



What Is Income in Respect of a Decedent (IRD)?

Questions: Can you help me to understand the concept of IRD and the tax effects associated with it?

Answer: Broadly speaking, IRD is money owed to a decedent at the time of his or her death that would have been included in the decedent's gross income had the decedent lived to collect such sums. The rules governing IRD are found in IRC § 691.

But first a little history ... IRC § 691 was enacted to close a *Catch 22* in the tax rules.

Most individuals are on a cash basis method of accounting. Prior to the enactment of IRC § 691, if an individual died after completing all the actions necessary for income to be considered earned or a transaction to be considered completed but before receiving the money owed, the cash accounting rules prevented these sums from being included on the decedent's final income-tax return. Then, if such income were included in the decedent's estate, it would escape taxation due to the application of the basis step-up rules found in IRC § 1014(a).

This changed with the enactment of IRC § 691, along with the application of IRC § 1014(c), which provides that the step-up in basis at death "shall not apply to property which constitutes a right to receive an item of income in respect of a decedent under section 691."

As they exist today, the IRD rules shift the income-tax burden from the decedent to those who receive the income. But more on that later ...

Common Sources of IRD

The following are common sources of IRD:

- Wages or other employee compensation such as renewal commissions, deferred compensation, vacation pay, or bonuses owed the decedent at death

- Interest owed the decedent at death
- Dividend income where the decedent dies between the date of record and the date of payment
- Rental income paid after death but attributable to the period prior to death
- Royalties paid after death but attributable to the period prior to death
- Medical expense reimbursements that would have been income to the decedent had he lived
- The decedent's share of partnership income or S corporation income earned prior to death
- Death benefits paid to a decedent's heirs after death that are directly related to the decedent's past economic activities, even if the decedent had no legally enforceable right to receive such compensation prior to death
- Annuities with a refund feature or payment to the beneficiary at the owner's death
- Income earned on the sale of property under an installment sale where payments are received after death
- Distributions from a 403(b) tax deferred annuity
- Distributions from qualified plans and IRAs

IRD Taxation

IRD is includible in the decedent's gross estate and is subject to estate tax. However, in contrast to most situations where assets that are part of an estate receive a basis step-up under IRC § 1014(c), the recipient of an IRD asset takes the decedent's basis (i.e., carryover basis).

Not only is IRD taxed for estate-tax purposes, but the estate or beneficiary who receives the IRD will pay income tax in the same manner as the decedent. Thus, if the income would have been ordinary income to the decedent, then it is ordinary income to the recipient. Likewise, if the income would have been treated as capital gain to the decedent, then it is treated as capital gain to the recipient.

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When is IRD Taxable?

Items of IRD are included in gross income in the taxable year when received.¹ This rule applies regardless of the recipient's accounting method. Thus, an accrual basis taxpayer will recognize IRD only when it is actually received.²

In general, if any person to whom IRD is taxable disposes of the right to the income through a sale, exchange, or gift, the transfer will trigger IRD taxation.³

If, however, the person who receives the IRD dies and leaves the remaining income to another individual, there is no inclusion in the second decedent's final return. Of course, the person who receives the remaining income from the second decedent must include it in his/her gross income as it is received.

Installment obligations are a common form of IRD. Recognition of IRD occurs as the installment payments are received and upon transfer of the obligation as outlined above. However, additional rules are applicable. Any cancellation of an installment obligation is treated as a transfer and is taxable at its fair market value.⁴ Furthermore, a transfer of an installment obligation to the obligor will result in the recognition of IRD.⁵

IRC § 691(b): Deductions in Respect of a Decedent (DRD).

The recipient of IRD generally may take deductions attributable to that income, but such offsets are limited to those for trade or business expenses, and expenses incurred for the production of income, interest, taxes and depletion. No capital or ordinary loss carry forward from the decedent is permitted. Nor are deductions for charitable donations, casualty losses, or medical expenses allowed.

