How to…
Recognize & Report
Income in Respect of Decedent

Presented by
Monica Haven, EA, JD, LLM
mhaven@pobox.com
www.mhaven.net

Learning Objectives

- Understand that IRD is *both* an asset *and* income.
- Identify which items must be reported as IRD and which may be deducted as DRD.
- Learn how to report IRD on Forms 1041 and 706.
- Correctly calculate and allocate the §691(c) ETD deduction from the estate tax return.
- Recognize planning opportunities that can be used to minimize tax impact of IRD.

Topics we will cover…

- Dual nature of IRD.

- Sources of IRD:
  - Employment compensation
  - Retirement benefits
  - Investment income
  - Pass-through entity income
  - Litigation proceeds
  - Alimony payments

- DRD Deductions:
  - Business expenses
  - Depletion allowances
  - Certain Schedule A deductions

- How and where to report IRD.

- How to calculate & claim the estate tax deduction.

Not defined in IRC

Treas. Reg. 1.691(a)-1(b)

"those amounts to which a decedent was entitled as gross income but which were not properly includible in computing his taxable income for the taxable year ending with the date of his death or for a previous taxable year under the method of accounting employed by the decedent"

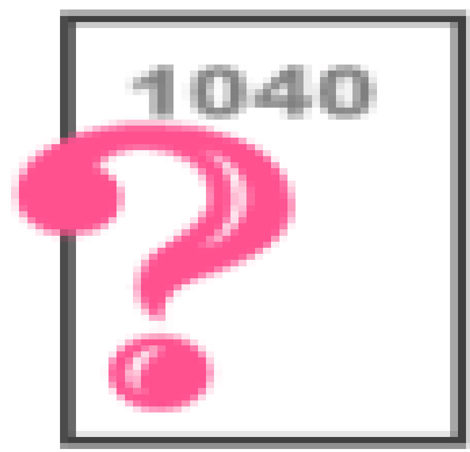
Example

Facts

- Bob worked for XYZ Corp & received paycheck each Monday morning for work performed the previous week
- Bob worked last week & then died over the weekend
- Bob's executor will collect the final pay check on Bob's behalf

Where should income be reported?

- ❑ Form 1040
- ❑ Form 1041
- ❑ Form 706
- ❑ Widow's Form 1040



Method of Accounting

- Cash – report income upon constructive <u>receipt</u>
  claim deductions when <u>paid</u>

- Accrual – report income as it is <u>earned</u>
  report expenses when <u>incurred</u>

<u>Analysis</u>

- Individuals must generally use cash-basis reporting & do not include accrued income.
- Therefore, decedent cannot include wages earned but not yet paid before DoD.

(This is IRD!)

IRD is taxable

- To recipient when received
- Who is recipient?
  - Decedent's personal representative (if paid to estate) → Form 1041
  - Decedent's beneficiary (if paid to individual) → Form 1040

History: Back Story

Estate Tax (enacted 1916) assessed upon transfer of decedent's wealth

- Initially as low as 1 – 10%
- Raised to 77% in 1940's
- Rate remained unchanged through mid-70's

- Unintended Consequence: High net worth individuals transferred wealth during life to avoid tax at death

- Result: Gift Tax (enacted 1932)

History: IRD Introduced

- IRD was initially deemed to be an asset
  - Accrued – but still unpaid income – was considered *owned* by the decedent.
  - In this manner, income was converted to *corpus* (principal) on DoD…
  - …And became a part of the decedent's net worth on the estate return.
  - Reportable assets received stepped-up basis.

    NOTE: No step-up for IRD under *current* rules.

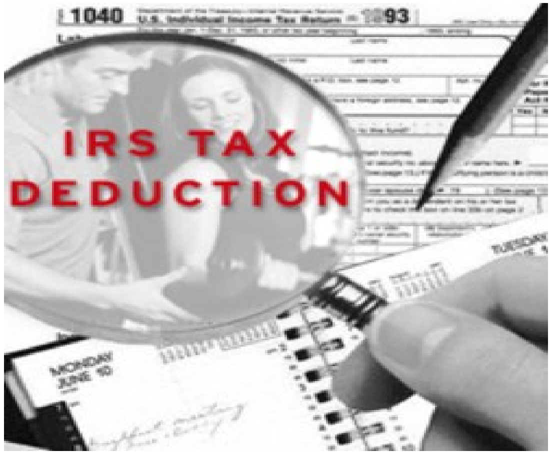
- Tax Code change in 1934
  - Accrued income (IRD) becomes taxable as *income* on decedent's final 1040.
  - Thus, cash-basis taxpayers are treated as if accrual-basis reporting applies…
  - …And are forced into early recognition of income.
  - This ignores the basic principal that taxpayers must have liquidity with which to pay taxes due.

