, the personal representative had chosen to include the \$94 interest earned on the bond before death in the final income tax return of Will's uncle, he would report \$406 ( $\$500 - \$94$ ) as interest when he cashed the bond at maturity. This \$406 represents the interest earned after his uncle's death and was not included in his estate, so no deduction for federal estate tax is allowable for this amount.

### *Example 3*

Will's uncle died owning series HH bonds that he acquired in exchange for series EE bonds. Will was the beneficiary on these bonds. His uncle used the cash method of accounting and had not chosen to report the increase in redemption price of the series EE bonds each year as it accrued. His uncle's personal representative made no election to include any interest earned before death in the decedent's final return. Will's income in respect of the decedent is the sum of the unreported increase in value of the series EE bonds, which constituted part of the amount paid for series HH bonds, and the interest, if any, payable on the series HH bonds but not received as of the date of the decedent's death.