Income in respect of a decedent
Why some gift horses deserve a hard look

The adage "don't look a gift horse in the mouth" is often applied to inheritances. But for certain types of assets, a thorough inspection may reveal an unexpected tax bite. Most inherited property is tax free to the recipient, but there's an exception for property that's considered income in respect of a decedent (IRD). IRD can be a significant estate planning issue, especially if you have large balances in an IRA or other retirement account — or inherit such assets.

What is IRD?

IRD is income that the deceased was entitled to, but had not yet received, at the time of his or her death. It's included in the deceased's estate for estate tax purposes, but not reported on his or her final income tax return, which includes only income received before death.

To ensure that this income doesn't escape taxation, the tax code provides for it to be taxed when it's distributed to the deceased's beneficiaries. Also, IRD retains the character it would have had in the deceased's hands. For example, if the income would have been long-term capital gain to the deceased, such as uncollected payments on an installment note, it's taxed as such to the beneficiary.

IRD can come from various sources, including:

- Unpaid salary, fees, commissions or bonuses,
- Distributions from traditional IRAs and employer-provided retirement plans,
- Deferred compensation benefits, and
- Accrued but unpaid interest, dividends and rent.

The lethal combination of estate and income taxes (and, in some cases, generation-skipping transfer tax) can quickly shrink an inheritance down to a fraction of its original value.

Planning tips for recipients

If you inherit IRD property, you may be able to minimize the tax impact by taking advantage of the IRD income tax deduction. This frequently overlooked write-off allows you to offset a portion of your IRD with any estate taxes paid by the deceased's estate and attributable to IRD assets. You can deduct this amount on Schedule A of your federal income tax return as a miscellaneous itemized deduction. But unlike other deductions in that category, the IRD deduction isn't subject to the 2%-of-adjusted-gross-income floor.

Keep in mind that the IRD deduction reduces, but doesn't eliminate, IRD. And if the value of the deceased's estate isn't subject to estate tax — because it falls within the estate tax exemption amount ($2 million for 2008), for example — there's no deduction at all.

Calculating the deduction can be complex, especially when there are multiple IRD assets and beneficiaries. Basically, the estate tax attributable to a particular asset is determined by calculating the difference between the tax actually paid by the deceased's estate and the tax it would have paid had that asset's net value been excluded. For example, suppose you inherited a $1 million IRA and the net value of the deceased's estate was $5 million. The estate tax on $5 million (in 2008) is $1,350,000. If the IRA had been excluded, the estate's net value would have been $4 million and the estate tax would have been $900,000. Your IRD deduction is equal to the difference between the two, or $450,000.

If you receive IRD over a period of years — IRA distributions, for example — the deduction must be spread over the same period. Also, the amount includible in your income is *net* IRD, which means you should subtract any deductions in respect of a decedent (DRD). DRD includes IRD-related expenses you incur — such as interest, investment advisory fees or broker commissions — that the deceased could have deducted had he or she paid them. Thus, to minimize IRD, it's important to keep thorough records of any related expenses.

Planning tips for your estate

IRD can dramatically alter the consequences of your estate plan. Suppose you plan to divide your assets equally among your three children and a charitable organization: One child receives $1 million in real estate, one receives $1 million in publicly traded stocks, one receives $1 million in an IRA and the charity receives $1 million in cash.

On closer examination, it turns out that your children aren't treated equally after all. The real estate and stock are entitled to a stepped-up basis. This means that, when your children sell them, their taxable gain will be based on the assets' value when they inherited them — not on what your basis was. So if they sell the assets as soon as they inherit them, they'll generally owe no tax on the sale. And even if they sell them later and recognize some gain, it may be taxed at the beneficial long-term capital gains rate — perhaps only at 15%. The IRA balance, on the other hand, is IRD subject to income tax at rates as high as 35%.

You can avoid short-changing your third child by leaving him or her the cash and donating the IRA to charity. As an exempt entity, the charity isn't subject to tax on IRD.

Another strategy for dealing with IRD is dividing IRD assets equally among your beneficiaries. Or you can defer the tax by leaving IRD assets to your spouse or to a credit shelter trust for his or her benefit.

A horse of a different color

IRD assets are treated differently than other assets for estate planning purposes. To avoid unpleasant tax surprises, be sure to work with your estate planning advisor to identify IRD assets, assess the tax implications and develop a strategy for eliminating or minimizing IRD.

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