So what is it?
Asset or Income???

- It's BOTH!

- IRD is includible as an *asset* on Form 706 and as *income* on Form 1041 (or beneficiary's 1040)

- Consolation Prize: To mitigate double taxation, fiduciary (or beneficiary) receives income tax deduction for any estate tax paid



Double Taxation: Example

Facts

- Wages of $10K had been earned but not yet paid to employee before death.
- Decedent's estate subject to 40% estate tax & 35% income tax.

Result

Total estate & income taxes owed = $7,500

BUT fiduciary may claim deduction on Form 1041 for estate tax paid on Form 706…

Estate Tax paid: $4,000 (= 40% of $10K)

Taxable income: $6,000 (= $10K - $4K estate tax deduction)

Income tax: $2,100 (= $6K X 35% tax rate)

Combined Estate & Income taxes: $6,100 (= $4,000 estate + $2,100 income)

Sources of IRD
Employment-related: Compensation

- Salaries & Wages
  - Include as IRD if earned before death but paid after DoD
  - No federal income tax w/h but subject to FICA

  NOTE: Included on decedent's final W-2 but not in Box 1

- Bonuses
  - IRD *even if* amount cannot be determined until after DoD & decedent did not have enforceable right

- Fringe Benefits
  - Accrued vacation & sick pay (unless excludable as workman's comp)

Sources of IRD
Employment-related:
Post-death Compensation

Contractual

Employment contract guaranteed payment of $10,000/month for services rendered to be paid to employee's estate for 1 year after death.

- Report as IRD income on Form 1041
- Report as IRD asset on Form 706 [b/c employee had rights]

Voluntary

Employer voluntarily issued monthly checks to deceased employee's spouse for 1 year after death.

- Report on Form 1041 [b/c attributable to employee's services]
- Do NOT report on Form 706

Sources of IRD
Employment-related:
Stock Options (Statutory)

IRD if granted to decedent & exercised by fiduciary (or beneficiary)

ISO

- Sale of Option: Income recognition on post-death gain → IRD
- Exercise: No ordinary inc recognition but AMT on bargain element → no IRD
- Sale of Stock: LT capital gain treatment → no IRD

  NOTE: Fiduciary (or beneficiary) is not subject to the "usual" holding period required to avoid a disqualifying sale

Non-qualified

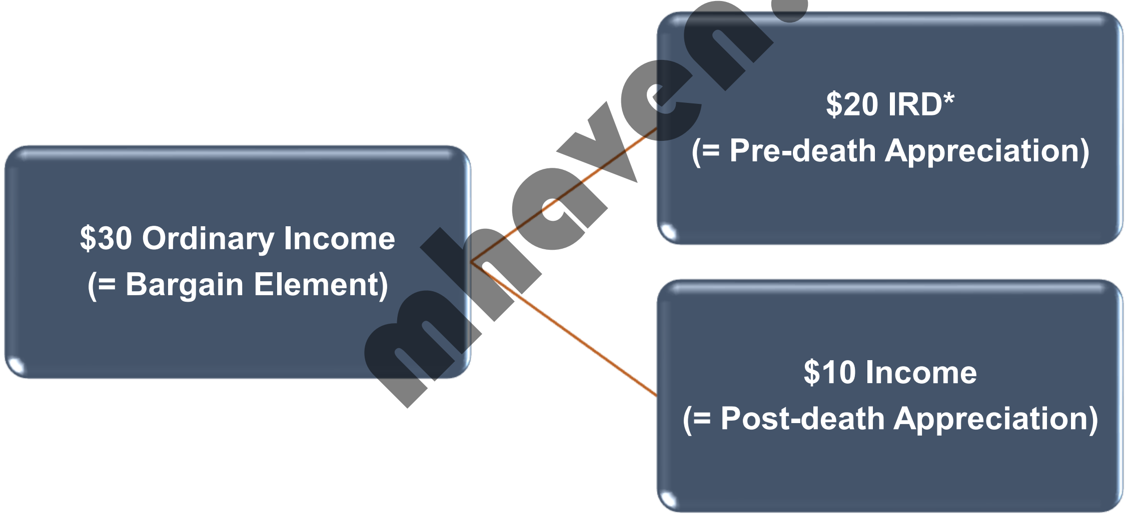
- Exercise: Income recognition on bargain element attributable to pre-death appreciation (but no AMT) → IRD

  NOTE: Post-death appreciation of option is treated as ordinary income → no IRD

Example:
Non-qualified Stock Option

- Employee received NQ options to buy 500 shares of DEF at $50/share.
- Employee died when the stock was valued at $70/share.
- Executor exercised options when the stock was at $80/share.

Tax Consequences



NOTE: No IRD if employee had previously elected § 83(b) treatment.

