CHAPTER 65

Planning Strategies to Avoid Income in Respect of Decedent (IRD)

RANDY GARDNER (Leawood, Kansas) and BOB KEEBLER (Green Bay, Wisconsin)

Figuring out how to avoid the double tax on Income in Respect of a Decedent (IRD) assets is perplexing. Here are steps to help you through the analysis:

Identify who is going to pay the estate tax.

If there is no will or the will is silent on the issue, many states require that the distributed assets bear their burden of estate tax. Most wills direct debts and taxes to be paid from the residuary share. If the recipient of the IRD asset and the residuary are the same, there is no problem. However, if the recipient of the IRA is a child and the taxes are to be paid from the surviving spouse's residuary share, the surviving spouse may be surprised by the small amount received after paying the debts and taxes attributable to other properties in the estate.

Do not forget to claim the income tax deduction for the estate taxes paid.

If the estate tax is paid from the residuary and not from the property itself, this deduction is often overlooked.

If possible, defer the payment of income tax on the IRD by postponing the receipt of IRD income.

Normally heirs want to collect accounts receivable as soon as possible and installment payments when they are due, but retirement plan distributions can usually be stretched over the life expectancy of the designated beneficiaries. Although postponing collection of income also means postponing the deduction for estate taxes paid, breaking the payments into smaller pieces at lower marginal income tax rates and taking advantage of the time value of money by paying the income tax in the future rather than today support deferring the receipt of income. The benefit of this approach is enhanced if the IRD asset is growing tax free as a retirement account likely is.

Retirement accounts left to multiple beneficiaries generally must be distributed over

support is correct because of compound subject, although the sentence might be worded more clearly, maybe: ...paid, it also provides the benefit of lower marginal income tax rates (since the payments are broken up into smaller amounts) and takes advantage of the time value of money by paying income tax in the future rather than today.

the life expectancy of the oldest beneficiary. PLR 200537044 added a beneficial twist to the strategy of trying to reduce the marginal rates of tax on the distributees by allowing multiple IRAs within trusts to be named as beneficiaries. The ruling allowed each beneficiary to receive the assets over his or her own life expectancy, rather than the life expectancy of the oldest beneficiary.

If the decedent has a lower marginal income tax rate than the beneficiaries, execute a Roth conversion or distribute the IRD asset to the decedent before death.

The decedent might have a lower tax rate because: the decedent's marginal income tax rate is lower than the tax rates of the estate or heirs; the decedent's anticipated time of death is early in the year, before much income has been earned; or the IRD asset is eligible for special income tax treatment, such as lump sum distribution averaging, pre-1974 capital gain treatment, or the benefits of net unrealized appreciation on employer stock.

Avoid estate tax by transferring the IRD asset to the surviving spouse.

The first spouse to die typically designates the surviving spouse as the beneficiary. This transfer qualifies for the marital deduction and usually has the added advantage of spreading the distribution of the income at lower marginal tax rates over the life of the surviving spouse. Surviving spouses have the discretion to: withdraw the retirement plan assets when needed; stretch the distributions over their life expectancies; or treat the retirement accounts as their own by rolling the assets over to their own IRAs. Under the Pension Protection Act of 2006, non-spouse beneficiaries can now transfer retirement plan assets and IRAs to their own accounts, but they do not have the option of postponing distributions until 70½ as a spouse does.

Revenue Ruling 2006 — 26, 2006-22 I.R.B. 1 addresses the issues of holding an IRA in a qualified terminable interest property (QTIP) trust. QTIP treatment allows the first spouse to die control over the ultimate disposition of the trust property after the death of the second spouse, yet still receive a marital deduction. In order to qualify for the marital deduction, the QTIP trust must distribute its income annually to the surviving spouse. What is the income of an IRA that produces income, but is also required to make required minimum distributions (RMD)? For a spouse who can compel the IRA custodian, through the trustee, to invest in productive assets, the Ruling holds that the IRA must distribute to the spouse the higher of the RMD or IRA income. After distribution from the IRA the trust, the amount is distributable to the surviving spouse.

Avoid estate tax by transferring the IRD asset to charity.

Another effective way to avoid the two layers of tax on IRD assets is to take advantage of the estate tax charitable deduction. Charitably-inclined clients can transfer IRD assets to charity while transferring assets which receive a step up in basis and have minimal income tax impact at the beneficiary level to the estate and heirs.

Unless the will provides otherwise, some states require that a decedent's estate be distributed pro rata to the estate beneficiaries. In other words, if an estate has three beneficiaries — two children and one charity — and three assets — $1 million in securities, a $1 million residence, and a $1 million IRA — the executor might be required to transfer a ⅓ interest in each of the assets to each of the beneficiaries. If the will provides for specific bequests or gives the executor discretion regarding how to divide the assets among the beneficiaries, the IRA could be transferred to charity and the house and securities could be transferred to the two children.

To summarize, the estate tax portion of the tax on IRD can be avoided by making marital or charitable transfers. The income tax portion can be minimized by postponing distributions of IRD and spreading the distributions among beneficiaries.

Randy Gardner, LLM, MBA, CPA, CFP®, is the Director of Education for WealthCounsel, LLC and also a Professor of Tax and Financial Planning and Director of the Certificate in Financial Planning Program at the University of Missouri – Kansas City.

Robert S. Keebler, MST, CPA, Partner, Virchow Krause & Company, LLP, focuses his practice on family wealth transfer and succession planning, retirement distribution planning, estate administration, and IRS representation.