

# Income in Respect of a Decedent

Under the Internal Revenue Code (IRC), a cash basis taxpayer is generally required to recognize income for federal income tax purposes when the income is actually received. If, however, a cash basis taxpayer dies after becoming entitled to an item of income, but before actually receiving it, the income may not be included on his or her final income tax return because it has not been received.



Such income is termed income in respect of a decedent (IRD).<sup>1</sup> In general, the ultimate recipient of the IRD (e.g., the decedent's estate or heirs) must include the IRD as taxable income for income tax purposes when received. Also, the decedent's estate must include the value of the IRD, for estate tax purposes, as property in which the decedent had an interest.<sup>2</sup>

## The Nature of IRD

Although not defined in the IRC,<sup>3</sup> the regulations (Reg. 1.691(a)-1(b)) describe IRD as “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.” IRD also includes the following:

- All accrued income of a cash basis decedent
- Income accrued solely by reason of the decedent's death, if the decedent reported under the accrual method
- Income to which the decedent had a contingent claim at the time of death<sup>4</sup>

The regulations also specify that IRD includes income in respect of a prior decedent. If the present decedent received the right to income from a prior decedent and the amount was not properly includible in computing the present decedent's taxable income for the year ending on the date of his or her death, the amount is income in respect of the present decedent when it is paid.

## Common Sources of IRD

Income in respect of a decedent can arise from a number of common situations. A few frequently encountered sources of IRD are listed below.

- **Wages or other employee compensation:** Such as renewal commissions or deferred compensation, earned by a cash basis decedent, but unpaid at the time of death.
- **Interest on U.S. savings bonds:** Under certain circumstances, untaxed interest on U.S. savings bonds is IRD.

<sup>1</sup> Only in very limited situations will the activities of accrual basis taxpayers generate IRD.

<sup>2</sup> See IRC Secs. 691(a) and 2033, respectively.

<sup>3</sup> State or local tax treatment of IRD may differ from federal law.

<sup>4</sup> The regulations do not explain the meaning of the term contingent claim. Instead, the courts must be relied upon to interpret this term.

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- **Dividend income:** This income is created if the decedent dies between the date of record and the date of payment.
- **Rental income:** If paid after death and attributable to the period before death, rental income is IRD.
- **Distributions from qualified plans and IRAs:** These are usually considered IRD. Spousal beneficiaries of distributions from IRAs may elect to treat a decedent's IRA as his or her own and avoid having the distribution classified as IRD.
- **Partnership interests:** A decedent's share of partnership income prior to death is considered IRD.
- **S corporations:** For the estates of decedents dying after August 20, 1996, IRD can result from inheriting S corporation stock.

### Deductions in Respect of a Decedent

The law allows the recipient of IRD to deduct certain expenses incurred by the decedent but not yet paid at the time of death. Such expenses are termed deductions in respect of a decedent (DRD) and are allowable as deductions for both estate and income tax purposes.<sup>1</sup> IRC Sec. 691(b) identifies five types of expenses and one type of credit, which qualify as DRD.

- The deduction for ordinary and necessary business expenses under IRC Sec. 162
- The interest deduction allowed under IRC Sec. 163
- Deductible taxes under IRC Sec. 164
- Expenses incurred for the production of income under IRC Sec. 212
- The deduction for depletion under IRC Sec. 611
- Foreign tax credits under IRC Sec. 27

### Income Tax Deduction for Estate Tax Paid

IRC Sec. 691(c) allows, for income tax purposes, the recipient of IRD a deduction for the federal estate tax attributable to the amount of IRD included in the decedent's estate. The amount of estate tax attributable to the IRD is determined by first calculating the estate tax due on the gross estate, which includes the IRD, and then calculating the estate tax due on the gross estate excluding the IRD.

The deduction for estate tax paid is allowed to the recipient in the year in which the IRD is actually received. For individual taxpayers, the deduction is taken as a miscellaneous itemized deduction (not subject to the 2% of AGI limitation) on Schedule A.

**Note:** Under the Tax Act of 2001, the federal estate tax is gradually phased out until its final repeal in the year 2010. If Congress does not act at that time to repeal it for the years following, it will automatically revert back to the rates in effect during the year 2001, with an exemption for the first \$1,000,000 of assets.

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<sup>1</sup> See IRC Sec. 642(g).