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AVOIDING RECOGNITION OF GAIN IN DISPOSING OF IRD ASSETS

— by Neil E. Harl*

Handling and disposing of assets producing income in respect of decedent¹ to avoid recognition of gain has long posed a problem.² With items of income in respect of decedent, income uncollected at death is later subjected to income taxation to someone other than the decedent, for example, an estate, heir or beneficiary.³ If income in respect of decedent items are distributed by the estate, the items generally remain subject to income tax and are not subject to the trust rules⁴ allowing a deduction for amounts paid or credited to a beneficiary.⁵

General rule on disposition

In general, the transfer of an income-in-respect-of-decedent item is a recognition event for non-charitable transferees.⁶ This includes transfer by sale, gift, exchange or other disposition or the satisfaction of an installment obligation at other than face value.⁷ 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.⁸ There is, however, ordinarily no income in respect of decedent triggered where a decedent's IRA is transferred to the surviving spouse's IRA.⁹

Ordinarily, disposition of an item of IRD to a charitable organization also triggers gain¹⁰ with an offsetting charitable deduction.¹¹ Of course, the charitable deduction is of value only for those who itemize¹² and to the extent the taxpayer receives a real benefit from itemization.¹³

Possibility of avoiding recognition of gain

Beginning in 1995, the Internal Revenue Service has ruled that an in-kind distribution of Series E and Series HH U.S. Government Savings Bonds from a decedent's estate to a charitable beneficiary did not trigger gain as to the unreported interest.¹⁴ In a 1995 ruling,¹⁵ the will directed that the residuary estate be distributed in fractional shares to four charitable beneficiaries but, under fiduciary powers, the estate distributed cash to three charitable beneficiaries and bonds to a fourth charitable beneficiary. Because the decedent's will and local law allowed non-pro rata property distributions, the distribution of bonds was not considered to be a pro rata distribution followed by an exchange by the beneficiaries.¹⁶ Accordingly, the distribution did not trigger gain from IRD. Presumably, when the charitable

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beneficiary redeemed the bonds, there would have been IRD to report by the beneficiary but the tax-exempt status of the beneficiary would have meant that no income tax was due on the IRD.

In a 1998 private letter ruling,¹⁷ Series E and HH savings bonds passed by will to a charitable beneficiary without recognition of the accrued interest as income.

The Internal Revenue Service ruled, in a 1997 private letter ruling,¹⁸ that a charitable organization receiving the proceeds from an individual retirement account (IRA) at the death of the last to die of the IRA owner and spouse was required to report the IRA distribution of income.

However, in a 2002 private letter ruling,¹⁹ the disposition involved four I.R.C. § 403(b) annuity contracts, three qualified retirement accounts (IRAs)²⁰ and, as successor beneficiary, a custodial account containing the decedent's interest in the predeceased spouse's retirement account.²¹ The decedent named the estate as beneficiary of all of the retirement accounts except for the custodial account for which the estate was successor beneficiary.

The decedent's will, in accordance with state law, gave the executor power to make distributions in cash or in-kind including non-pro rata distributions. The executor had requested a ruling that the proposed assignment of the retirement accounts, in satisfaction of the charities' percentage shares of the estate, would not cause either the estate or any of the individual beneficiaries to have taxable income.

IRS ruled that the items in question could be distributed to charitable organizations in satisfaction of the decedent's bequest to the charities without triggering income in respect of decedent to the estate or the individual beneficiaries.²² The ruling points out that if a right to income in respect of decedent is transferred by an estate to a specific legatee or a residuary legatee, only the specific or residuary legatee must include the amount in gross income when received.²³ Moreover, the assignment would not cause any of the amounts to be taken into account in computing the estate's distributable net income (DNI) for the year of the assignment.²⁴

The ruling noted that the charitable organizations would realize income in respect of decedent by reason of the distribution to them from the retirement accounts assigned to the charities but that the resulting income would not be taxable by reason of the exempt status of the charities.²⁵

In conclusion

With careful planning, it is possible to leave IRD items (including retirement accounts) to charitable organizations without triggering the IRD to the estate or beneficiaries other than for the charitable beneficiaries receiving the accounts.

FOOTNOTES

- ¹ I.R.C. § 691(a). See generally 6 Harl, *Agricultural Law* § 47.03 (2002); Harl, *Agricultural Law Manual* § 6.02[1] (2002).
- ² See, e.g., Rev. Rul. 69-297, 1969-1 C.B. 131 (distributions from profit sharing trust with estate as beneficiary).
- ³ I.R.C. § 691(a).
- ⁴ I.R.C. §§ 661, 662.
- ⁵ See *Edward D. Rollert Residuary Trust v. Comm'r*, 80 T.C. 619 (1983), *aff'd*, 752 F.2d 1128 (6th Cir. 1985); *Estate of Dean v. Comm'r*, T.C. Memo. 1983-276.
- ⁶ I.R.C. § 691(a)(2).
- ⁷ *Id.*
- ⁸ Treas. Reg. § 1.691(a)-4(a).
- ⁹ Ltr. Rul. 200023030, March 10, 2000.
- ¹⁰ I.R.C. § 691(a)(2).
- ¹¹ See Rev. Rul. 55-157, 1955-1 C.B. 293.
- ¹² See I.R.C. § 63(d).
- ¹³ See I.R.C. § 68 (itemized deductions reduced for adjusted gross income above the "applicable amount").
- ¹⁴ Ltr. Rul. 9537011, June 16, 1995; Ltr. Rul. 9845026, Aug. 11, 1998.
- ¹⁵ Ltr. Rul. 9537011, June 16, 1995.
- ¹⁶ *Id.*
- ¹⁷ Ltr. Rul. 9845026, Aug. 11, 1998.
- ¹⁸ Ltr. Rul. 9723038, March 11, 1997.
- ¹⁹ Ltr. Rul. 200234019, May 13, 2002.
- ²⁰ See I.R.C. § 408.
- ²¹ I.R.C. § 403(b)(7).
- ²² *Id.*
- ²³ Treas. Reg. § 1.691(a)-4(b)(2).
- ²⁴ Ltr. Rul. 200234019, May 13, 2002.
- ²⁵ I.R.C. § 501(c)(3).