Kentucky Inheritance Tax

Kentucky Department of Revenue



Questions to Address

- How do I interpret **KRS 140.063**?
- Are **Real Estate Selling Expenses** allowable as a deduction?
- Are **Trustee Fees** an allowable deduction?
- How do I recognize and compute a **Bequest of Tax**?
- How is **Power of Appointment Property** treated?

Assets cannot be reported at alternate value.

Assets are to be reported at date of death value pursuant to KRS 140.010. The Department does not allow for alternate value, unless real estate qualifies for agricultural value pursuant to KRS 140.300 – 140.360.

Be sure when valuing IRAs and brokerage accounts you include all assets in the account and report them at date of death value.

- Don’t forget cash from the total portfolio value.
- Don’t forget accrued interest on bonds and/or accrued dividends.
- Don’t forget annuities held in or reported with the account.
- Remember, stocks are reported at their fair cash value as of the date of death. Stock values are determined by using an average of the high and low quoted selling price on the decedent’s date of death. If the date of death is on a day the stock exchanges are closed, average the high and low for the last working day preceding the date of death and the first working day after the date of death.

How do I interpret KRS 140.063 – Exemption of annuities or other payments under employees' trusts; retirement annuities; individual retirement bond, accounts, and annuities?

Per KRS 140.063(1)(a), tax on an annuity or profit-sharing plan is based on whether the annuity or profit-sharing plan is a qualified or non-qualified plan under the Internal Revenue Code applicable provisions. If the annuity or profit-sharing plan is a qualified plan, Kentucky calculates the tax on the value of the decedent's contribution to the plan at the date of death.

The employer's contribution to the plan is not taxable. If the annuity or profit-sharing plan is a non-qualified plan, tax is calculated on the total value of the plan.

KRS 140.063 - Subsections (1) and (2) of KRS 140.063 are applicable to:

- Retirement plans that qualify for exemption under Section 401(a) and 403(a) of the Internal Revenue Code;
- Retirement annuity contracts purchased by employers which are educational organizations or charitable organizations as defined under Section 170(b)(1)(A)(ii) or (vi) of the Internal Revenue Code;
- Retirement annuity contracts purchased by employers which are religious organizations (other than a trust) exempt from federal income tax under Section 501(a) of the Internal Revenue Code; and
- Retirement annuity contracts purchased by the Department of Defense for members of the armed forces as provided under the United States Code Title 10, Chapter 73.

KRS 140.063 - Subsections (3) and (4)

Pursuant to subsection (3) of KRS 140.063, the value of an annuity received by beneficiaries from individual retirement accounts and individual retirement annuities (IRAs) and retirement bonds, described under Internal Revenue Code Sections 408(a), 408(b), and 409(a) are exempt from inheritance tax, with certain restrictions as provided under subsection (4).

KRS 140.063 Subsection (4) defines the term “annuity” as:

An annuity contract or other arrangement providing for a series of substantially periodic payments to be made to a beneficiary (other than the executor) for his or her life or over a period extending for at least thirty-six (36) months after the date of the decedent’s death.

KRS 140.063 - Subsection (4) can be summarized as restricting the exclusion in two ways:

- It restricts the exclusion amount to the amount the participant (the Decedent) was allowed a deduction for income tax purposes (under Sections 219/220 of the Internal Revenue Code unless the IRA is from a “rollover” contribution); and
- It restricts the exclusion to certain arrangements that qualify as an “annuity” under the statute because it meets certain distribution requirements.

KRS 140.063 - The provisions in subsections (5) and (6) furnish the guidance we need to properly interpret the meaning of the term "annuity" defined in subsection (4).

What is meant by a series of substantially equal periodic payments?

- Payments are "periodic" if they are made at regular intervals. Payments are considered periodic only if an option providing for periodic payments is elected not later than the date the inheritance tax return is due.
- Payments are considered "substantially equal" even though the amounts received by the beneficiary may vary. Payments are not considered "substantially equal" if more than 40% of the total amount payable to the beneficiary is payable to the beneficiary in any 12-month period.

Payments must be for the beneficiary's life, or for a period extending at least 36 months after the date of the decedent's death.

