What is IRD?

Summary

"…*income in respect of a decedent* refers to those amounts to which a decedent was entitled as gross income but which were not properly includible in computing his taxable income for the taxable year ending with the date of his death or for a previous taxable year under the method of accounting employed by the decedent" [Treas. Reg. § 1.691(a)-1]. Clear as mud!

The information contained herein is for educational use only and should not be construed as tax, financial, or legal advice. Each individual's situation is unique and may require specialized treatment. It is, therefore, imperative that you consult with tax and legal professionals prior to implementation of any strategies discussed.

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I. INTRODUCTION

Bob worked for XYZ Company and was paid weekly each Monday morning for work completed during the previous week. Unfortunately, Bob passed away over the weekend and obviously could no longer collect his pay check for work that he already performed. Sue, the executor of Bob's estate, will collect what was owed to Bob once she is duly appointed and can submit proper documentation. At year-end, XYZ will issue a W-2 which will include these final wages paid. On which return should this income be reported?

Bob was a cash-basis taxpayer and, as such, was responsible for reporting only income that was actually or constructively received during the calendar year on his individual income tax return (**Form 1040**). Since Bob was not alive at the time XYZ issued the pay check, Bob did not receive that final payment. Does the income, then, truly belong on Bob's final return?

Executor Sue received the income as the personal representative of Bob's estate but did not perform the services necessary to earn the income. Does she correctly include the income on the fiduciary's income tax return (**Form 1041**)?

Accrued income – earned but not yet paid – is actually an asset which increases the net worth of the individual who earned it. Should the accrual be added to the value of the decedent's estate on the date of death and be reported on the decedent's estate tax return (**Form 706**)?

Interestingly, XYZ offered to reissue Bob's uncollected paycheck in his widow's name so that she could deposit it directly to her account. Should she, then, report the income on her personal return (**Form 1040**)?

Where does it go?!

II. INCOME-IN-RESPECT-OF-DECEDENT DEFINED

Income-in-Respect-of-Decedent (IRD) is not defined in the Internal Revenue Code but rather in the regulations as "those amounts to which a decedent was entitled as gross income but which were not properly includible in computing his taxable income for the taxable year ending with the date of his death or for a previous taxable year under the method of accounting employed by the decedent."[1] In other words, income that does not belong on a decedent's final **Form 1040**, must by necessity be reported elsewhere. But where? The answer may depend upon the type of accounting method employed by the individual taxpayer.

A. CASH VERSUS ACCRUAL ACCOUNTING

Taxpayers are free to choose any method of accounting – cash or accrual – so long as that method "clearly reflects income".[2] The chosen accounting method must reflect

[1] Treas. Reg. 1.691(a)-1(b).

[2] Treas. Reg. 1.446-1(a)(2).

income consistently from year to year. To change methods, IRS consent must be obtained by filing **Form 3115, Application for Change in Accounting Method.**

In general, individual taxpayers use the cash method by choice or default. It is a system that is intuitive and relatively simple to apply in that income is reported once constructive receipt occurs and deductions are claimed once expenses are paid. Income is constructively received as soon as the recipient has control of it without substantial restrictions or limitations.[3]

Taxpayers using accrual-method accounting, on the other hand, report income as it is earned even if payment has not yet been received. In the same vein, expenses are deducted when incurred even though actual payment has not yet been made. This means that records of accounts receivable and accounts payable must be maintained. With some exceptions,[4] the accrual method must be used to account for inventory purchases and sales. This allows some taxpayers to employ a hybrid method of accounting by using the accrual method for inventory and the cash method for all non-inventory income and expenses.

B. EFFECT OF CASH-BASIS ACCOUNTING

If, then, individual taxpayers generally employ the cash method, it becomes clear that accrued income (not yet paid to the decedent) cannot be included on the decedent's individual tax return and must, therefore, be reported elsewhere. While we cannot yet say with certainty to whom this income will be taxed, we know definitively that it will *not* be taxed to the decedent.

Furthermore, income to which the decedent merely had a contingent claim at death is also not includible on the decedent's final 1040, nor is income-in-respect-of-a-*prior*-decedent includible on the current decedent's tax return. In some instances, the most recent decedent may have been entitled to income from a previously deceased individual. But, as with income from any source, the prior accrual is not taxable to the current decedent if it was not yet paid to him prior to his own date of death.

C. WHAT IS IRD?

In short, IRD is income that had been earned by a taxpayer prior to his death but that had not yet been paid to him. IRD is taxable to the recipient in the year of receipt, whether the recipient is the decedent's estate or the decedent's beneficiary. If IRD is paid to the estate, it is reported by the fiduciary on **Form 1041 US Income Tax Returns for Estates and Trusts**. If IRD is paid directly to a beneficiary, it is reported on the beneficiary's individual tax return (**Form 1040**). EXCEPTION: If the decedent is a specified terrorist

[3] Treas. Reg. 1.451-2(a).

[4] Taxpayers with average annual gross receipts of $1 million or less may use the cash method to account for inventory purchases and sales [Rev. Proc. 2001-10]. Additionally, taxpayers with average annual gross receipts of $10 million or less may use the cash method if the business is primarily a service-type business [Rev. Proc. 2002-28].

victim, income received after the date of death and before the end of the decedent's tax year is excluded from the recipient's gross income.[5]

III. HISTORICAL PERSPECTIVE

The US Estate Tax – in its present incarnation – was enacted in 1916 with the intent of taxing assets as they passed from decedent to beneficiary. While the first $50,000 [over $11 million in today's dollars] of each estate remained exempt from taxation, excess amounts were taxed at rates ranging from 1 to 10% on estates over $5 million [$1 billion in today's dollars].[6] Rates continued to climb in fits and starts, rising as high as 77% in the 1940s and did not decline significantly again until the mid-70s.

In hindsight, it now comes as no surprise that taxpayers desperately sought to avoid this heavy burden. Reasoning that the government imposed the estate tax on the transfer of wealth at death, taxpayers quickly sought to transfer assets during life. Congress was but a step behind and by 1932, enacted the modern-day version of the Gift Tax with which we are still saddled. Thus, all transfers of wealth – whether during life or after death – are subject to one form of tax or another. To further discourage the potential pre- and post-death tax dodge, the rates at which gift and estate taxes are assessed are identical.

Clever as Congress was, one source of income managed to escape income taxation, if only briefly. By 1934, even this loophole was closed. In earlier days, IRD was deemed to have been an asset – accrued but unpaid income which a decedent "owned" at death. As a result, IRD was rightfully includible on a decedent's estate tax return as a part of his potentially taxable net worth. Despite its name, IRD (*Income*-in-Respect-of-Decedent) was not taxed as income and was instead included as an asset on the estate tax return where it received a stepped-up (or stepped-down)[7] in basis as did all other assets.[8]

Then in 1934,[9] Congress had a change of heart and mandated that all income accrued to a decedent at death be "reported as income on the decedent's final income tax return. This

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[5] The Victims of Terrorism Tax Relief Act of 2001 defines "specified terrorist victim" as "any decedent…who dies as a result of wounds or injury as a result of terrorist attacks against the United States on April 19, 1995, or September 11, 2001, or…who dies as a result of illness incurred as a result of an attack involving anthrax occurring on or after September 11, 2001, and before January 1, 2002." § 101 exempts victims from income tax for the year of death and the prior year; § 102 of the act excludes certain death benefits from income; § 103 sets special lower estate tax rates both for victims of included terrorist acts and for combat-zone-related deaths of members of the armed forces. [Carr, *Tax Relief for Terrorism Victims*, The Journal of Accountancy, March 31, 2002, available at http://www.journalofaccountancy.com/Issues/2002/Apr/TaxReliefForTerrorismVictims.htm, last accessed May 10, 2017].

