Preparing the PA Inheritance Tax Return

Charles Bender, Esq.
November 2, 2018
Summary of PA Inheritance Tax

• PA is one of the few states that still has an inheritance tax
  – NJ also has inheritance tax

• Most states adopted a pick-up tax tied to the federal state death tax credit
  – When credit was changed to a deduction, many states decoupled their state tax from federal rules
    • NY has a $5,250,000 exemption in 2018
    • NJ and DE repealed their estate taxes effective in 2018
    • PA and FL constitutions prevented decoupling
Summary of PA Inheritance Tax

• Applies to transfers of most assets at death
  – Cash
  – Securities
  – Real estate
  – Most retirement accounts
  – Joint assets
    • Other than joint with spouse
  – Revocable trusts
  – Tangible personal property
Summary of PA Inheritance Tax

• Exemptions
  – Life insurance
  – Certain retirement accounts

• Deductions
  – Funeral expenses and administrative costs
  – Debts of decedent, mortgages and liens

• Charitable bequests
  – Subtract from net value of estate to determine net value subject to tax
### Summary of PA Inheritance Tax

- **Tax rates:**

<table>
<thead>
<tr>
<th>Category</th>
<th>Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Spouse</td>
<td>0%</td>
</tr>
<tr>
<td>Children/grandchildren/parents</td>
<td>4.5%</td>
</tr>
<tr>
<td>Siblings</td>
<td>12%</td>
</tr>
<tr>
<td>All other beneficiaries</td>
<td>15%</td>
</tr>
</tbody>
</table>

Charitable bequests – effectively taxed at 0%
Summary of PA Inheritance Tax

- Tax return must be filed by 9 months after DOD
- Payment of tax is due with return
- 5% discount for tax paid with 90 days of DOD
Summary of PA Inheritance Tax

• Calculation of discount for early payment
  – Lesser of
    • Amount of tax paid divided by 19 and
    • 5% of actual tax due
  – You cannot overpay tax to get larger discount
  – In effect, estate earns 10% on the early payment
    • As long as estate is liquid, it makes economic sense to make prepayment
    • Beneficiary can lend estate money to prepay tax
Summary of PA Inheritance Tax

• There is no PA gift tax
• But gifts made within one year of death > $3,000 per calendar year are included in estate
• If gifts are spread over two calendar years, you can get two $3,000 exclusions
• Cautions:
  – Carryover basis for Federal income tax
    • Save 4.5% inheritance tax, but pay 20% + 3.1% capital gains
  – Gifts made under Power of Attorney
    • POA must authorize gifts
Summary of PA Inheritance Tax

• Differences between federal and PA rules
  – Life Insurance
  – Marital Deduction
  – Applicable Exclusion
  – Inclusion of joint property
    • PA uses % of ownership rule
    • Federal uses contribution rule
  – Joint property with spouse
    • Federal includes \( \frac{1}{2} \) and qualifies for marital deduction
    • PA does not report it at all
Summary of PA Inheritance Tax

• Who must file a PA Inheritance Tax Return
  – Resident decedent (Form Rev-1500)
  – Non-resident decedent who owned PA situs property (Form Rev-1737-A)
    • Real estate
    • Tangible personal property
    • Note – non-resident's intangible property not subject to tax
  – Nonresident Decedent Affidavit of Domicile (Rev-1737-1) – to be submitted with every Nonresident return
Summary of PA Inheritance Tax

• Domicile
  – The place where you live and have permanent home
  – You can only have one domicile
  – Subjective test – based on state of mind and intention
  – Objective factors used to show intent
Summary of PA Inheritance Tax

Domicile Factors

- Voter registration
- Driver’s license
- Auto registration
- EP documents
- Address used for credit cards, social security, passport, federal taxes
- State tax returns
- Bank relationships
- Health insurance
- Church / synagogue
- Club memberships
- Place of work
- Number of days in the state – 183 day rule
Summary of PA Inheritance Tax

• Domicile determines
  – Where you pay most taxes
  – Where you vote
  – Where your driver’s license is issued
  – Where Last Will and Testament is probated

• 183 day rule for income taxes
  – It is possible to be resident for income tax purposes and a nonresident for inheritance tax purposes
Summary of PA Inheritance Tax