- Sale of Stock: Sales Price – (Exercise P + Post-death Appreciation)

Sources of IRD
Employment-related:
Employee Stock Purchase Plans

Basic Rules

- Must be non-discriminatory
- Must be exercised within 5 years after grant if strike ≥ 85% of stock price
- Non-transferrable during life; but can be bequeathed

Tax Treatment

- Exercise: No ordinary income recognition (& no AMT) → no IRD
- Sale of Stock: LT Capital gain treatment if stock held ≥ 1 year after exercise *and* ≥ 2 years after grant

NOTE: If holding period not met by fiduciary, ordinary income must be recognized → IRD

Sources of IRD
Employment-related: Deferred Compensation

Employer-Employee Agreement
- Allows employee to defer recognition of income until later (e.g., retirement)
- IRD if post-death payments are made to estate (or beneficiary)

Tax Treatment
- Agreement to forfeit all payments during life in exchange for employer's promise to pay at death
- IRD when accumulated deferral is paid out

NOTE: Although decedent did not have right to income, post-death income is classified as IRD to prevent tax loophole

Sources of IRD
At Retirement: Traditional IRA

- Lump-sum distributions (= FMV_{DOD} – Decedent's Basis) taxed as IRD in year of payment

<u>Explanation</u>
Had decedent lived & taken withdrawals, *decedent* would have been taxed on all income & growth in excess of basis → in decedent's stead, fiduciary (or beneficiary) must now recognize IRD

BUT no IRD if spouse makes rollover to Spousal IRA

Sources of IRD
At Retirement: Traditional IRA (cont'd)

IRAs with pre-tax contributions only

- FULL balance on DoD = IRD
- Beneficiary must include as income but may claim deduction for estate taxes attributable to IRD
- Post-death appreciation is not IRD (but is, of course, income to the beneficiary)

IRAs with some non-deductible contributions

- Payout amount – Decedent's Non-deductible Contributions – Post-death Appreciation = IRD

Sources of IRD
At Retirement: Roth IRA

- Qualified* Distributions are tax-free
  *Distributions may not be taken until at least 5 years after decedent made first contribution to his Roth IRA

- If distribution taken before 5 years…
  - Pre-death earnings = IRD
  - Post-death earnings are income

NOTE: Account must generally be distributed in full by end of 10th year after DoD, unless beneficiary is disabled or a surviving spouse/minor child of plan participant

REMINDER: Spouse can elect to treat Roth as own IRA

Sources of IRD
At Retirement: Roth IRA (cont'd)

Deathbed Conversion from Traditional to Roth
- Recognize income prior to death
- Reduce taxable estate
- Minimize IRD that must be recognized by beneficiary

Tax savings achieved only if:
- Decedent's estate > than applicable estate tax exclusion since IRA will be doubly taxed as asset on 706 *and* IRD income
- Beneficiary's tax bracket > decedent's
- Beneficiary does not itemize and cannot use Estate Tax Deduction
- Estate subject to state death tax w/o offsetting Estate Tax Deduction

Sources of IRD
At Retirement: Employer Plan

- No tax consequence when plan transferred to fiduciary (or beneficiary)
- IRD inclusion when plan assets distributed

<u>Example</u>

- Decedent's plan valued at $175K on DoD (includes pre-death appreciation of $90K)
- Executor later liquidates plan assets for $200K

→ Decedent's unrealized appreciation is IRD (= $90K)
→ Estate's Basis is $85K (= $175K FMV$_{DOD}$ - 90K appreciation)
→ Estate's gain on sale is $115K (= $200K sale price - 85K basis)

Sources of IRD

Investments: Savings Bond Interest

- EE & I-bonds are issued at discount & mature at full face value
  → The difference between maturity value and purchase price is deemed "interest"

- Taxpayer (while alive) may <u>choose</u> to report interest *either*:
  1. At maturity
     If taxpayer dies pre-maturely, executor may then <u>choose</u> to:
     - Include decedent's accrued interest on final 1040
       → beneficiary liable only for post-death accruals
     - OR allocate decedent's interest to beneficiary
       → Beneficiary may <u>choose</u> to include interest at maturity or accrue annually

  2. OR annually
     If taxpayer dies pre-maturely, interest between year-start and DoD = IRD

US Savings Bonds Example

<u>Facts</u>

- Decedent bought $1000 Series EE bond for $500.
- $94 interest accrued pre-death (not included on decedent's final 1040).