[6] Robbins, *Estate Taxes: An Historical Perspective*, The Heritage Foundation, January 16, 2004 [available at http://www.heritage.org/research/reports/2004/01/estate-taxes-an-historical-perspective, last accessed May 10, 2017].

[7] IRC § 1014(a).

[8] Under the theory that accrued income items became "corpus" at the time of death (reportable only on the estate tax return), the deductibility of accrued expenses was similarly not allowed on the decedent's income tax return.

[9] 1934 Revenue Act, §§ 42 and 43.

resulted in the income's [sic] being taxed even though the deceased had not yet received it. In essence the provisions treated cash-basis taxpayers as accrual-basis taxpayers and clearly ignored a basic tenet of taxation: the wherewithal-to-pay concept."[10] By taxing accrued income to the decedent who had not yet received that income, the new law effectively (and unfairly) accelerated income recognition, potentially bunched income so that it might be subject to higher marginal rates, and forced payment of tax liabilities with dollars not yet available. Depending upon the source of the offending IRD, necessary tax dollars might not become available until years in the future.

With the Code change, IRD now became subject to both income *and* estate taxation; as income to the decedent on his final return, as well as an asset of the decedent's estate.[11] To resolve the dilemma of double taxation, Congress next introduced an income tax deduction allowing fiduciaries and beneficiaries to deduct an allocable percentage of any estate tax paid which was attributable to IRD.[12]

IV. SOURCES OF IRD

Any item of income attributable to the decedent but not included on his final individual income tax return may potentially be deemed IRD depending upon the decedent's accounting method. IRD then becomes taxable to the decedent's fiduciary or beneficiary; yet it retains the same character it would have had if it had been reported by the decedent.[13] Fiduciaries and beneficiaries of cash-basis decedents must report all IRD upon receipt (unless the decedent himself had constructive receipt prior to death); while fiduciaries and beneficiaries of accrual-basis decedents must report only qualified death benefits and deferred compensation since all other income would have already been includible on the decedent's 1040.

Let's examine potential sources of IRD most commonly encountered.[14]

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[10] As excerpted from Zimmermann, Eason and Leahey, ***The Importance of IRD:*** *Greater diligence can help CPAs avoid costly tax return omissions*, Journal of Accountancy, April 2004 [available at http://www.journalofaccountancy.com/issues/2004/apr/theimportanceofird.htm, last accessed May 10, 2017].

[11] Ferrari, *Income in Respect of a Decedent: Deductions, Capital Gains, and Double Deductions*, Santa Clara Law Review, Vol. 5, Nr. 2, January 1, 1964: "Congressional and judicial attempts to subject income, 'earned' by decedents while living, to income taxation after death is a reflection of efforts to reconcile two conflicting policies in the tax law. First, although section 443(a)(2) closes a decedent's taxable year on the date of his death, the intervention of death should not cause income 'earned' while the decedent was alive to escape taxation. Cash and accrual basis taxpayers should be treated similarly in the event of death. Secondly, section 1014 requires that 'property' as contrasted with income, receive a basis in the hands of the recipient equal to the fair market value of the property at the date of death."

[12] Internal Revenue Code of 1939, § 126; codified later under the Internal Revenue Code of 1954, § 691.

[13] Treas. Reg. 1.691(a)-3.

[14] While this listing is comprehensive, it is not all-inclusive – some unusual sources may have been omitted.

A. COMPENSATION

Salaries and Wages: Compensation for services performed by the decedent prior to death but paid after death is IRD, includible as an asset of the decedent's estate *and* as income to the fiduciary or beneficiary when received. IRD wages are not subject to federal income tax withholdings, but remain subject to Social Security and Medicare taxes if paid during the calendar year of the decedent's death. These withholdings are reported on the decedent's final **Form W-2**. However, wages which are not subject to income tax withholding are, of course, not included in Box 1 of the W-2.

☞ If IRS wages are paid in any year after the decedent's death, no withholdings should be deducted by the employer payer.

Bonuses: Bonus payments paid to the decedent's estate or beneficiary have been held to be IRD,[15] even if amount of the bonus was not determined until after death and the deceased employee did not have an enforceable right to the bonus prior to death. Similarly, a discretionary post-death payment authorized by the employer's board of directors has been deemed IRD – again, the decedent had no vested right to this payment.[16]

Fringe Benefits: Accrued vacation and sick pay is IRD,[17] although sick pay that would have been excludable for the decedent under IRC §105 (received under a workmen's compensation plan) is not IRD.

Post-death Payments: Tax treatment may vary depending on whether an employer makes a voluntary or contractual payment to the decedent's estate or beneficiary. If the payment is voluntary – whereby the deceased employee did not possess any right to that payment during life – it need not be included as part of the decedent's gross estate on **Form 706**. On the other hand, if the payment is, in fact, a continuation of some form of compensation to which the decedent would have been entitled, it becomes a part of the decedent's estate and is reportable on **Form 706**.

☞ Regardless of whether the payment is voluntary or non-discretionary, it is includible as income on **Form 1041**.

[15] *O'Daniel's Estate v. Comm*, 173 F.2d 966 (1951).

[16] *Estate of Edward Bausch v. Comm*, 186 F.2d 313 (1951).

[17] Rev. Rul. 59-64.

Contractual Post-death Payments
Taxpayer and Employer entered into a contract which guaranteed that the employee would receive $10,000/month for services rendered and that the monthly salary would continue to be paid to the employee's estate for one year after death. The salary payments received by the estate are included in its gross income and are considered IRD.

Voluntary Post-death Payments
Although the employer was not contractually obligated to continue salary payments after the death of the employee, the employer voluntarily issued monthly checks to the deceased employee's surviving spouse for one year after death. These payments are still IRD because they are attributable to services previously provided by the employee but the payments are not includible in the decedent's gross estate.

Statutory Stock Options: The exercise by the estate's fiduciary or decedent's beneficiary of a stock option previously granted to the decedent but not yet exercised by him is IRD.[18] Tax treatment will vary depending upon whether the option in question is treated as an Incentive Stock Option (ISO) or a non-qualified stock option (NSO):

ISOs – if the decedent was an employee of the issuing company within three months of death and the option granted to him was transferrable, the decedent's estate may benefit from ISO tax treatment just as the decedent would have if he had remained alive:

- If the option is sold, income will be recognized as IRD on the difference between the sales price of the option and the value of the option at date of death (or alternate valuation date).

  ☞ The fiduciary or beneficiary is not subject to the usual holding period requirements that would have been imposed on an employee wishing to avoid a disqualifying disposition.

- If exercised, there will be no income recognition for regular tax purposes, although income will be recognized on the bargain element of the transaction (= FMV_{stock} – Strike $Price_{option}$) for AMT purposes.
- If the stock received upon exercise is eventually sold, capital gain (*not* IRD) treatment will apply.

NSOs – the IRD portion equals the difference between the FMV of the stock on the date of death (or alternate valuation date) and the option's exercise price – in other words, IRD equals the bargain element.[19] Non-qualified stock options are not subject to AMT consequences. Any post-death appreciation in the value of the option prior to

[18] IRC § 421(c)(1).

[19] If income realized upon the exercise of a decedent's non-qualified stock options is bequeathed to a charitable organization, the IRD becomes taxable to the charity (not the decedent's estate). However, if the stock options are exercised by the decedent's personal representative, the IRD becomes taxable to the estate since it acquired the right to receive the stock from the decedent. [*Companion to PPC's 1041 Deskbook*, Self-study Continuing Professional Education, Thomson Reuters © 2009.]

exercise is not IRD but is nevertheless treated as ordinary income to the fiduciary or beneficiary.