• Changing Domicile Requires
  – Intention to adopt a new home
  – Relinquishing former home
  – An act of removal to the new home
• Burden of proof is on the taxpayer
• Establish as many favorable factors as possible
• Filing Declaration of Domicile
Preparing PA Inheritance Tax Return

• Page 1
  – Decedent Information
    • Name, DOB, DOD, SSNO, Spouse’s name
  – Fill in boxes
    • Original-supplemental return; 706 required
    • Agriculture/business exemption; living trust; spousal trusts
    • Future interest compromise; remainder return
    • Litigation proceeds; safe deposit boxes
  – Correspondent information
    • Attorney, executor or administrator
Preparing PA Inheritance Tax Return

• Page 2
  – Recapitulation - Assets
    • Schedule A – Real estate
    • Schedule B – Stocks and bonds
    • Schedule C – Closely held business interests
    • Schedule D – Mortgages/notes receivable
    • Schedule E – Cash, bank accounts and personal property
    • Schedule F – Joint property
    • Schedule G – Inter-vivos transfers and miscellaneous non-probate property
Preparing PA Inheritance Tax Return

• Page 2
  – Recapitulation - Deductions
    • Schedule H – Funeral expenses and administrative costs
    • Schedule I – Debts, mortgages and liens
    • Charitable and governmental bequests
    • Sole use trusts for surviving spouse
  – Tax calculation
    • Net value of estate taxable at each applicable tax rate
Preparing PA Inheritance Tax Return

• Page 3
  – Tax payments and credits
    • Prior payments and discounts
    • Balance due or overpayment
      – Check box at bottom of page 2 to request a refund
  – Specific questions
    • Transfers with retained interests
    • Transfers within one year of death
    • In trust for accounts
    • IRAs, annuities or other non-probate property
Preparing PA Inheritance Tax Return

- Schedule A – Real Estate
  - Report real estate owned individually or as tenants in common
    - JTWROS property goes on Schedule F
  - Valuation methods
    - Appraisal
    - Sales Price
    - Real Estate Tax Assessment
    - State Tax Equalization Board
      - Common level ratio
Preparing PA Inheritance Tax Return

• Schedule A – Real Estate
  – Expenses of sale – reported on Schedule H
    • Can only be deducted if actually paid – you cannot estimate
    • Suspend the valuation until property sells (15 months)
    • Pay tax and extend return for extra time to sell
      – File after property sells, even if late
  – Tax basis
    • Lower value may save inheritance tax
    • Higher value may save future capital gains tax
    • Federal versus PA valuation
      – Does PA value determine federal income tax basis
Preparing PA Inheritance Tax Return

• Schedule AU – Real estate used in agriculture
  – Exemption for transfers of real estate devoted to the business of agriculture to family members
    • Family includes lineal ancestors-descendants, siblings, aunt/uncles, nieces/nephews, and spouses of same
    • Agricultural use must continue for 7 years
  – Exemption for farmland, commodities, easements and reserves
    • These items do not have to be reported on return
  – Exemptions apply for decedents dying after 6/30/12
Preparing PA Inheritance Tax Return

• Schedule B – Stocks and Bonds
  – Securities owned individually or as tenants in common
    • JTWROS property goes on Schedule F
  – Value at the average of high and low on DOD
    • If DOD on weekend, average of Friday and Monday averages
  – Most brokerage houses will provide these values
  – Other commercial services provide the values
  – Savings Bond Calculator on treasury website
Preparing PA Inheritance Tax Return

• Schedule C – Closely Held Corps, Partnerships and Sole Proprietorships
  – Attach Schedule C-1 for corporations
  – Attach Schedule C-2 for partnerships
  – No schedule needed for proprietorships
  – LLC – use schedule based on how it is taxed
    • Corporation, partnership or disregarded entity
  – Attach supporting documentation
    • Tax returns, financial statements
  – Describe valuation method
Preparing PA Inheritance Tax Return

• Schedule C – Closely Held Corps, Partnerships and Sole Proprietorships
  – Consider having professional valuation prepared
    • It should include all of the relevant information for C-1 or C-2
  – Discounts may be appropriate
    • Minority
    • Lack of liquidity
    • Lack of control
    • Blockage
Exemption for QFOBIs

Section 2111(t) provides exemption from PA inheritance tax:

A transfer of a qualified family-owned business interest to one or more qualified transferees is exempt from inheritance tax

Applies to decedents dying on or after 7/1/2013
Preparing PA Inheritance Tax Return

Definition of QFOBI

- Sole proprietorship or interest in an entity carrying on a trade or business
  - Fewer than 50 employees
  - Net book value less than $5M
  - In existence for 5 years prior to decedent’s death
  - Wholly owned by decedent or decedent and QTs
  - Engaged in trade or business other than management of investments or income producing assets
Preparing PA Inheritance Tax Return

Definition of QT

- Husband and wife
- Lineal descendants
- Siblings and sibling’s lineal descendants
- Ancestors and ancestors siblings
- Added by Act 84 of 2016
  - Trusts for any of above family members
  - Spouses for any of the above family members
Preparing PA Inheritance Tax Return

Recapture Provisions

• QTs must continue to own QFOBIs for 7 years
• Must report QFOBI on inheritance tax return
• Each QT must file annual certification
• If QFOBI is no longer owned by QT
  – Tax will be due on the QFOBI
  – Tax becomes lien on assets of QT
  – Act 84 of 2016 makes liability “joint and several”
Preparing PA Inheritance Tax Return

Potential Tax Savings

- Depends on relationship of QT to decedent
- Suppose $5M business interest

<table>
<thead>
<tr>
<th>Relationship</th>
<th>Tax Rate</th>
<th>Tax Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Husband/wife:</td>
<td>$5M x 0%</td>
<td>$0</td>
</tr>
<tr>
<td>Child/grandchild:</td>
<td>$5M x 4.5%</td>
<td>$225,000</td>
</tr>
<tr>
<td>Brother/sister:</td>
<td>$5M x 12%</td>
<td>$600,000</td>
</tr>
<tr>
<td>All others:</td>
<td>$5M x 15%</td>
<td>$750,000</td>
</tr>
</tbody>
</table>
Preparing PA Inheritance Tax Return

Issues with Definition of QFOBI

• Sole proprietorship or interest in an entity carrying on a trade or business
  – Fewer than 50 employees
  – **Net book value less than $5M**
  – In existence for 5 years prior to decedent’s death
  – Wholly owned by decedent or decedent and QTs
Preparing PA Inheritance Tax Return

Net book value < $5M

- Inheritance tax is imposed on FMV of assets
- Book value bears no relationship to FMV
- Example:
  - Investment real estate purchased for $5M
    - $500K allocated to land; $4.5M allocated to building/improvements
    - Over time, building/improvements are fully depreciated
    - Over time, FMV of building appreciates to $10M
  - Book value = $500K; FMV = $10M
  - If ownership interest qualifies as QFOBI, $10M will be excluded from PA inheritance tax
Preparing PA Inheritance Tax Return

- In above example, tax savings would be:

<table>
<thead>
<tr>
<th>Relationship</th>
<th>Taxable Value</th>
<th>Tax Rate</th>
<th>Tax Savings</th>
</tr>
</thead>
<tbody>
<tr>
<td>Husband/wife:</td>
<td>$10M</td>
<td>0%</td>
<td>$0</td>
</tr>
<tr>
<td>Child/grandchild:</td>
<td>$10M</td>
<td>4.5%</td>
<td>$450,000</td>
</tr>
<tr>
<td>Brother/sister:</td>
<td>$10M</td>
<td>12%</td>
<td>$1,200,000</td>
</tr>
<tr>
<td>All others:</td>
<td>$10M</td>
<td>15%</td>
<td>$1,500,000</td>
</tr>
</tbody>
</table>
Preparing PA Inheritance Tax Return

Issues with Definition of QT

• Since trusts now can be QTs (Added by Act 84 of 2016)
  – Parent can put QFOBI in trust for a child
  – Decedent can put QFOBI in trust for spouse
    • QTIP/UCT planning with QFOBIs
    • Sole use trust is a QT
  – You can put QFOBI in living trust for yourself
Preparing PA Inheritance Tax Return

Other Issues

• Business purpose not just managing investments
  – Aimed at preventing decedent from putting cash in entity, buying securities and claiming exemption
  – FLP owning securities will not qualify as QFOBI
  – The statute does not specifically address business of real estate investments
    • Department of Revenue position is that business of owning and renting real estate does not qualify
    • May or may not be correct
Preparing PA Inheritance Tax Return