1. Fiduciary elects to include accrued interest on final 1040 (but passes it on to beneficiary)
   → Beneficiary may elect to include accrued interest on his own 1040 or report full $500 at maturity
   → If 706 filed, Beneficiary may claim deduction for estate tax attributable to interest accrual

2. Fiduciary elects to include accrued interest on 1040
   → Beneficiary liable for only $406 of interest (= $500 – $94)
   → No IRD since interest represents post-death accrual

Sources of IRD
Investments: Treasury & Muni Interest

- Treasuries
  - Pre-death interest accrual = IRD
  - Post-death accruals = income to fiduciary (or beneficiary)

- Munis
  - Only taxable interest generates IRD; therefore tax-free interest ≠ IRD
  - HOWEVER, value of muni + accrued interest = asset on Form 706

NOTE: Interest on private-activity bonds subject to AMT!
NOTE: Fiduciary (or beneficiary) cannot use estate tax deduction to offset AMT liability since no IRD inclusion

Sources of IRD
Investments: CDs & Bank Acct. Interest

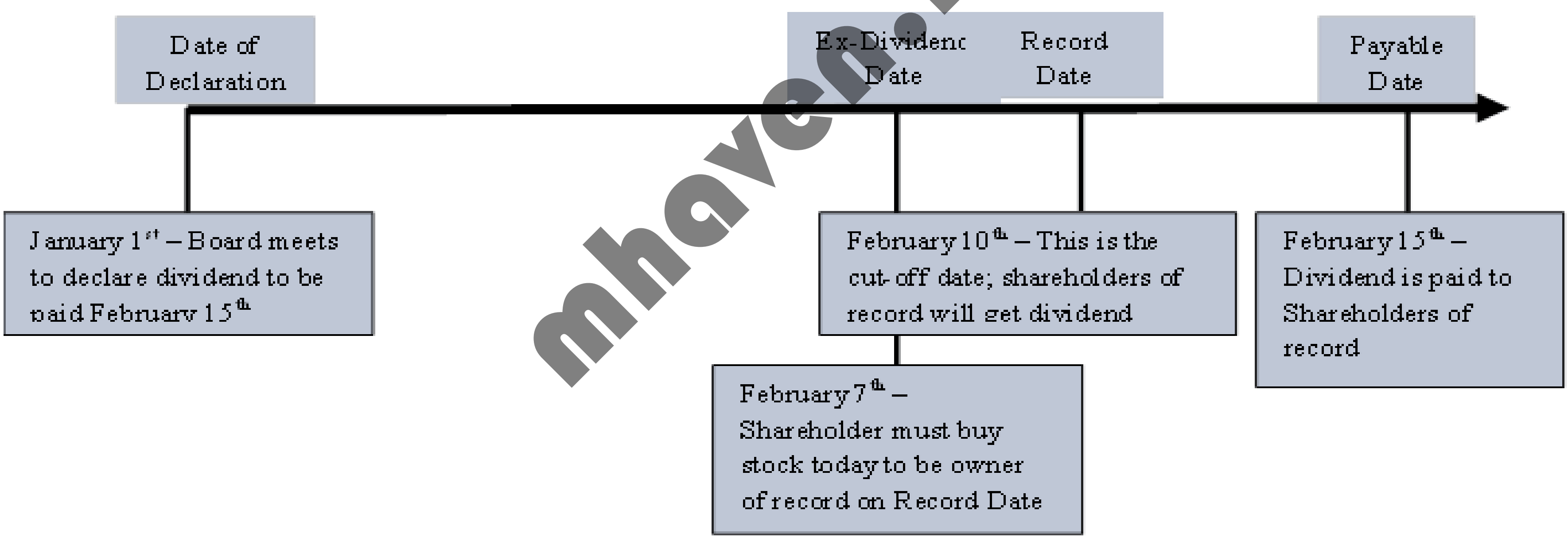
- Pre-death interest on CD paid at maturity = IRD

- Pre-death interest on savings account paid at end of month after death = IRD

NOTE: Unless notified of new EIN assigned to decedent's estate, bank will likely issue only one 1099 attributing all interest to decedent's SSN
→ Fiduciary must allocate pre- and post-death interest:
  - Form1040: Pre-death interest actually received by decedent
  - Form 1041 & Form 706: Pre-death interest accrued but not received by decedent (= IRD)
  - Form 1041: Post-death interest

Sources of IRD
Investments: Dividends

- Dividends payable prior to DoD = IRD
- Decedent must have owned shares on/before Record Date



Sources of IRD
Investments: Annuities

- Annuities are contractual agreements between investor & insurer (based on annuitant's life)
- Provide tax-deferred growth during Accumulation Phase
- Provide guaranteed payments during Pay-out Phase

<u>If annuitant dies *after* payments have begun</u>
- Continuing payments to fiduciary (or beneficiary) = IRD

<u>If annuitant dies *before* payments have begun</u>
- Eventual payments to fiduciary (or beneficiary) in excess of decedent's basis = IRD

Annuities Example

Facts

- Owner selected 10-yr term certain
  → Policy will pay owner (then beneficiary) for 10 years
- Owner's pre-determined exclusion ratio is 40%
  → Portion of owner's investment is allocated to each payment until fully recovered

Result

- Owner (then beneficiary) will include 60% of each payment as taxable income.
- This amount is IRD.

