

Price & Farrington's Estate and Tax Planning FastFaxts

May, 2004

Estate, Tax and Wealth Planning for Advisors and Clients

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The Overlooked Trillion-Dollar Plus Income Tax Deduction: *Planning for IRD*

The least understood and most complicated income tax deduction is also the one that's most often missed – even though it could be worth a trillion dollars or more to taxpayers who are failing to claim it.

If you or your clients have deferred-income-type assets in a taxable estate – or inherit them from one – you must learn about this. *Here's the story:*

Double Danger. When deferred-income-type assets are in your taxable estate, they can be subject to taxation at near-confiscatory rates – 80% or more. Assets that face this danger include:

- ☞ Balances in IRAs, 401(k)s, and other tax-deferred retirement accounts;
- ☞ Pension payments owed to designated beneficiaries;
- ☞ Survivor annuities issued by insurance companies;
- ☞ Proceeds due on installment sales;
- ☞ Royalty rights;
- ☞ Untaxed deferred interest on Series E, EE, and I savings bonds;
- ☞ Deferred compensation from employers;
- ☞ Damage awards from lawsuits;
- ☞ Other income-producing items.

IRD. The income from such items,

when later paid out to heirs, is called *income in respect of a decedent* (IRD).

Trap if you don't know the rules.

The income-producing item's value is first subject to estate tax at rates up to 48%. Then the income later paid out by the item – the IRD – is subject to income tax at rates up to 35%. The total tax due from adding these tax rates can be as much as 83% - leaving as little as 17% for heirs!

Example. Ludwig leaves \$1 million in an IRA that is subject to 44% federal estate tax (we're not considering Washington state estate tax here). The IRA's beneficiary is in the 35% tax bracket. The estate must first pay \$440,000 tax on the IRA (his estate provides funds to pay this tax), then the beneficiary must pay \$350,000 of income tax payable on the distribution of the IRA balance – if he doesn't know the IRD rules. The total IRS tax bill comes to \$790,000!

Tax relief from Congress. Congress decided this double taxation is unfair. As a remedy, it created partial relief in the form of an income tax deduction for federal estate tax (but not for state estate tax) previously paid on an asset that creates IRD. This is often called the "deduction for IRD" and can be claimed as the IRD is paid out.

Example. Daphne dies leaving \$1 million in an IRA subject to 44% federal estate tax. The tax of \$440,000 is paid as in the example above. The IRA's beneficiary is in the 35% tax bracket. If he...

- ☞ Takes a full distribution of the \$1 million, the deduction for IRD lets him deduct \$440,000 against it. As a result, he pays income tax on only \$560,000 – and the deduction for IRD saves him \$154,000 plus any state income tax savings on the deduction.
- ☞ Takes distributions from the IRA over-time, the deduction for IRD is taken proportionately. If the IRA is distributed at a rate of \$100,000 per year, the deduction for IRD is \$44,000 per year until the entire \$440,000 is consumed. This saves \$15,400 of income tax per year plus any state income tax savings on the \$44,000 deduction. Any addi-



tional distributions from the IRA in excess of \$1 million (due to investment returns) would be fully taxed.

Overlooked deduction. The biggest mistake made with the deduction for IRD is that many people – perhaps most – *don't claim it at all*. The main reasons it is the most overlooked of all income tax deductions are:

- ☞ Most individual taxpayers don't even know it exists.
- ☞ Professionals who deal with an estate often don't talk to each other about it, so it falls through the cracks.

Example. Neither the executor nor the advisor who prepares an estate's tax return has any responsibility for the personal returns of heirs who would claim the IRD deduction, and doesn't even think about it – unless there is a formal agreement stipulating that he or she *will* take responsibility. At the same time, the tax advisors of those heirs don't know if any estate tax was paid. Or the heirs prepare their own returns and are ignorant of the whole issue. So the deduction is simply missed.

There is no "information reporting" for the deduction. No form, such as a W-2, 1099, or K-1 is filed by anyone to report the deductible amount to a taxpayer who doesn't know about it.

Records for past years are lost. The IRD deduction may be spread out over many years – in the case of an IRA distributed over the beneficiary's life expectancy, 20 years or more. And a balance of the avail-

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When assets, such as IRAs, are subject first to estate tax and then to income tax when paid to an heir, the heir is entitled to an income tax deduction under I.R.C. Section 691 (c) for "income in respect of a decedent" (IRD) for the estate tax previously paid.

IRS Ruling: When the heir is a spouse and the estate tax marital deduction results in no estate tax being due, the IRD deduction is still available based on the "hypothetical" taxable estate of the deceased. Since IRS rules on IRD are complex, clients should consult a tax advisor. ■

Of Chickens and Eggs...

