

**Abstract:** Income in respect of a decedent (IRD) can create a surprisingly high tax bill for those who inherit property, especially substantial distributions from IRAs or retirement plans. This article discusses how IRD works and what taxpayers can do to claim an itemized deduction for estate taxes attributable to amounts reported as IRD.

## **Watch out for IRD issues when inheriting money**

Once a relatively obscure concept, income in respect of a decedent (IRD) can create a surprisingly high tax bill for those who inherit certain types of property, such as IRAs or other retirement plans. Fortunately, there are ways to minimize or even eliminate the IRD tax bite.

### **How it works**

Most inherited property is free from income taxes, but IRD assets are an exception. IRD is income a person was entitled to but hadn't yet received at the time of his or her death. It includes:

- Distributions from tax-deferred retirement accounts, such as 401(k)s and IRAs,
- Deferred compensation benefits and stock option plans,
- Unpaid bonuses, fees and commissions, and
- Uncollected salaries, wages, and vacation and sick pay.

IRD isn't reported on the deceased's final income tax return, but it's included in his or her taxable estate, which may generate estate tax liability if the deceased's estate exceeds the \$5.49 million (for 2017) estate tax exemption, less any gift tax exemption used during life. (Be aware that President Trump and congressional Republicans have proposed an estate tax repeal. It hasn't been passed as of this writing, but check back with us for the latest information.)

Then it's taxed — potentially a second time — as income to the beneficiaries who receive it. This income retains the character it would have had in the deceased's hands. So, for example, income the deceased would have reported as long-term capital gains is taxed to the beneficiary as long-term capital gains.

### **What can be done**

When IRD generates estate tax liability, the combination of estate and income taxes can devour an inheritance. The tax code alleviates this double taxation by allowing beneficiaries to claim an itemized deduction for estate taxes attributable to amounts reported as IRD. (The deduction isn't subject to the 2% floor for miscellaneous itemized deductions.)

The estate tax attributable to IRD is equal to the difference between the actual estate tax paid by the estate and the estate tax that would have been payable if the IRD's net value had been excluded from the estate.

Suppose, for instance, that you're the beneficiary of an estate that includes a taxable IRA. If the estate tax is \$150,000 with the retirement account and \$100,000 without, the estate tax attributable to the IRD income is \$50,000. But be careful, because any deductions in respect of a decedent must also be included when calculating the estate tax impact.

When multiple IRD assets and multiple beneficiaries are involved, complex calculations are necessary to properly allocate the income and deductions. Similarly, when a beneficiary receives IRD over a period of years — IRA distributions, for example — the deduction must be prorated based on the amounts distributed each year.

### **We can help**

If you inherit property that could be considered IRD, please consult our firm for assistance in managing the tax consequences. With proper planning, you can keep the cost to a minimum.

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