August 8, 2016

Mark Mossman
Mossman Law Firm
122 East Fourth St.
Vinton, IA 52349
(319) 472-2396
mark@mossmanlawfirm.com

Re: Inheritance Tax on Tax-Paid Share

Dear Mr. Mossman:

The Iowa Department of Revenue ("Department") has received your email regarding the stepped-up basis calculation formula in Iowa Admin. Code r. 701-86.14(5).

Facts as Provided in Your Email

You are working on an Iowa 706 for an estate in which property is devised to persons subject to inheritance tax. The governing instrument directs that the tax is to be paid from the residue of the estate.

You believe the calculation formula in Iowa Admin. Code r. 701-86.14(5) is incorrect.

You proposed in your email that the stepped-up basis in the above example should be $1100—the $1000 the nephew is inheriting plus the $100 tax. The tax is then 10% of this amount, which comes out to $110.

Analysis

Iowa Code § 450.5 imposes inheritance tax liability on "[a]ny person becoming beneficially entitled to any property or interest in property by any method of transfer as specified in this chapter, and all personal representatives and referees of estates or transfers taxable under this chapter, are respectively liable for all taxes to be paid by them respectively."

Iowa Admin. Code r. 701-86.14(5) states

> If a decedent's will provides that taxes are to be paid from the residue of the estate and not the respective beneficial shares, a "stepped-up" basis will be utilized when computing the shares which will result in the appropriate beneficiaries' shares to include the tax obligation that was paid as an additional inheritance. A "stepped-up" basis is

based on gifts prior to the residual share; shares paid out of the residue are not stepped-up.

> Example: Decedent's will gives $1,000 to a nephew and directs that the inheritance tax on this bequest be paid from the residue of the estate. The stepped-up share is computed as follows:
> Tax: $1,000 × 10% = $100. Divide the tax by the difference between the tax rate and 100 percent (90 percent in this example): $100 divided by 90% = $111.11. Add the stepped-up tax of $111.11 to the original bequest of $1,000. This results in a stepped-up share of $1,111.11, which allows the nephew to keep $1,000 after the tax is paid.

While Iowa Code § 450.5 places the inheritance tax burden on the person receiving property, "[i]t is well settled that a testator may by appropriate provisions in his will shift the burden of taxation so as to relieve certain gifts at the expense of others." *In re Tedford's Estate*, 140 N.W.2d 908, 910 (Iowa 1966). By writing the will so that it provides for the payment of inheritance tax out of the residue of the estate, rather than leaving the tax liability to the beneficiary, the estate is discharging the beneficiary's obligation to pay inheritance tax. The discharge of an obligation by a third party is a taxable transaction and the recipient is liable for tax on the value of the discharged obligation. *Old Colony Trust Co. v. Commissioner*, 279 U.S. 716, 729 (1929). The nephew in Iowa Admin. Code r. 701-86.14(5) is liable for inheritance tax on the $1,000 share and tax on the amount paid towards the tax by the residue of the estate.

The example set forth in Iowa Admin. Code r. 701-86.14(5) is better understood if it is expanded and examined step-by-step. The goal is for nephew to end up with $1,000 and not pay any tax. The tax on $1,000 is $100. Nephew has an obligation to pay this, but Decedent's estate is going to pay. Therefore, Nephew's $100 obligation is being discharged, which is itself a taxable transaction. *See Old Colony Trust Co.* at 729. The tax on the $100 is $10. Nephew has an obligation to pay this amount, but again the estate is going to discharge Nephew's obligation by paying this amount. The discharge of the $10 obligation is again a taxable event. The tax on $10 is $1, but again the estate is going to discharge this obligation by paying that amount. The tax on $1 is $0.10, the tax on $0.10 is $0.01, and so on. Therefore, the total amount of Nephew's tax obligation that is going to be discharged is $111.11 ($100 + $10 + $1 + $0.10 + $0.01). This amount is then added to Nephew's share, resulting in a stepped-up basis of $1,111.11. After Nephew's inheritance tax obligations are paid by the estate his share will be $1,000. The same numbers result by using the formula described in Iowa Admin. Code r. 701-86.14(5).

Examining the rule step-by-step leads to the conclusion that if the estate continues to pay Nephew's tax, Nephew will continue to be liable for tax on those payments and the cycle will continue *ad infinitum*. The formula in Iowa Admin. Code r. 701-86.14(5) prevents this "absurdity" by establishing the total amount of tax required to be paid and adding that amount to the basis. *See Old Colony Trust Co.* at 730.

Recently the Kentucky Supreme Court stated that Iowa has not specifically addressed whether the bequest of tax is a taxable transaction. *Estate of McVey v. Department of Revenue*, 480 S.W.3d 233, 243 n. 10 (Ky. 2015). This formula however has been used in Iowa courts. *See Estate of Carl A. Holvik*, Probate No. 10827, (Iowa Dist. Ct. 1965) (stating that the formula used "in arriving at the amount of a tax free bequest is a correct one.").

I hope this information has been helpful to you. Please remember that this letter is an informal opinion based only on the facts you provided and on the current law. In the future, the Department could take a position contrary to that stated in this letter. Any written advice or opinion rendered to members of the public by Department personnel that is not written pursuant to a Petition for Declaratory Order under 701 IAC 7.24 is not binding upon the Department. If you have any additional questions regarding this matter please do not hesitate to contact me.

Sincerely,

Theresa A. Dvorak
Policy Section
Taxpayer Services and Policy Division
Iowa Department of Revenue
(515) 281-3194
theresa.dvorak@iowa.gov