If the value of the option was readily ascertainable at the time of grant, the employee would have been taxed on the value of the option in excess of any amount paid by him; thus, no post-death recognition of IRD would accrue to the fiduciary or beneficiary. Additionally, no tax consequences would ensue at exercise; instead, the basis of the stock would equal the value of the option on the grant date plus the strike price used to obtain the stock at exercise. But because the option value at grant is often unknown, ordinary income recognition for most NSOs must be postponed until exercise.

Employee was granted non-qualified options to purchase 500 shares of DEF Company at $50/share. Employee died prior to exercise when the stock was valued at $70/share. Employee's personal representative later exercised the options when the stock was trading at $80/share.

The bargain element of $30/share is in its entirety ordinary income; however, only the portion attributable to the increase in value during employee's lifetime is IRD. Thus, $20 is IRD; the remaining $10 is taxable income to the estate. Once the stock is later sold by the executor, the estate will be liable for capital gains equal to the excess of the FMV of the stock on the date of sale over the FMV of the stock on the date of exercise (i.e., the exercise price plus the amount included in ordinary income).

☞ If, prior to death, the deceased employee had elected ordinary income treatment at the time of option grant as per §83(b), no IRD would accrue to the fiduciary or beneficiary.

Employee Stock Option Plans:[20] No income is recognized on the grant or exercise dates, only upon ultimate disposition of the stock. No AMT adjustments are required.

- If the option is exercised by the fiduciary or beneficiary and the stock is then held for at least one year past the exercise date *and* two years past the grant date, any gain will be considered long-term.[21] If, however, the holding period is not satisfied, the gain will be treated as ordinary and deemed to be IRD.
- If, instead, the employee had exercised the option prior to death and the stock then passed to the estate, no ordinary income (or IRD) would be recognized upon disposition of that stock.

☞ Any ordinary income previously recognized by the decedent would not increase the basis of the shares held by the fiduciary or beneficiary, which would instead receive a stepped-up (or down) basis on the date of death.

[20] ESPPs must be nondiscriminatory and are usually offered to non-management employees. The option must be exercised within 5 years after the grant date if the price of the option is at least 85% of the FMV of the stock at the time of exercise. Otherwise, the option must be exercised within 27 months of the grant date. Unlike ISOs, however, ESPPs are not transferable during the employee's lifetime but may pass at death by will or intestacy.

[21] IRC § 423.

Deferred Compensation: Sometimes an employer and employee might agree that payment for services rendered currently will be made in the future, possibly as late as after retirement. By deferring current income, the employee may be able to benefit from lower marginal tax brackets later. If the agreement allows for post-death deferred compensation payments to be paid to the employee's fiduciary or beneficiary, these payments will be IRD.[22]

In some instances, employees agree to forfeit all payments of deferred compensation during life in exchange for the employer's promise to pay the accumulated deferral to the employee's spouse after death. These payments are then taxed to the beneficiary upon receipt and will be IRD.[23]

You'll note that IRD classification does not hinge solely on whether the decedent would have been entitled to the payments if still alive. Instead, courts have often ruled in favor of IRD classification if only to ensure that post-death income does not escape taxation.

Retirement Distributions

Traditional IRA – lump-sum distributions from a decedent's Traditional IRA in excess of decedent's basis are taxable as IRD in the year of receipt by the beneficiary.[24] The decedent's basis is equal to any non-deductible contributions made to the IRA.

In its *Heritage Planning* newsletter, MFS explains that "[m]ost 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 [the plan participant] 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."[25]

[22] *Bernard v. United States*, 215 F. Supp. 256 (1963).

[23] *Estate of Florence E. Carr*, 37 T.C. 1173 (1962).

[24] Rev. Rul. 92-47.

[25] *IRD: A tax rule beneficiaries need to know*, MFS Heritage Planning, Cat. Nr. 10161.1.3 [available at http://www.google.com/url?sa=t&rct=j&q=&esrc=s&source=web&cd=1&ved=0CEIQFjAA&url=http%3A%2F%2Fwww.tuveinvestments.com%2Fpdf%2FEstate%2520Planning%2FIRD%2520a%2520tax%2520rule%2520beneficiaries%2520need%2520to%2520know.pdf&ei=tlmhUOS_HYPiiAKm6YHYBg&usg=AFQjCNFT9GJiM0BCSvrJuUdWWCFdpyJrgg&cad=rja, last accessed May 11, 2017].

Traditional IRA with only tax-deductible contributions *– decedent owned a Traditional IRA to which all contributions previously made had been tax-deductible; therefore, the full balance on the date of death (including all income and growth accrued prior to death) is taxable as IRD which the beneficiary must include this amount as income. Any distribution to the beneficiary in excess of the date of death account balance (including post-death appreciation) is not IRD and is simply ordinary income taxable to the beneficiary.*

Traditional IRA with some non-deductible contributions *– the beneficiary must subtract all non-deductible contributions made by the decedent from the total amount received from the IRA, including income earned pre- and post-death, to determine the taxable inclusion amount. IRD, then, is this taxable amount less any income earned after the decedent's date of death.*

A spousal beneficiary can avoid IRD classification if he rolls-over the decedent's IRA into his own Traditional IRA.

In certain limited circumstances, a deathbed conversion to a ROTH may yield a significant tax benefit by accelerating the recognition of income, triggering the recognition of income prior to death, reducing the size of the decedent's estate and ultimately minimizing the potential tax liability of the IRA beneficiary. However, tax savings can only be achieved if: (1) the decedent's estate is significantly above the federal estate tax filing threshold causing the IRA to be doubly taxed as part of the decedent's estate and again as part of the beneficiary's income; (2) the beneficiary is in a higher bracket than the decedent; (3) the beneficiary is unable to itemize deductions and claim his allocable portion of the Estate Tax Deduction on Schedule A; or (4) the decedent's estate is subject to *state* estate taxes for which there is no offsetting estate tax deduction.

ROTH IRA – qualified distributions[26] are tax-free to the beneficiary (as they would have been to the decedent).[27] Part or all of a distribution made after the IRA owner's death that does not satisfy the 5-year holding requirement becomes taxable to the beneficiary. The taxable portion is equal to the earnings in the account. Earnings attributable to the period prior to death are IRD; post-death earnings are income to the beneficiary.

Qualified Employer Plan – transfers of the employer's stock in a qualified retirement plan to a decedent's estate or beneficiary have no immediate tax consequence; however, upon eventual distribution of the plan shares, the original cost of the

[26] Qualified distributions are those made at least five years after the year in which the plan participant first contributed to the account.

[27] Generally, the entire interest in the Roth IRA must be distributed by the end of the fifth calendar year after the year of the owner's death unless the interest is payable to a designated beneficiary over his or her life or life expectancy. If paid as an annuity, the distributions must begin before the end of the calendar year following the year of death. If the sole beneficiary is the decedent's spouse, the spouse can delay the distributions until the decedent would have reached age 70½ or can treat the Roth IRA as his or her own Roth IRA. [*Assets qualifying as income in respect of a decedent (IRD)*, Financial Planning Body of Knowledge available at http://financialplanningbodyofknowledge.com/wiki/Assets_qualifying_as_income_in_respect_of_a_decedent_%28IRD%29_%28Consumer_Pages%29, last accessed May 11, 2017].

employer's stock plus the value of any additional assets received less any employee contributions is includible as IRD.

At death, plan assets were valued at $175,000 which included pre-death appreciation of $90,000. The fiduciary eventually sold the employer's stock for $200,000. The fiduciary must report all pre-death appreciation ($90,000) as IRD. The post-death appreciation of $25,000 (= $200,000 Sales Price - $175,000 FMV at death) is not IRD.

Fiduciary's Basis is $85,000 (= $175,000 FMV at death - $900,000 IRD recognized).
Gain on sale of the stock is $115,000 (= $200,000 Sales Price - $85,000 Basis).

