Kentucky Inheritance Tax: Pitfalls & Planning Opportunities

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Kentucky is one of six states—soon to be five—which imposes an inheritance tax. An inheritance tax is a tax on a beneficiary's *right to receive property* from a deceased person. The more distant the relationship between the deceased person and the beneficiary, the higher the tax rate. Contrast this with the better known estate tax, which is a tax based on the value of the property owned by a deceased person at their death.

Some, particularly non-exempt beneficiaries, may argue that Kentucky's imposition of an inheritance tax makes us unusual in a bad way (hence the proposed House Bill 308 which, if passed in its current state, would repeal the inheritance tax for those dying after August 1, 2024). Regardless of one's thoughts on the virtues of the tax, attorneys, executors and beneficiaries should all make sure they have a cursory understanding of the tax in order to avoid cumbersome estate administrations, unnecessary penalties and interest payments, and disgruntled clients.

Kentucky Inheritance Tax: Brackets and Beneficiaries

Kentucky Revised Statutes Chapter 140 creates the Kentucky inheritance tax. As with many tax statutes, KRS 140 is clunky and difficult to comprehend on first read (and on second read, and third read for this author). Fortunately, the Kentucky Department of Revenue has a plethora of helpful materials available online at *www.revenue.ky.gov*.

The amount of inheritance tax owed is dependent on the relationship between the beneficiary inheriting the property and the deceased person who owned the property at their death. The more distant the relationship, the higher the tax bracket. Kentucky divides beneficiaries into three classes: Class A (fully exempt), Class B (less exempt) and Class C (least exempt). **Class A** beneficiaries consist of spouse, parent, children (biological, step and adopted), grandchildren (can be issue of biological child, adopted child or stepchild), siblings (whole or half), and educational, religious and charitable institutions. **Class B** beneficiaries consist of nieces and nephews (half or whole), children-in-law, aunts, uncles and great-grandchildren (issue of biological, step or adopted child). **Class C** beneficiaries – the highest bracket – consists of everyone else not listed in Class A or Class B.

Class B beneficiaries hit a top marginal tax rate of 16% on inheritances of $200,000 or more, and Class C beneficiaries hit the top marginal tax rate of 16% on inheritances of $60,000 or more. For example, a $200,000 inheritance left to a nephew would incur a $22,960 inheritance tax liability, and a $200,000 inheritance left to a cousin would incur a $28,670 inheritance tax liability. These are significant tax liabilities which should be discussed with i) clients during the estate planning process, and ii) executors/administrators and beneficiaries during the estate administration process.

Pitfalls and Planning

Attorneys should make sure they are having detailed conversations with their clients regarding potential Kentucky inheritance tax liability. First, many clients may be surprised to learn that Kentucky imposes an inheritance tax, and some may alter how their estates are to be distributed once they are informed of the tax. Clients could be rightfully upset to learn that a significant portion of their estates could wind up in the hands of the Kentucky Department of Revenue simply due to the nature of the relationship between the client and the intended beneficiary. Many have closer relationships to nieces, nephews, cousins or more distant relatives than they do to their parents or siblings, and they would be justified in feeling that they are being arbitrarily penalized for these relationships. Better that the client have this conversation with their counsel prior to executing their Wills than for the client to learn of this information after the fact from a third party.

Second, the attorney and client should discuss how the client would like to handle payment of any inheritance tax liability. Generally, inheritance tax is paid *out of the share* received by a beneficiary. For example, if a cash bequest of $25,000 were left to a nephew (Class B beneficiary) a tax of $1,160 would be owed, so the nephew would ultimately receive $23,840 from the estate. However, some clients may want any inheritance tax liabilities to be paid as a *general debt* of the estate. Continuing with the example above, if the client included a provision in their Will for any inheritance taxes to be paid as a general debt of the estate, the nephew would receive the full $25,000 bequest, and the inheritance tax liability would be paid by the executor as a debt of the estate. How the client decides to allocate payment of inheritance tax has implications for how simple the administration of the estate will

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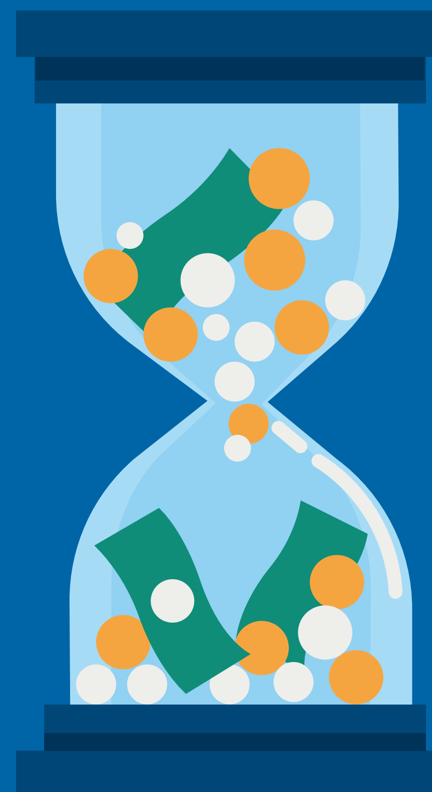

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be, as well as whether or not exempt residuary beneficiaries ultimately receive a smaller share of the estate in order to cover the taxes owed by a non-exempt beneficiary.

Additionally, clients should be informed of the three year look back rule. Any gifts made by a client to an otherwise non-exempt beneficiary within three years prior to the client's death – regardless of whether the client was making the gift for estate planning purposes or simply to be charitable to a friend – will be presumed to be made "in contemplation of death" and will incur inheritance tax liability. Transfers made more than three years prior to death can also be subject to inheritance tax if it is determined that such transfer was made "in contemplation of death."

