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DEDUCTING INTEREST EXPENSE WITH 15-YEAR INSTALLMENT PAYMENT OF FEDERAL ESTATE TAX

— by Neil E. Harl*

A major economic question associated with the decision to use 15-year installment payment of federal estate tax at death is whether the interest is deductible as an administration expense in the estate for federal estate tax purpose or as an income tax deduction.2

Original IRS position

The Internal Revenue Service took the position in 1975 that interest on deferred federal estate tax was not deductible as an administration expense of the estate.3 However, that ruling was held invalid in a 1977 Tax Court case and in 1978 was revoked.5 In the Tax Court decision, Estate of Bahr, the interest payments were deductible under local law (Texas) as an expense of administration.7

Since Estate of Bahr, IRS seems to be adopting a two part test for deductibility — (1) interest must be deductible under local law and (2) the expense must be actually and necessarily incurred. Although originally IRS seemed to be allowing a deduction (if the tests were met) of the entire amount of projected interest, in 1980 IRS took the position that interest was deductible only as it accrues.9

Income tax or estate tax deduction

As with interest payments generally, a deduction may be claimed for federal income tax purposes or federal estate tax purposes but not for both.10 If an income tax deduction is claimed, the estate must file a statement, attached to the fiduciary income tax return, that the items have not been allowed as federal estate tax deductions and that all rights to deduct the amounts for that purpose are waived.11 However, an estate is not required to waive an income tax deduction in order to take an estate tax deduction for administrative expenses.12

If the executor of the estate files a waiver and claims the initial interest payments for income tax purposes, later payments may nonetheless be deducted for federal estate tax purposes.13 If interest was deducted for income tax purposes but waivers were not filed, and the period of limitation on assessment of income tax has expired, interest expense may be deductible for federal estate tax purposes.14

Impact of interest deduction on marital deduction

The IRS position has been that state law determines the source from which interest payments are made.15 In particular, the question is whether the marital deduction is reduced if and to the extent that interest is claimed as a federal estate tax deduction.16 In Estate of Richardson, state law did not provide an answer. The court held that the marital deduction was not reduced on the grounds that estimated interest cannot be determined with certainty.18 IRS now agrees, in the form of a 1993 ruling.19

FOOTNOTES

1 I.R.C. § 6166.
4 Estate of Bahr v. Comm’r, 68 T.C. 74 (1977), acq., 1978-1 C.B. 1 (projected interest payments were deductible administration expenses).
6 N. 3 supra.
7 See 68 T.C. 74,83 (Tietjens, J. dissenting) (1977). See Ltr. Rul. 7912006, Dec. 12, 1978 (deductibility of interest allowed for Sixth Court of Appeals area because prior case held deductibility was determined by state law alone); Ltr. Rul. 8429008, April 5, 1984.
8 N. 3 supra.
10 I.R.C. § 642(g).
11 See Treas. Reg. § 1.642(g)-1.
12 Estate of Keitel v. Comm’r, T.C. Memo. 1990-416 (attorney’s fees allowed as estate tax deduction although estate had not waived right to claim income tax deduction).
14 Rev. Rul. 81-287, 1981-2 C.B. 183 (doctrine of equitable recoupment permits amount of estate tax overpayment to be offset by deficiencies and interest

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resulting from deduction of interest on income tax returns); Ltr. Rul. 8429008, April 5, 1984.
16 Id.

CASES, REGULATIONS AND STATUTES

by Robert P. Achenbach, Jr.

BANKRUPTCY

GENERAL-ALM § 13.03.*

ATTORNEY’S FEES. The debtor filed a Chapter 11 case and the debtor’s attorneys claimed that during the case, the debtor was able to produce a crop because of the legal efforts of the attorneys. The crop was sold and the proceeds placed in escrow but the case was later dismissed. The attorneys claimed a portion of the proceeds under the Nebraska Attorney Lien statute, Neb. Rev. Stat. § 7-108. The court held that the statute did not apply because the proceeds were not held by an adverse party. The court also held that any claim to the proceeds as an administrative expense in the bankruptcy case was lost when the case was dismissed. Matter of Olson, 161 B.R. 45 (D. Neb. 1992), aff’g, 101 B.R. 134 (Bankr. D. Neb. 1989).

