Estate planning

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IRD: A tax rule beneficiaries need to know

Did you know that if you leave 401(k) assets and certain other types of assets to your heirs, they could be considered "income in respect of a decedent (IRD)" and be subject to double taxation? Taking IRDs into consideration now could result in significant tax savings for your heirs later. It pays to plan ahead.

What is IRD?

Income in respect of a decedent is income that is payable after the death of the person who was entitled to it and that would have been taxable to him or her if the person had lived to receive it. The income is not includible in the decedent's final tax return because it was not payable until after 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.

Unpaid compensation owing at death

If a person dies prior to retirement, he or she is likely to be owed some amount of money in connection with his or her employment. The employer may owe the individual 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, which would have been includible in the person's gross income if he or she had lived to receive them. However, they are not includible in the decedent's final tax return because they were not payable until after death.

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By the numbers

- Don't look for a **one-size-fits-all** estate plan. It doesn't exist. The right plan for you will depend on your personal circumstances.
- **Two taxes.** IRD can be subject to income tax and estate tax. Double taxation can be mitigated by using a particular IRS deduction, known as the IRD or Section 691(c) deduction.*

* Source: cpa2biz.com
IRD — The Hot Potato of Wealth Transfer, April, 2005.

Key points

Inherited estates of up to $2 million do not fall under the IRS' definition of taxable income. However, there are some exceptions — called "IRDs" — you'll want to consider when planning the disposition of your estate.

IRD examples include:

- qualified retirement plan distributions
- traditional IRA distributions
- any remaining employee compensation

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Here is an example:
Fred earned the right to receive a $3,000 quarterly bonus from his employer based on his work performance from January 1 through March 31 of 2006, but his company does not actually pay the bonuses to employees until May 1. Fred died on April 19, 2006. The $3,000 bonus isn't includible in Fred's final tax return for calendar year 2006 because, although he had earned the right to receive the bonus, it wasn't payable until after he 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 invested in employer-sponsored retirement plans and traditional 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 or her account, distributions made to the person's beneficiary after death will be considered IRD to the recipient because these distributions would have been taxable to the decedent if he or she had received them.

Annuities
With both qualified and nonqualified annuities, the death benefit generally is included in the owner's gross estate. In addition, the beneficiary must pay income taxes on any earnings.

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 ($2 million for decedents who died in 2006 and 2007), 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

This is a simplified hypothetical example to illustrate how the IRD deduction could reduce your overall tax liability.

The late Helen's $3,000,000 estate (after deductions and exemptions) is valued at $2,657,140. Assuming a 35% federal estate tax rate, the total federal estate tax comes to $930,000, (no federal income or state taxes are included in this example). Helen 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 less $810,000). Because the IRA is IRD, Kevin is subject to income tax on his inheritance.

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 liability 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

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What planning strategies exist?

With the advice of her investment professional and/or estate planning advisor, 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. The chart below compares 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.

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 67.5% of his inheritance! If, however, some careful tax planning had been done before Helen died, Kevin's tax rate attributable to his inheritance would have been only 17.5%, half of his 35% regular income tax rate. This is because Kevin gets to take the deduction for estate taxes paid on the IRA even though the estate taxes weren't paid out of the IRA.

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, whether she specifically named Kevin as the IRA's designated beneficiary 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.

Paying the tax: Choose wisely and potentially keep more

	IRA assets used to pay estate taxes	Estate taxes paid with other assets
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%

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

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.

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.

Resource

www.irs.gov

Internal Revenue Service

Contact your investment professional for more information or visit **mfs.com**.

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