Payment of Inheritance Tax

All property belonging to a resident of Kentucky is subject to the tax except for real estate located in another state. Also, real estate and personal property located in Kentucky and owned by a nonresident is subject to being taxed. If tax is owed, it must be paid within 18 months of the individual's death. However, if the tax is paid within nine months of death, a five percent discount is allowed, which can be significant, particularly if a majority of the estate passes to non-exempt beneficiaries. If payment is not made within 18 months, interest and penalties begin to accrue.

Absent language to the contrary, all executors and administrators (hereafter "personal representatives"), trustees, beneficiaries and heirs shall be personally responsible for the taxes until they are paid, but only to the extent that property from the estate come into their hands, and in no case shall the personal representative or trustee be liable for a greater amount than passes through their hands. KRS 140.190. Courts have held that this joint responsibility to pay the tax generally precludes personal representatives from liability to the beneficiaries for failing to timely pay the tax because, within certain limitations, the obligation to pay the tax is placed as much on the beneficiaries/heirs receiving the property as it is on the personal representative. *Motch's Ex'x v. Motch's Ex'rs*, 306 Ky. 334 (1948).

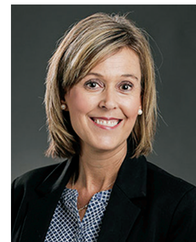
This joint obligation is particularly useful in situations where an individual with a minimal probate estate named a non-exempt individual as a transfer-on-death (TOD) beneficiary of a non-probate asset. For example, say an individual owned a $100,000 savings account at death, along with a $3,000 checking account. The individual, who never married or had children, named a friend as a transfer-on-death beneficiary of the savings account, while the checking account passed through the individual's probate estate. An inheritance tax of $12,670 will be owed on the transfer to the friend, though the probate estate only consists of $3,000. If the friend refuses to cooperate with the personal representative of the probate estate, the personal representative cannot be held responsible by the friend for either i) failure to obtain the nine month discount, or ii) failure to pay the tax at all.

Should a personal representative find themselves in a situation like the one above, the Kentucky Department of Revenue recommends the personal representative make a reasonable effort to collect the tax owed from the non-exempt beneficiary. If the non-exempt beneficiary refuses to cooperate, the Department advises that the personal representative should i) file the inheritance tax return, ii) pay any tax owed on any probate assets in the personal representative's hands passing to non-exempt beneficiaries, iii) list the non-probate asset passing to the friend on the return, and iv) make a note that the friend has not paid their share of the inheritance tax liability. The Department will then reach out to the friend to bill them individually for the tax owed. This prevents an uncooperative beneficiary from holding up the administration of the probate estate.

Last, inheritance tax owed as a result of certain qualified retirement plans, such as IRAs, can be avoided if certain requirements are met. Under KRS 140.063, an otherwise taxable IRA can avoid triggering inheritance tax if the receiving non-exempt beneficiary enters into an agreement with the custodian of the IRA to make "substantially equal periodic payments from the account over a period exceeding 36 months." Kentucky law states that this arrangement converts the IRA into an annuity, and annuities are exempt from Kentucky inheritance tax. To prove the above requirements are met, the Kentucky Department of Revenue requires written documentation from the beneficiary and the financial institution managing the IRA evidencing the agreement. Depending on the financial institution, obtaining these written materials can be effortless, impossible and anything in-between.

The Kentucky inheritance tax can serve as an unwelcome surprise to personal representatives, beneficiaries and attorneys who do not frequently practice in probate. To avoid unnecessary taxes and headaches, attorneys and clients should take a moment to familiarize themselves with our unusual tax regime.

Matthew Burnett, Dinsmore & Shohl, practices in the areas of estate, gift and income tax planning, asset protection planning, and estate (probate), trust, and guardianship administration. Burnett also advises individual and corporate fiduciaries regarding their responsibilities and liabilities, and beneficiaries regarding protecting and securing their interests in wills, trusts and powers of attorney.



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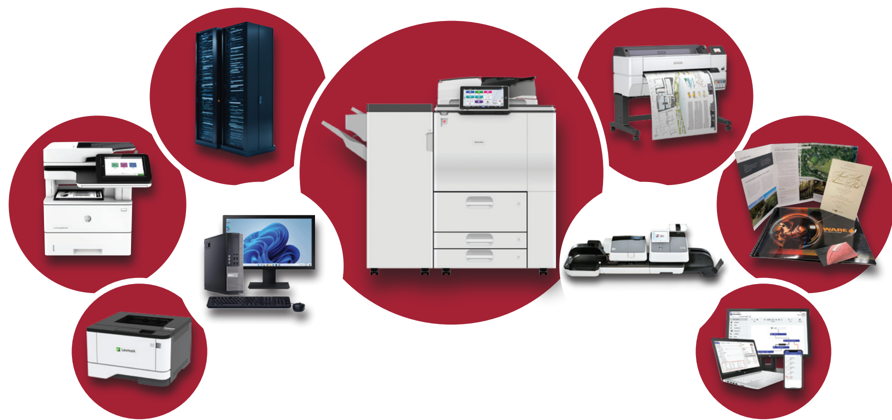

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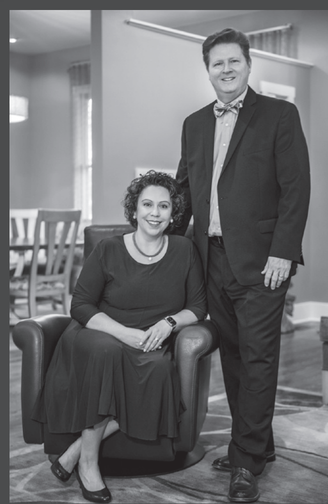

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