AUTOMATIC STAY. In exchange for a delay in the sale of collateral farmland, the debtor had agreed in a pre-petition foreclosure case to allow the judgment creditor immediate relief from the automatic stay if the debtor filed for bankruptcy. The debtor operated several businesses and planned to use income from the land to fund the 100 percent payment Chapter 11 plan. The judgment creditor sought enforcement of the pre-petition agreement and relief from the automatic stay to sell the land. The court held that the pre-petition agreement alone was insufficient to require relief from the automatic stay absent a showing of bad faith on the part of the debtor. The court upheld the denial of relief from the automatic stay because no bad faith was shown and the property was necessary for a successful reorganization. Farm Credit of Central Florida v. Polk, 160 B.R. 870 (M.D. Fla. 1993).

ENVIRONMENTAL CLEANUP COSTS. The debtor had leased land for its manufacturing business from a third party. The debtor moved its business to another location and eventually filed for Chapter 11. After the filing, the New Jersey Dept. of Environmental Protection and Energy (NJSEPE) discovered a hidden illegal seepage pit. After the claims bar date, the NJSEPE issued an administrative order and penalty assessment requiring the debtor to clean the pit and assessing the debtor a penalty. The debtor sought to avoid the order and penalty as untimely claims. The court held that the order and penalty were not claims because the cleanup involved an ongoing threat to the environment, the state was not seeking reimbursement for cleanup costs, and the order and penalty were an attempt by the state to force the debtor to comply with environmental laws. In re Torwico Electronics, Inc., 8 F.3d 146 (3d Cir. 1993).

EXEMPTIONS

AVOIDABLE LIENS. The debtors and trustee entered into a court approved agreement to sell the debtors’ homestead to the debtors for the amount which would have passed to the estate upon the sale of the property. The agreement and order acknowledged the debtors’ exemption and judgment and tax liens against the property. After purchasing the property from the estate, the debtors sought to avoid one of the judgment liens as impairing the homestead exemption. The court held that the court approved agreement was res judicata as to the debtors as to the value of the residence and the amount of the liens and any impairment of the exemption. In re Glenn, 160 B.R. 837 (Bankr. S.D. Calif. 1993).

HOMESTEAD. Seven years before filing for bankruptcy, the debtor transferred a residence to a business associate in an attempt to shield the house from tax liens. The debtor continued to have possession and control over the property and made the payments on loans secured by the property. The court held that the transfer was fraudulent given the attempts to hide the true nature of the transaction and the transfer was made when the debtor was insolvent; therefore, the debtor was denied the use of the homestead exemption for fraudulent pre-bankruptcy planning. The court rejected any requirement that the fraud occur in contemplation of filing bankruptcy; therefore, the fact that the fraud occurred seven years before the filing had no affect on the eligibility of the debtor for the exemption. In re Curry, 160 B.R. 813 (Bankr. D. Minn. 1993).

The debtor purchased an undivided interest in 150 acres of rural land owned by the debtor’s family. A portion of the land was platted and subdivided and offered for sale in units of one to five acres. The rest of the land was left idle with the intent to use it for further development once the platted portion was sold. The debtor conveyed 5.5 acres of the platted land to the debtor’s spouse and the couple built a house on the land for use as their residence. The debtor claimed the 5.5 acre residence, the debtor’s interest in the platted acres and the debtor’s interest in the unplatted acres as a rural homestead exemption under Tex. Prop. Code § 41.002(b)(1). The court held that the 5.5 acres was qualified for the homestead exemption but that the platted and unplatted property was not entitled to the exemption because the debtor’s intent to sell that property existed before the debtor established a residence on a portion of the land. In re McCain, 160 B.R. 933 (Bankr. E.D. Tex. 1993).

FEDERAL TAXATION-ALM § 13.03[7].*