B. SELF-EMPLOYMENT INCOME

Receivables: Trailing sales commissions paid to the selling agent's fiduciary or beneficiary after death are taxed as IRD.[28]

Royalty income attributable to an author or inventor prior to his death but paid post-death is IRD. Royalty payments accrued post-death from the decedent's invention or authorship are not IRD.[29]

Post-death income received from a covenant-not-to-compete negotiated prior to death is IRD.

Sales Revenues: Uncollected sales proceeds from the sale of inventory made by a cash-basis taxpayer are normally classified as accounts receivable and not includible in the taxpayer's income. However, once the taxpayer dies, these accounts receivable are deemed to be IRD if they originated from the efforts of the decedent prior to death.[30]

Farm Crops and Livestock: Crops and livestock – whether harvested or un-harvested – raised by the decedent during life and owned at death are not IRD. Considered to be assets of the estate (reportable on **Form 706**), mere ownership does not convert them to IRD. However, if the farmer had sold or pledged his harvest or livestock prior to death, entitling him to proceeds he could not himself collect after death, the transactional proceeds become IRD.

[28] *Helen Rich Findlay*, 39 T.C. 580 (1962). Decedent had attempted to circumvent IRD by bequeathing one-half of the commissions receivable each to his wife and ex-wife but the Court ruled that even if IRD is exempt from estate taxation as per the marital deduction, it is not exempt from income taxation.

[29] Rev. Rul. 60-227.

[30] *Dixon v. US*, 96 F. Supp. 986.

Farmer sold and delivered 5,000 crates of oranges to co-op but did not collect payment prior to death. Farmer attempted to negotiate the sale for another 4,000 crates but did not complete the transaction prior to death. Farmer's personal representative collected payment for the 5,000 previously sold and arranged to also sell the remaining 4,000 crates. The gain on sale from the 5,000 crate transaction is IRD and taxable upon receipt. The gain on sale of the remaining 4,000 crates is not IRD.

☞ "The determining factor is whether the estate is entitled to receive sales proceeds (IRD) or the actual assets (not IRD)."[31] [See crop shares below.]

C. INVESTMENT INCOME

Interest

US Savings Bonds[32] – Series EE bonds are issued at discount, which means that the investor pays half-price for a bond that will mature years later at full face value (e.g. a bond with a $50 face value is purchased for $25). No interest is paid during the life of the bond; only at redemption or maturity. However, the difference between the face value at maturity and the purchase price is nevertheless deemed to be "interest", not growth or capital gain.[33]

Although interest is not in fact credited to the investor until maturity or redemption, a taxpayer may elect to report accrued interest from Series EE or I bonds on an annual basis.[34] Once the election is made, it applies to all Series EE bonds currently owned by the taxpayer, as well as those acquired later.

If the investor dies prior to maturity or redemption, the personal representative may elect to report the accrued interest by (1) including the decedent's portion of interest on the decedent's final 1040 and allocating all post-death accruals to the fiduciary's or beneficiary's return; or (2) allocating both pre- and post-death accruals to the fiduciary or beneficiary in their entirety. The fiduciary or beneficiary may then choose to report the accrued interest at maturity or ratably each year as it accrues.

[31] *Companion to PPC's 1041 Deskbook*, Self-study Continuing Professional Education, Thomson Reuters © 2009.

[32] Interest income is subject to federal but not state taxation and may even be federally tax-free if bonds are redeemed to pay for college tuition or other college fees.

[33] EE bonds purchased after April 30, 1997 and before May 1, 2005, earn interest based on 90% of the average yields on five-year Treasury securities for the preceding six months. These bonds increase in value every month and interest is compounded semiannually. If the bond does not reach its face value after 17 years, a one-time adjustment is made to increase the bond's redemption value to its face value. Series EE Bonds issued after April 30, 2005 earn a fixed interest rate for at least 20 years; the rate is determined at issue. [*2011 Tax Year 1040 Quickfinder Handbook*, Thomson Reuters © 2011.]

[34] Rev. Rul. 55-655.

☞ If the decedent had previously elected to report accrued interest income annually, the interest represented by the growth in value between the start and the date of death in the year of death must be reported as IRD.

Fiduciary does not include accrued interest on 1040
Cash-basis decedent owned $1,000 Series EE bond (purchased for $500). Between the date of purchase several years earlier and the date of death, $94 of interest had accrued. Decedent's personal representative elects not to include the $94 of accrued interest on the decedent's final 1040. The cash-basis beneficiary may elect to include annually accrued interest on his individual tax return or report the full amount of interest ($500) at maturity. At that time, the beneficiary may claim a deduction for any federal estate tax allocable to the inclusion of the decedent's accrued interest as IRD, if a return was filed and estate tax was paid.

Fiduciary elects to include accrued interest on 1040
If, instead, the personal representative chooses to include the accrued interest of $94 on the decedent's final 1040, the beneficiary would be responsible for reporting only $406 of interest (= $500 – $94). This amount represents the interest earned after the date of death and is not includible as IRD on the estate tax return; thus, no deduction for federal estate tax will be allowable.

Series I bonds are issued at face value in denominations of $50, $75, $100, $200, $500, $1,000 and $5,000 and all interest is paid at redemption or maturity. The interest rate is based on a fixed rate of return throughout the life of the bond *plus* an inflation rate that is adjusted semi-annually. Generally, tax is deferred until redemption or maturity (30 years); however, a cash-basis taxpayer may elect to apply the accrual method (much like with Series EE bonds).[35]

Treasury Bonds – interest that accrued prior to the decedent's date of death is IRD. Post-death interest is not IRD but is includible as taxable income of the fiduciary or beneficiary.

☞ T-Bills, unlike T-Bonds, are short-term instruments (maturity of one year or less) that are issued at discount. Interest will be realized at maturity – the pre-death portion accrued during the decedent's life is IRD.

Accrued interest on a bond that is redeemable for the payment of federal estate taxes but that was not yet received by the decedent prior to death is IRD. This interest is not reportable on the decedent's final 1040. Instead, the estate will treat it as taxable income in the year of receipt if the personal representative elects to redeem the bonds to pay any estate tax due.

Municipal Bonds – since only taxable interest can create IRD, tax-free interest paid on obligations issued by state and local authorities is not IRD. However, if the bonds are private activity bonds the fiduciary or beneficiary may be subject to AMT. Unfortunately, because the interest is otherwise not considered IRD, neither the estate nor the beneficiary will be entitled to an IRD deduction and will be unable to offset any of the potential AMT liability.

[35] IRC § 454(a).

☞ While the accrued tax-exempt interest is not IRD, the value of the municipal bond plus accrued interest must nevertheless be included as an asset of the estate.

Original Issue Discount (OID) – if an investor purchases a bond originally issued at discount [even if the bond is later available at par or premium on the secondary market], he is required to pro-rate the discount over the life of the bond and include the total pro-rated amount accrued on a daily basis throughout the year as taxable interest.[36] This has the effect of "converting" a cash-basis taxpayer to one forced to use the accrual method for purpose of reporting OID interest. As a result, no IRD ensues at death since the decedent will have already accounted for all accrued income.

Savings Accounts – interest receivable on these accounts is considered IRD regardless of whether the decedent had an enforceable right to withdraw the accrued income prior to his death.[37] (Early withdrawal penalties are waived if the account is closed due to the account holder's death.)

Dividends: Amounts payable to a shareholder of record prior to his death are IRD.[38]

A dividend declared on January 1st is payable on February 15th to all shareholders who own the company stock and appear in the company's record on February 10th. You'll note that February 10th is a critical cut-off date: If the investor owns the shares on that date, he will get the dividend. If he does not own the shares on Record Date, he will not get the dividend. Therefore, if a decedent was an owner of record on February 10th, he was automatically entitled to the dividend. If he then died in the period between the record and payable dates, his fiduciary or beneficiary would nevertheless receive the dividend that had already accrued to him.

