

# Pennsylvania Inheritance Tax

## Compared with the Federal Estate Tax



Passage of the American Taxpayers Relief Act on Jan. 2, 2013, brought a degree of stability to the Federal Estate Tax, although one hesitates to predict how long this stability will last considering the tax's recent history. Nevertheless, the act professes to reflect permanent changes in the Internal Revenue Code transfer tax provisions that affect estates.

The Pennsylvania Inheritance Tax, on the other hand, is fundamentally unchanged. It continues to be applicable to all estates, and probably will continue as such.

However, there are two changes that all estate planners should keep in mind. First, recent Supreme Court

action and IRS regulations make it clear that a same-sex marriage will be recognized the same as any other marriage and that, for Federal Estate Tax purposes, the word "spouse" will include those persons in a same-sex marriage. The same is true for Pennsylvania Inheritance Tax purposes, and persons in a same-sex marriage will be afforded all of the benefits given to married couples under the statute.

Second, the recent promulgation of regulations by the IRS under section 2704 of the Internal Revenue Code make drastic changes in the valuation of certain asset holdings, particularly those involved in family business enterprises. While these regulations probably will not become final until

sometime in 2017, they should be read with care by every practitioner.

The purpose of this bulletin is to compare current (2016) Federal Estate Tax provisions with current Pennsylvania Inheritance Tax rules to increase awareness of the similarities and differences that exist. The information herein is not all-inclusive. Therefore, any planning should be done in consultation with a professional knowledgeable in estate planning.

*All references to the Federal Estate Tax will be in regular type. All references to Pennsylvania Inheritance Tax will be preceded with this symbol ▣.*

### Property Included in the Gross Estate

The Federal Estate Tax is based on the total assets of a U.S. citizen or resident, regardless of the location of these assets.

▣ There is no Pennsylvania Inheritance Tax on real estate or tangible personal property located outside the state.

### Alternate Valuation

For Federal Estate Tax purposes, the legal representative of the estate may elect to adopt an alternate valuation, the object of which is to reduce the amount of estate tax otherwise payable

when, within the six-month period following the decedent's death, the gross estate has suffered a decrease in its aggregate value. In that situation, the legal representative may value all the property in the gross estate on the date of the decedent's death or on the date that is six months after the date of death.

If alternate valuation is adopted, property sold, distributed, or otherwise disposed of during the six-month period is to be valued as of the date of disposition. The alternate valuation cannot be used to establish a higher income tax step-up in basis. Thus, the election cannot be made unless the estate's total value and tax thereon are reduced as a result of the election.

▣ For Pennsylvania Inheritance Tax purposes, assets are valued as of the date of death. There are no alternate valuation provisions.

### Transfers in Contemplation of Death

For Federal Estate Tax purposes, gifts made prior to death are not included in the gross estate, unless they are made within three years prior to death and are includable under Sections 2036 (retained life estate), 2037 (transfer taking effect at death), 2038 (revocable transfer), or 2042 (life insurance). However, all gifts made within three years of death are included for purposes of qualifying for special use valuation, deferred payment of estate tax, qualified redemptions to pay

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estate tax, and estate tax liens. The law also requires that any gift tax paid on includable gifts must be included in the decedent's gross estate. Those gifts required to be in the gross estate will be valued at full fair market value as of date of death or the alternate valuation date.

For Pennsylvania Inheritance Tax purposes, transfers made prior to one year before the date of death are excluded from taxation. Gifts made within one year of the date of death are included, and are taxable to the extent they exceed \$3,000 per donee.

## Retirement Benefits

For estates of decedents dying after Dec. 31, 1984, all retirement benefits are includable in the gross estate for Federal Estate Tax purposes, regardless of the form of payment. There are limited exceptions for benefits that had commenced prior to 1985.

Proceeds from qualified employee benefit plans that are exempt for Federal Estate Tax purposes are exempt from the Pennsylvania Inheritance Tax. Since the federal exclusion was eliminated for estates of most individuals dying after Dec. 31, 1984, this exclusion is no longer significant. Payments are also exempt to the extent that the decedent (prior to death) did not otherwise have the right to possess (including proprietary rights at termination of employment), enjoy, assign, or anticipate the payment of proceeds.

## Joint Interests

### Property jointly owned by spouses:

For Federal Estate Tax purposes, the estate of the first spouse to die will include one-half of the value of property jointly owned with right of survivorship, regardless of which spouse furnished the consideration for the property.

**Other joint interests:** For Federal Estate Tax purposes, the gross estate includes the value of property held jointly by the decedent and the other joint owner. If acquired by gift or inheritance, only the decedent's fractional share of the property is



included. In all other cases, the entire value of the property is included, except to the extent that the executor or administrator can prove that consideration for the acquisition of the property was actually furnished by the surviving joint tenant.

### Property held jointly by spouses:

Such property is exempt from Pennsylvania Inheritance Tax unless the property was transferred into joint name by the decedent within one year of the date of death. If transferred within one year prior to death, the one-year transfer in contemplation of death rule applies, causing 100% inclusion in the estate of the transferor spouse. Because the amount passes to the surviving spouse in any event, and because transfers to a surviving spouse are now taxable at a 0% rate (see material under Computational Differences), there is no increase in the amount of tax.