Sources of IRD
Investments: Capital Gains

- If decedent was entitled to sales proceeds, then IRD
  i.e., property (inventory) sold pre-death but proceeds collected post-death by fiduciary (or beneficiary)

  <u>Example</u>
  - Seller contracts to sell home pending Buyer's loan approval w/i 60 days
  - Seller dies before Buyer receives timely loan approval

  →Gain on sale = IRD

  NOTE: If Buyer had not qualified until Day 65; gain ≠ IRD

- Capital assets (inventory) includible in estate ≠ IRD
  → receive basis step-up instead

Sources of IRD
Investments: Installment Sales

- Estate (or beneficiary) has to use same Gross Profit Percentage as decedent

- If self-canceling at death of lender, treat as taxable transfer
  → include as-yet unrecognized income as IRD to fiduciary (or beneficiary)
  TIP: Bequeath sufficient cash to beneficiary which he may then use to pay off note & make sure terms of loan allow for penalty-free pre-payment

- If note sold at discount by executor, IRD can be reduced by amount of discount

More Sources of IRD
Self-employment Income

- Sales Revenues – uncollected income at death (*even if* decedent was cash-basis taxpayer)

- Receivables
  - Insurance Commissions – trailing sales commissions paid to fiduciary (or beneficiary)
  - Royalties – pre-death earnings
    NOTE: Post-death royalties on decedent's invention or writing ≠ IRD

- Contracts – post-death income received from agreements made before death

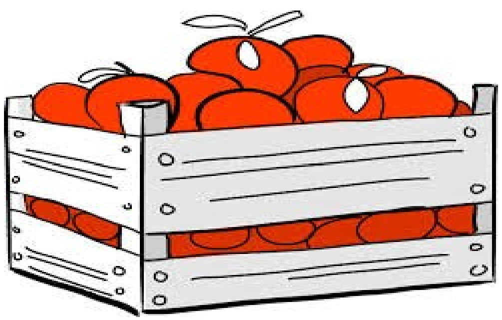
More Sources of IRD
Crops & Livestock

- Assets owned at death are reported on Form 706
- IRD *only* if farmer had sold or pledged harvest or livestock pre-death

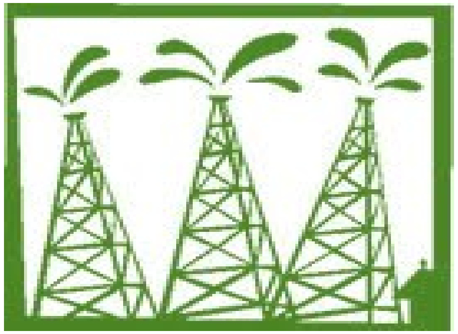
Example

- Farmer delivered 5,000 crates of oranges but did not collect payment.
- Farmer also tried but did not complete sale of another 4,000 crates.
- Executor collects payment for 5,000 crates & arranges sale of remainder.

→ Gain on sale of 5,000 crates = IRD
→ Gain on sale of 4,000 ≠ IRD



More Sources of IRD
Rental & Royalty Income



- Rents
  - Accrued rents paid after DoD = IRD

    REMINDER: Advance rents are liabilities (not IRD)

- Crop Shares
  - Crops or livestock are used to pay rent = IRD

- Oil & Gas Royalties
  - Income before DoD = IRD

  NOTE: Royalties are often paid in arrears → contact payer to determine amounts "suspensed" (earned previously but paid later)

More Sources of IRD
Flow-Through Entities: Partnerships

- Income prior to DoD reported on decedent's K-1 → final 1040
- Income after DoD reported on fiduciary's K-1 → fiduciary's 1041 (≠ IRD)
- IRD *only* if income attributable to decedent's efforts:
  - Fiduciary (or beneficiary) receives decedent's guaranteed payments.
  - Fiduciary receives payments attributable to unrealized receivables (if decedent was general partner in service partnership).
  - Insurance proceeds from buy-sell agreement which represent payments for decedent's work-in-progress.