Annuities: Whether fixed or variable,[39] annuities are contractual arrangements between investors and insurance companies which offer tax-deferred growth during the pay-in (or accumulation) period and guaranteed payments during the pay-out phase. Payouts may continue throughout the life of the contract owner and stop at the owner's death or continue beyond if the owner selected joint and survivor or term certain payout options.

[36] IRC § 1272.

[37] *Richardson v. US*, 177 F. Supp 394 (1959).

[38] *Putnam's Estate v. Comm.*, 324 U.S. 393 (1945).

[39] These terms are used to define annuities during the accumulation phase – "fixed" if the annuity's growth is established by contract and remains unchanged throughout the life of the contract [similar to the guaranteed rate of interest offered by a bank CD] or "variable" if the annuity's growth will fluctuate based on the performance of the underlying portfolio [much like a mutual fund is dependent upon the stocks and bonds managed by the investment advisor].

If the annuitant (the individual upon whose life expectancy the policy payouts are computed) dies after the policy owner has already begun to receive payments, continued payments to the deceased owner's surviving beneficiaries are taxed in the same manner as if the decedent had received the payments; the taxable portion is treated as IRD. If, on the other hand, the annuitant dies before the start of the pay-out phase, eventual payments from the annuity – whether received as a lump-sum or over time – are considered IRD if they exceed the decedent's investment in the contract.

Annuities are taxed based on the FIFO principle, which means that a pro-rated portion (based on the exclusion ratio) of each payment during the pay-out phase is deemed to be a return of investment and, as such, is not taxable. Once the investment in the contract has been fully recovered, the remaining payments become fully taxable. If the policy owner dies before the full amount of his investment has been recaptured and no further payments are due under the contract (single-life), the amount of unrecovered investment may be deducted on the deceased owner's final 1040 as an itemized deduction not subject to the 2% AGI limitation.[40] However, if continuing payments are required, the beneficiary will continue to recapture a percentage of the owner's investment from each payment in the same manner the deceased owner would have. As a result, the taxable portion of each payment is classified as IRD.

Annuity owner selected a 10-year term certain option when she entered the pay-out phase, guaranteeing that the policy would continue payment to her (or her beneficiary) until the time period had elapsed. The owner's exclusion ratio is 40%, meaning that 60% each payment is taxable as ordinary income. If the owner dies before the end of the payout phase (10 years), her beneficiary will also include 60% of each payment as taxable income (until the owner's cost has been fully recovered) – this income is IRD.

Capital Gains: Since property – including capital assets as well as dealer inventory – obtained from a decedent receives a step-up in basis,[41] the gain on sale resulting from the sale of this property by a decedent's estate or beneficiary is not IRD. However, if the property was sold prior to the date of death, any sales proceeds collected post-death will be IRD if the decedent had substantially fulfilled all of his obligations to ensure completion of the transaction.[42]

☞ Mere ministerial activities performed post-death do not eliminate IRD.[43] On the other hand, if material contingencies had not yet been satisfied prior to the date of death, the eventual gain on sale is not IRD.

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[40] IRC § 67(b)(10).

[41] IRC § 1014.

[42] The IRD test, therefore, is whether the decedent was *entitled* to the proceeds as per Treas. Reg. 1.691(a)-1: "In general, the term 'income in respect of a decedent' refers to those amounts to which a decedent was *entitled* as gross income but which were not properly includible in computing his taxable income for the taxable year ending with the date of his death or for a previous taxable year under the method of accounting employed by the decedent."

[43] *Trust Company of Georgia v. Ross*, 392 F.2d 694 (1967).

Seller and Buyer enter into a contract for the transfer of seller's personal residence pending buyer's loan approval within 60 days. Seller dies before the contingency period expires but Buyer nevertheless receives loan approval within the agreed-up time-frame and closes the deal with Seller's personal representative. The gain on sale is IRD. If, however, Buyer had not qualified for the loan until Day 65, the sale would have been the result of a new post-death contract, and so the resulting gain would not be IRD.

Proceeds from the sale of a jointly-owned residence are deemed to be IRD unless the surviving tenant becomes the full owner of the property by operation of state law.

Installment Sales: The fiduciary or beneficiary must use the same gross profit percentage and report the same proportionate share of each installment payment as gain, just as the decedent would have if he had lived.[44]

Self-canceling Installment Obligation – if, as part of the original agreement, an installment obligation lapses upon the death of the lender, the cancellation of the note is treated as a taxable transfer. Any as-yet unrecognized income from the original sale of the asset is IRD and includible as taxable income to the fiduciary (not the decedent) in the year of cancellation.[45]

Discounted Installment Note – if the personal representative of a deceased taxpayer sells the decedent's note during administration of the estate for less than its face value, any remaining unrecognized gain (which would be taxable as IRD) may be reduced by the amount of the discount.

Community Property Income[46] – no disposition of an installment obligation results from the revocation by, or the death of, one spouse who transfers a community property installment obligation to a revocable trust or to a trust that is irrevocable with respect to the decedent's one-half interest from which the surviving spouse receives all income for life. Both halves of the trust will result in IRD income, even though the survivor's half is not includible in the decedent's estate.[47]

[44] IRC § 453B(c), Treas. Reg § 1.691(a)-5(a).

[45] IRC § 691(a)(4).

[46] General Rule: A husband and wife who are residents of a community property state generally are considered to each own half of the community property. At the death of either spouse, the total value of the community property – even the surviving spouse's part – becomes the basis of the entire property. For example, a husband and wife owned community property that had an adjusted basis of $100,000 at the time the husband died. The fair market value at his date of death was $150,000, and half the FMV was includible in the husband's estate. If the wife was the sole beneficiary, her new basis as of the husband's date of death would be $150,000.

[47] Rev. Rul. 76-100.

D. RENTAL INCOME

Rents: Payments of rents or leaseholds accrued during the decedent's life but paid after death are IRD. If any portion of the accrued rent represents an advance payment, it is considered a *liability* and is not IRD.

Crop Shares: If a land owner 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 IRD and is reported in the year in which the crop shares or livestock are sold or otherwise disposed of.[48] Only a pro-rated portion of the crop share income is IRD if the taxpayer died during the rental period; proceeds in excess of the IRD are taxable as income to the decedent's estate.

A cash-basis taxpayer leased part of his farm for a 1-year period beginning March 1st. The agreed-upon rent equaled one-third of the tenant's crop, payable in cash when the crop share is sold at the landlord's direction. The landlord died on June 30th (he was alive during 122 days of the rental period). Seven months later, the taxpayer's personal representative sold the crop for $1,500. $501 is IRD (= 122/365 X $1,500); the balance ($999) is income to the estate.

Oil and Gas Royalties: Royalty income for production that occurred prior to decedent's date of death is IRD.

Check statements for several months following the date of death since royalty payments are often paid in arrears, making it necessary to match the income reported with what was accrued pre-death. Contact the payer to inquire whether any months of production prior to death have remained unpaid ("suspensed") since these royalties are also IRD.

E. INCOME FROM FLOW-THROUGH ENTITIES

Partnerships: Since a partner's death closes the taxable year of a partnership with respect to the decedent, a final K-1 will be issued to the partner and all income on the K-1 should be reported on the decedent's final **Form 1040**. A second K-1 will be issued to the fiduciary or successor partner; none of that income is IRD. IRD should only result when payments have been received by a cash-basis partnership after a partner's death for amounts earned before his or her death.[49]

Liquidation of Partner's Interest – payments for the distributive share of partnership income or guaranteed payments[50] accrued to the deceased partner paid after death are IRD. If the decedent's beneficiary (estate) receives payments from a third party in exchange for the right to receive future payments from the partnership, IRD only results if the payments are attributable to unrealized receivables or goodwill, and the deceased partner was a general partner in a service partnership.