**Other joint interests:** Property held jointly with individuals other than a spouse is includable in the estate of a decedent in that the value of the property is multiplied by the percentage of fractional ownership of the decedent. If transferred into joint name by the decedent within one year prior to death, the transfer in contemplation of death rule applies and causes 100% inclusion and taxation.

## Life Insurance Proceeds

For Federal Estate Tax purposes, the gross estate includes the proceeds of life insurance which are receivable by the estate, or are receivable by other beneficiaries if the decedent possessed any incidents of ownership at time of death. Rights, which constitute "incidents of ownership," include the

right to change the beneficiary of the policy, the right to borrow against the policy, the right to assign the policy, the right to revoke an existing assignment of the policy, and a reversionary interest that exceeds 5% of the value of the policy at the date of death.

Proceeds of life insurance policies are totally exempt from Pennsylvania Inheritance Tax, even if paid to the estate or if the decedent possesses incidents of ownership.

## Powers of Appointment

In general, for Federal Estate Tax purposes, the gross estate includes property over which the decedent (at the time of death) had a general power of appointment created after Oct. 21, 1942, regardless of whether it is exercised or with respect to which the decedent released such a power of appointment prior to death. Property subject to a limited power of appointment is not includable, even if exercised.

Property subject to a power of appointment held by a decedent is exempt from Pennsylvania Inheritance Tax. For example, if property is transferred from a deceased parent to a trust for the benefit of a child of the decedent and the transferred amount is subject to a testamentary power of appointment held by the child, it will not be taxed in the estate of the child. If the trust is for the benefit of a surviving spouse, however, and the surviving spouse has a testamentary power of appointment over the trust property, it may be taxable in the estate of the surviving spouse if the trust qualifies as a "sole use" trust. (See comment on sole use trust under Marital Deduction.)

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## Deductions

### Administration Expenses

Administration expenses are fully deductible for Federal Estate Tax purposes, but only to the extent not deducted on the estate's income tax return.

Administration expenses are fully deductible for Pennsylvania Inheritance Tax purposes. Pennsylvania also allows a family exemption deduction of \$3,500 paid to a member of the immediate family living with the decedent at the time of death.

### Charitable Deduction

For Federal Estate Tax purposes, a deduction is allowed for charitable bequests, but split-interest bequests cannot be deducted unless they comply with the specific rules of Section 2055(e) imposing mandatory annual pay-out requirements. If a residuary estate is left to charity, the deduction for charitable bequests is reduced by the amount of federal and state death taxes payable out of the residuary estate.

Transfers to qualified charitable organizations are exempt from Pennsylvania Inheritance Tax.

### Marital Deduction

For Federal Estate Tax purposes, a marital deduction is allowed for property interests that are considered to have passed from the decedent to the surviving spouse as defined in the statute and regulations. Any property transferred to a spouse during lifetime or at death can be transferred free of gift and estate taxes. Transfers to a spouse can be outright or can be made in trust, either to a power of appointment trust, an estate trust, or a qualified terminable interest trust. Property held in trust for which a marital deduction is allowed in the decedent's estate will be includable for estate tax purposes in the estate of the surviving spouse.

For Pennsylvania Inheritance Tax purposes, property passing to a surviving

spouse is taxable, but at a rate of 0%. This rate applies to both outright transfers and to transfers for the sole use of the surviving spouse (such as a transfer in trust or in a similar arrangement under which the surviving spouse is the only possible income and principal beneficiary during the spouse's lifetime). All succeeding interests that follow the surviving spouse's interest in a sole use trust (or similar arrangement) will be subject to tax at the death of the surviving spouse. However, the decedent's personal representative may elect on the inheritance tax return to treat an otherwise qualified sole use transfer as taxable, thus eliminating taxation when the surviving spouse dies. A sole use trust does not include a trust (or similar arrangement) over which anyone, including the surviving spouse, possesses an inter vivos power of appointment.

### State Death Taxes

The credit for state death taxes has been eliminated for the estates of decedents dying after Dec. 31, 2004. It is replaced for those estates by a deduction from the gross estate.

The Pennsylvania estate tax, previously determined by reference to the repealed federal credit, has been eliminated completely for the estates of decedents dying on or after Jan. 1, 2005. There is no Pennsylvania estate tax because there no longer is any federal credit.