More Sources of IRD
Flow-Through Entities: S-Corps

- Entity may perform an interim closing of the books with shareholder consent

  → allocate pre- & post-death income

- Income attributable to unrealized receivables = IRD

  → can be used to reduce basis of inherited (acquired) stock

More Sources of IRD
Litigation Proceeds

If settlement related to services provided by decedent = IRD
If settlement related to sale of asset or goodwill ≠ IRD

<u>Example</u>

- Plaintiff sued for fraud arising from sale of business to Defendant but outcome uncertain at Plaintiff's death
- Later (after Plaintiff's death) court awards Plaintiff's estate $50K

→ No IRD
→ Report gross proceeds on fiduciary's Schedule D; offset entire amount by stepped-up basis

More Sources of IRD
Life Insurance

- If policy sold prior to decedent's death = IRD
- If decedent owns policy on 3rd party insured = IRD
  NOTE: Cash value of policy includible in decedent's estate

<u>Example</u>
- Taxpayer bought life insurance on niece for \$10K + \$1K/year
- Taxpayer died after 10 years when cash value was \$80K → Basis = \$20K
- Executor paid another year at \$1K until niece died while estate was being administered
- Estate, as beneficiary, receives policy value of \$300K

→ Taxable income of \$279K (= \$300K Proceeds – \$20K Decedent's Basis – \$1K Estate's Basis)
→ Taxable amount includes IRD of \$60K (= \$80K Cash Value$_{DoD}$ – \$20K Decedent's Basis)

More Sources of IRD
Trust & Estate Income

If decedent was a beneficiary of another's trust or estate, post-death payments = IRD

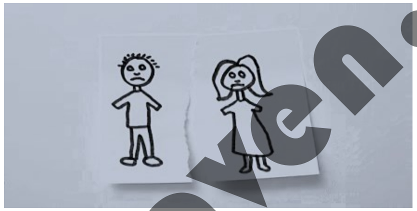
<u>Example</u>

- Decedent was beneficiary of trust & received annual distributions every December 31st
- Decedent died in September
- Trust had $40K of accounting income during year of death

→ $30K reported on final 1040
→ remaining $10K reported on 1041 as IRD

More Sources of IRD
Miscellaneous

Alimony
- Spousal support collected by fiduciary (or beneficiary) = IRD



Medical Reimbursements
- If associated expense previously deducted on decedent's 1040 = IRD

So what the h… *is* IRD?

Courts look at Two Tests:

1. Legal Enforceability
   → Could decedent have *enforced* his right to the income?

2. Economic Activities
   → Had all requisite events *occurred* prior to death to create the income?

Still no clear answer

In general…

- IRD is attributable to decedent's pre-death activities, and
- includes income that decedent would have reported if he had lived, but
- his right to that income was not always clearly discernible on DoD, although
- decedent's right must have been vested before DoD

IRD Reference Chart

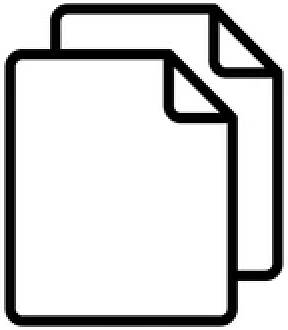
Source of Income	Notes Regarding IRD Treatment
Accounts Receivable	Uncollected sales proceeds from pre-death sales of crop or inventory
Accrued Vacation Pay	IRD
Alimony	IRD
Annuities	If annuitant dies <u>after</u> policy owner began withdrawals, IRD equals taxable portion of *all* payments; if annuitant dies <u>before</u> start of pay-out, IRD equals *all* payments in excess of owner's investment in the contract
Bonuses	IRD even if the bonus amount is determined after death
Buy/Sell Agreement	Insurance proceeds used to pay the beneficiary for decedent's work-in-progress are IRD
Capital Gains	Not IRD unless property was sold by decedent and all contingencies were resolved before death
Community Property	Both halves receive basis step-up even though only half of property is includible in deceased spouse's estate (Form 706); both halves of property eligible for IRD treatment (Form 1040 or 1041)
Crop Shares	IRD reported when crop shares are sold
Crops & Livestock	Not IRD unless sold or pledged prior to death

Available in the Appendix of my *Student Text – see* Publications page

Reporting IRD

- Retains character as if reported by decedent
- Must be reported by fiduciary (or beneficiary)

REMINDER: IRD is "income" and an "asset"
→ must report on fiduciary's 1041 (or beneficiary's 1040) and 706 (if required to be filed)



Deductions in Respect of Decedent (DRD)

- DRDs typically correspond to deductions that would have been allowable on decedent's Schedule A
- Deductible if liable for & paid by fiduciary (or beneficiary)
- May be reported on *both* 706 *and* fiduciary's 1041 (or beneficiary's 1040)

NOTE: If DRD claimed on 706, fiduciary (or beneficiary) may only claim tax deduction for estate taxes paid based on <u>net</u> DRD (= IRD – DRD).