• Schedule D – Mortgages, Notes & Receivables
  – Generally list original and date of death balances
  – Discounts may be appropriate
    • Risk of non-payment
    • Interest rate discount or premium
Preparing PA Inheritance Tax Return

- Schedule E – Cash, Bank Deposits & Misc. Personal Property
  - Report individual and tenant in common accounts
    - JTWROS accounts go on Schedule F
  - Misc. Personal Property includes
    - Tangible personal property located in PA
      - Consider appraisals where appropriate
    - Wages unpaid at death
    - Accrued rents due unpaid at death
    - Tax refunds due
Preparing PA Inheritance Tax Return

- **Schedule F – Jointly Owned Property**
  - Report JTWROS assets
    - Do not show assets owned T/E & JTWROS with spouse
  - List joint owners at top of Schedule
  - List property at bottom of Schedule
  - Only Decedent’s % share of asset is taxable
  - Report assets made joint within 1 year on Schedule G
    - Can still qualify for $3,000 exclusion
Preparing PA Inheritance Tax Return

• Schedule G – Inter-Vivos Transfers and Misc. Non-Probate Property
  – List beneficiary and relationship for tax rate purposes
  – Retirement accounts
    • Exclusion for decedent under 59 ½ (because of 10% penalty)
    • Deferred comp or other arrangements may be exempt
      – Have to examine terms of arrangement
  – Revocable trust accounts
  – Transfers within one year of death
    • Subject to $3,000 exemption
Preparing PA Inheritance Tax Return

• Schedule H – Funeral and Administrative Costs
  – Funeral expenses include
    • Cost of funeral, including undertaker, flowers, burial clothes
    • Executor’s travel expenses
    • Burial plot
    • Monument
    • Amounts paid to clergy
    • Funeral luncheon and Shiva expenses
    • Cost of cremation
  – May be paid by family member and reimbursed
  – Prepaid arrangements are not deductible
Preparing PA Inheritance Tax Return

• Schedule H – Funeral and Administrative Costs
  – Administrative costs include
    • Executor/Administrator commissions
    • Attorney fees
    • Family exemption
    • Probate fees
    • Accountant fees
    • Return preparer fees
  – May be paid by family member and reimbursed
Preparing PA Inheritance Tax Return

• Schedule H – Funeral and Administrative Costs
  – Administrative costs include
    • Cost of maintaining estate property for a limited period
      – Liability insurance, real estate taxes
      – Utilities, lawn maintenance, snow removal
    • If real estate is part of residue of estate
      – Cost of sale are deductible if actually paid
        » Realtor commissions
        » Transfer taxes
        » Seller’s assist
        » Repairs and maintenance
    • If real estate is specifically devised, these expenses are not deductible
Preparing PA Inheritance Tax Return

• Schedule I – Debts, Mortgages & Liens
  – Unpaid bills as of DOD
  – Secured loans are deductible, even if asset securing loan is not included in estate
    • Mortgage on non-PA real estate is not deductible
  – Medical bills (if not reimbursed by insurance)
  – Real estate taxes due as of DOD
  – Income taxes due for year of death and earlier periods
  – Joint obligations deductible up to decedents share
    • ½ of mortgage on T/E real estate is deductible, even though property is not taxable
Preparing PA Inheritance Tax Return

• Schedule J – Beneficiaries
  – Taxable distributions
    • List name, address, relationship and share of estate
    • Department of revenue uses this to calculate tax
  – Non-Taxable Distributions
    • Sole use trusts
    • Charitable and governmental distributions
Preparing PA Inheritance Tax Return

• Schedule K – Life Estate, Annuity & Term Certain
  – Used when tax rate is different for current and future beneficiaries
    • Life estate to sibling, remainder to children
    • Life estate spouse, remainder to children
  – Department of Revenue uses IRS actuarial tables
    • Available on IRS website
    • Commercial software is available
Preparing PA Inheritance Tax Return

