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WHEN INCOME IN RESPECT OF DECEDENT IS RECOGNIZED
— by Neil E. Harl*

Items of income in respect of decedent require careful planning attention after death.1 As property that does not receive a new income tax basis at death,2 the pre-death basis (possibly zero) carries over with the gain taxable to the estate, the heirs or beneficiary.3 The income recognition event can lead to substantial income tax liability.4

Typical IRD items

In a farm or ranch estate, items of income in respect of decedent are relatively common.

• Share rents held by a non-materially participating decedent at death or share rents which the decedent had a right to receive at the time of death for economic activities occurring before death are income in respect of decedent taxable on subsequent sale by the estate or other successor.5 If a non-materially participating landlord dies during a rent period, with crops and livestock sold after death, the portion of the proceeds allocable to the period before death is income in respect of decedent. That portion is also includible in the gross estate for federal estate tax purposes as accrued rent. The remaining amount represents ordinary income earned by the estate after the landlord's death. The proceeds of sale are apportioned according to the number of days in the rental period before and after death.

Growing crops, stored crops and livestock raised under a material participation lease receive a new income tax basis at death as do the same type of asset in the hands of an operating farmer.6

• Interest on Series E or EE bonds or Series H or HH bonds issued for E bonds is income in respect of decedent.7 The interest may be reported on the final return of the decedent even though the decedent held the bonds uncashed at death.8 If the accrued interest is reported on the decedent’s final return, the resulting income tax is deductible on the estate tax return as a claim against the estate.9

If such bonds are redeemed by the estate, the interest amount is includible in the estate’s gross income as income in respect of decedent.10 In that event, the income tax on the interest is not deductible for federal estate tax purposes.

For jointly held bonds, the surviving joint tenant may report the interest income.11

• Payments under installment land contracts or contracts for deed are treated as income in respect of decedent.12 Payments received after death are treated as income in respect of decedent and the recipient, whether estate representative, legatee or other successor reports the income in the same manner as the decedent would have done if living.13

• Sales contracts normally convert gain from assets into income in respect of decedent if there is a legally binding contract and the decedent has performed the substantive (as opposed to the ministerial) acts required as preconditions of sale.14 However, sales contracts for farm products entered into before death may not produce income in respect of decedent if a significant economic contribution needs to be made by the estate or other successor after death.15

• Lump sum distributions as well as periodic payments from qualified retirement plans (including IRAs and Keogh plans) are income in respect of decedent.16

When income recognized

With items producing income in respect of decedent not receiving a new income tax basis at death,17 the question is when the gain is recognized for income tax purposes.

• Transfer of an item of income in respect of decedent is ordinarily an income recognition event for non-charitable transferees.18 This includes transfer by sale, gift, exchange or other disposition or the satisfaction of an installment obligation at other than face value.19 The transfer of an item of income in respect of decedent results in recognition of gain in the amount received upon sale, or the fair market value of the right, whichever is greater.20 In the event of a gift, the gain in the item of income in respect of decedent is recognized to the extent of the fair market value of the IRD item at the time of the gift.21

• An important point to note is that, in general, disposition of an item producing income in respect of decedent triggers the gain, even if it is a gift to a charitable organization.22 The donor is, of course, entitled to a charitable deduction which offsets the income in respect of decedent.23 Thus, a gift or bequest to a qualified charity of Series E bonds, payments under an installment land contract, stored grain produced under a non-materially participating share lease or qualified retirement plan benefits produce both gain from IRD and an offsetting gift tax, estate tax or income tax charitable deduction.

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• The disclaimer of an interest in an item of income in respect of decedent does not constitute a transfer and so gain is not recognized on the exercise of a qualified disclaimer.24

• If an installment obligation passes into an estate and in turn is transferred to a beneficiary of the estate, the event is not taxable unless the obligor is a beneficiary.25 In the event the beneficiary is someone other than the obligor, the income tax basis in the hands of the beneficiary is the decedent's basis adjusted for installments received by the estate prior to the distribution to the beneficiary.26

Disposition of an installment obligation to the obligor triggers income in the estate to the extent the obligor acquires the installment obligation .27

Keep in mind that disposition of installment obligations entered into by the estate constitutes a taxable disposition.28 This is a particularly important rule for the sale of land that has been valued under special use valuation.29 Section 1040 of the Internal Revenue Code operates to shield from recognition the gain on transfer of special use land to a qualified heir.30 But that section does not appear to shield from recognition the gain on the distribution of an installment obligation from the estate. The statutory exception for installment obligations entered into by the decedent and passed through the estate.31 does not appear to apply to installment obligations entered into by an estate inasmuch as the distribution from the estate does not involve "transmission of installment obligations at death."32

• Transfers occurring by operation of law, such as passage to a surviving joint tenant by right of survivorship do not result in recognition of gain.33

Income tax deduction

A taxpayer reporting income in respect of decedent is entitled to an income tax deduction for the federal estate tax on the rights to receive income in respect of decedent that are included in the decedent's gross estate.34 The deduction is based on the highest federal estate tax rate payable by the estate.35

FOOTNOTES

2 I.R.C. §§ 691(a), 1014(a).
3 E.g., Rev. Rul. 64-289, 1964-2 C.B. 173 (share rents under nonmaterial participation lease taxable to whomever triggers gain in crops).
4 E.g., Apkin v. Comm’r, 86 T.C. 692 (1986) (Series E bond interest taxed to surviving joint tenant (child) on redemption).
8 Id.
11 See Apkin v. Comm’r, 86 T.C. 692 (1986) (all interest, including interest before decedent’s death, taxed to co-owner as beneficiary on redemption; no election had been made by decedent to report accrued interest as income). See also Ltr. Rul. 9024016, March 14, 1990 (interest included in income of co-owner in year bonds redeemed, disposed of or reached maturity unless I.R.C. § 454(a) election made; for bonds co-owned by decedent and joint owner, surviving joint owner may elect under I.R.C. § 454(a)).
15 Estate of Peterson v. Comm’r, 74 T.C. 630 (1980), aff’d, 667 F.2d 675 (8th Cir. 1981) (calves sold before death were too light at death to meet contract specifications).
17 See n. 2 supra.
18 I.R.C. § 691(a)(2).
19 Id.
20 Treas. Reg. § 1.691(a)-4.
21 Id.
25 I.R.C. § 453B(c).
26 Id.
27 I.R.C. § 691(a)(4), (5).
29 See I.R.C. § 2032A.
30 I.R.C. § 1040(a).
31 I.R.C. § 453B(c).
32 Id.
34 I.R.C. §§ 691(c)(2)(A), 691(c)(2)(C).
35 I.R.C. § 691(c)(2)(C).