

In this world nothing is certain but death and taxes.

—Benjamin Franklin

This sentiment may not be more strongly felt than when the Internal Revenue Service (IRS) assesses estate taxes at a rate as high as 48% in 2004 (47% in 2005) upon the death of a loved one. Fortunately, there is a little known deduction called Income in Respect of a Decedent (IRD) that can help reduce the amount of income tax owed by beneficiaries.

Under the Internal Revenue Code Section 691(a), IRD refers to amounts to which a decedent was entitled as gross income, but which were not includable as taxable income in the year of death. In a number of private letter rulings, the IRS ruled that IRD applied to (1) a distribution from a qualified plan of the balance as of the employee's death, (2) distributions from a decedent's IRA and (3) the death benefit paid to beneficiaries of a nonqualified deferred variable annuity to the extent that the death benefit exceeded the owner's investment in the contract.

In order to determine the beneficiary's deduction amount, the deceased's federal estate tax should be calculated twice, once with the net IRD included and again with the net IRD excluded. The difference in the two results is the beneficiary's income tax deduction.

While income tax is still required to be paid on the death benefit proceeds that beneficiaries receive (although just on the gains in the case of a nonqualified variable annuity contract), their effective tax rate may be lower because of the IRD deduction.

THE BENEFIT TO BENEFICIARIES

Assumptions:

- Nonqualified annuity owner dies, leaving annuity contract valued at \$200,000.
- Taxable gain in annuity valued at \$100,000.
- Owner was in 48% federal estate tax bracket.
- Beneficiary is in the 35% federal income tax bracket, filing as a single taxpayer, and will be taking a lump-sum distribution (state income tax not taken into consideration).

	Using IRC 691(a)	Not using IRC 691(a)
Estate tax paid: $\$200,000 \times 0.48 = \$96,000$	\$96,000	\$96,000
Estate tax without IRD portion: $\$100,000 \times 0.48 = \$48,000$	\$48,000	\$48,000
Tax deduction to beneficiary: $\$96,000 - \$48,000$	\$48,000	\$0
Taxable amount to beneficiary:	$\$100,000 - \$48,000 = \$52,000$	\$100,000
Income tax paid by beneficiary:	$\$52,000 \times 0.35 = \$18,200$	\$35,000
Beneficiary's effective tax rate:	$\$18,200 / \$100,000 = 18.2\%$	$\$35,000 / \$100,000 = 35\%$
Beneficiary's net amount received:	$\$100,000 + \$81,800 = \$181,800$	$\$100,000 + \$65,000 = \$165,000$

Discussions with beneficiaries regarding distribution planning and the use of the IRD deduction to help ease the tax impact on their inheritance may be a great way to earn their business in the future. For more information, contact the Advanced Marketing team at (800) 722-2333 (or (800) 748-6907 in NY) ext. 3939 or by e-mail at AdvMkt@PacificLife.com.

¹Highest federal estate tax rate in 2004. ²35% marginal federal income tax rate in 2004.

The Economic Growth and Tax Relief Reconciliation Act for 2001 ("EGTRRA") reduces income and estate tax rates over the next several years, ultimately eliminating the estate tax by 2010. EGTRRA is subject to future congressional legislation. Barring congressional action, a "sunset" provision will terminate all EGTRRA provisions on January 1, 2011.

When you talk to your clients about IRD deductions, remember these important details:

- An IRD deduction is a tax deduction and not a tax credit.
- The deduction will be taken as income is realized.
- In order to utilize this deduction, a beneficiary must itemize deductions on a Schedule A.
- If two or more individuals utilize the IRD deduction, each recipient will be entitled to their proportionate share of the deduction in accordance with the distribution amount received by the beneficiary.



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Mailing address:
P.O. Box 7187, Pasadena, CA 91109-7187
(800) 722-2333 • www.PacificLife.com



Mailing address:
P.O. Box 7138, Pasadena, CA 91109-7138
(800) 748-6907 • www.PacificLifeandAnnuity.com

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