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Death and Taxes: A Primer on the Pennsylvania Inheritance Tax

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Special to the Legal

Many people have been sleeping easier at night ever since January 2, when President Obama signed The American Taxpayer Relief Act of 2012 (“ATRA”) into law, thereby permanently setting the federal estate tax exemption to \$5 million, indexed for inflation. This means that for many individuals there will be no federal estate tax payable if the individual dies with an estate which is under this large exemption amount (or double that amount for married couples). However, the elimination of federal taxation on these estates does not mean that estate planning should be ignored for tax purposes since there may still be state inheritance/estate taxes to consider, such as is the case in Pennsylvania.

For Pennsylvania residents, the Pennsylvania inheritance tax is applicable to all estates, irrespective of the size. Unlike with the Federal estate tax regime, Pennsylvania has no exemption amount, meaning that the first dollar of the taxable estate (gross estate less allowable deductions) is subject to tax. Thus, in order to properly structure the estate plan for any Pennsylvania resident, regardless of the size of his or her pockets, it is important to understand the ins and outs of the inheritance tax.

This is how the Pennsylvania inheritance tax works, in a nutshell:

1. ***What is taxed?*** All real property and all tangible personal property, including, but not limited to cash, cars, furniture and jewelry located in Pennsylvania are taxable. All intangible property, which includes such items as stocks, bonds, bank accounts and notes receivable, is taxable regardless of where located. Jointly-owned property (except for joint property owned by husband and wife) is taxable to the extent of the decedent's fractional portion in the property. In addition, gifts made within one year of death are included in the taxable estate to the extent that the gifts exceed \$3,000.
2. ***What is exempt from the tax?*** The following assets are exempt from Pennsylvania inheritance tax:

- Property owned by husband and wife with rights of survivorship if the joint ownership was created by the decedent more than one year of the decedent's death.
 - Proceeds of life insurance policies.
 - Qualified Retirement Plan Benefits and IRAs of a decedent who was under age 59 ½ at the time of death.
 - Transfers to qualified charitable organizations.
3. ***What is the relationship and tax rate?*** One of the key differences between the Pennsylvania inheritance tax and the Federal estate tax is that, for Pennsylvania, the tax rate varies depending on the relationship of the heir to the decedent, whereas, the Federal estate tax only distinguishes the spouse, but not other relatives. The inheritance tax rates in Pennsylvania are as follows:
- 0 percent on transfers to a surviving spouse (including transfers to a “sole use” trust for the spouse, as described below) or to a parent from a child aged 21 or younger;
 - 4.5 percent on transfers to direct descendants and lineal heirs;
 - 12 percent on transfers to siblings; and
 - 15 percent on transfers to other heirs (for now, this would include same-sex spouses).

Given that the tax rates vary substantially depending on relationship, it is important to carefully consider the relationship of each beneficiary to the decedent before finalizing an estate plan. For example, in the case of a client who wishes to transfer a large bequest to a friend or to a same-sex partner, each of whom would be taxed at the highest rate of 15%, it may be advisable to make that individual the beneficiary of life insurance proceeds (rather than, or in addition to, bequests under the Will) since life insurance proceeds are fully exempt from the inheritance tax.

4. ***What about property passing to the spouse?*** As stated above, for Pennsylvania inheritance tax purposes, there is no tax on property passing to a surviving spouse since the tax rate is 0 percent. This rate applies to both outright transfers and to transfers for the “sole use” of the surviving spouse (e.g., 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). If property is left in a “sole use” trust for a spouse, the property will not be subject to tax until the death of the surviving spouse, unless the executor elects to include the trust in the first decedent’s estate for planning purposes (and pays tax using a “future interest compromise” procedure). Deferring the tax until the second death, pursuant to 72

Pa.C.S. § 9113(a), may be beneficial in situations where the surviving spouse relies on the trust assets for living expenses or expects to use not only trust income, but principal as well, thereby leaving a smaller amount in the trust which will ultimately be subject to tax at the spouse's death. Also, if the surviving spouse moves out of Pennsylvania, then it is possible to avoid the tax altogether. Thus, when dealing with sole use trusts, it is important to carefully consider whether or not to defer the tax depending on the relevant facts and circumstances.

Recently, the Pennsylvania Department of Revenue issued a new, somewhat controversial, Statement of Policy regarding Sole Use Trusts, set forth at 61 Pa. Code § 94.3. The Statement of Policy establishes a notice requirement for returns filed after July 1, 2012, concerning potential tax liability for sole use trusts which are terminated during the surviving spouse's lifetime pursuant to voluntary agreement of the beneficiaries. This potential tax liability during the surviving spouse's lifetime appears to be inconsistent with Pennsylvania law for two reasons: (1) Pennsylvania law does not impose a gift tax on property transferred during lifetime (other than with respect to gifts made within one year of death); and (2) property passing outright to a surviving spouse at death, for Pennsylvania inheritance tax purposes, qualifies for the full marital deduction.

5. ***What is the due date and how can taxpayers get a discount?*** The Inheritance tax return and payment are due nine months after the individual's death. However, there is a 5% pre-payment discount if the inheritance tax is paid within three months of decedent's death. By paying the tax six months early, this 5% discount amounts to a 10% *after-tax* return on assets on an annualized basis, which, in today's times, is hard to beat.

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