

## info sheet

## IRD: A tax rule beneficiaries need to know

### What is “income in respect of a decedent?”

Income in respect of a decedent (IRD) is income that is payable after the death of the person who was entitled to it and that would have been taxable to him if he had lived to receive it. The income is not includible in the decedent’s final tax return, because it was not payable until after his death, but it is taxable to the estate or the beneficiary.

### What kinds of income are IRD?

There are various types of income that can be IRD, but some of the most common types are unpaid compensation owing at death, retirement plan benefits, and commercial annuities. Let’s look at each in detail.

#### Unpaid compensation owing at death

If a person dies prior to retirement, he is likely to be owed some amount of money in connection with his employment. His employer may owe him a check for unused vacation time, or a client may not yet have paid a fee for services rendered. The decedent had earned the right to receive these amounts, and they would have been includible in his gross income if he had lived to receive them. However, they are not includible in the decedent’s final tax return because they were not payable until after his death.

#### Example:

Fred earned the right to receive a \$3,000 quarterly bonus from his employer based on his work performance for January 1 through March 31 of 2002, but his company does not actually pay the

bonuses to employees until May 1. Fred died on April 19, 2002. The \$3,000 bonus isn’t includible in Fred’s final tax return for calendar year 2002 because, although he had earned the right to receive the bonus, it wasn’t payable until after Fred died. The \$3,000 is considered to be IRD and will be taxable to his estate or to his beneficiaries.

#### Retirement Plan Benefits

Most of the money people have invested in employer-sponsored retirement plans and Individual Retirement Accounts (IRAs) went into the plan or IRA on a pretax basis, and therefore is taxable to them when it’s distributed. If the plan participant or IRA owner dies with money remaining in his account, distributions made to his beneficiary after his death will be considered IRD to the recipient because these distributions would have been taxable to the decedent if he had received them.

#### Annuities

With both qualified and non-qualified annuities, the death benefit is generally included in the owner’s gross estate. In addition, the beneficiary must pay income taxes on any earnings. But thanks to IRD, the beneficiary may get some tax relief. If estate taxes are owed by the estate, the beneficiary is entitled to an IRD itemized deduction on his or her income taxes. This deduction minimizes the impact of the estate and income taxes due on the IRD asset.

**Example:**

- \$1,000,000 annuity death benefit (\$400,000 earnings)
- \$500,000 estate tax (assuming 50% rate)
- \$200,000 deduction for estate tax paid on IRD (\$400,000 X 50%)
- \$70,000 income tax paid at 35% rate (\$200,000 X 35%)

**Is IRD property included in the taxable estate for estate tax purposes?**

Yes, IRD items are included as part of the decedent's taxable estate, and if the estate is larger than the applicable credit (\$1 million for decedents dying in 2003), the estate will be subject to tax.

**So IRD can be subject to two taxes — income tax and estate tax?**

It can, but the U.S. income tax system provides some relief from the double taxation to recipients of IRD in the form of an income tax deduction equal to their proportionate share of the estate taxes paid on the IRD. This deduction is frequently referred to as the IRD deduction or the Section 691(c) deduction.

**How is the income tax deduction for estate taxes on IRD calculated?**

First, you have to calculate the estate taxes due on the entire estate, and then you subtract the item of IRD and calculate the estate tax again. The difference between the results is the amount of federal estate tax attributable to the item of IRD. If two or more beneficiaries share the item of IRD, each beneficiary's percentage of the total tax deduction will be equal to his or her percentage of the item of IRD.

**Case Study: Helen and Kevin**

The late Helen's taxable estate (after deductions and exemptions) is valued at \$3,000,000. The total estate tax comes to \$930,000.<sup>1</sup> She had named her grown son (Kevin) as the beneficiary of her IRA, valued at \$240,000. When the estate tax is recalculated excluding the IRA, the tax comes to \$810,000. Therefore, the estate tax attributable to the IRA is \$120,000 (\$930,000 - \$810,000). Because the IRA is IRD property, it is also subject to income tax at the beneficiary level.

Kevin's inheritance, along with his other income for the year, would ordinarily put him into the 35% tax bracket. However, Kevin can effectively reduce his tax rate by claiming the IRD deduction for the federal estate taxes attributable to the IRA.

So Kevin's tax return will reflect the following:

● Total IRD includible in income	\$240,000
● Less deduction for estate taxes paid	(\$120,000)
● IRD subject to income tax after deduction	\$120,000
● Income tax on IRD at 35%	\$42,000

<sup>1</sup> This example only illustrates U.S. federal estate and income taxes. No state income, estate, or inheritance taxes are included in the example.

