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The New Pa. Inheritance Tax Exemption for Qualified Family-Owned Business Interests

By Charles Bender

On July 9, Gov. Tom Corbett signed House Bill 465 into law making numerous changes to the Pennsylvania tax law, including the inheritance tax. Section 34 of the act added a new Section 2111(t) to the Tax Reform Code of 1971 (TRC), providing that the transfer of qualified family-owned business interests to qualified transferees is not subject to Pennsylvania inheritance tax. Section 42(4) of the act provides that Section 2111(t) shall apply to estates of decedents who die on or after July 1, 2013.

The purpose of the new provision is to protect certain family-owned business interests from being subject to Pennsylvania inheritance taxes. While the Pennsylvania inheritance tax rates are modest relative to the federal estate tax rates, the Pennsylvania inheritance taxes can still be substantial, particularly if the beneficiary is not a spouse, child or lineal descendent of the decedent. The Pennsylvania inheritance tax rate is based on the relationship of the beneficiary to the decedent: 0 percent for spouses, 4½ percent for parents, children and grandchildren, 12 percent for siblings and 15 percent for all other beneficiaries. Based on the $5 million ceiling in the statute, the tax savings could be anywhere from zero for spouses, to $225,000 for parents, children and grandchildren, to $600,000 for siblings, to $750,000 for other beneficiaries. The concern addressed by the statute is that small, family-owned businesses are often illiquid assets of an estate, and a tax of this size could force the family to sell the business in order to pay the tax. The Pennsylvania inheritance tax is due within nine months from the date of death.

The new statute will be of limited use since it only applies to a narrowly defined asset type. The revenue estimates for this provision indicate that the loss of tax revenue will only be about $3.8 million per year.[1] Compare this to the $803.57 million of revenue generated by the Pennsylvania inheritance tax in the fiscal year ended June 30, 2012,[2] and it is apparent that the provision is not expected to have a significant impact in many estates. However for estates where the provision does apply, the tax savings can be important. In addition, a careful review of the statutory language reveals that its application may be broader than anticipated, creating opportunities for significant tax savings through advance planning.

Statutory Requirements

A link to the text of the statute is contained in an endnote hereto.[3] The heart of the provision is the definitions of qualified family-owned business interest (QFOBI) and qualified transferee (QT).

QFOBI is defined as a sole proprietorship or an interest in an entity carrying on a trade or business that:

1. has fewer than 50 full-time employees,
2. has a net book value of less than $5 million,
3. has been in existence for five years prior to the decedent's death,
4. is wholly owned by the decedent or the decedent and members of the decedent's family that are QTs, and
5. is engaged in a trade or a business, the principal purpose of which is not the management of investments or income producing assets.

QT is defined as:

1. husband and wife,
2. lineal descendants,
3. siblings and the sibling's lineal descendants, and
4. ancestors and the ancestor's siblings.

In addition to these definitions, the statute has several requirements in order for the QFOBI to qualify for the inheritance tax exemption. These requirements include:

1. The interest must continue to be owned by a QT for seven years after the decedent's death.
2. The interest must be reported on a timely-filed Pennsylvania inheritance tax return.
3. A certification must be filed annually by each QT for the seven-year period. Failure to file the certification will result in loss of the exemption and the inheritance tax will be due upon the interest. In addition, the QT must notify the Department of Revenue of any transaction or occurrence causing the interest to fail to qualify for the exemption
4. If the QFOBI is no longer owned by a QT during the seven-year period, inheritance tax will be due upon the interest. The tax will be equal to the tax that would have been paid on the interest had it not been exempt at the time of the decedent's death, and interest on the unpaid tax will be assessed from the due date of the decedent's inheritance tax return at the rate applicable to underpayments.
5. Property transferred to the QFOBI within one year of the decedent's death is not eligible for the exemption unless it was transferred for a legitimate business purpose.
6. Inheritance tax and interest that would be due on the QFOBI becomes a lien in favor of the commonwealth on the real and personal property of the QT at the time of the transaction or occurrence that disqualifies the QFOBI for the exemption. The tax and interest is collectible in the same manner as delinquent taxes, and the lien remains in effect until all tax and interest is paid in full.