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[48] IRS Publication 559 *Survivors, Executors and Administrators,* Cat. No. 15107U, March 19, 2012.

[49] Treas. Reg. § 1.742-1.

[50] IRC § 736(a).

☞ While third party payments generally are not IRD, proceeds from the sale of deceased partner's interest are IRD to the extent of the decedent's share of the entity's accounts receivable.

The estate of a deceased partner received $50,000 for the decedent's interest in the business. Included in this payment was $20,000 for the decedent's share of the partnership's unrealized receivables; hence, the $20,000 is IRD.

Buy/Sell Agreement – these agreements typically specify that the decedent's life insurance proceeds are required to be used for the redemption of the decedent's portion of the business. In some instances, however, a partnership or shareholder agreement may specify that a portion of the life insurance proceeds are to be used to pay the decedent's beneficiary for the decedent's work-in-progress; this portion of the insurance proceeds will be deemed IRD.[51]

S-Corporations: Income from an S-Corp is not IRD since income earned prior to death will be included on the decedent's final 1040; income earned after death will be reported on the fiduciary return.[52] (While S-Corps generally pass items of income and loss through to a shareholder using a daily allocation, the entity may perform an interim closing of the books on the date of death with shareholder consent.)

Once again, any income attributable to unrealized receivables is IRD which must be used to reduce the basis of the inherited or acquired shares of the decedent's stock.

Taxpayer inherited a decedent's 30% share of an S-Corp valued at $75,000 on the date of death, including $5,000 of unrealized receivables. The heir later sold the shares for $100,000 realizing a $30,000 gain – remember, the heir's basis in the stock must be reduced by the amount of IRD that was included in the FMV at death; in this case, the $5,000 of receivables was IRD.

F. OTHER

Alimony: Spousal support payments collected by the fiduciary or beneficiary are IRD.[53]

Medical Reimbursements: Reimbursements for medical expenses previously deducted on the decedent's individual return are IRD.

Trust or Estate Income: If a deceased taxpayer was the beneficiary of another's estate or trust, pre-death income distributions from these entities will be includible as taxable income on the taxpayer's final 1040; post-death distributions will be reportable by the decedent's estate as IRD.

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[51] *Estate of Cartwright*, 183 F.3d 1034 (1999).

[52] IRC § 1367(b)(4).

[53] *Kitch v. Comm.*, 103 F.3d 104 (1996).

*Decedent was the beneficiary of his parents' trust which was required to make annual distributions. Decedent died 9 months after the start of the current year during which the trust had $40,000 of accounting income. No distributions were made until year-end. $30,000 of trust income (representing ¾ of the year) should be reported on **Form 1040**; the remaining $10,000 should be reported on **Form 1041** as IRD.*

Litigation Proceeds: Settlement proceeds may be IRD if they are related to services provided by the decedent before death or the decedent had the imminent right to receive income. Settlement proceeds that arise from the sale of an asset or goodwill are probably not goodwill[54] and should receive a stepped-up basis as per IRC § 1014(c).

*Prior to his death, plaintiff sued defendant for fraud. The outcome of the case was uncertain at the time of plaintiff's death; only later did the court find in plaintiff's favor, awarding plaintiff's estate $50,000. Since the claim arose when plaintiff sold his business to defendant, the settlement proceeds are not treated as IRD. Instead, the gross proceeds should be reported on Schedule D of **Form 1041**and offset in their entirety by the stepped-up basis of the asset on plaintiff's date of death.*

Life Insurance: Proceeds of life insurance are not IRD. However, if the proceeds are the result of a policy transfer for consideration which occurred prior to the policy owner's death, they are IRD.

*Taxpayer purchased a life insurance policy with a face value of $300,000 on the life of his niece for $10,000 plus $1,000 annual premiums. Taxpayer died after 10 years – the cash value of the policy ($80,000) was included as an asset in taxpayer's estate on **Form 706**.*

Taxpayer's personal representative paid the annual premium for another year but then the policy matured when the niece passed away while taxpayer's estate was being administered. As beneficiary of the policy, the estate received the full policy value of $300,000 of which $279,000 (= Proceeds – Taxpayer's Basis of $20,000 – Estate's Basis of $1,000) was subject to income tax. The taxable amount included $60,000 of IRD (= Cash Value of Policy on date of death – Taxpayer's Basis of $20,000).

HSA and MSA: The beneficiary of a decedent's HSA or MSA account must include the fair market value of this account (at date of death) as income on his personal return. The includible amount may be offset by any qualified medical expenses paid by the beneficiary on the decedent's behalf within one year from his date of death. The beneficiary may also claim an estate tax deduction for the IRD inclusion, if applicable.

☞ If the decedent's spouse is the designated beneficiary of the account, the spouse will become the owner of the account and avoid IRD inclusion. If, however, the spouse is not the *named* beneficiary, the spouse will be subject to the same tax consequences as any other beneficiary.

G. SUMMARY

[54] Author's opinion as expressed in *Companion to PPC's 1041 Deskbook*, based on the similarity to the sale of property subject to a material contingency that is not resolved prior to decedent's death.

Courts have made sweeping interpretations of IRD, liberally encompassing many sources of income that would seemingly not be includible. Ferrari[55] concludes that various generalizations about the nature of IRD can be made:

- IRD is not limited merely to income that would have been reportable had the decedent lived to collect it;
- The extent or value of the right to receive IRD need not be determined or ascertainable on the decedent's date of death;
- However, the value of the IRD must be, in some manner, attributable to the decedent's activities prior to death; and
- Realization or vesting of the right to the IRD must occur prior to death.

It seems that any "substantial likelihood of receipt [might be] enough to make a payment IRD."[56]

Two Tests: Courts look to two tests to determine whether the decedent or the beneficiary (estate) should be taxed on the income:

1. Legal Enforceability Test – could the decedent have enforced his right to the income?
2. Economic Activities Test – have all requisite events to create the income occurred?

Caveat: It is not always clear whether income from a particular source will be considered IRD. Listed throughout this text are the most common types of IRD most practitioners will encounter but where a unique situation arises, it is best to embark upon thorough research of Treasury Regulations, Revenue Rulings and judicial decisions. [See Reference Chart in *Appendix* for a listing of most frequently encountered sources of IRD.]

V. DEDUCTIONS-IN-RESPECT-OF-DECEDENT

Just as there may be IRD, there may also be attendant deductions-in-respect-of-decedent ("DRD") which a cash-basis decedent would have had the right to deduct had he paid them prior to death.[57] Most deductions which could be claimed on Schedule A of **Form 1040** are eligible for DRD treatment, except:

- Credit card charges made by decedent since they are considered paid when charged.
- Checks written before death if decedent had *sufficient* funds; if insufficient, then DRD.
- Decedent's medical expenses.[58]
- Decedent's alimony payments.

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[55] Ferrari, *Income in Respect of a Decedent: Deductions, Capital Gains, and Double Deductions*, Santa Clara Law Review, Vol. 5, Nr. 2, January 1, 1964.

[56] *Companion to PPC's 1041 Deskbook*, Self-study Continuing Professional Education, Thomson Reuters © 2009.

[57] IRC § 691(b).

[58] Expenses for decedent's medical care may be deducted on the decedent's final 1040 if (1) paid within one year of death, (2) not deducted on **Form 706**, and (3) a statement is filed with **Form 1040** stating that the estate tax deduction is waived [IRC § 213(c)].