DRD Expenses

<u>Allowable:</u>

- Decedent's checks written pre-death – only if <u>in</u>sufficient funds
- Business & other income-producing expenses
- Investment expenses – only if in excess of 2% AGI limitation
- Interest – only if eligible under interest tracing rules
- State & local income taxes, as well as property taxes
- Depletion – only if percentage method used
- Foreign Tax Credit – only if paid on item of IRD

<u>Not Allowed:</u>

- Decedent's credit card charges (considered paid when charged)
- Decedent's alimony payments
- Decedent's medical expenses
- Depreciation (attendant asset gets stepped-up basis instead)
- Loss carry-forwards & NOLs (amounts not used on final 1040 are forfeited)
- Estate taxes assessed by individual states

Estate Tax Deduction
IRC § 691(c)

ETD = Estate Tax paid on net IRD

- Can be used by fiduciary (or beneficiary) to reduce taxable IRD income on 1041 (or 1040)
- Deductible only if estate tax was paid by fiduciary (or beneficiary)
- Must be claimed in same year that IRD is included in income

No ETD if
- **Form 706 not required to be filed**
- **No IRD reported on Form 706**
- **No estate tax due with Form 706**
- **DRD claimed exceeds IRD reported**

How to Calculate ETD

MUST re-compute Estate Tax (Form 706)…

Step 1
Recompute Estate Tax
= Adjusted Gross Estate on Form 706 (Page 1, Line 5) – Net IRD

Step 2
Calculate Estate Tax Deduction
= Estate Tax Due on Form 706 – Recomputed Estate Tax [see Step 1]

Step 3
Allocate ETD to fiduciary (or beneficiary)

Form 706: Adjusted Gross Estate

Form **706**

(Rev. August 2012)

Department of the Treasury
Internal Revenue Service

United States Estate (and Generation-Skipping Transfer) Tax Return

▶ **Estate of a citizen or resident of the United States (see instructions). To be filed for decedents dying after December 31, 2011, and before January 1, 2013.**

▶ **Information about Form 706 and its separate instructions is at *www.irs.gov/form706*.**

OMB No. 1545-0015

Part 1—Decedent and Executor

1a Decedent's first name and middle initial (and maiden name, if any)
1b Decedent's last name
2 Decedent's social security no.

3a County, state, and ZIP or foreign country and postal code, of legal residence (domicile) at time of death
3b Year domicile established
4 Date of birth
5 Date of death

6b Executor's address (number and street including apartment or suite no.; city, town, or post office; state; country; and ZIP or postal code) and phone no.

6a Name of executor (see instructions)

6c Executor's social security number (see instructions)

Phone no.

6d If there are multiple executors, check here ☐ and attach a list showing the names, addresses, telephone numbers, and SSNs of the additional executors.

7a Name and location of court where will was probated or estate administered
7b Case number

8 If decedent died testate, check here ▶ ☐ and attach a certified copy of the will.
9 If you extended the time to file this Form 706, check here ▶ ☐

10 If Schedule R-1 is attached, check here ▶ ☐
11 If you are estimating the value of assets included in the gross estate on line 1 pursuant to the special rule of Reg. section 20.2010-2T(a) (7)(ii), check here ▶ ☐

1	Total gross estate less exclusion (from Part 5—Recapitulation, item 13)	1	
2	Tentative total allowable deductions (from Part 5—Recapitulation, item 24)	2	
3a	Tentative taxable estate (subtract line 2 from line 1)	3a	
b	State death tax deduction	3b	
c	Taxable estate (subtract line 3b from line 3a)	3c	
4	Adjusted taxable gifts (see instructions)	4	
5	Add lines 3c and 4	5	
6	Tentative tax on the amount on line 5 from Table A in the instructions	6	
7	Total gift tax paid or payable (see instructions)	7	
8	Gross estate tax (subtract line 7 from line 6)	8	

Adjusted Gross Estate

Claiming the Deduction

- ETD must be allocated to beneficiary if some or all of estate is distributed to beneficiary
  NOTE: Allocation is based on values of *gross* IRD (without DRD subtracted) apportioned between fiduciary & beneficiary

- If IRD is taxed as ordinary income, ETD must be claimed by
  - Fiduciary on Form 1041, Line 19, or
  - Beneficiary on Form 1040, Schedule A (as a miscellaneous deduction *not* subject to 2% AGI)

- If IRD taxed as capital gain, gain may be reduced by allocable ETD (but not below 0)

ETD on Form 1041

Form **1041** Department of the Treasury—Internal Revenue Service

U.S. Income Tax Return for Estates and Trusts **2012** OMB No. 1545-0092

▶ **Information about Form 1041 and its separate instructions is at *www.irs.gov/form1041*.**

A Check all that apply:
- ☐ Decedent's estate
- ☐ Simple trust
- ☐ Complex trust
- ☐ Qualified disability trust
- ☐ ESBT (S portion only)
- ☐ Grantor type trust
- ☐ Bankruptcy estate-Ch. 7
- ☐ Bankruptcy estate-Ch. 11
- ☐ Pooled income fund

For calendar year 2012 or fiscal year beginning , 2012, and ending , 20

Name of estate or trust (If a grantor type trust, see the instructions.)