KRS 140.063 - What beneficiaries can take this exemption?

- They are **named beneficiaries** to the account;
- they received the IRA as a **specific bequest**; or
- they received the IRA as **residue** per intestate law, a will, or a trust agreement.

KRS 140.063 - How can the IRA be paid out to the beneficiary in a series of substantially equal periodic payments extending for at least thirty-six (36) months and still be exempt?

- They can be paid from the **decedent's existing IRA** account;
- rolled over into an **inherited IRA** and paid out; or
- rolled over into the **beneficiary's IRA** and paid out.

KRS 140.063 – Things to note:

- If the beneficiary elects to have the IRA paid out to them in a **lump sum**, it is **fully taxable**.
- If the beneficiary takes **no distributions** from the IRA, it is **fully taxable**.
- If the beneficiary decides to take **unscheduled distributions** from the IRA, it is **fully taxable**.
- If the beneficiary **does not provide appropriate documentation from the custodian of the IRA** on how the IRA will be paid out, it is **fully taxable**.

Transfers intended to take effect at death and gifts given within three (3) years:

All **Transfers** intended to take effect at death, including those transfers in which the transferor has retained possession, enjoyment, income, or other powers over transferred property, are taxable, regardless of when transferred, except in the case of a bona fide sale for an adequate and full consideration in money or money's worth, pursuant to KRS 140.020(1). The common terminology is "retained life interest" and usually involves real estate.

Transfers and gifts (continued) –

- **Gifts** given within three years of death generally are taxable.
- **Transfers** made by the decedent in contemplation of, or intended to take effect at or after, the decedent's death are subject to Kentucky's inheritance tax, pursuant to KRS 140.020(1).
- Further, all **Gifts** and **Transfers** of property made by the decedent within three years prior to death are presumed to have been made by the decedent in contemplation of death, unless proof is furnished to the contrary.

  Reference KRS 140.020(2)

A transfer or gift is subject to inheritance tax if:

- The transfer was made within three years of the date of death;
- The transfer was a material part of the estate or was made in a final disposition or distribution of the estate; and
- An adequate, valuable consideration was not furnished by the donee.

How may a gift given within three years of the date of death not be taxable?

- There is an established pattern of gift giving of more than three years of the date of death.
- The gift was given for a living reason.

Note: If the estate believes a gift is not taxable, a written statement with documentation must be submitted with the return rebutting the presumption of death.

Incorrect distribution of Qualified Terminable Interest Property (QTIP) - KRS 140.100(4)

At the death of the surviving spouse, the value of the property is included in the **QTIP Property Schedule** after being reduced by any applicable expenses because of the property's inclusion in the surviving spouse's estate.

The tax due from each beneficiary of the property is calculated by combining the distributive share received from the first spouse's estate, if any, and the beneficiary's share of the **QTIP Property** included in the **QTIP Property Schedule**.

The result is reduced by any tax previously paid by the beneficiaries in the first spouse's estate, including any discount earned.

QTIP (continued) –

It is the long-standing practice of the Department to compute the inheritance tax based on the relationship of the beneficiaries receiving the remainder interest of the **QTIP Trust** to the decedent - either from the first estate or from the second estate.

The Department's practice is to allow the closest relationship to be used that generates the least amount of tax.

Note: The distribution of the **QTIP Property** is reported separately from the distribution of the property of the second estate. You could have two distributions for the same person.

Administration Expenses

If **Administration Expenses** are deducted on the Kentucky Inheritance Tax Return, they cannot be taken as deductions on the Kentucky Fiduciary Income Tax Return, Form 741. They may only be deducted on one return or the other, not both.

These expenses would include attorney's fees, personal representatives' commission, real estate taxes, real estate selling/closing costs, etc. See KRS 141.900(11)(d)(1)(b) and (11)(d)(2) for taxable years beginning prior to January 1, 2018, and KRS 141.017(2) and KRS 141.019(2)(f).

Are Real Estate Selling Expenses allowable as a deduction on the return?

Expenses related to the sale of real estate may be deductible as costs of administration if the decedent's last will and testament directs the executor to sell the property.