- Depreciation is not deductible since the attendant assets get a stepped-up basis instead.
- Prior-year passive and net operating losses, as well as capital loss carry-forwards are deductible on **Form 1040** only—unused deductions are forfeited and not considered DRD.

Expenses that qualify as DRD include:
- Business and other income-producing expenses.[59]
- Interest, if otherwise eligible under interest-tracing rules.[60]
- Taxes – state and local income, as well as property taxes.[61] Estate taxes assessed by and paid to an individual state are not deductible as DRD.
- Investment Expenses (in excess of the 2% AGI Limitation).
- Percentage Depletion[62]. If the decedent used another method of depletion, that deduction is allowable on only the final **Form 1040** and is not DRD
- Foreign Tax Credit[63] – the fiduciary or beneficiary is entitled to claim the credit if foreign tax was required to be paid on an item of IRD.

DRD may be claimed on both **Form 706** and the fiduciary's or beneficiary's income tax return in the same manner as the decedent would have claimed the deduction. DRD is a deduction available only to the recipient of the IRD who must have been liable for *and* have actually paid the DRD expenditure.

☞ If DRD was claimed on **Form 706**, the tax deduction on the fiduciary's or beneficiary's income tax return is limited to the estate tax allocable to *net* IRD (= IRD – DRD).

VI. HOW TO REPORT IRD

IRD must be included in the income of one of the following:
- The decedent's estate, if the estate received it;
- The beneficiary, if the right to income passed directly to the beneficiary as a result of the decedent's death and the beneficiary received it; or
- Any person to whom the estate properly distributed the right to receive it.[64]

If the fiduciary or beneficiary transfers the right to the IRD, the transferor must include the greater of the amount received for the right or the fair market value of the right in income. If the right to IRD is gifted, the donor must include the fair market value of the right at the time of the gift.

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[59] IRC §§ 162 and 212.

[60] Treas. Reg. §1.163-8T.

[61] IRC § 164.

[62] IRC §611.

[63] IRC § 27.

[64] IRS Publication 559 *Survivors, Executors and Administrators*, Cat. No. 15107U, March 19, 2012.

IRD retains the same character when reported by the fiduciary or beneficiary as it would have if it had been reported by the decedent.

VII. INCOME TAX DEDUCTION FOR ESTATE TAX PAID

IRD is claimed *both* as income on the fiduciary's **Form 1041** or the beneficiary's **Form 1040** *and* as an asset on **Form 706** although it does not receive a stepped-up basis. The estate tax attributable to the IRD inclusion on the estate tax return is deductible as an expense on the income tax return of the fiduciary or beneficiary.[65]

This deduction is known as the Estate Tax Deduction (ETD) and is equal to the estate tax paid on *net* IRD (after DRD has been deducted). The computation is tedious and time-consuming and can only be calculated by preparing **Form 706** *twice*; once with the net IRD included and then again without net IRD included in the taxable estate. The difference between the resulting tax liabilities represents the estate tax attributable solely to the net IRD. It is this amount that may be claimed as an income tax deduction by the fiduciary or beneficiary.

ETD must be claimed in the same year that the corresponding IRD is included in the fiduciary's or beneficiary's income. ETD may be deducted as an above-the-line deduction on fiduciary's return (Line 19) or as a miscellaneous itemized deduction *not* subject to the 2% AGI limitation on the beneficiary's return.[66] This, of course, means that the deductions can only provide a tax benefit to the beneficiary who itemizes deductions and completes Schedule A. If the fiduciary or beneficiary is subject to AMT, ETD is neither a preference nor adjustment item and is not added back to taxable income when computing alternative minimum taxable income.

ETD is calculated at the time that **Form 706** is originally prepared and does not change throughout the distribution period. A pro-rated portion of the ETD may be allocated to each distribution (and distributee). ETD attributable to the fiduciary must be reduced on a pro-rata basis by any income distributed to a beneficiary who may then claim his own allocable share of ETD.[67] The proration is computed based on the values of *gross* IRD[68] allocated to the fiduciary and each beneficiary, regardless of how much IRD is actually collected. If the IRD actually collected is less than the prorated value, the ETD must be recalculated and reduced.

Cash-basis decedent had $10,000 of accounts receivable and $5,000 accrued bond interest on the date of death, as well as $4,000 unpaid business expenses which the estate's fiduciary was required to pay. The net IRD of $11,000 was included on ***Form 706*** *– the resulting estate tax totaled $8,500 after applicable credits. Upon recalculating the estate tax liability without inclusion of the net IRD, the total would have*

[65] IRC § 691(c).

[66] IRC § 67(b)(8).

[67] IRC § 691(c)(1)(A).

[68] Since the proration is based on gross rather than net IRD values, individual beneficiaries not liable for any DRD are not disadvantaged relative to beneficiaries liable for DRD payments.

been $4,700 after credits. Thus, the amount of estate tax that qualifies for the ETD is $3,800 (= $8,500 – 4,700).

Assuming that two beneficiaries shared in the estate and that one received the accounts receivable and the other the bond interest, the ETD eligible for a Schedule A deduction on each beneficiary's ***Form 1040*** *is calculated based a pro-rated percentage of the total IRD collected:*

Beneficiary # 1: ($10,000 ÷ 15,000) X $3,800 = $2,533
Beneficiary # 2: ($5,000 ÷ 15,000) X $3,800 = $1,267

If Beneficiary # 1 only collected $5,000 of the total accounts receivable that were allocated to him, he may only claim one-half of the allocated ETD as a Schedule A deduction. While it seems that this beneficiary has just lost a valuable tax deduction, it should be noted that he also was not required to include the extra $5,000 of IRD that he did not in fact receive. NOTE: The total amount of IRD was, however, previously included as an asset of the decedent's estate on ***Form 706.***

If Beneficiary # 1 receives the remaining $5,000 IRD in the following year, he must include it in taxable income but may then claim the previously unused ETD as a deduction on Schedule A.

ETD may be a potentially valuable deduction which is often times overlooked by the tax practitioner who did not prepare the decedent's estate tax return along with the beneficiary's income tax return. Authors Zimmerman, Eason and Leahey recommend the use of a targeted questionnaire to collect information about possible IRD-related distributions from clients who have received inheritances.[69]

If IRD includes income received by a surviving annuitant under a joint and survivor annuity, special rules must be followed to compute the proper amount of ETD for the surviving policy holder: Multiply (1) the excess of the value of the annuity death of the deceased annuitant over the total amount excludable from the gross income of the surviving annuitant by (2) a fraction consisting of the value of the annuity for estate tax purposes over the value of the annuity death of the deceased annuitant.[70]

If any portion of the IRD was attributable to capital gains, qualified dividends, or gains on small business stock,[71] that gain must be reduced – but not below zero – by the ETD allocable to the gain.[72]

Estate taxes paid to an individual state[73] do not generate ETD. Instead, such taxes may be used to reduce the gross estate when computing the Adjusted Gross Estate[74] which is the same

[69] Zimmermann, Eason and Leahey, ***The Importance of IRD:*** *Greater diligence can help CPAs avoid costly tax return omissions*, Journal of Accountancy, April 2004 [available at http://www.journalofaccountancy.com/issues/2004/apr/theimportanceofird.htm, last accessed April 19, 2015].

[70] Treas. Reg. 1.691(d)-1.

[71] IRC § 1202.

[72] IRC § 691(c)(4).

starting point for calculating the ETD with and without net IRD. Given that state estate taxes are not an IRD or DRD item, the computation of ETD remains unaffected when recomputed for ETD attributable to net IRD.

There will be no ETD if:

- **Form 706** was not required to be filed;
- **Form 706** was filed but no estate tax liability resulted;
- No IRD was reported on **Form 706**;
- Net IRD is less than zero; in other words, DRD exceeded IRD.