### Exclusion

The Federal Estate Tax is computed by allowing a credit for the amount of tax computed on an exclusion amount. For 2002 and 2003, this amount was \$1 million. For 2004 and 2005, the amount was \$1.5 million. For 2006, 2007, and 2008, the amount was \$2 million. For 2009, the amount was \$3.5 million. For 2010 and thereafter, the exclusion is \$5 million adjusted for inflation after 2011. For 2012, the inflation-adjusted amount is \$5.12 million; for 2013, the amount is \$5.25 million; for 2014, the amount is \$5.34 million; for 2015, the amount is \$5.43

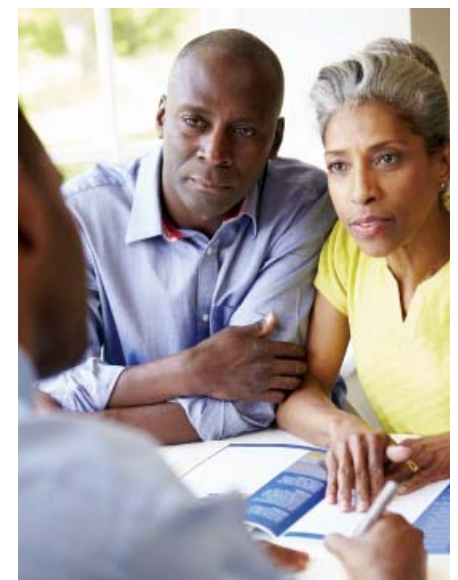
million; for 2016, the amount is \$5.45 million. In addition, for the estates of decedents who die after 2010, the exclusion for spouses is portable. In other words, if one spouse dies and does not use the full exclusion amount, the unused amount may be used by the surviving spouse in addition to the surviving spouse's own exclusion amount.

Pennsylvania has no general exclusion amount. Therefore, the first dollar of the taxable estate (gross estate less allowable deductions) is subject to tax.

### Computational Differences

For Federal Estate Tax purposes, the tax is computed on the transfer of assets both during life (if the transfer took place after Dec. 31, 1976) and at death. The computed tax is then reduced by any gift tax paid on lifetime gifts and by the credit for the exemption amount. Other credits that reduce the estate tax are the estate tax on a prior transfer of assets from other estates received by the decedent within 10 years of death and foreign death taxes on assets taxed by other nations.

The rate tables for the Federal Estate Tax are found in Section 2002 of the Internal Revenue Code. The maximum rate presently applicable to the estates of decedents is 40%.



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▮ Pennsylvania Inheritance Tax is computed at four levels, depending upon the relationship of the transferee to the decedent (see chart).

Rate	Transferee
0%	Spouse and parent of a child who dies prior to age 22
4.5%	Grandparent, parent (unless the 0% rate applies), lineal descendants (stepchildren and their descendants are considered lineal descendants), and spouse (including widow or widower) of a child
12%	Sibling (including a half-sibling)
15%	All others

## Special Valuations

For Federal Estate Tax purposes, if certain conditions are met, real property used in a closely held business or used as a farm may be valued in a decedent's gross estate on the basis of its actual use, rather than on the usual basis of "highest and best use." The purpose is to benefit the estates of farmers and owners of closely held businesses by reducing the estate tax and, therefore, encouraging qualified heirs to continue family use of the property for farm and other small-business purposes. This special use valuation cannot, however, reduce the value of the property by more than \$750,000, adjusted for inflation, in the case of a decedent who died after 1998. The amount of this inflation-adjusted amount in 2015 is \$1.1 million.

▮ For Pennsylvania Inheritance Tax purposes, complex provisions provide for a reduction in value or an exemption for real estate used for agricultural purposes in certain contexts and for a limited exemption for a family-owned business interest.

## Generation-Skipping Transfers

A federal tax is imposed on a generation-skipping transfer. A generation-skipping transfer means a taxable distribution, a taxable termination, or a direct skip. A taxable distribution is any distribution from a trust to a skip person. A taxable termination occurs at the time of the termination of an interest in property held in trust where no nonskip person thereafter has an interest in the property. The termination may be by death, lapse of time, release of a power, or otherwise. A direct skip is a taxable transfer to a skip person. A skip person generally is an individual who is two or more generations below the generation of the transferor or is a trust in which all of the interests are held by skip persons. The tax is designed to be substantially equivalent to the estate tax, which would have been imposed if the property had actually been transferred outright to each generation, except that the rate, instead of being based upon a sliding scale, is determined by reference only to the maximum Federal Estate Tax rate instead of the estate tax progressive rate table.

There is a generation-skipping transfer tax exemption allowed to every individual. The exempt amount is the same as the general exclusion amount for Federal Estate Tax purposes (i.e., \$5 million adjusted for inflation after 2011).

▮ Pennsylvania does not impose a separate generation-skipping transfer tax.

## Filing and Paying the Tax

The due date for filing the return and paying the Federal Estate Tax is nine months after the date of death. An extension of time for filing the return may be granted for an additional six months (Form 4768). An extension of time to pay the tax may be granted for a period not to exceed 12 months when there is reasonable cause (Form 4768). Relief is applicable with respect to 2010 returns where the option to pay estate tax is chosen.

▮ The due date for filing the Pennsylvania return and paying the Inheritance Tax is nine months after the date of death. An extension for filing may be granted for an additional six months. To the extent the tax is paid within three months after death, a discount of 5% is allowed.

## Installment Payment Election

For Federal Estate Tax purposes, if certain conditions are met, the payment of estate tax attributable to an interest in a closely held business can be made in installments over a 15-year period.

▮ For Pennsylvania Inheritance Tax purposes, tax due on qualifying small-business transfers can be paid in 20 quarterly installments with interest.

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