If the will does not direct the executor to sell the real estate, or the will gives the executor the discretion to sell the property, the executor should provide the Department of Revenue with a copy of the Court's Order permitting the sale that also includes **the reason the sale was necessary**.

Real Estate Selling Expenses (continued) –

The Department will determine if the reason given made the sale of the property necessary. See KRS 140.090(1)(h). Expenses related to the sale of real estate held by a trust are not deductible on the inheritance tax return. Such expenses are considered expenses of the trust, not the estate.

Allowable Deductions for inheritance tax purposes are governed by KRS 140.090. In calculating the value of the distributive shares, the following deductions and no others shall be allowed:

a) Debts of the decedent, except debts secured by property not subject to the tax jurisdiction of Kentucky; and except debts barred by the statute of limitations;

b) Taxes accrued and unpaid, except those on property not subject to the tax jurisdiction of Kentucky;

c) Death duties paid to foreign countries;

d) Federal estate taxes, in the proportion which the net estate in Kentucky subject to federal estate taxes bears to the total net estate everywhere subject to federal estate taxes; all calculations are subject to approval by the Department of Revenue;

Allowable Deductions (continued) –

e) Drainage, street, or other special assessments due and unpaid which are a lien on said property;

f) Funeral, monument, and cemetery lot maintenance expenses actually paid not exceeding in total five thousand dollars ($5,000);

g) Commission of executors and administrators in the amount actually allowed and paid;

h) Cost of administration, including attorney's fees actually allowed and paid.

Note: Are **Trustee Fees** an allowable deduction on the return? **No.** KRS 140.090 authorizes a deduction for the commission of the executor or administrator in the amount actually allowed and paid, and for costs incurred in the administration of the estate, including attorney fees actually allowed and paid, but this would not include any amounts paid for the administration of a trust, which exists independently from the decedent's estate, regardless of how that trust was funded.

Disclaimers of Transfers at Death Pursuant to KRS 394.610 – 394.680

If a beneficiary disclaims a bequest made by the decedent in the will, the bequest passes to the beneficiary's issue pursuant to KRS 394.400, unless the Will provides for a contingency. If no contingency or issue, the bequest is included as part of the residuary estate pursuant to the will – KRS 394.500.

Note: The Disclaimer must be filed with the district court within nine (9) months of the decedent's date of death.

Disclaimers of Transfers Under Non-Testamentary Instruments Pursuant to KRS 394.035

If a beneficiary disclaims an interest in jointly owned property, either in part or in whole, the interest passes as if the beneficiary was never a joint owner pursuant to KRS 394.035(3). Unless the non-testamentary instrument or contract provides for another disposition, the interest will pass pursuant to the terms of the Will.

Note: The Disclaimer must be filed with the trustee or the custodial institution within nine (9) months of the decedent's date of death.

Bequest of Tax

How do I know the decedent has bequeathed a Bequest of Tax?

The key is in the wording of the tax-exoneration clause in the will and/or trust agreement. Based upon our longstanding practice, for a bequest of tax to exist, the will or trust must contain wording such as, “pay inheritance taxes out of the residue of my estate (trust)” or “pay inheritance taxes out of my estate (trust).”

The **key words** are “inheritance taxes” and “from the residue of my estate (trust)” or “out of my estate (trust).”

If the will says, “pay taxes,” “pay death taxes,” “pay estate taxes,” or “pay any taxes resulting by reason of my death,” this is not a bequest of tax. If the will directs inheritance taxes be paid but does not state the taxes are to be paid from the residue/estate, a bequest of tax does not exist.

Bequest of Tax (continued) -

How do I compute a Bequest of Tax?

Pursuant to the Kentucky Supreme Court decision in Estate of McVey v. Dep't of Revenue, 480 S.W.3d 233 (Ky. 2015), the bequest of tax is to be computed on all specific bequests, gifts, and/or survivorship property before calculating any residual distribution(s).

When the computation of the bequest of tax is involved, the beneficiary's distributive share includes any specific bequest(s), other property passing directly to the beneficiary because of the wording of an instrument, and the bequest of tax. The effect of the bequest of tax is to reduce the amount of residue passing to the residuary beneficiaries.