VIII. TAX PLANNING

Poor IRD planning can often lead to unintended consequences. For example, "you leave your house to your son and your IRA (composed of deductible contributions and earnings) to your daughter. If the house and the IRA have the same market value, your daughter will end up receiving less than your son because she will have to pay income taxes on each IRA distribution she receives."[75]

As a result, it might be wise to consider leaving IRD items to taxpayers less affected by the attendant unpleasant consequences, such as a tax-exempt charity, a credit shelter trust, or a young beneficiary. In the first instance, IRD will be entirely exempt from income taxation; in the second and third cases, payment of the income tax may be deferrable until the death of a surviving spouse or until the youngster earns sufficient taxable income subject to tax filing requirements.

There are generally two ways to structure a charitable bequest of IRD: (1) Have the IRD paid directly to a charity so that the charity, rather than the fiduciary or beneficiary recognizes all of the IRD income, or (2) have the fiduciary receive the taxable IRD and then claim an offsetting charitable income tax deduction for the distribution of the IRD to a charity.[76]

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[73] Currently, fourteen states and the District of Columbia impose an estate tax while six states have an inheritance tax. Maryland and New Jersey have both. [as per Tax Foundation, May 25, 2016, https://taxfoundation.org/does-your-state-have-estate-or-inheritance-tax-0/, last accessed May 9, 2017].

[74] Computations on Page 1 of **Form 706** begin with the Total Gross Estate on Line 1. This figure which effectively represents the value of all of the decedent's assets is then adjusted for a number of items, including the State Death Tax Deduction on Line 3b to eventually arrive at the Adjusted Gross Estate on Line 5 which becomes the starting point for the ETD computation.

[75] *Income in Respect of a Decedent*, John Jastremski The Retirement Group Blogspot, December 26, 211 [available at https://theretirementgroup.wordpress.com/2011/12/26/income-in-respect-of-a-decedent-12262011/, . last accessed May 11, 2017].

[76] But caution is warranted: IRS Chief Counsel Memorandum ILM 200848020 denied a charitable income tax deduction to a trust after it received taxable IRA distributions and then distributed the amounts to charities. Additional complications may arise from proposed regulation 1.642(c)-3(b)(2) which provides that when a governing instrument specifies a source of income (such as IRD) to be used for a charitable income tax deduction, the

Of course, if it is possible, it is best to avoid the matter of IRD altogether by ensuring that income is fully recognized on the decedent's final return and not passed on to the fiduciary or beneficiary as IRD. If the marginal tax rate of the decedent is lower than that of the fiduciary or the decedent is entitled to deductions that might otherwise go unused if there is no offsetting taxable income, it is best to accelerate the anticipated income, rather than have it be treated as IRD:

For example, accrued but previously unreported interest from U.S. savings bonds may either be reported as income on the decedent's 1040, as IRD on the fiduciary's 1041, or as income on the beneficiary's 1040 if he cashes in the bonds. BEWARE: Allocating the income to the fiduciary will likely result in a higher tax liability since the marginal tax brackets for fiduciaries are severely compressed in comparison to the brackets for individuals.

For similar reasons, the decedent's personal representative may want to elect out of installment treatment for sales occurring in the year of death to accelerate income onto the decedent's 1040 rather than the fiduciary's 1041.

If, despite all of these suggestions, the fiduciary remains burdened with IRD, he may wish to consider the use of a fiscal[77] rather than a calendar year to gain the time needed to accumulate deductions which can be used to offset income already received.

Or he may be able to quickly close the estate's tax year before ever receiving taxable income. Of course, the income will eventually be received and will be taxable, but the deferral of income recognition may reduce the total tax liability, particularly if the income in question is substantial.

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instructions must have an economic effect independent of income tax consequences in order to be respected. [As excerpted from Hoyt, *Treacherous Waters: Using IRD for Charitable Bequests*, 2008.]

[77] The tax year may end with the last day of any month not more than twelve months after death. The first fiscal year may be a short tax year. [IRC §§ 441 and 443(a)(2).]

APPENDIX: IRD Reference Chart

Source of Income	Notes Regarding IRD Treatment
Accounts Receivable	Uncollected sales proceeds from pre-death sales of crop or inventory
Accrued Vacation Pay	IRD
Alimony	IRD
Annuities	If annuitant dies after policy owner began withdrawals, IRD equals taxable portion of *all* payments; if annuitant dies before start of pay-out, IRD equals *all* payments in excess of owner's investment in the contract
Bonuses	IRD even if the bonus amount is determined after death
Buy/Sell Agreement	Insurance proceeds used to pay the beneficiary for decedent's work-in-progress are IRD
Capital Gains	Not IRD unless property was sold by decedent and all contingencies were resolved before death
Community Property	Both halves receive basis step-up even though only half of property is includible in deceased spouse's estate (Form 706); both halves of property eligible for IRD treatment (Form 1040 or 1041)
Crop Shares	IRD reported when crop shares are sold
Crops & Livestock	Not IRD unless sold or pledged prior to death
Deferred Compensation	IRD
Dividends	IRD if decedent was owner-of-record prior to death
Employee Stock Option Plans	Income recognition is deferred until disposition of stock
Employer's Voluntary Payment	IRD on Form 1041 but not includible on Form 706 unless payment is continuation of employee's compensation
HSA & MSA Accounts	The full value of the account less any medical expenses paid on decedent's behalf is IRD to the beneficiary [exception if *named* spouse]
Installment Sales	If self-canceling obligation, IRD equals as-yet unrecognized income from original sale; if note is sold at a discount, IRD will equal remaining unrecognized gain less amount of discount
Insurance Commissions	Trailing sales commissions on decedent's sales made during life
Interest: Municipal Bonds	Tax-free interest is not IRD
Interest: OID	No IRD
Interest: Savings Accounts	Early withdrawal penalties are waived for closure of account after death
Interest: T- Bonds	Accrued interest on a bond that is redeemable for the payment of estate tax is IRD
Interest: T-Bills	Pre-death accrual of interest is IRD
Interest: US Savings Bonds	If decedent previously elected to report accrued interest annually, IRD equals total of interest accrued before date of death
IRA: ROTH	Only pre-death earnings in the account are taxable
IRA: Traditional	Full balance of account if decedent made only tax-deductible contributions; if non-deductible contributions made, IRD equals account value at death less decedent's non-deductible contributions less any post-death earnings
ISOs	No income recognition upon exercise for regular tax but bargain element subject to AMT; estate/beneficiary do not have to satisfy holding requirements for capital gain treatment
Life Insurance	Not IRD unless policy sold to 3rd party prior to owner's death
Medical Reimbursements	IRD if medical expenses previously deducted on decedent's 1040
Non-compete Agreement	IRD
Non-qualified Stock Options	Bargain element equals IRD but income recognition often postponed until exercise; no AMT consequences
Oil & Gas Royalties	IRD, but watch for payments in arrears or "suspensed" payments
Partnership	Decedent's K-1 income is not IRD; Guaranteed Payments issued post-mortem are IRD; if income stream transferred to 3rd party, payments attributable to unrealized receivables & goodwill are IRD if decedent was a general partner in a service partnership
Qualified Employer Plan	Income is recognized only when plan shares are distributed
Rents	Advance rents are not IRD
Royalties	If attributable to decedent's efforts as an author or inventor
Sales of Inventory	IRD
S-Corporation	Not IRD since new K-1 will be issued to estate/beneficiary
Settlement Proceeds	IRD if related to decedent's services or right to receive income; not IRD is related to the sale of an asset or goodwill
Sick Pay	Not IRD if received from workmen's compensation plan
Trust or Estate Income	Post-death distributions from another's trust/estate are IRD
Wages	Not subject to income tax withholding but subject to FICA taxes