Which came first? Don't be chicken. Walk to the other side of the road and take a guess. The answer, when it comes to IRD (income in respect of a decedent) deductions, is: "It doesn't matter." The IRS held that where a person inherited the remaining payments from an annuity and reported income from those payments on her income tax return, she was entitled to Section 691 income tax deductions for the estate tax generated by including the annuity in the deceased's estate—even though the estate hadn't yet paid the estate tax it owed.

Facts. An individual inherited the right to receive the remaining payments from an annuity for a term of years. The decedent's executor reported the value of the annuity in the decedent's estate tax return. But the tax itself had not been paid by the time the taxpayer reported the annuity payments she received on her income tax returns for the period in issue. During those years, the taxpayer claimed deductions under IRC Section 691(c) for the amount of the estate tax attributable to the annuity payments she received.

Comments. Section 691 requires someone who receives IRD to include it in gross income if the right to receive that income was acquired because of the decedent's death, or by bequest, devise or inheritance from the decedent. The code section later provides for a deduction by the person who is required to include the income. The deduction is for the federal estate tax which is generated by including the income in the decedent's estate.

The Regulations provide that a person who is required to include IRD in gross income may take an income tax deduction—during the same taxable year—for an amount equal to that portion of the estate tax imposed upon the decedent's estate which is attributable to the inclusion in the decedent's estate of the right to receive that income amount.

Neither the Code nor the Treasury Regulations requires the estate tax to be paid first before a recipient of IRD is allowed to claim a deduction for the estate tax attributable to amounts required to be included in income. For example, consider an estate that has elected to pay estate tax in installments. The estate might not have paid the estate tax (because it was not payable) by the time the IRD is required to be included in income. The IRS saw no reason to block the taxpayers IRD deduction under 691(c) just because the tax to which it is attributable had not yet been paid. ■



able deduction must be carried forward from year to year. If past records weren't prepared or were lost, the deduction is lost.

It's very hard to learn about the deduction. There is no single IRS publication that explains its application in detail. Information about it is spread around different IRS publications and rulings. The result is that the deduction is routinely missed by taxpayers, often for year after year.

Trillion dollar error. The dollar amount of overlooked deductions for IRD already missed, along with what might be missed in the future, stands to be huge – perhaps a trillion dollars or more. Government data shows that tax-deferred retirement accounts that can produce IRD now hold \$11 trillion dollars. Of this, \$3 trillion is owned by persons in the highest tax brackets who are expected to owe estate tax – and both of those numbers are growing rapidly. These retirement accounts are just one of several kinds of assets that produce IRD. Not all of these assets will be subject to estate tax. But, if out of this more than \$11 trillion, only a little more than \$2 trillion eventually becomes subject to estate tax, the total deduction for IRD will be \$1 trillion. As of now, most of these deductions are probably being missed!

What to do. To preserve the deduction for IRD it's important for the tax professional who prepares an estate's tax return to work together with the tax advisors of the heirs of the estate and beneficiaries of assets included in the estate, such as IRAs.

The estate's tax professional should inform each heir in writing of the amount of estate tax that was paid on each item of IRD and should spell out how the rules work. Then, each heir's tax advisor should use this information to create a schedule of available deductions that may be claimed against IRD in the future. The information and schedule may have to be used for many years, long after the professionals who prepared it are gone from the scene. So it must be fully self-explanatory to be able to survive a future IRS audit and should be safely stored with other vital "permanent" documents.

The bottom line.

- ☞ If your or your client's estate is large enough to be subject to estate tax, discussions for planning for IRD should begin with tax advisors now.
- ☞ If you inherit an IRA or other item of IRD, contact the executor of the deceased to find out if any estate tax was paid and get the needed information to manage the deduction for IRD.

Technical rules for deductions for IRD are complicated, so be sure you're advised by a tax attorney, CPA or accountant who is experienced in dealing with them. *Let us know how we can help.* ■

Folks who miss the IRD deduction when they first inherit can go back and amend their returns. But they shouldn't dawdle. Taxpayers can go back only three years when amending returns. Any unclaimed deduction older than that is forfeited.

A client of an attorney and financial planner learned that lesson the hard way. On her broker's advice, the client withdrew over a five year period the \$750,000 that she inherited in her brother's 401(k) plan. Unaware of the IRD deduction, she never claimed it. By the time she contacted her attorney, all the funds had been distributed. Only three years of returns could be amended. The cost of those lost two years? About \$120,000 in income tax deductions. ■



Glen D. Pina