**What planning strategies exist?**

With the advice of her investment professional and/or estate planning adviser, Helen might have made decisions that could have worked out better for her son. The best solution for Kevin is if other assets are used to pay the estate taxes attributable to the IRA. A life insurance trust properly established for this purpose may be a good solution. Compare the effect on Kevin’s inheritance if the IRA assets are used to pay a proportionate share of the estate taxes versus the effect if other assets (i.e. life insurance trust assets) are used to pay the taxes.

	<b>IRA Assets Used to Pay Estate Taxes</b>	<b>Estate Taxes Paid with Other Assets</b>
IRA Distribution	\$240,000	\$240,000
Less Estate Taxes Paid from IRA	(\$120,000)	(0)
Less Income Tax on IRA Distribution	(\$42,000)	(\$42,000)
IRA Value After Taxes	\$78,000	\$198,000
Total Tax on IRA Inheritance	67.5%	17.5%

As you can see, if the IRA assets are used to pay the estate taxes, then after paying \$120,000 in estate tax and \$42,000 in income tax, Kevin would be left with only \$78,000 out of his \$240,000 inheritance. Taxes would have eaten up 67½% of his inheritance! If, however, some careful tax planning was done before Helen died, Kevin’s tax rate attributable to his inheritance is only 17.5%, which is half of his 35% regular income tax rate.

**Are there any other helpful planning techniques?**

There are some other planning techniques that could be beneficial here. For example, Helen could have directed that her IRA be used to fund charitable bequests she made in her will, leaving more non-IRD assets to pass on to Kevin. Bona fide charities aren’t subject to income taxes, and there is an estate tax deduction for gifts to charities. Therefore, charities receive a larger benefit from the inheritance of IRD than a tax-paying individual does.

If Helen couldn’t avoid leaving IRD to tax-paying beneficiaries, she could have attempted to steer more of the IRD toward her beneficiaries in lower income tax brackets and more of her non-IRD assets to the beneficiaries in higher brackets. A beneficiary in the 25% tax bracket will get to keep more of his inheritance than one in the 35% tax bracket will. Also, if Helen had drawn more of the income she needed during her lifetime from her IRD assets instead of her non-IRD assets, her estate would have contained a larger percentage of non-IRD assets at her death.

### Is there anything that Kevin can do after Helen's death to decrease the taxes on his inheritance?

Kevin may be able to make some choices that will help to ease the tax bite. Instead of taking his entire share of the inherited IRA out in a lump sum, he may be able to “stretch” his IRA distributions over his life expectancy. Depending on how long a period Kevin can stretch out the distributions and the rate of return generated by the IRA, Kevin may be able to effectively offset the income tax on the required distributions with tax-deferred growth on the balance of the IRA account. Kevin's ability to take advantage of this strategy will depend on a number of factors, including Helen's age when she died, the method of distribution (if any) that she had elected, and whether or not the estate has other liquid assets from which to pay the estate taxes. Kevin should meet with his investment professional or tax adviser before taking any distributions from the IRA.

### Should I design my estate plan so that IRD will not pass to my heirs?

There is no “one-size-fits-all” estate plan. The rules and choices involved in making an estate plan are complicated and numerous, and the right choices for you will depend on your personal circumstances (how much you own, what you own, how much of it you need now and what you want done with what's left when you're gone).

Our example showed the difference that careful planning can make for beneficiaries of IRD. The best way to figure out the choices you have and which options will best help to carry out your intentions is to discuss it with a qualified estate planning professional.

Obviously, dealing with finances can be complex at any time, no less when dealing with the loss of a loved one at the same time. That's why proper estate planning ahead of time can help spare your heirs difficulties and confusion later on — as well as ensure that as much of your hard-earned and long-saved assets go to them, rather than to Uncle Sam in unnecessary taxes.

### Resources for further information

[www.irs.ustreas.gov](http://www.irs.ustreas.gov)

#### Department of the Treasury Internal Revenue Service

Articles on tax issues for you, as well as links to publications and forms you may need.

[www.webtax.com](http://www.webtax.com)

#### World Wide Web Tax

A directory of Web sites providing information, expert advice, and tips on taxes.

[www.cpap.com](http://www.cpap.com)

#### *The CPA Journal*

Information and news on taxes. The September 2000 issue looks at the IRD deduction as a way to improve wealth preservation.

Contact your investment professional for more information or to construct a personalized Heritage Planning<sup>SM</sup> Profile to help your parents, your children, or yourself.

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