CHAPTER 64

The Tax on Income in Respect of a Decedent – an Estate Tax for Everyone

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There is a tax applicable to estates even your CPA might miss. This tax could hit you for up to 35% and potentially applies to any estate, not just those over a certain amount. This is a tax on what is referred to as Income in Respect of a Decedent (IRD).

What is IRD? Simply put, IRD is any income owed to the decedent that was not collected by the decedent before death. An example of IRD is a paycheck paid for the last days the decedent worked but not actually sent until after the date of death. Another example of IRD are the proceeds of a contract entered into by the decedent in selling a car. A final, and very significant example of IRD, is a tax-deferred retirement account, such as an IRA.

Because IRD isn't collected during the decedent's life, it is not included — and, therefore, not taxed — on the decedent's last income tax return. Instead, IRD is taxed as income to whomever receives this income after the decedent's death. This means the decedent's heirs pay the tax. If your heirs aren't expecting to pay this tax — for instance, if they cash out your IRA, planning to enjoy it as tax-free inherited income, they could be in for quite a shock months later when their income taxes become due. But being unaware of the potential for this trap on smaller estates is not the most serious problem. It is even worse for estates large enough to be subject to estate taxes.

The most serious problems occur when the estate exceeds the federal estate tax exclusion and has most of its liquid assets in an IRA or other tax-deferred retirement account. It is not uncommon for a taxable estate to consist primarily of some real estate, an IRA or 401(k), and a checking or savings account. When this happens, you are hit with a double-whammy. First, even though income taxes will be owed on the IRA withdrawals (as IRD), the IRA still counts in the total size of the estate when calculating the estate tax. If your heirs do not want to sell your home, that leaves them with the IRA as the primary source of funds with which to pay the estate tax. Unfortunately, withdrawing funds from the IRA to pay taxes triggers the second whammy, income taxes on IRD. With no other liquid assets to cover the income taxes, the IRA would need to be further cashed out to cover the additional taxes.

That further cashing out would trigger yet more taxes on IRD, leading to a cascade of withdrawals that could very quickly eat up upwards of 80% of the IRA, just in taxes. Fortunately, there are steps you can take to ameliorate this problem.

First, even if you only find out about the IRD problem after cashing out the IRA to pay estate taxes, there is some relief offered by the IRS. The IRS allows a tax deduction based on the amount of the estate taxes attributable to the IRD. The deduction can only be taken when the IRD income is actually received, for example, when money is withdrawn from an IRA — and is prorated based on the total amount of the IRD.

> **EXAMPLE:** Robin passed away leaving three properties worth a total of $3,750,000 and an IRA worth $750,000. Her other assets are negligible. Assume the federal estate tax rate is 45% and applies to any assets over $3,500,000. Robin's estate will owe estate taxes of $450,000. Without including the IRA, Robin's estate would owe only $112,500. The IRD income tax deduction for Robin's IRA is $337,500, the difference between those two amounts. For each $750 withdrawn from the IRA, the recipient will qualify for a $337.50 IRD deduction. The deduction will not completely offset the taxes paid, but it lowers the worst case scenario from an 80% combined tax to a 60% combined tax.

One way of ameliorating the tax net is to purchase life insurance to cover estate taxes when the estate contains few liquid assets except for an IRA or another tax-deferred retirement account. Paying estate taxes with life insurance proceeds allows the IRA to remain untouched and to continue to do what it does best, grow your money tax free (until it is withdrawn). This strategy can be combined with the IRD deduction, minimizing the taxes owed when IRA distributions are made.

Ultimately, you want to be prepared for the taxes on IRD in your estate. That means informing your beneficiaries about taxes on IRD and having sufficient liquid, non-IRD assets available to cover the full cost of your estate taxes. With IRAs becoming an ever larger share of estates, appropriate planning to handle the taxes on IRD is of supreme importance. You want to leave your heirs the fruits of your estate, not a tax headache. Don't get caught off guard. Start tax-proofing your estate today.

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