Income in Respect of a Decedent (IRD) Maximize the Deduction

Understanding the tax deductibility of income in respect of a decedent (IRD) is gaining significance as the baby boomer generation reaches retirement. Many parents of the baby boomer generation have accumulated significant wealth that will create taxable estates. The following years will be critical, as many individuals will become beneficiaries of estates that include IRD, elevating the importance of the IRC section 691(c) deduction.

The calculation of an individual's gross estate upon death includes all property the decedent owns or has an interest in, and therefore would include any income owed to the decedent at the time of death but not yet received. The fair market value of IRD is included in the income tax return of the beneficiary, whether an heir, an estate, or a trust (IRC section 691). Because the inclusion in both the estate tax return and the income tax return of the recipient can create double taxation, the tax laws provide for a tax deduction under IRC section 691(c).

This deduction is allowed to the beneficiary of any IRD that caused an increase in the estate tax of the decedent. The deduction can reduce the added income tax the beneficiary would bear as a result of including the IRD on its return. Even though this is conceptually simple, taking the federal estate tax deduction on IRD is often erroneously calculated or missed entirely. Increased knowledge of what constitutes IRD and how and when the deduction is taken, and recognition of why it is a continued problem, can result in more-accurate reporting and reduced taxes.

Explanation of IRD

In order to prevent the bunching of all income received after a decedent's death on the final income tax return, Congress enacted IRC section 691, which essentially provides for taxing the beneficiary on the postmortem income as it is received. While there is no universal definition of IRD found in the IRC, Treasury Regulations section 1.691(a-b) provides a general guideline that IRD includes "those amounts to which a decedent was entitled as gross income but which were not properly includable in computing taxable income for the taxable year ending with the date of his death." What constitutes IRD can vary depending on the type of income received, the method of accounting used by the decedent, and the date the income is actually received.

Tax issues arise when the recipient of the IRD is subject to the taxation on this income. According to IRC section 691, the following parties may be subject to IRD from the following:

- the estate of the decedent, if the right to receive the income is acquired by the decedent's estate from the decedent;
- the person who acquires the right to receive the income by way of the decedent's death, if the right to the income is not acquired by the decedent's estate from the decedent; and
- the person who acquires the right to receive the income by bequest, devise, or inheritance, if the right to the income is received through a distribution from the decedent's estate.

No matter who the beneficiary is, the income, when received, will be taxed to the beneficiary as it would have been taxed to the decedent. Whenever a taxpayer dies, the beneficiary of the property generally receives a step-up (or step-down) in basis in the property equal to the fair market value of the property on the decedent's date of death (IRC section 1014). Any increase in basis will help offset any gross sale proceeds. As an exception, however, IRD is denied this IRC section 1014 basis to prevent realized but unrecognized income from evading its predetermined recognition by hiding behind a taxpayer's death. IRD does not receive a step-up in basis, because the income has not been taxed on the decedent's individual income tax return, although it is includible as an asset on the decedent's estate tax return.

Example. Ann, a decedent, was owed $500 in wages upon her death. The beneficiary of these wages, Bob, will have the same basis in the income as Ann did, in this case $0. Bob will recognize the same amount of income as would have been recognized by Ann, in this case all $500.

Almost all IRD is included in the gross estate of a decedent, much like all other decedent property, but it is also included in the beneficiary's income tax return when received, to ensure proper taxation of the actual recipient. The IRD beneficiary's deduction comes in the form of a miscellaneous itemized deduction not subject to the 2% of AGI floor equal to the estate tax attributable to the net IRD [IRC section 67(b)(8)].

Income That Constitutes IRD

To determine whether an item of income is IRD, one must first ascertain whether the income has been included on the decedent's individual income tax return. If it has not been subjected to income tax, one must determine how it would have been taxed to the decedent; a decedent's income reported by the beneficiary retains the same character it would have had in the hands of the decedent [IRC section 691(a)(3); Treasury Regulations section 1.691(a)-3]. The other consideration is the accounting method used by the decedent. In general, beneficiaries of cash-basis decedents must claim all IRD when actually received unless the income was constructively received on the decedent's date of death. On the other hand, the beneficiaries of an accrual-basis decedent must claim only qualified death benefits and deferred compensation owed to the decedent as IRD; other income, such as interest and wages accrued on decedent's date of death, would be reported on an accrual basis on the decedent's final Form 1040.

