Interest on Estate Taxes: A Comment

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Confusion pervades over the correct starting point for calculating refundable interest on overpayment of estate taxes

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In 1989, TRUSTS & ESTATES published an article by James E. Williamson describing how certain interest paid with additional assessments of federal estate tax can be a deduction that is available for administrative expense.¹ Nathan Oestreich and Mr. Williamson subsequently expanded this idea in an article on computing such a deduction for interest paid to the Internal Revenue Service (IRS), when making payments of interest and taxes arising from a federal estate tax audit, or when a federal estate tax return has been amended.² Both articles, however, failed to comment on the calculation of an interest refund due the estate when the IRS audit, or amended return, resulted in an overpayment of interest and taxes. This omission apparently caused some confusion. We have been contacted by estate representatives seeking refunds, stating the IRS examiners referred them to these articles for a correct starting point when calculating the interest refundable on estate tax overpayments.³

Since neither article addressed the calculation of refundable interest on estate tax overpayments, apparently some people assumed the same logic and circular calculation formulas that applied to the calculation of interest payable also applied to refundable interest. The correct starting point to determine the refundable interest, however, does not depend on the same logic and circular calculation. As illustrated in the Oestreich and Williamson article, this calculation is necessary to simultaneously determine the amount of additional estate tax due and the deductible interest payable. This comment is an attempt to clear up any misconception that the same logic and mathematical formulas should be used for calculations of refundable interest on estate tax overpayments.

More specifically, we wish to point out that the correct starting point for calculating both interest due and interest receivable is, indeed, the final estate tax liability. However, the determination of this final tax liability depends upon the amount of deductible interest payable which requires the simultaneous circular calculation. Any deductible interest payable is part of the simultaneous circular calculation, but any subsequent refundable interest is not. In sum, once the final estate tax liability has been established, the correct amounts of both interest payable and interest refundable can be calculated starting from the due date of the federal estate tax return.

This article, will illustrate the entire conceptual approach, and will:

1. Re-examine the justification for the interest deduction and the logic underlying the circular calculation of the deduction;
2. Re-examine the original Oestreich-Williamson circular calculation example;
3. Introduce payments to the IRS resulting in taxes and interest refunds when the IRS audit is finalized; and,
4. Show that both the interest payable and interest refundable can be calculated from this final estate tax liability, starting from the due date for filing the federal estate tax return.

The Deduction For Interest Paid

As described in the original Williamson article, because of the phase out of the deduction for personal interest, administrators of estates are claiming the deduction for postdeath interest on income tax, gift tax and estate tax deficiencies as necessary administrative expenses that are deductible to the extent allow-
able under local law. This idea was illustrated by Oestreich and Williamson with a simplified example.

In the original example, a California resident died July 1, 1987. The original federal estate tax return for his estate was filed on March 31, 1988, showing a net taxable estate of $12 million. The tax paid at that time was:

Unified transfer tax $6,340,800
Unified credit (192,800)
State death tax credit (1,386,800)
$4,761,200

The audit of the federal estate tax return was finished March 31, 1990. The IRS proposed the following tax increase based on a net increase of $1 million in adjustments to the decedent's estate:

Additional unified transfer tax (less)
Additional state death tax credit:

$600,000
- (160,000)
$440,000

Since the final settlement of the audit was past the due date for filing the federal estate tax return, interest must be paid with the additional tax. It first appeared, the payment would be increased by approximately 25 percent, or $110,000, bringing the entire federal payment to $550,000. The California pick-up tax also gave rise to potential interest of about $40,000. At this point, total additional federal and California payments, including interest, equaled:

$750,000 (440,000 + 110,000 + 160,000 + 40,000)

However, electing to treat the interest accruing with the estate tax deficiency as an administrative expense deductible from the gross estate not only reduced the tax deficiency by the marginal unified transfer tax rate, but also reduced the amount of interest payable with the deficiency. Consequently, the reduction in the interest expense increases the tax deficiency (since the taxable estate will be increased by the decrease in the interest deduction). This, in turn, increases the tax and, thus, the interest due, leading to an apparently endless circular calculation.

In the original example, these seemingly complex calculations were solved simultaneously with four equations, to find the correct amount of:

1. additional federal tax due;
2. additional state tax due;
3. additional federal interest due; and,
4. additional state interest due.

The Circular Calculation Problem

The first step was to insert the figures from the audit changes along with the appropriate tax rates and interest rates into the four equations:

1. AFT - .60(1,000,000 - FI - SI) - ASDTC
2. ASDTC = .16(1,000,000 - FI - SI)
3. FI = .25(AFT)
4. SI = .25(ASDTC)

The first two equations were rewritten as:

5. AFT - .60(1,000,000 - .25AFT - .25ASDTC) - ASDTC
6. ASDTC = .16(1,000,000 - .25AFT - .25ASDTC)

The simultaneous solution of these equations resulted in:

7. AFT = 382,609
8. ASDTC = 139,130

Then, inserting the solutions from steps 7 and 8 into equations 3 and 4:

9. FI = .25(382,609) = 95,652
10. SI = .25(139,130) = 34,783

Once the amounts of the tax deficiencies and interest due were determined, a comparison was made of the additional federal and state estate taxes that would be due on the decedent's estate with and without the interest taken as a deduction from the gross estate. (See Exhibit 1 on the following page.)