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Issues with Definition of QFOBI

All of these QFOBI requirements must be in existence as of the date of decedent's death. The full-time employee requirement and the five years of existence requirement are both relatively straight forward.

The more interesting requirement is that the net book value of the business must be less than $5 million. This provision relates to the value of the business as a whole, not the decedent's interest in the business. The exemption is not for $5 million of value from the decedent's estate; it is for the value of the decedent's interest in a business that has a book value of $5 million or less. For example, if the decedent owns 50 percent of a business that has a book value of $10 million, the decedent's interest is not exempt.

The statute defines qualified family-owned business based on net book value rather than fair market value. This distinction is very important, making the potential tax savings from this provision significant. Book value is an accounting concept based on the historical cost of assets owned by the business less accumulated depreciation on those assets and less liabilities. It has very little relationship to the fair market value of an ownership interest in the business. For example, suppose a business owns an apartment complex that was originally purchased for $5 million. At the time of purchase, $500,000 of the purchase price was allocated to the land and $4,500,000 was allocated to the building and improvements. Over the years, the building and improvements were fully depreciated so that they have a zero book value at the time of decedent's death. And suppose as of the date of decedent's death, the apartment complex has a fair market value of $10 million. The book value under this example would be $500,000, the amount allocated to the land, since all of the improvements have been fully depreciated. However, the fair market value of the property is $10 million. Absent this new exemption from inheritance tax, the full $10 million would be subject to the tax. The tax savings in this example would be $450,000 for parents, children and grandchildren, $1.2 million for siblings and $1.5 million for other beneficiaries. Many family-owned businesses will have balance sheets showing the book value of their assets significantly lower than the current fair market value of the business itself. This distinction between book value and fair market value makes the applicability of this provision as well as a potential tax savings much greater than it appears from the $5 million ceiling in the statute.

Another interesting aspect of the statute is that it does not limit the decedent to one QFOBI. It merely states that a transfer of a QFOBI is exempt from inheritance tax as long as it meets the statutory requirements. If a decedent owns an operating company and a real estate company that owns the real estate used by the operating company, both interests could qualify as QFOBIs. In the example above with the real estate having a book value of $500,000 and a fair market value of $10 million, suppose the tenant of that real estate company is the decedent's operating company. If the operating company has a book value of less than $5 million, both the interest in the real estate company and the interest in the operating company would be exempt under the statute. The operating company could be worth $100 million yet it would still be exempt for Pennsylvania inheritance tax purposes under this provision.

The definition of QFOBI also excludes businesses with a principal purpose of managing investments or income-producing assets owned by the business. While this provision could arguably apply to every business, it is aimed at entities that own marketable securities. It prevents the taxpayer from creating an entity funded with $5 million of cash and/or securities and then claiming that that entity is a business qualifying for the exemption. This restriction does not appear to apply to a real estate entity, as long as it is operated as a business.

Another restriction is that assets transferred within one year of death to a business do not qualify for the exemption unless the property was transferred for a legitimate business purpose. This appears to be aimed at preventing transfers in contemplation of death into an entity in order to qualify for this exemption. In the example above, with a real estate entity that owns a building with a $500,000 book value and a $10 million fair market value, this restriction would prevent someone from transferring $4.5 million of cash into the entity within a year of death and having the $4.5 million escape Pennsylvania inheritance tax. However, if the building needed substantial improvements and the cash was transferred to the entity to finance those improvements, then the transfer should qualify even if it is within one year of the decedent's death.

The statutory language regarding this restriction does not fit within the framework of the exemption. The assets of the business are not exempt from taxation; rather the interest in the business is exempt from taxation. To say that assets transferred to the business within one year of death do not qualify for the exemption does not make sense, because the underlying assets of the business never qualify for the exemption. The QFOBI is exempt if it qualifies, not the assets of the business. It appears that this provision is intended to work like the gifts within one year of death provision in Section 2107(c)(3) of the TRC. If this is the intent, the statute should say that transfers to a qualified family-owned business within one year of the decedent's death are subject to tax unless the transfer is for a legitimate business purpose.