Specific examples of compensation owed to a beneficiary because of a decedent's death and treatment are as follows:

Wages and salaries. Salary or wages earned by a cash-basis decedent but unpaid as of his date of death constitute IRD. Bonuses for services rendered payable to a cash-basis decedent upon death are considered IRD if there was "substantial certainty" the bonus would have been awarded, unless paid directly to the recipient and thus considered a gift *[O'Daniel's Estate v. Comm.*, 37 AFTR 1249 (1948)]. Fringe benefits are considered IRD unless they would not have been included in the decedent's gross income, such as payments for permanent loss or disfigurement. Postdeath payments to a third party are classified as IRD even though the decedent was not entitled to them [*Estate of DiMarco v. Comm.*, 87 T.C. 653 (1986)].

Self-employment income. Outstanding income owed to a self-employed decedent (accounts receivable) is considered IRD but is not subject to self-employment tax.

Interest. IRD includes interest accrued but not paid to a cash-basis decedent.

Accrual-basis decedents do not consider accrued but unpaid interest as IRD, but instead claim the revenue on their final 1040.

Dividends. Decedents must be entitled to the dividend at death for the dividend to be considered IRD. A decedent would be entitled if the record date of the dividend precedes the decedent's date of death. If the record date is after the date of death, dividends are considered ordinary income to the decedent's beneficiary.

Rents and royalties. Rents accrued on a day-to-day basis since the last rental payment that remain unpaid on a cash basis at the decedent's date of death represent IRD. Unpaid royalties attributable to predeath time periods qualify for IRD treatment (Revenue Ruling 60-227, 1960-1CB262).

Example. Barney, a cash-basis taxpayer, died on June 30. Upon his death, Barney had accrued but not yet received $150 in interest on bonds and $500 from a rental house. Barney's beneficiary will include $650 in IRD in his gross income when the interest and rent are received.

Sales proceeds. To be considered IRD, sales proceeds must meet the following requirements [Reg. IRC section 1.691(a)-2(b)]:

- The decedent entered into the contract for sale of the property at hand;
- The property must have been in a deliverable state upon the decedent's death (executor has only a passive or administrative role in the sale);
- No material contingencies would have disrupted the sale; and
- The decedent would have constructively or actually received the sale proceeds if he had lived (the sale could have been considered a receivable).

Example. John, a self-employed car salesman, enters into a contract to sell a car by agreeing to the buyer's written offer. John has full title to this car and the car is located on his lot. John suddenly dies, before the buyer receives the car and before John collects the proceeds. The executor of John's estate would be required to perform only a passive role in the sale by collecting the proceeds and handing over the keys to the car. The beneficiary of the sale proceeds would therefore include the amount as IRD, because John had contracted the sale, had placed the car in deliverable state, had no material contingencies on the car, and would have recorded the proceeds in gross income had he lived.

Sales dependent on a decedent's death do not constitute IRD, because the sale proceeds were not realized before death [Treasury Regulations section 1.691(a)-2(b)].

If property is still owned by the decedent at death, the beneficiaries receive an IRC section 1014 stepped-up basis in the property and no IRD. This is a valuable planning tool for individuals looking to give property to someone else without the recipient's also receiving a large capital gain upon sale of the property.

Deferred compensation. Deferred compensation includes payments received under such plans [e.g., 401(k)s and traditional IRAs], whether or not the decedent was eligible to receive the payments upon death (IRC sections 2031 and 2039).

Deferred compensation can either be monies payable to an employee [defined for IRD purposes as amounts that an employee agrees can be deducted from his earnings for payment at a later date; amounts that are tax deferred; and amounts for which the postponed payments have not been paid upon a decedent's death, as per Treasury Regulations IRC section 1.691(a)-2(b)] or monies not payable to an employee, as well as monies payable to an employee's beneficiaries upon the employee's death.

