



Fox Rothschild LLP
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Preparing the PA Inheritance Tax Return

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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 - NJ and DE repealed their estate taxes effective in 2018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:

Spouse:	0%
Children/grandchildren/ parents:	4.5%
Siblings:	12%
All other beneficiaries:	15%

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 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



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- 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



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- 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



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- 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



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- 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



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



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- 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



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- 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



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- Schedule B – Stocks and Bonds
 - Securities owned individually or as tenants in common
 - JTWRORS 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



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- 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



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- 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



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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



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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



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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



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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”



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Potential Tax Savings

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

Husband/wife:	$\$5M \times 0\% = \0
Child/grandchild:	$\$5M \times 4.5\% = \$225,000$
Brother/sister:	$\$5M \times 12\% = \$600,000$
All others:	$\$5M \times 15\% = \$750,000$

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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



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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



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- In above example, tax savings would be:

Husband/wife:	$\$10\text{M} \times 0\% = \0
Child/grandchild:	$\$10\text{M} \times 4.5\% = \$450,000$
Brother/sister:	$\$10\text{M} \times 12\% = \$1,200,000$
All others:	$\$10\text{M} \times 15\% = \$1,500,000$



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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



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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

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- 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



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- Schedule E – Cash, Bank Deposits & Misc. Personal Property
 - Report individual and tenant in common accounts
 - JTWRORS 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



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- Schedule F – Jointly Owned Property
 - Report JTWRORS assets
 - Do not show assets owned T/E & JTWRORS 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



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- 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



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- 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



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- 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



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- 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



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- 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
 - $\frac{1}{2}$ of mortgage on T/E real estate is deductible, even though property is not taxable



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- 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



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- 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



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- 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



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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



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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



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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



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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



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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%)



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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



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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



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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



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- 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



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