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Robert P. Achenbach, Jr.

Contributing Editor

Dr. Neil E. Harl, Esq.

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Disposition of Income-in-Respect-of-Decedent Assets

-by Neil E. Harl*

Because of their peculiar income tax character, items of income in respect of decedent¹ require careful planning attention, particularly with respect to post-death dispositions.² With IRD assets not receiving a new income tax basis at death,³ the pre-death basis carries over to the estate or heirs with the gain taxable to the estate, the heirs, a beneficiary or a specific or residuary legatee.⁴ The income recognition event can lead to substantial income tax liability inasmuch as the income tax basis is often zero for the more common IRD items.⁵

What is income in respect of decedent?

The regulations state that the term “income in respect of decedent” refers to those amounts to which a decedent was entitled as income, but which were not properly includable in figuring the decedent’s taxable income for the taxable year ending with the date of the decedent’s death or for a previous taxable year under the method of accounting employed by the decedent.⁶

That definition does not, however, provide an explanation of why growing crops and stored crops being produced under a non-material participation share rent lease are classified as income in respect of decedent⁷ while growing crops and stored crops being produced under a share rent lease with sufficient involvement by the landowner to constitute material participation (as well as growing crops and stored crops produced by a sole proprietor farmer) are not considered to be income in respect of decedent.⁸ Likewise, that definition does not explain fully why real estate held at death receives a new income tax basis⁹ but land sold under land contract before death is treated as income in respect of decedent¹⁰ and does not receive an income tax basis at death equal to the fair market value at death¹¹ or as of the alternate valuation date.¹² Nor does the definition explain fully why Series E bond interest is classed as IRD at death¹³ along with interest on certificates of deposit¹⁴ but gain on most assets is eliminated at death.¹⁵ Similarly, the definition does not provide a convincing rationale of why distributions from a qualified retirement plan such as an Individual Retirement Account are IRD (because contributions to the plan were income tax deductible and earnings accumulated tax-free) but a tractor purchased a year before death and completely depreciated out in the year of purchase¹⁶ receives a new income tax basis at death even though the gain wiped out at death was the result of a tax deduction.

* Charles F. Curtiss Distinguished Professor in Agriculture and Emeritus Professor of Economics, Iowa State University; member of the Iowa Bar.

So, while the definition is somewhat vague, the concept of income-in-respect-of-decedent has taken on clear meaning in tax law.

Disposition of IRD items

With assets classified as income in respect of decedent not receiving a new income tax basis at death, a great deal of importance attaches to the disposition of those items. A letter ruling issued in 2008 emphasizes, once again, that, with careful planning, it is possible to dispose of IRD property without triggering gain.¹⁷

The general rule is that transfer of an IRD item is ordinarily an income recognition event.¹⁸ That is the case if the transfer is by “sale, exchange, or other disposition, or the satisfaction of an installment obligation at other than face value, but does not include transmission at death to the estate of the decedent or a transfer to a person pursuant to the right of such person to receive such amount by reason of the death of the decedent or by bequest, devise, or inheritance from the decedent.”¹⁹ Thus, if a lump-sum distribution from an IRA is distributed to a beneficiary, the amount of the distribution less the owner’s non-deductible contributions to the IRA is includible in the beneficiary’s gross income on receipt.²⁰ In the event of a gift, the gain in the IRD item is based on the fair market value of the IRD item at the time of the gift.²¹

Similarly, disposition of an item of IRD to a charitable organization also triggers gain.²² However, IRS ruled in 2008 that the transfer of an inherited IRA to four charities was not a taxable event; the charities were required to include the IRD amount in their income (but the amount is not taxable to charities that are tax exempt) but not the estate or trust making the distribution.²³ In a 2006 letter ruling, the transfer of IRAs to a charitable organization in satisfaction of the charity’s share of the residue of the estate did not trigger gain to the estate.²⁴ The charitable organization would be required to include the amount of IRD from the IRA in its gross income when received but that is of no concern to exempt charities. A 2004 ruling reached the same conclusion where the assignment of IRAs and deferred annuity contracts in satisfaction of a charity’s share of the residuary estate did not cause the estate or any beneficiary of the estate to have taxable income from the IRD or to cause the estate to include any amount involved in its distributable net income.²⁵ In a 2002 letter ruling, the proposed assignment of retirement accounts in satisfaction of their percentage shares of the estate did not cause either the estate or any of the individual beneficiaries to have taxable income and the amount distributed to the charities was not taken into account in the computation of the estate’s distributable net income (DNI) for the year of the assignment.²⁶ The charities, the ruling acknowledged, would realize income from the IRD but because of their exempt status²⁷ would not be taxable on the distribution amount even though it was IRD.²⁸

In conclusion

The key factor, of course, is in avoiding fact situations that fall within the statutory language included in the term “transfer.”²⁹

FOOTNOTES

¹ I.R.C. § 691.

² See generally 6 Harl, *Agricultural Law* § 47.03 (2008); Harl, *Agricultural Law Manual* § 6.02[1] (2008); Harl, *Farm Income Tax Manual* § 2.10[3] (2007 ed.). See also Harl, “When Income in Respect of Decedent is Recognized,” 6 *Agric. L. Dig.* 129 (1995).

³ I.R.C. §§ 691(a), 1014(c).

⁴ See Treas. Reg. § 1.691(a)-4(a).

⁵ E.g., *Apkin v. Comm’r*, 86 T.C. 692 (1986) (Series E bond interest taxed to surviving joint tenant (child of bond purchasers) on redemption).

⁶ Treas. Reg. § 1.691(a)-1(b).

⁷ Rev. Rul. 64-289, 1964-2 C.B. 173. See *Davison v. United States*, 292 F.2d 937 (Ct. Cl.), *cert. denied*, 368 U.S. 939 (1961).

⁸ See Rev. Rul. 58-436, 1958-2 C.B. 366.

⁹ I.R.C. § 1014(a)(1).

¹⁰ I.R.C. § 691(a)(1).

¹¹ I.R.C. § 1014(a)(1).

¹² I.R.C. § 2032(a).

¹³ E.g., Ltr. Rul. 200004030, Nov. 2, 1999.

¹⁴ Rev. Rul. 79-340, 1979-2 C.B. 320.

¹⁵ I.R.C. § 1014(a)(1).

¹⁶ I.R.C. §§ 179, 168(k).

¹⁷ Ltr. Rul. 200826028, March 27, 2008.

¹⁸ I.R.C. § 691(a)(2).

¹⁹ I.R.C. § 691(a)(2).

²⁰ Rev. Rul. 92-47, 1992-1 C.B. 198.

²¹ Treas. Reg. § 1.691(a)-4(a).

²² See I.R.C. § 691(a)(2). See Rev. Rul. 55-157, 1955-1 C.B. 293 (offsetting charitable deduction).

²³ Ltr. Rul. 200826028, March 27, 2008.

²⁴ Ltr. Rul. 200633009, May 16, 2006.

²⁵ Ltr. Rul. 200452004, August 10, 2004.

²⁶ Ltr. Rul. 200234019, May 13, 2002.

²⁷ I.R.C. § 501(c)(3).

²⁸ *Id.*

²⁹ I.R.C. § 691(a)(2).