To be excluded from IRD, the beneficiary must prove that the compensation would not have been included in the decedent's gross income when received. For example, Roth IRA distributions would not have been taxable to the decedent and thus are not taxable to the beneficiary, because original contributions to the plan were not tax deductible.

In addition, retirement distributions that exceed the IRA owner's taxable IRA balance (the value at date of death, including appreciation and accrued income less nondeductible contributions) are not considered IRD (Revenue Ruling 92-47, 1992-1CB198).

Example. John receives $500 per month in distributions from a traditional IRA plan. John dies after receiving 10 distributions, while the value of the account is $7,500, including unrealized appreciation and accrued income and less nondeductible contributions. John's daughter, Sue, receives the right to the IRA balance upon John's death, and must include $7,500 of IRD in her gross income in each year she receives a distribution.

Installment sale receipts. The recipient of an installment obligation from a decedent would continue reporting the receipt of payments just as the decedent had.

The IRD portion of an installment sale payment should equal the gross profit ratio multiplied by the annual payment, plus any accrued interest of a cash-basis decedent not yet received [IRC section 691(a)(4)].

Example. Dan sells a piece of real estate he owns for $200,000. The buyer promises to make 10 equal annual principal payments of $20,000 for the next 10 years. Dan's adjusted basis in the property was $80,000 at the date of the sale. Therefore, the gross profit ratio of this sale was 60% [($200,000 – $80,000) ? $200,000], and 60% of each annual payment is reported as a gain. Dan dies after receiving only two annual $20,000 payments. The installment obligation becomes an asset of Dan's beneficiary, his estate; when it receives the third annual payment, it would consequently report $12,000 in IRD. This reporting will continue if the note is passed to a beneficiary. Any interest that was accrued and owed to Dan upon his death would also be considered IRD; any interest accruing after Dan's date of death would be classified as ordinary income.

Partnerships. Under IRC section 706, partnership income attributable to the period before the decedent's death should be included in the partner's final income tax return. All partnership income attributable to postmortem periods will be included in the income tax return of the successor (estate or beneficiary) of the deceased partner's partnership interest. Thus, no IRD will be recognized by the successor no matter how much distribution from the partnership is received by a successor at a later date. In addition, IRD generally includes unrealized receivables of a cash-basis partnership upon the partner's death that were later realized by the partnership [IRC section 751(c)].

Example. Nona, a 20% partner in calendar-year and cash-basis N Partnership, died on June 19. Nona's successor (her estate) continued as the partner for the remainder of the year. N Partnership's income for the period ended June 19 was $180,000, and unrealized receivables at Nona's death were $10,000. Nona's share of this income ($36,000) was reported on her final K-1 and subsequently on her final income tax return. N Partnership's income for the remainder of the year was $210,000, and the unrealized receivables were collected and realized. Nona's estate included its share of this income ($42,000) in its gross income reported on its first estate income tax return. At year-end, N Partnership distributed the entire year's proportionate share of income and collections ($78,000 of income and $2,000 of postdeath realized receivables) to Nona's estate. Only $2,000 would be considered IRD, because the other portion of the distribution had already been reported in either Nona's or the estate's gross income.

S corporations. An individual inheriting S corporation stock from a decedent must treat the decedent's pro rata share of any IRD items (accrued but unpaid income items) as IRD. S corporation stock received by a beneficiary would receive an IRC section 1014 step-up in basis [Reg. IRC section 1.1367-1(j)]. The basis of S corporation stock that is acquired from a decedent must be reduced by the value of the stock that is attributable to the IRD items of the decedent related to the S corporation [IRC section 1367(b)(4)(B)].

Example. XYZ Inc., an S corporation, has 300 shares of stock outstanding. John owns 75 shares, which are worth $100,000 at his date of death. Also on this date, XYZ's accrued but not received income totaled $8,000. As a result, the beneficiary, Sam's basis in the 75 shares received from John is stepped up to $100,000 (according to IRC section 1014), then reduced by $2,000 (Sam's share of IRD items). In addition, Sam must report $2,000 of IRD on his income tax return.