Issues with Definition of QTs

In order to meet the definition of QFOBI, the entity must be wholly owned by the decedent or the decedent and members of the decedent's family that are QTs. This provision could disqualify certain businesses that one

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might otherwise expect to qualify. For example, if the decedent transferred a nominal number of shares to a valued employee, this would disqualify the business, assuming the employee is not a QT. The same result could happen if the decedent transfers shares during lifetime to a family member who is outside the definition of QT. For example a son-in-law or daughter-in-law is not included in the definition of QT.

The first category of QT is husband and wife. There is no need to include husband and wife in the definition of QT since there is a zero tax rate on transfers between spouses. This does raise a question for same sex couples and how they would be treated under the statute. Pennsylvania does not currently recognize same-sex marriage, and same-sex partners are 15 percent beneficiaries for inheritance tax purposes. If two same-sex partners own a business together, the surviving partner would not qualify as a QT under the statute.

The statute defines lineal descendants as QTs. However, spouses of lineal descendants are not QTs. Likewise, while siblings and sibling's lineal descendants are QTs, their spouses are not QTs. The statute does not appear to exempt a spouse's siblings either, so brothers-in-law and sisters-in-law are not QTs. Ancestors and ancestor's siblings are exempt, so parents would be exempt, but a spouse's parents are not exempt. Ancestor's siblings, aunts and uncles are exempt, but children of aunts and uncles are not exempt.

Trusts are also not included in the definition of QT. If a parent decides to put the business in trust for children, that would take the transfer outside the scope of the exemption. Suppose the decedent's will leaves the business outright to children, but there is a minority/disability clause in the will that provides that dispositions to minors or disabled beneficiaries are held in trust during their minority or disability. If there are any minor or disabled children at the time of the decedent's death, this clause would disqualify the interest for the exemption. A sole use trust for a spouse would allow the QFOBI to pass in trust for a surviving spouse, but not because it is a QFOBI. Rather, it would pass tax-free because of the 0 percent tax rate for transfers to a spouse. But when the spouse dies, the QFOBI would not be exempt even if the assets pass to a QT, since the interest was not owned by the spouse at the time of his or her death.

The statute provides that as of the date of decedent's death, the entity must be wholly owned by the decedent or by the decedent and members of the decedent's family who meet the definition of QT. So if the business is owned by a trust, it would not be treated as owned by the decedent under this provision. This would be true even if the trust is a grantor trust for federal income tax purposes and the decedent is treated as the owner of the trust assets for federal income tax purposes. The legal owner under Pennsylvania state law is still the trust.

Issues Related to Recapture of the Tax

Once all of the statutory requirements are met and the QFOBI is exempt from Pennsylvania inheritance tax, there are several other requirements that must be met going forward to maintain the exemption. The first requirement is simply that the QFOBI must be reported on a timely filed inheritance tax return. The second requirement is that the interest must continue to be owned by a QT for seven years after the decedent's death. If the QFOBI is transferred to a non-QT within seven years of the decedent's death, it will trigger recapture of the tax plus interest. The tax and interest become a lien in favor of the commonwealth on the real and personal property of the owner of the QFOBI at the time of the transaction or occurrence that disqualified the QFOBI from the exemption. This could create some interesting issues to the extent that it is inconsistent with the terms of the decedent's will. For example, the will might provide that all death taxes, including the Pennsylvania inheritance tax, should be paid from the residue of the estate. The QFOBI might be distributed in a pre-residuary bequest so that the QT receiving the QFOBI is not liable for the tax under the will. However, under the statute, the tax and interest are treated as a lien on the assets of the QT.

The statute does not require that the QFOBI be owned by the same QT for the entire seven-year period. For example, if the business is left to two children and then one of the children transfers the QFOBI to the other child, this would not trigger recapture. However, if the child transfers the QFOBI to his or her spouse, this would trigger recapture since the child's spouse is not a QT with respect to the decedent. The recapture applies separately to each QT. A disqualifying transfer by one QT will not trigger recapture for QFOBIs owned by other QTs who do not transfer their interests.

