

CALIFORNIA FRANCHISE TAX BOARD

Legal Ruling No. 421

March 9, 1982

DEDUCTIBILITY OF INTEREST ON INHERITANCE TAXES

Syllabus:

(1) Is an estate entitled to a deduction under Section 17230, Revenue and Taxation Code, for interest paid on California inheritance taxes imposed under Section 13401, Revenue and Taxation Code?

(2) If the estate may not deduct such payments, are the beneficiaries of the estate entitled to a deduction for interest paid on their behalf?

(3) If deductible by the beneficiary, when is a cash basis beneficiary entitled to a deduction for interest expense?

(4) What is the income tax effect to beneficiaries who receive distributions from the estate where the testator has designated that such distribution is to pass free of inheritance taxes?

Decision:

(1) An estate may not deduct interest on inheritance taxes, as such obligation is ultimately that of the beneficiary.

(2) Interest on inheritance taxes is deductible by the beneficiary subject to the tax. Accrual basis taxpayers may deduct when all events have transpired to fix the liability.

(3) Cash basis beneficiaries are entitled to deduct interest payments only where they have paid such interest out of their own funds or when, as to them, the facts indicated a final distribution has occurred and that amounts receivable by them have been reduced by such interest.

(4) Beneficiaries who receive distributions "free of inheritance taxes" have actually received an additional specific bequest equal to the appropriate amount of inheritance tax on their combined distribution. Accordingly, such beneficiaries will be entitled to deduct the applicable interest expense to the extent allowable under their method of accounting, as outlined above.

Discussion:

Inheritance taxes are imposed upon the transfer of assets by will or the laws

of succession, Sections 13304, 13401, and 13601, Revenue and Taxation Code. The property thus transferred is subject to lien for such tax, Section 13401, Revenue and Taxation Code. The persons liable for payment of the tax are the executor or administrator of the estate and the transferee of the property upon which the tax is imposed, Section 14101, Revenue and Taxation Code. The executor or administrator, however, must deduct the tax from the property transferred, if the property is money, or if the property is not money, he must collect the tax from the transferee, Section 14121, Revenue and Taxation Code.

As Section 14101 imposes the liability upon the executor or administrator, it is clear that such liability is personal to the representative of the estate and not a liability of the estate itself. The tax is not a charge upon the general estate of the decedent; it is collectable out of each specific share or interest to which the beneficiary succeeds, and not from the general property of the estate. Cohn v. Cohn, 20 Cal. 2d 65, 123 P.2d 833 (1942).

While the personal representative has personal liability for the payment of inheritance tax, such liability is administrative in character, and the ultimate liability falls upon the transferee out of the property transferred or by the direct collection by the personal representative, Section 14121, Revenue and Taxation Code; Estate of McLaughlin, 243 C.A.2d 516, 52 Cal. Rptr. 543 (1966); Hostetter v. U.S., 113 F.2d 64 (1970).

The obligation to pay interest appends to the obligation to pay the tax, Sections 14211, 14212 and 14301, Revenue and Taxation Code. as the estate has no obligation to pay the tax, and as the personal representative may shift the ultimate liability for the tax to the transferee, neither the estate nor the personal representatives may deduct the interest on the inheritance tax. Estate of McClatchy v. Comm., 12 T.C. 370 (1949); U.S. v. Norton, 250 F.2d 902 (5th Cir. 1958); J. B. Hynes v. Comm., 74 T.C. 1266 (1980).

The beneficiary subject to the inheritance tax may deduct the interest on the tax in accordance with his method of accounting. An accrual basis beneficiary may deduct such interest when all events have occurred which fix his obligation to pay such interest. Cal. Admin. Code, Tit. 18, Reg. 17591(2); U.S. v. Anderson, 269 U.S. 422, 70 L.Ed. 347 (1926).

A cash basis beneficiary's deduction for interest on the inheritance tax will be allowed only when it is established that such beneficiary has personally advanced funds for the payment of the interest, or that the ultimate distribution by such beneficiary has been reduced by such interest. A partial distribution will have no effect on the deductibility of such interest, as it is not then determinable whether or not the interest will ultimately be charged against the beneficiary's total available distribution. However, where the facts demonstrate that, as to a particular beneficiary, the distribution is complete and that the distributable property has been charged with the interest obligation, a deduction will be allowed even though the estate has not yet

terminated.

Payment by the personal representative of interest on inheritance taxes out of the funds of the estate will not in and of itself result in a deduction for the cash basis beneficiary. Such payment is a payment by the estate entity, which creates a receivable asset in the hands of the estate and a corresponding obligation of the beneficiary to reimburse the estate for such interest, either by direct payment or by a reduction of the beneficiary's ultimate distribution. Cf. Hostetter v. U.S., supra.

Where a will provides that certain property is to pass to a beneficiary free of inheritance tax, such a provision is considered an additional specific bequest equal to the inheritance tax on the combined distribution. Estate of Irwin, 196 Cal. 366, 237 P. 1074 (1925); Calif. Admin. Code, Tit. 18, Reg. 13601-13603(e). Such additional bequest is to be drawn from the residue of the estate, to the extent available, then drawn from general bequests. To the extent the residue and general bequests are insufficient to cover the specific bequest of an amount equal to the inheritance taxes, the provision in the will providing for a tax-free bequest is disregarded. Estate of Nesbitt, 158 C.A.2d 630; 323 P.2d 474 (1958).

There is some language in cases which suggests that when a testator directs a bequest to be paid to a beneficiary free of inheritance tax, such provision causes the tax to fall upon the estate, Estate of McLaughlin, supra, and Estate of Hendricks, 11 C.A. 3d 204; 89 Cal. Rptr. 748 (1970). However, the statements therein, to the extent that they suggest that the estate has a liability for such taxes do not reflect the provisions of Sections 14101, 14121, and 14301, Revenue and Taxation Code, Cal. Admin. Code, Tit. 18, Reg. 13601-13603(e), or the California Supreme Court holdings of Estate of Irwin, supra, or Cohn v. Cohn, supra. Moreover, the above language may be interpreted in a manner to suggest only that the remainder of the estate's assets must be drawn upon (in the priorities outlined in the Estate of Nesbitt, supra) to satisfy the additional specific bequest to the beneficiary resulting from the original "tax free" bequest.

Accordingly, the beneficiary who is to receive a bequest "free of inheritance taxes" is the ultimate obligor on his portion of the inheritance tax. Therefore, in accordance with the principle outlined above, a beneficiary may deduct interest on such tax according to his method of accounting.

Where, in the administration of an estate, an interest obligation relating to a specific or general bequest is paid by the residuary beneficiary, such residuary taker is not entitled to a deduction, as he has no legal obligation to pay such interest. Such residuary taker is left only with a cause of action against the primary obligor for such amounts effectively paid by him.