

By Kathy Chu

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NEW YORK (Dow Jones)--Today's transfer of wealth could be tomorrow's burden under a little-known but punishing tax provision.

The provision, income in respect of a decedent, or the IRD, is nothing new. But it's garnered more attention in recent years as retirement plans - vehicles that are subject to this tax - often make up the largest asset in the estates of Depression-era investors and baby boomers.

This tax bite is a reason to start early with estate planning. And it's an incentive to consider IRD tax-reducing strategies such as accelerated withdrawals from retirement plans, charitable donations and life insurance.

"IRD is one of the biggest wrecks that I see coming," said Gil Parks, a certified financial planner and senior advisor at American Express Financial Advisors Inc.

The provision applies to the taxable income that a person earned but didn't receive while alive and that is passed along to a descendant. This income can include payouts from Individual Retirement Accounts, 401(k) assets and savings bond income, among other things.

Unlike the death tax, which hits less than 2% of estates, the IRD provision affects most estates nowadays because of the growth of income-taxable assets such as defined contribution plans. Many of these assets reaped heady gains from the roaring stock market of the 1990s.

"This generation is really the first to have significant qualified assets pursuant to these plans," said Louis Kokernak, a certified financial planner in Austin, Texas.

Misunderstood and Misused

The IRD provision has the most taxing implications for the heirs of high net-worth individuals who are unlikely to exhaust their retirement plans.

Unlike most estate distributions, which are received tax-free unless they exceed certain limits, an IRD asset is subject to regular income tax regardless of the amount of the asset. Estate and other taxes may also apply.

And in cases when wealth is passed along to grandchildren, there's another possible problem: the generation-skipping transfer tax.

The burden is lightened somewhat by deductions that can be taken for any federal estate tax paid on IRD assets. But don't count on getting away without paying Uncle Sam something.

Even if a beneficiary doesn't want the asset and passes it along to someone else, the initial recipient may still be responsible for income taxes.

Throw in a few other stipulations, and it's easy to see why the IRD is one of the most misunderstood and misused concepts in the taxation system.

"I think people think it's something new or different, or they confuse it with the estate tax," said Drew Bottaro, a senior advisor and tax attorney at Pillar Financial Advisors, Waltham, Mass.

Reducing The Tax Bite

Accelerated withdrawals on retirement plans can mitigate IRD tax burdens.

Take the "deathbed liquidation," for instance. If all the money is withdrawn from an IRA shortly before death, then the income tax becomes a liability of the estate - leaving fewer assets subject to any death tax, according to Bottaro.

Also, when possible, it's smart to roll over some of the pension plan assets into a tax-free vehicle such as a Roth IRA. The ideal time to make this move is between the end of wage-earning days and before the beginning of pension payouts, when lower tax brackets apply.

Other options are to give the IRD asset to a charitable foundation - bypassing both income and estate taxes - or to set up a charitable remainder trust.

A donation to charity makes sense if heirs are already getting other assets, especially non-IRD-taxable items such as appreciated stock.

If the goal is to provide for both the heir and a favored charity, then a charitable remainder trust may be a good bet. The trust will pay a family member income for life. What is left when the heir dies will go to the charity.

Another choice: using pension plan distributions to buy life insurance. The insurance will pay income and estate taxes when the time comes. This leaves the wealth transfer intact for its intended purpose, to give heirs a helping hand.

Just be aware that some financial planners may get a commission from selling insurance products, and so consider all available options before buying.

It's also a good idea to bring a tax attorney or accountant into the estate-planning process if assets are expected to take a hard hit from income and death taxes. These professionals can work out exactly how the IRD will affect an estate's bottom line.

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(END) DOW JONES NEWS 05-08-02

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