Deductions in Respect to a Decedent

Regardless of accounting method, IRD is subject to income tax when a triggering event, generally the actual receipt of the income by the beneficiary, occurs. One way to initially reduce the tax to the beneficiary is by claiming a deduction in respect to decedent (DRD) to offset the revenue. The IRS allows any recipient of current or future IRD to deduct any properly allocable expenses against the income that was properly not claimed on the decedent's final return [IRC section 691(b)]. Common DRD items include fiduciary fees, commissions paid to dispose of assets, and state income taxes. To be considered DRD, the expense must be paid by the beneficiary that actually acquires an interest in the property. DRD can be used to offset IRD on both the estate tax return and the beneficiary's income tax return, just as IRD is taxed on both.

DRD is treated similar to IRD in that it must be deducted in the same manner as the decedent would have taken the deduction.

Example. Bob inherits property from Pam upon her death. This property includes a parcel of real estate, and $5,000 in gross wages payable to Pam upon her death. During the current tax year, Bob collects the $5,000 in wages, less $1,000 in federal taxes and $500 in state taxes; he also pays $1,200 in property taxes on the real estate inherited. On Bob's current-year income tax return, he must claim the $5,000 in wages as IRD and include it in his gross income. Bob may, however, deduct $500 of DRD for the state income taxes withheld from Pam's final paycheck. Bob may also deduct $1,200 for the property taxes he paid, even though the real estate did not generate any IRD. These DRD items will be deducted in the same form as they would have been on Pam's return.

Calculation of the Deduction

If an estate is subject to federal estate tax and the gross estate includes IRD, the beneficiary may claim all or part of the federal estate tax deduction on its income tax return [IRC section 691(c)]. The calculation of this deduction varies depending upon the number of IRD items and IRD recipients. No matter the intricacy of the computation, the goal remains the same: 1) calculate the estate tax that qualifies for the deduction, and 2) determine the IRD recipient's portion of the deductible tax.

According to IRC section 691(c) and Treasury Regulations section 1.691(c)-1, the federal estate tax deduction available to a beneficiary is calculated as follows:

- Establish the fair market value of all IRD items that are included in the gross estate. This value may not be what is ultimately collected by the beneficiary. Next, determine the net value of the IRD by reducing the above value by all related DRD, regardless of which beneficiary claims the deductions [IRC section 691(c)(2(B)].
- Calculate the net estate tax on the gross estate, including the value of all IRD, and reduce it by any credits allowed. Exclude the net value of all IRD, and recompute the net estate tax. The difference between the two calculations is the estate tax attributable to the inclusion of the net IRD and is the total deduction available to all IRD beneficiaries [IRC section 691(c)(2)(C)].

An example for the calculation can be seen in the Exhibit.

This deduction can be taken by the beneficiary as a miscellaneous itemized deduction not subject to the 2%-of-AGI limit. However, if more than one beneficiary receives IRD, or if IRD is received by a single person in more than one year, an additional computation must be made to determine each recipient's annual deduction. The appropriate allocation of the deduction is calculated according to IRC section 691(c)(1)(A):

- Divide the individual gross value of any IRD being included in a beneficiary's gross income by the total gross value of all IRD being included in the gross estate of the decedent. IRD should not be reduced by corresponding DRD when making this calculation.

- Multiply this fraction by the total federal estate tax deduction. The result will be the allocable federal estate tax deduction for each individual per year.

The following examples show the effect of situations that include multiple IRD recipients, including a surviving spouse, differences in the value of IRD and the actual IRD received, and IRD received over multiple years.

