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Income in Respect of a Decedent

Taxpayers are generally required to recognize income for federal income tax purposes in the year in which it is received. If, however, someone dies before receiving income to which he or she is entitled, that income is not included on his or her final income tax return. Instead, such income, referred to as "income in respect of a decedent," or IRD, is included as gross income in the decedent's estate for federal estate tax purposes. And, IRD also becomes taxable income to the person or entity who ultimately receives it (in direct contrast to the general rule that inherited property is not included in an heir's taxable income).

The inclusion of IRD on both the estate tax return (Form 706) and the recipient's income tax return creates the potential for double taxation. Fortunately, to avoid this result, the tax code provides an income tax deduction for any estate tax paid that is attributable to IRD.

What constitutes IRD?

According to the Internal Revenue Code, IRD represents "those amounts to which a decedent was entitled to receive as gross income but which were not properly includable in computing taxable income for the taxable year ending with the date of his death." In plain English, IRD is income the decedent earned but did not receive prior to death. Common sources of IRD include:

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- Uncollected salaries, wages, bonuses, commissions, vacation pay, and sick pay
- Uncollected alimony
- Uncollected rent
- Interest and dividends accrued
- Distributions from certain deferred compensation and stock option plans
- Taxable distributions from employer-sponsored retirement plans, including pension plans, profit-sharing plans, and simplified employee pension plans (SEPs)
- Taxable distributions from individual retirement accounts (IRAs)
- Gain from the sale of property if the sale is deemed to occur before death, but proceeds are not collected until after death
- Accounts receivable of a sole proprietor
- Difference between the face amount and the decedent's basis in an installment sales obligation
- Distributive share of partnership items for the period before death for a partnership tax year that ends after death, unless the death causes the partner's tax year to close

Who owes income tax on IRD?

IRD is taxed to the person or entity receiving it. This can be the decedent's estate, the surviving spouse, or some other beneficiary. IRD is reported on the recipient's income tax return in the year it's received. If IRD is paid to the decedent's estate, it is reported on the fiduciary return (Form 1041). If IRD is paid directly to a beneficiary, it is reported on the beneficiary's income tax return (Form 1040).

Character of IRD

The character of the income taxed to the recipient is the same as it would have been in the hands of the decedent; capital gains are taxed as capital gains, and compensation and interest are taxed as ordinary income. There is no step-up in basis for IRD items.

Deductions in respect of a decedent

There are also deductions in respect of a decedent (DRD), which can offset IRD. DRD items are deductible expenses that were owed at the time of death, but not yet paid. Such items might include real estate taxes, state income tax, and deductible interest. As with IRD, DRD can be taken on both the estate tax return and the beneficiary's income tax return, and must be deducted in the same manner as the decedent would have taken the deduction.

The deduction can be taken by the IRD recipient who is obligated to and actually pays the DRD items. DRD items are deductible in the year in which they are paid.

If DRD is taken on the estate tax return, the income tax deduction for estate tax paid on IRD is limited to net IRD (IRD minus DRD).

Income tax deduction for estate tax paid on IRD

If estate tax is paid on IRD, a deduction can be claimed on the income tax return that must report the IRD. For individual taxpayers, the deduction is available (as a miscellaneous deduction) only if they itemize. The deduction, however, is not subject to the 2% AGI floor for miscellaneous itemized deductions.

The deduction is calculated by recomputing Form 706 without IRD, then subtracting this number from the original estate tax due. The difference is the estate tax on IRD and the amount of the total deduction.

The IRD recipient's portion of the deductible tax must then be determined by:

- Dividing the value of the IRD included in the beneficiary's income by the total value of the IRD included in the decedent's estate (**not** reduced by DRD), then
- Multiplying this fraction by the total estate tax deduction

Example: *Amy dies leaving three children, Bob, Candy, and Dennis. Bob and Candy each inherit $10,000 in IRD items, and Dennis inherits $5,000 in IRD items. Bob becomes liable for $1,000 in DRD items. The net IRD included in Amy's estate is $24,000 ($10,000 + $10,000 + $5,000 - $1,000). Assume the estate tax attributable to the IRD items is $10,800. Each child's estate tax deduction is calculated as follows:*

Bob and Candy:

$10,000 / by $25,000 = .4

.4 x $10,800 = $4,320 each

Dennis:

$5,000 / by $25,000 = .2

.2 x $10,800 = $2,160

Planning for IRD

If IRD items will make up a large portion of your estate, failing to plan for them may have unintended results. For example, say 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. You can avoid such results by properly allocating IRD items.

The inclusion of IRD on both the estate tax return (Form 706) and the recipient's income tax return creates the potential for double taxation. Fortunately, to avoid this result, the tax code provides an income tax deduction for any estate tax paid that is attributable to IRD.

Here are some strategies to consider:

- Leave IRD items to charity, which is exempt from income taxes.
- Leave an IRA to a young beneficiary, which has the potential to defer the payment of income taxes for as long as possible.
- Leave IRD items to a credit shelter trust. This postpones the payment of estate tax until the death of the surviving spouse, and thus the payment of income taxes.

For further help with planning for IRD, see your estate planning attorney or tax planning professional.

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