Each QT must also file a certification for each of the seven years of the recapture period. The commonwealth is to issue a new form for this purpose. The certification requirement includes a provision that the QT must notify the Department of Revenue of any transaction or occurrence that causes the interest to fail to qualify for the exemption within 30 days of such transaction or occurrence. The most likely event would be the sale to a non-QT, such as a non-related third party. However, in some circumstances it may not be as clear that the recapture tax is due. For example, if the underlying business goes bankrupt, does the QT have to pay the inheritance tax on the asset based on its value as of the date of death? Similarly, if the family simply closes the business, does this trigger the recapture tax? Suppose the business consists of a rental property in the Poconos, and sometime after the decedent dies, the children decide to stop renting the property and use it as a vacation home.

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The statutory language triggering recapture is:

> a qualified family-owned business interest that was exempted from inheritance tax under the subsection that is no longer owned by a qualified transferee at any time within seven years after this decedent's date of death shall be subject to inheritance tax due to the Commonwealth under §2107 in an amount equal to the inheritance tax that would have been paid or payable on the value of the qualified family-owned business interest using the valuation authorized under §2121 for nonexempt transfers of property.

The triggering event for recapture is that the QFOBI is no longer owned by a QT. The statute makes no reference to the activities of the business itself. So if a QT inherits a QFOBI that otherwise qualifies under the statute, then causes the business to sell its assets to a third party but continues to own the QFOBI for the balance of the seven-year period, this transaction should not trigger recapture under the statute. The assets need not even stay in the business to reach this result. Rather, the QT would just have to continue to own the QFOBI for the seven-year period even if the business activity is terminated.

Planning Opportunities

There are substantial planning opportunities created by this new exemption from Pennsylvania inheritance tax for QFOBIs. When clients have low basis business assets, the opportunity to take advantage of the difference between fair market value and book value on these assets is considerable. Tax planners often advise clients to retain these types of assets until death in order to obtain a step up in income tax basis for federal tax purposes. Now there is a Pennsylvania inheritance tax benefit to retaining low basis assets until death as well. Estate planners will need to understand the book value of the business when working with business owners. It may be possible to structure the business assets into more than one entity to increase the value that can pass under this exemption. As mentioned above, separating the operating company from the real estate company can significantly increase the value of this exemption. This structure makes sense for other business and tax reasons. Now there is a Pennsylvania inheritance tax benefit as well.

Suppose a client owns 10 rental real estate properties in his or her individual name. This is likely to be one business for purposes of the QFOBI provision. However, if the client were to own 10 limited liability companies and each LLC owns one property, there may now be 10 QFOBIs available for transfer free of inheritance tax. There are good business reasons for having separate entities for each of the properties, such as limitation of liability. Now there is a Pennsylvania inheritance tax benefit as well.

In estate planning for business owners, it is now important not to overlook any of the requirements for qualifying a business interest for the new exemption. For example, the business owner should not transfer the business interest to a revocable living trust if the business interest would otherwise qualify as a QFOBI. Similarly the beneficiary cannot be a trust either.

Minimizing the inheritance tax savings may not always be a primary planning objective. If the client is concerned about leaving a business interest outright to a child because of creditor or divorce problems, it would be better to pay the inheritance tax than risk losing the asset to a creditor or future ex-spouse. In addition, the seven-year holding requirement imposed on the QT could create a hardship on the future operation of the business. For example, it could limit the QT's ability to raise financing and grow the business. Of course, if such circumstances occur, the QT could simply decide to pay the inheritance tax in order to go forward with the transaction needed to grow the business.

Analysis of the statute shows that the opportunities for Pennsylvania inheritance tax savings are much greater than the $5 million ceiling in the law would indicate. Substantial value can pass to family members free of Pennsylvania inheritance tax. In fact there is no cap on the amount of value that can be excluded from the estate. With careful planning under the right circumstances, this provision can be a windfall to transferees of family-owned businesses in Pennsylvania. ■

[1] Pennsylvania Governor Signs Tax Code Changes, BNA Daily Tax Report, July 15, 2013.

[2] Commonwealth of Pennsylvania, Comprehensive Annual Financial Report for the Fiscal Year Ended June 30, 2012, page 42.

[3] http://goo.gl/H8Urg7

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