¹ IRC § 691(a)(1)

² Reg. § 1.691(a)-2(a)

³ IRC § 691(a)(2)

⁴ IRC § 691(a)(5)(A)(ii)

⁵ IRC § 691(a)(5)(A)

IRC § 691(c): Deduction for Federal Estate/Generation Skipping Tax Paid.

As discussed previously, an IRD item is subject to estate tax in the decedent's estate and is subject to income tax to the recipient. Also, such income may be subject to generation skipping transfer tax.

To alleviate this *double taxation* effect, IRC § 691(c) allows the recipient of the IRD an income tax deduction for the federal estate tax attributable to the IRD received. The deduction for estate tax paid is taken only as the income is received and in the same proportion. For example, if the income is received over a period of 12 years in equal amounts, the recipient may take one-twelfth of the total deduction in each of the 12 taxable years.

Where the income would have been ordinary income to the decedent, the deduction is claimed as an itemized deduction, not subject to the two percent floor. The IRD tax deduction is excluded from treatment as a miscellaneous itemized deduction for purposes of alternative minimum tax (AMT).⁶

In contrast, the IRD tax deduction for estate tax attributable to IRD that is capital gain must be deducted against capital gain.

If more than one type of IRD is distributed or more than one beneficiary receives IRD, the IRD tax deduction is allocated pro rata. That is, each recipient is entitled to that share of the total IRD deduction, which is in the same proportion that his/her share of the IRD bears to the total gross IRD that was included in the estate.

Computation of the IRC § 691(c) Deduction.

The amount of the deduction is calculated by computing the federal estate tax (or generation skipping transfer tax) including the net value of all IRD items, and then recalculating the federal estate tax (or generation skipping transfer tax) excluding the net value of all IRD items. The difference between the two results is the amount of the IRD tax deduction.

⁶ IRC § 56(b)(1)

IRC § 691(c)(2)(B) defines the net value of all items of IRD as the excess of the value of all items of IRD over the value of all items of DRD.

The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA)

Under the EGTRRA provisions, the step-up in basis rules under IRC § 1014 are repealed for decedents dying in 2010 (for one year only) and replaced with a modified carryover basis provision. Under the modified carryover basis provisions, a recipient will have a basis in property equal to the *lesser* of the decedent's adjusted basis or the fair market value at death. In addition, there will be a step-up in basis for the first \$1.3 million of assets plus a step-up in basis for up to \$3 million of assets passed to a surviving spouse. The basis step-up rules will not apply to items of IRD. This will cause IRD assets to remain subject to income tax. Finally, the IRD deduction for estate tax paid under § 691(c) will be irrelevant for the year of estate tax repeal.

Planning for IRD is Critical to Estate Planning: Focus on Qualified Plans and IRAs

Having IRD items in an estate can be costly to beneficiaries. For example, with a 49% effective combined state and federal estate-tax rate and a 35% federal income-tax rate, the overall effective tax rate on the IRD could approximate 65%. This tax bite can prove a shock to beneficiaries who aren't aware of IRD treatment.

More often than not, the IRD assets that generate the most concern are qualified plans and/or IRAs. These plans are the most tax efficient and flexible way to reduce current income and personal taxes for participants and accumulate sums tax deferred for retirement years. Unfortunately, quite the opposite is true from the point of view of the beneficiaries that inherit the IRD assets. Fortunately, with proper planning and the use of the IRD tax deduction, the impact of IRD can be reduced.

Let's review some techniques that can help mitigate IRD that results from large balance qualified plans and/or IRA accounts.

- **Spousal Rollover.** Perhaps the easiest way to delay the tax bite of IRD is to name the spouse

as beneficiary of the retirement accounts. This postpones any estate tax on the inherited assets and slows down the imposition of income taxes on payouts. A surviving spouse who receives an IRA rollover can generally delay required minimum distributions from the IRA until age 70½. In addition, once payouts begin, they can be stretched over the surviving spouse's remaining life.