The taxable estate is not enlarged or diminished because of the bequest of tax; it simply involves a diversion of benefits or funds from the residuary beneficiaries to the specific beneficiaries. The person(s) receiving a specific bequest will receive the full bequest (along with other property passing directly to him or her) as directed in the will without any reduction from taxes.

Bequest of Tax (continued) -

Bequest of Tax Example

You have a net estate that is valued for $100,000.00. The estate has a payable on death (POD) bank account for $40,000.00 that passes to the Son. The Will makes two specific bequests: $20,000.00 to the Daughter-In-Law and $10,000.00 to the Cousin, and the residue passes to the Son and Daughter-In-Law. The Will directed that the inheritance taxes be paid from the residue.

Son – Received (POD) Bank Account for $40,000.00

Since he is a class A beneficiary, there is no tax on $40,000.00. Therefore, his bequest of tax is $0.00.

Bequest of Tax (continued) -

Daughter-In-Law – Received a bequest for $20,000.00

Tax on $20,000.00 bequest	$ 860.00
Tax on $860.00 at 6%	51.60
Tax on $51.60 at 6%	3.096
Tax on $3.096 at 6%	0.18576
Tax on $0.18576 at 6%	0.0111456
Tax on $0.0111456 at 6%	0.000668736
Bequest of Tax	$ 914.89
Bequest	20,000.00
Total Bequests	$20,914.89

Bequest of Tax (continued) -

Cousin – Received a bequest for $10,000.00

Tax on $10,000.00 bequest	$ 570.00
Tax on $570.00 at 8%	45.60
Tax on $45.60 at 8%	3.648
Tax on $3.648 at 8%	0.29184
Tax on $0.29184 at 8%	0.0233472
Tax on $0.0233472 at 8%	0.001867776
Tax on $0.001867776 at 8%	0.00014942208
Bequest of Tax	$ 619.57
Bequest	10,000.00
Total Bequests	$10,619.57

Bequest of Tax (continued) -

Compute the Residue

Net Estate		$100,000.00
Less Son's POD Account	$40,000.00	
Less Daughter-In-Law's Bequests	20,914.89	
Less Cousin's Bequests	10,619.57	
Total POD & Bequests		- 71,534.46
Residue		$ 28,465.54

Note: There is no bequest of tax on residue.

Bequest of Tax (continued) – Distributive Shares

Son		
POD Bank Account	$40,000.00	
One-Half Residue	14,232.77	
Total Distributive Share		$ 54,232.77
Daughter-In-Law		
Bequest	$20,000.00	
Bequest of Tax	914.89	
One-Half Residue	14,232.77	
Total Distributive Share		$ 35,147.66
Cousin		
Bequest	$10,000.00	
Bequest of Tax	619.57	
Total Distributive Share		$ 10,619.57
Total Distributive Shares		$100,000.00

Does the Department recognize settlement agreements or agreed orders?

- Generally, settlement agreements between heirs, including nonjudicial settlement agreements among beneficiaries altering beneficial interests in a trust made subsequent to the decedent's death, are not controlling for inheritance tax purposes.
- However, if a decedent's will is declared invalid by a court, an order by the court settling the distribution issues among the heirs will govern the proper distribution for inheritance tax purposes.
- In addition, in cases where the decedent's last will and testament is ambiguous, a district court order determining the decedent's intent will govern for inheritance tax purposes.

See Cochran's Executrix and Trustee v. Commonwealth, 44 S.W. 2d 603 (Ky. 1931).

Can I Get a Copy of a Previously Filed Inheritance Tax Return?

Yes, but you must be entitled to a copy of the return, and the request must be made in writing. Entitled individuals are representatives of the estate and include the attorney, tax preparer, personal representative and beneficiary who receives residue. Also, the representatives of a beneficiary's estate may be entitled to a copy of the return.

Note: In general, an inheritance tax return is retained for twenty (20) years from the date the acceptance letter is issued, before being destroyed.

Taxation of a Power of Appointment (POA) for Deaths Occurring Prior to July 15, 2024

The taxation of a POA relating to deaths prior to July 15, 2024, are governed by the prior version of KRS 140.040.