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Overpayment Of Estate Taxes
In the example above, it was assumed that all additional taxes and interest would be paid only upon completion of the IRS audit (exactly two years after the due date of the return). Therefore, the example did not include the calculation of an interest refund. Because, this comment addresses the correct starting point for the calculation of an interest refund, we now will assume, using the same example, that on March 31, 1989, $500,000 was paid to the IRS and $200,000 was paid to the California Secretary of State. This assumption creates an overpayment of both taxes and interest where the IRS audit is completed on March 31, 1990.

We will now re-calculate the federal and state estate tax deficiencies and the related interest due. The only changes are that interest will accrue only until the tax payments exceed the liabilities for both tax deficiencies and interest (in this case, one year). With these changes, the equations become:

1. AFT = .60(1,000,000 - FI - SI) - ASDTC
2. ASDTC = .16(1,000,000 - FI - SI)
3. FI = .118AFT
4. SI = .118ASDTC

The first and second equations become:

5. AFT = .60(1,000,000 - .118AFT - .118ASDTC) - ASDTC
6. ASDTC = .16(1,000,000 - .118AFT - .118ASDTC)

A simultaneous solution of these two equations results in:

7. AFT = 410,908
8. ASDTC = 149,421

The above solutions to steps 7 and 8 can be inserted in equations 3 and 4:

9. FI = .118(410,908) = 48,487
10. SI = .118(149,421) = 17,632

We can now calculate the amount of the refund claims at March 31, 1990. (See Exhibit 2.)

**Proof Of Interest Calculation**
Now we can demonstrate that the correct starting point for both the interest payable and interest refundable is the final tax liability and the
due date of the federal estate tax return.

1. The deductible federal interest payable as of March 31, 1989:

   (Final tax liability x federal interest rate)

   410,908 x .118 = 48,487

2. The deductible state interest payable as of March 31, 1989:

   (Final tax liability x state interest rate)

   149,421 x .118 = 17,632

Since interest accrues continuously (positive or negative), the calculation of interest payable stops on March 31, 1989, when there are overpayments and the calculation of interest receivable begins. Therefore, the calculation of both federal and state interests receivable are:

3. The refundable federal interest at March 31, 1990:

   (Overpayment at March 31, 1989 x federal interest rate)

   40,605 x .118 = 4,791

4. The refundable state interest at March 31, 1990:

   (Overpayment at March 31, 1989 x state interest rate)

   32,947 x .118 = 3,888

Conclusion

In summary, we have discussed the correct starting point for the calculation of refundable interest on overpayments of estate tax. The article attempts to clarify some confusion regarding this calculation when there was a predecessor period requiring a circular calculation of deductible interest expense and estate taxes due. As illustrated in the example, the correct starting point for calculations of both interest due and interest receivable is the final audited estate tax liability.

FOOTNOTES


3. One specifically stated, "I was referred to this article due to some complications encountered in a claim for refund we filed with the Internal Revenue Service." He added, "The IRS claims we erred in filing this claim, in that for purposes of computing interest accrued on the account, we started with the final audited estate tax liability... when interest was to start accruing on... (the due date of the return)." He then concluded, "I understand this final liability may not be the correct starting point for calculating the interest on the overpayment of taxes, but I am not sure how to determine the starting point. Without the interest deduction, the tax liability would have been increased (by some amount), but this also would not be a correct starting point." See "A New Deduction is Available," supra note 1 at 59, Rev. Rul. 79-252, 1979-2 C.B. 353; Rev. Rul. 69-402, 1969-2 C.B. 176; see also 1977-2 C.B. 2 and 3 acquiescing in Estate of Webster v. Comm'n, 65 T.C. 968 (1976).


5. California is a pick-up state tax, this amount would be paid to the Secretary of State.

6. The 5 percent surtax brings the effective marginal rate to 80 percent.

7. The federal and state interest rates assessed with tax deficiencies change every quarter. For purposes of their illustration, Oestreicher and Williamson assumed the federal interest rate to be about 25 percent for two years, or approximately 11.5 percent compounded annually.


9. See "Interest on Estate Taxes," supra note 2 at 18. The four equations were given as:

   1. AFT = MFTRNAC - FI - SI - AS-DTC
   2. AS-DTC = MSTRNAC - FI - SI
   3. FI = FIR/AFT and,
   4. SI = SIR/AS-DTC.

   Where:

   AFT = additional federal estate tax
   MFTR = marginal federal tax rate
   MSTR = marginal state tax rate
   NAC = net audit changes
   AS-DTC = additional state death tax credit
   FI = interest due with additional federal estate tax
   SI = interest due with additional state estate tax
   FIR = federal interest rate
   SIR = state interest rate

   11. Id. at 19.
   12. Id.
   13. Id.
   14. Id.
   15. Id.

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