- **Rollovers to Non-Spouse Beneficiaries.** The Pension Protection Act of 2006 made it possible to make tax-free rollovers from qualified plans, IRAs, governmental 457 plans and 403(b) plans of a deceased individual to an IRA of a non-spouse beneficiary. Prior to this law, tax-free rollovers were limited to the spouse. The transfer must be a trustee-to-trustee transfer. The IRA must be in the name of the deceased owner of the original retirement plan and can only be used by a beneficiary who is a designated beneficiary.

Distributions rules applicable to beneficiaries still apply. Prior law provided for stretch distributions to a non-spouse beneficiary but plans often did not allow for such distributions. So, because there was no rollover allowed, payouts were often made in lump sums, which accelerated IRD.

- **Stretch IRAs.** If an owner only takes the minimum required distributions (MRD), withdrawing the lowest required amount each year, more tax-deferred growth can occur and a larger IRA balance may be left to the beneficiary. By naming a younger person as a designated beneficiary, the payout is spread over the beneficiary's longer life expectancy and this allows for additional compound growth. The non-spousal beneficiary rollover discussed earlier now allows those individuals to use the stretch IRA strategy.

However, for this technique to work, there must be funds available to provide estate-tax liquidity without withdrawing from the IRA. A solution is to use a portion of the MRD to pay premiums on a life insurance policy to cover estate taxes, further maximizing the amounts passed to the heirs.

- **Tax Bracket Planning.** Another simple approach to IRD taxation is to leave these assets to family members in lower income-tax brackets thus mitigating dollars lost to taxes on receipt of the IRD.
- **Direct Charitable Bequest.** For clients who want to leave some assets to charity at their death, using retirement benefits for that purpose is often the most tax efficient way to fund the gift because tax benefits left to charities are generally exempt from income.

Naming the charity as a beneficiary of the retirement plan is straightforward and involves the fewest difficulties. The benefits are paid directly to the charity, income tax on the benefits is easily avoided, the charity's tax exemption makes the distribution non-taxable, and an estate-tax charitable deduction is available for the full value of the charity's interest.

Life insurance can again play a role since it can be used to replace the donated value that would have otherwise gone to the heirs.

It is important to clarify that generally no tax-free lifetime assignment to a charity is available. That is, assets in either a qualified plan or an IRA cannot go directly to a charity while the plan participant or IRA owner is living without first being taxed as income to the participant.⁷

While the income-tax consequences of a lifetime distribution to a charity may be offset by the charitable contribution deduction, keep in mind that the phase-out of itemized deductions and personal exemptions for higher income individuals may reduce this deduction amount.

- **Using a Testamentary Charitable Remainder Trust (CRT).** The idea of leaving a retirement plan to a CRT is based on the theory that the CRT pays no income tax, so more funds will be

available to be invested for the benefit of the non-charitable beneficiaries. Thus, the beneficiaries could expect a larger annual income from the CRT than they would receive by investing the after-tax value of the benefits distributed to them directly. But there is a need to qualify this statement.

First, it's important to remember, that the income beneficiary of a CRT receives only the income from the reinvested plan proceeds since the principal of the CRT eventually goes to the charity.

Second, although the CRT pays no income tax when it receives a distribution from a retirement plan, under the *four-tier* system of taxation applicable to these trusts, the beneficiary will more than likely have to pay income tax on the distribution from the CRT to the extent it represents a pass-through of the retirement benefit (i.e., ordinary income).

Third, if retirement benefits are paid to a CRT, the IRD tax deduction, for all practical purposes, disappears.

On the flip side, the payout from a CRT may be more attractive than directly naming individual beneficiaries if the retirement plan does not allow a life expectancy payout, especially when the estate tax benefits of the charitable deduction are taken into account.

Once again life insurance can be used to replace the donated value that would have gone to the heirs.

In Summary. While IRD presents a taxation challenge, clients working with their advisors can monitor and address the impact of major IRD items (often qualified plans and IRAs) so that taxes at death are reduced and more assets can be passed on to heirs.

⁷ During 2006 and 2007 only, a taxpayer over the age of 70½ may exclude from gross income up to \$100,000 of otherwise taxable distribution from a traditional IRA or Roth IRA made to a qualified public charity.