- **Schedule M – Future Interest Compromise**
  - Used when tax rate is different for current and future beneficiaries, and their interest cannot be calculated
    - Trust with principal invasion provisions
  - Prepare explanation of the compromise offer
    - Reasons for allocation to each class of beneficiary
    - If you don’t prepare offer, Department of Revenue will resolve all conflict by taxing at the higher applicable rate
Preparing PA Inheritance Tax Return

PA Inheritance Taxation of Trusts

• When a trust is a beneficiary of an estate
  – What tax rate applies to the trust assets
  – Look through trust to identify beneficiaries
  – Tax rate is based on rate applicable to beneficiaries
    • If all beneficiaries are lineal descendants – tax rate = 4.5
Preparing PA Inheritance Tax Return

PA Inheritance Taxation of Trusts

• What if beneficiaries are in different tax classes
  – Income to brother (12%)
  – Remainder to children (4.5%)

• Future Interest Compromise
  – Schedule M of Form Rev-1500
Preparing PA Inheritance Tax Return

PA Inheritance Taxation of Trusts

• Factors used in future interest compromise
  – Ages of beneficiaries
  – Terms of trust
    • Withdrawal rights
    • Principal invasion provisions
    • Powers of appointment
  – Financial circumstances of beneficiaries
    • Likelihood of principal distributions
  – Types of assets
Preparing PA Inheritance Tax Return

PA Inheritance Taxation of Trusts

• Explanation of compromise offer
  – Need for principal distributions
  – Beneficiaries other sources of support
  – Likelihood that assets will be needed for
    • Health, education, maintenance and support
  – Special needs
Preparing PA Inheritance Tax Return

PA Inheritance Taxation of Trusts

• Compromise offer
  – How much of trust assets allocated to each class
    • Charity (0%)
    • Spouse (0%)
    • Lineal descendants/ascendants (4.5%)
    • Siblings (12%)
    • Others (15%)
Preparing PA Inheritance Tax Return

PA Inheritance Taxation of Trusts

• Example 1
  – Parent created education trust for child
    • $100,000
    • Child about to enter college at $50,000/year
    • Anything left at age 25 paid outright to child
    • If child dies before, remainder to parent’s siblings
  – You could argue that entire trust is taxed at 4.5%
    • What if child is getting full scholarship
    • What if other parent is obligated to pay for college
Preparing PA Inheritance Tax Return

PA Inheritance Taxation of Trusts

• Example 2
  – Client creates trust
    • Income to parents
    • Followed by income to spouse
    • Followed by remainder to children
  – Calculate value of parents life estate
    • Adjust for factors like health, other assets, special needs
  – Do the same for spouse
  – The balance then goes to children
Preparing PA Inheritance Tax Return

PA Inheritance Taxation of Trusts

• Example 2 (continued)
  – There is room for creativity
    • Minimize likelihood that parents will need trust assets
    • Maximize likelihood that spouse will need trust assets
    • Minimize assets available for children
  – If your compromise is reasonable, the Department of Revenue is usually reasonable
  – In drafting trusts with multiple classes of beneficiaries
    • Take compromise factors into account to allow for planning
    • Disclaimers can help
Preparing PA Inheritance Tax Return

• Schedule O – Deferral/Election of Spousal Trusts
  – Trust for the sole use of surviving spouse
  – Similar to marital trust for federal estate tax purposes
  – Options for taxation
    • Tax as sole use trust
      – Tax rate is 0%
      – Tax is deferred until spouse dies
    • Elect out of sole use taxation
      – Make a compromise offer
      – Portion of trust allocated to spouse is taxed at 0%
      – Balance taxed at remainder beneficiary rates
      – Trust is not taxed when spouse dies
PA Inheritance Taxation of Trusts

• When to consider paying tax on sole use trust
  – Spouse is in poor health
  – Assets in trust are expected to appreciate
  – Spouse will not need distributions from trust

• When to consider deferring tax on sole use trust
  – Spouse is in excellent health
  – Assets in trust are expected to depreciate
  – Spouse will need to spend trust assets
  – Spouse will move to another state
PA Inheritance Taxation of Trusts

• Non-sole use trust for spouse (credit shelter trust)
  – Where trust allows distributions to others (children)
    • Income & principal sprinkled among spouse and children
  – Compromise must be filed
  – Alternative
    • Have non-spouse beneficiaries disclaim their interests
      – Just for distributions during spouse’s lifetime
      – They can still be remainder beneficiaries