Multiple IRD recipients. David died, leaving three children, Cory, Mark, and Joe. Upon David's death, Cory and Mark each inherited $10,000 in IRD items and Joe inherited $5,000 in IRD items. Upon David's death, Cory was liable for an item of DRD valued at $1,000, making the net IRD included in David's gross estate $24,000. Assume that when the calculation shown in the Exhibit is done, the net estate tax attributable to the IRD items is $9,900. The calculation of each child's portion of the $10,000 estate tax deduction is as follows:

Cory's and Mark's Deduction

$10,000 x $9,900 = $3,960
$25,000

Joe's Deduction

$ 5,000 x $9,900 = $1,980
$25,000

Multiple IRD recipients with a surviving spouse. Assume Henry was survived by his wife, Cathy, and left IRD items of $10,000 to her, $10,000 to his son William, and $5,000 to his daughter Anne. Because the $10,000 left to Cathy qualifies for the marital deduction, it is excluded from the gross estate when calculating the total estate tax deduction. Assume the estate tax attributable to the inclusion of the $15,000 in IRD in Henry's gross estate is $6,200. Cathy would then be entitled to an IRC section 691(c) deduction of $2,480 [($6,200 x $10,000) ÷ $25,000], even though her share of the IRD did not contribute to any estate tax, because of the marital deduction (Revenue Ruling 67-242, 1967-2CB277).

Differences between the value of IRD and the actual amount received. The value of an item of IRD upon the decedent's death is used to determine the maximum federal estate tax deduction that an IRD recipient may claim, regardless of how much IRD is actually collected. If the amount of IRD actually collected is less than the determined value, the available IRC section 691(c) deduction must be recalculated. Assume that Steve inherits accrued but unpaid rent valued at $9,000 from Brad, a cash-basis taxpayer. The estate tax attributable to this rent, and thus the maximum IRC section 691(c) deduction, is $3,000. If, however, Steve is able to collect only a third of the rent ($3,000), he is entitled to only a third of the federal estate tax deduction ($1,000). Although Steve has lost a $2,000 deduction, he does not pay income tax on the uncollected rent of $6,000. An estate tax liability has already been calculated on the $9,000 value of the IRD, however, resulting in tax consequences.

IRD received over multiple years. Goldie is bequeathed an item of IRD valued at $10,000. The total IRC section 691(c) deduction related to this IRD is $3,000. Over the next 10 years, Goldie collects $1,000 per year related to this item of IRD. As a result, she is entitled to a federal estate tax deduction of $300 ($3,000 x $1,000/$10,000) per year to help offset the gross income included on her income tax return.

The examples above show that any person who includes IRD in gross income for the year is entitled to a portion of the IRC section 691(c) deduction regardless of whether IRD contributed to the estate tax and regardless of whether the amount of the IRD collected was less than its value. In addition, by not taking into account DRD items when computing each individual's annual deduction, individuals that are not liable for the DRD do not receive any advantage from its payment by the liable beneficiary.

It is worth noting that each individual federal estate tax deduction can be claimed only in the same year in which the IRD is included in the recipient's gross income. For example, a beneficiary cannot record IRD in its gross income in the year of the decedent's death yet claim the IRC section 691(c) deduction in the following year, even if the estate was not settled until the second year. Likewise, if IRD is received by a beneficiary in a tax year following that of the decedent's death, the federal estate tax deduction will be taken in the year the income is recognized, regardless of when the estate tax was actually paid. In addition, a federal estate tax deduction may not be fully deductible if the deduction results in the total deductible Schedule A items exceeding the overall limit on itemized deductions specified in IRC section 68. Finally, an IRC section 691(c) deduction may not be fully used to a beneficiary's advantage if the beneficiary's total itemized deductions do not exceed the beneficiary's allowable standard deduction.

Caveats

Despite the obvious income tax benefits of the federal estate tax deduction, the failure to recognize IRD and the deduction can be problematic for several reasons. Often, different tax advisors, CPAs, or attorneys prepare Forms 706, 1040, and 1041 for all the parties involved. This alone may be the primary reason behind miscalculated or lost deductions for estate taxes attributable to IRD on a beneficiary's tax return. Erroneously computed deductions can also be attributed to the scarce literature on the subject and the fact that most tax software programs merely refer users to IRS publications when calculating the deduction. Finally, the IRC section 691(c) deduction can easily be miscalculated when IRD is paid out over several years, making the computation complex and ongoing.

Debra H. Oden, JD, LLM (Tax), CPA*, is an associate professor at Missouri State University, Springfield, Mo.*
Ben Sutherland, CPA, MAcc*, is a staff accountant at Whitlock, Selim & Keene LLP, Springfield, Mo.*