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# An 80% Tax Bracket?

## Beware the Hidden Tax Trap of IRD

by Christopher R. Jarvis, MBA and Michael B. Allmon, CPA

We know that there isn't an 80 percent income tax bracket (though none of us would be surprised if one emerged). However, there is a way for an asset to generate an 80 percent -- or greater -- tax liability.

The asset category is income in respect of decedent (IRD). This is an important issue as nearly all high-wealth clients face this potential tax cost and should be looking for advice to help their families avoid it. Also, a number of experts have written that CPAs and attorneys who avoid this issue in an estate plan may be violating the standard of care and subjecting themselves to professional liability.

### What is IRD?

IRD is simply money people should have received and paid taxes on, but did not because they died before receiving the money. The most common types of IRD are unpaid commissions, bonuses and other receivables, as well as retirement plan (and IRA) balances.

The IRS' theory behind IRD is simple: There are two certainties -- death and taxes -- and even if you die, the tax bill doesn't go away. The government does not want deferred income, such as commissions and pension plan distributions, to pass to the heirs without someone first paying income tax on that money.

### How Can IRD Generate an 80% Tax Liability?

When an individual passes away and there is an estate tax liability to calculate, the CPA or attorney will total all assets and liabilities. The potential income tax liability from the IRD is not part of that calculation. Therefore, the estate tax liability is based on the value of the IRD asset. If the estate (or the heirs) takes the entire distribution of the IRD asset, there will be both an estate tax and income tax liability.

Let's say a client passes away with an estate valued at $5 million. The largest single asset in the estate is a $2.5 million pension. The client also leaves $2 million worth of real estate and a $500,000

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home. Since the client had a properly formed and funded living trust, the estate taxes totaled approximately $2 million.

Since the children don't want to sell the real estate in a short period of time, they take a withdrawal of $2 million to pay the estate taxes. This isn't a bad idea as they will still be left with $500,000 in the pension and $2.5 million in combined real estate, right? Wrong.

Next year, the income taxes on the $2 million withdrawal will be about $950,000. The first $500,000 can come from the remaining pension assets, but they will have to sell the home or mortgage the real estate to come up with the remaining $450,000 to pay the bill. Then, in the third year, they will have to mortgage the real estate for an additional $240,000 to pay the taxes on the $500,000 withdrawal of the pension. Of course, now the kids have to pay interest on the $690,000 outstanding loan.

So, from a $5 million estate, the heirs will pay $3.2 million in taxes and subject themselves to nearly $700,000 in debt.

When a client's estate can be decimated by 80 percent, how can we ignore the problem?

**How Can We Help Our Clients?**
While most advisers create estate plans to avoid probate and large estate taxes, many forget to address the estate/IRD problem. Some of the common strategies offered by professionals include charitable planning, stretch IRAs and capital transfer strategies.

**Charitable Planning.** Much of the literature on estate/IRD suggests that advisers should counsel clients to gift IRD assets to charity to avoid estate and income taxes. In our experience, charitable planning only works if the client has an interest in giving to a charity or there is a significant income tax or capital gains tax avoidance that accompanies the planning.

If you want your clients to give to charity just to avoid taxes, they have to be willing to leave their children significantly less. If you want to utilize charitable planning options for your clients, do so while they are alive so they can take advantage of the tax deductions.

Now, some advisers have touted that a client can "have his cake and eat it too" by leaving the IRD to a charitable foundation and have the children serve as executives of the charity. However, this use of a "quasi-charitable" entity for the exclusive benefit of reducing taxes with very little (or no) benefit to charity has been a major focus of recent IRS lawsuits, audits and attacks.

**Stretch IRA: Penny-Wise & Pound-Foolish?** Stretch IRAs are the most commonly discussed solution for estate/IRD. The concept is

that you can reduce your minimum required distributions from a retirement plan or IRA by naming children as joint beneficiaries. By reducing minimum distributions, clients can reduce their income tax liability and allow the funds to continue to grow tax-deferred.

There are two keys to understand before recommending this to clients: First, even though the IRA withdrawals are deferred, the entire value of the retirement plan is included in the estate when determining the estate tax liability. There is no estate tax deferral and the estate taxes are still due within nine months of the date of death, so the "estate" part of the estate/IRD problem is not addressed.

Second, the withdrawals from the IRA will be taxed at the children's marginal tax rates, which may result in tax arbitrage for the IRS. Many retirees live a rather modest lifestyle and have little income other than the retirement plan distributions. But the client's heirs, who will be in their late 40s to late 50s, will be in their top earning years and will be in a very high tax bracket.

Unless your clients are not going to be worth more than the exemption amount at the time of death and their heirs will be in the same or lower tax bracket from the time of the client's retirement until death, carefully consider whether a Stretch IRA is the best solution to maximize wealth transfer.

**Capital Transfer Strategies.** An approach that can save income and estate taxes (possibly all such taxes) on retirement plan assets is to use the plan assets to purchase life insurance on the life of your client. That insurance is then moved to a life insurance trust in a transaction called a capital transfer strategy.

On Sept. 3, 2002 the Department of Labor released an Amendment to Prohibited Transaction Exemption (PTE 92-6), which clarified a number of issues:

1. A profit-sharing plan (PSP) could purchase second-to-die insurance.
2. The policy could be distributed by or purchased from a PSP even if the policy was not in danger of being surrendered or lapsing (if not for the removal of the policy from the plan) as long as the plan has separate accounts for each participant.
3. The insured, the relatives of the insured and a trust for the benefit of the insured's heirs could purchase the policy from the retirement plan.
4. The value of the insurance policy, when purchased from a retirement plan, shall be the cash surrender value of the policy.

Here's how this may work: Bob, 66, and Mary, 65, are worth million in a profit-sharing plan. (An IRA would work as well, once the funds are rolled into a new profit- sharing plan).

Their brokerage, real estate and other non-pension assets support their retirement, but they are concerned with the estate/IRD tax liability from their PSP. Over a short number of years they purchase a life insurance policy with the $1.5 million in their plan assets. They also fund their ILIT with $500,000 by utilizing annual gifts and a portion of their unified credit.

The ILIT, in a later year, purchases the policy from the PSP for the policy cash surrender value of $500,000. Upon their deaths, $5 million is paid to their heirs tax-free.

Bob and Mary took an asset they understood to be worth less than $400,000 to their heirs (after taxes) and turned it into $5 million. If they expected to live an additional 17 years, they would have had to realize annual gains of 16 percent per year just to break even.

Given that their health conditions were average and their investments are returning less than 6 percent, this was a wise move for Bob and Mary.

**Pitfalls to Avoid**
Before helping your client address their IRD issues, be aware of "tainted IRAs," the need for a properly structured entity to sponsor any new IRD and "springing cash value" policies.

The estate/IRD is a significant issue facing many of your clients. If you do your homework there are some beneficial strategies to consider that will make you an even more effective adviser.

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