C Employer identification number

Name and title of fiduciary

D Date entity created

Number, street, and room or suite no. (If a P.O. box, see the instructions.)

E Nonexempt charitable and split-interest trusts, check applicable box(es), see instructions.
☐ Described in sec. 4947(a)(1). Check here if not a private foundation . . . ▶ ☐
☐ Described in sec. 4947(a)(2)

City or town, state, and ZIP code

B Number of Schedules K-1 attached (see instructions) ▶

F Check applicable boxes: ☐ Initial return ☐ Final return ☐ Amended return ☐ Change in trust's name ☐ Change in fiduciary ☐ Change in fiduciary's name ☐ Change in fiduciary's address

G Check here if the estate or filing trust made a section 645 election . . . . . . ▶ ☐

Income

1	Interest income	1	
2a	Total ordinary dividends	2a	
b	Qualified dividends allocable to: **(1)** Beneficiaries ______ **(2)** Estate or trust ______		
3	Business income or (loss). Attach Schedule C or C-EZ (Form 1040)	3	
4	Capital gain or (loss). Attach Schedule D (Form 1041)	4	
5	Rents, royalties, partnerships, other estates and trusts, etc. Attach Schedule E (Form 1040)	5	
6	Farm income or (loss). Attach Schedule F (Form 1040)	6	
7	Ordinary gain or (loss). Attach Form 4797	7	
8	Other income. List type and amount	8	
9	**Total income.** Combine lines 1, 2a, and 3 through 8 ▶	9	

Deductions

10	Interest. Check if Form 4952 is attached ▶ ☐	10	
11	Taxes	11	
12	Fiduciary fees	12	
13	Charitable deduction (from Schedule A, line 7)	13	
14	Attorney, accountant, and return preparer fees	14	
15a	Other deductions **not** subject to the 2% floor (attach schedule)	15a	
b	Allowable miscellaneous itemized deductions subject to the 2% floor	15b	
16	Add lines 10 through 15b ▶	16	
17	Adjusted total income or (loss). Subtract line 16 from line 9 | 17 |		
18	Income distribution deduction (from Schedule B, line 15). Attach Schedules K-1 (Form 1041)	18	
19	Estate tax deduction including certain generation-skipping taxes (attach computation)	19	
20	Exemption	20	
21	Add lines 18 through 20 ▶	21	
22	Taxable income. Subtract line 21 from line 17. If a loss, see instructions	22	
23	**Total tax** (from Schedule G, line 7)	23	

ETD Example

Facts
- At DoD, decedent had:
  - $10K uncollected commissions
  - $5K accrued bond interest
  - $4K unpaid business expenses

- Net IRD included on Form 706
  $11K (= $10K commissions + $5K interest - $4K expenses)

- Total estate tax paid was $8,500

- If IRD had been excluded, estate tax would have totaled $4,700
  → ETD is $3,800 (= $8,500 – 4,700)

- 2 beneficiaries split estate:
  - Bene A receives $10K commissions
  - Bene B receives $4K bond interest

ETD Allocation
- Beneficiary A: ($10,000 ÷ 15,000) X $3,800 = $2,533
- Beneficiary B: ($5,000 ÷ 15,000) X $3,800 = $1,267

ETD Example (cont'd.)

<u>Assume</u>

- Beneficiary A instead receives only ½ of the commissions in current year
  → Beneficiary must include $5K IRD income
  → Beneficiary may only deduct ½ of DRD (= $1,267)

- Beneficiary A receives remaining ½ of commissions in following year
  → Beneficiary may now claim previously unused DRD in Year 2

IRD Tax Planning

<u>Problem</u>

Taxpayer who bequests different assets (of equal value) to 2 beneficiaries may unintentionally saddle one beneficiary with all IRD

Example

- Son receives house (no IRD & stepped-up basis)
- Daughter receives retirement account (IRD)

<u>Solution</u>

Consider bequeathing IRD items to:

- Tax-exempt charity → does not pay tax on IRD
- Credit-shelter Trust → defer tax until death of surviving spouse
- Youngster → defer tax until child has tax filing requirement

Minimizing IRD

1. Accelerate recognition of income
   → Report on decedent's final 1040 (e.g., report accrued savings bond interest or elect out of installment sales)

2. Elect fiscal filing year for fiduciary's 1041 to gain time to accumulate DRD

3. Close estate prior to receipt of taxable IRD
   → Shift burden to beneficiary in lower marginal bracket

Monica Haven, E.A., J.D., L.L.M.

PHONE:	**(310) 286-9161**
FAX:	**(310) 557-1626**
E-MAIL:	**mhaven@pobox.com**
WEBSITE:	**www.mhaven.net**

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