- Any transfer by means of a POA (general or non-general) which passes to the donee at the death of the donor is subject to inheritance tax at the time of the death of the donor.
- The assessment is made at that time against the life interest of the donee and the remainder against the corpus.
- The value of the property to which the POA relates is determined as of the date of the death of the donor and taxed at the rates and applicable exemptions in effect at the death of the donor.
- The determination of the applicable rates and exemptions are governed by the relationship between the beneficiary to the donee.

Note: In the event an exemption authorized at the death of the donor is no longer available at the death of the donee, then the exemption shall be retrospectively disallowed at the death of the donee; and the remainder interest passing under the donee's POA, whether exercised or not, is added to and made a part of the donee's estate for purposes of determining the exemption and tax rates.

Taxation of a General Power of Appointment (POA) for Deaths Occurring on or After July 15, 2024

The taxation of a general POA relating to a death on or after July 15, 2024, is governed by the current version of KRS 140.040 enacted during the 2024 legislative session and made effective July 15, 2024.

- Effective for deaths on or after July 15, 2024 “power of appointment” is defined to mean only a general power of appointment and to exclude a limited or special power of appointment as defined under the statute and interpreted as nearly as practicable as defined under 26 U.S.C. sec. 2041.

- The POA is deemed a taxable transfer as if the property to which the POA relates belonged absolutely to the donee of the power and had been bequeathed or devised by the donee by will, regardless of whether the POA is exercised.

- The POA which passes to the donee at the death of the donor under any instrument is deemed to occur at the death of the donor. The assessment is made at that time against the life interest of the donee and the remainder against the corpus. The value of the property is determined as of the date of the death of the donor. The donee of the property is taxed at the rates and exemptions in effect at the death of the donor.

General POA for Deaths Occurring on or After July 15, 2024 (continued) –

- The determination of the applicable rates and exemptions are governed by the relationship between the beneficiary to the donee.

  Note: In the event an exemption authorized at the death of the donor is no longer available at the death of the donee:
  - the exemption shall be retrospectively disallowed at the death of the donee; and
  - the remainder interest passing under the donee's POA, whether exercised or not, is added to and made a part of the donee's estate for purposes of determining the exemption and tax rates.

- In all other cases, a transfer of a POA is deemed to take place at the death of the donee; the value of the property to which the power relates is determined as of the date of death of the donee; and the applicable rates and exemptions in effect at the death of the donee are governed by the relationship of the beneficiary to the donee of the POA.

The Exercise or Non-Exercise by the Donee of a Non-General Power of Appointment (Non-General POA) is No Longer a Taxable Transfer for Deaths Occurring on or After July 15, 2024

A POA that is limited by an ascertainable standard relating to the health, education, maintenance, and support of the individual holding the power of appointment; or

exercisable only by the individual holding the power of appointment in conjunction with another person having a substantial interest in the property subject to the power which is adverse to the exercise in favor of the individual holding the power, the individual's estate, creditors, or the creditors of the individual's estate, is a non-general power of appointment (Non-General POA).

Non-General POA for Deaths Occurring On or After July 15, 2024 (continued) –

- The exercise or non-exercise by the donee of a Non-General POA is no longer deemed a taxable transfer subject to inheritance tax under KRS 140.040 for deaths occurring on or after July 15, 2024.
- Estates in expectancy which are contingent or defeasible relating to a Non-General POA are subject to inheritance tax as provided by KRS 140.110.
- In cases of estates in expectancy which are contingent or defeasible, the tax is levied at the rate (or exempted) which, on the happening of the most probable contingencies or conditions named in the decedent's will or other instrument, would be applicable. Applicable exemptions and tax rates are based on a beneficiary's relationship to the decedent.

INHERITANCE TAX DISCLAIMER

The information in this presentation is for educational and informational purposes only and does not constitute legal advice. Information is presented generally and is subject to law changes. The inheritance tax statutes may be found at Kentucky Revised Statutes (KRS) 140.010 *et seq*.

Information in this presentation is believed to be accurate as of the date of publication. However, any statement in error that may occur during presentations made by the Department of Revenue as part of its tax education program shall not expressly or impliedly supersede the Department of Revenue's official interpretation of the law or its policies utilized in administering state revenue and tax laws.

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