The New PA Inheritance Tax Exemption for Interests in Qualified Family-Owned Businesses

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H.B. 465 signed into law July 9, 2013
– Numerous minor changes to PA tax law:
  • Increase cap on NOL deduction
  • Extended phase out of capital stock and franchise tax
  • Reorganization of Board of Revenue and Finance
  • Added 2 new tax credits
  • City Revitalization and Improvement Zone Program
  • Continues Philly 1% sales/use tax over 7% state/local rate
  • Sales/use tax exemption for aircraft parts/services
Changes to Inheritance Tax Law

• H. B. 465 created new exemption for qualified family-owned business interests
  – Added Section 2111(t) to TRC
  – Aimed at protecting family businesses
  – Concern that inheritance tax could cause family to sell business to pay tax
Summary of PA Inheritance Tax

- PA is one of the few states that still have 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
    - NJ, NY, DE among local states that decoupled
    - 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
  – Charitable
  – Administration expenses
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>
Exemption for QFOBIs

• Section 2111(t) provides new 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
Statutory Requirements

• Definitions
  – Qualified family-owned business interest (QFOBI)
  – Qualified transferee (QT)

• Provisions for recapture of tax
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
Definition of QT

• Husband and wife
• Lineal descendants
  – Children, grandchildren and great grandchildren
• Siblings and sibling’s lineal descendants
  – Brothers, sisters, nephews and nieces
• Ancestors and ancestors siblings
  – Parents, grandparents, uncles, aunts, grand uncles and grand aunts
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
Other Statutory Provisions

- Property transferred to business within 1 year of death is not eligible for exemption
- Applies to decedents dying on or after 7/1/2013
### Potential Tax Savings

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

<table>
<thead>
<tr>
<th>Relationship</th>
<th>Tax Calculation</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>
Potential Tax Savings

- At state level
  - PA inheritance tax generates $804M/year
  - QFOBI provision expected to cost $3.8M/year
  - Less than $\frac{1}{2}$ of 1% per year
Actual Tax Savings

• Impossible to estimate
• Impact will be much greater than the $5M threshold in the statute would suggest
• Statutory language and structure is flawed
• Significant planning opportunities for QFOBIs
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
Net book value < $5M

• Relates to value of business as a whole
  – Not decedent’s interest in the business
• If decedent owns 50% of business with net book value of $10M, the interest is not a QFOBI
Net book value < $5M

- Book value is an accounting concept
  - Based on historical cost of assets
  - Less accumulated depreciation
  - Less liabilities
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 of building will be $500K
  - FMV of building will be $10M
  - Ownership interest in investment property would qualify as QFOBI, and $10M will be excluded from PA inheritance tax
Net book value < $5M

- In above example, tax savings would be:

<table>
<thead>
<tr>
<th>Relationship</th>
<th>Tax Savings Calculation</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Husband/wife</td>
<td>$10M \times 0%</td>
<td>$0</td>
</tr>
<tr>
<td>Child/grandchild</td>
<td>$10M \times 4.5%</td>
<td>$450,000</td>
</tr>
<tr>
<td>Brother/sister</td>
<td>$10M \times 12%</td>
<td>$1,200,000</td>
</tr>
<tr>
<td>All others</td>
<td>$10M \times 15%</td>
<td>$1,500,000</td>
</tr>
</tbody>
</table>
Net book value < $5M

• Many family owned businesses will have balance sheets showing a book value significantly below the FMV of the business
  – Book value does not include good will unless paid for
  – “Sweat equity” does not impact book value
  – Intellectual property created by business may have low book value compared to FMV
  – Liabilities reduce book value
Unlimited QFOBIs

• Statute does not limit decedent to one QFOBI
  – Operating company can be a QFOBI
  – Real estate entity can be separate QFOBI

• In example above, suppose operating company rents real estate from real estate entity
  – If book value of operating company < $5M, it will be a QFOBI as well
  – Operating company could have FMV > $100M, and it would be still be exempt from PA inheritance tax
Issues with Definition of QT

- QFOBI must be wholly owned by decedent or decedent and QTs
  - No key employees
  - No non-QT partners/shareholders
  - No FLPs if there is a corporate GP
Issues with Definition of QT

• Husband and wife
  – Exemption not needed because of 0% tax rate
  – Same sex partner is not a QT
    • 15% tax rate applies
  – Trust for spouse is not a QT
    • Sole use trusts qualify for 0% rate
      – But on surviving spouse’s death, the sole use trust is not a QT, so the exemption for QFOBIs won’t apply in surviving spouse’s estate
    • Creates issues in coordinating with federal estate and gift tax planning
Issues with Definition of QT

• Lineal descendants
  – Children, grandchildren and great grandchildren are QTs
  – Spouses of lineal descendants are **not** QTs
    • Sons-in-law and daughters-in-law are **not** QTs
  – Trust for lineal descendants are **not** QTs
Issues with Definition of QT

• Siblings and siblings’ lineal descendants are QTs
  – Nieces and nephews are QTs
• Spouses of siblings and descendants are not QTs
• Spouse’s siblings are not QTs
  – Brothers-in-law and sisters-in-law are not QTs
• Trusts for siblings and descendants are not QTs
Issues with Definition of QT

• Ancestors and ancestors’ siblings are QTs
  – Parents, grandparents, aunts and uncles are QTs
  – Children of aunts and uncles are not QTs
    • Cousins are not QTs
• Spouse’s ancestors and their siblings are not QTs
  – Mother-in-law and father-in-law are not QTs
• Trusts for ancestors and their siblings are not QTs
Issues with Definition of QT

- Trusts are not QTs
  - Parent cannot put QFOBI in trust for a child
  - Decedent cannot put QFOBI in trust for spouse
    - Cannot use QTIP/UCT planning with QFOBIs
    - Sole use trust is not a QT on death of surviving spouse
  - You cannot put QFOBI in living trust for yourself
  - Minority/disability clauses could result in QFOBI going to a non-QT
Issues Related to Recapture of Tax

• QFOBI must continue to be owned by QT for 7 years following decedent’s death
• Transfer to non-QT triggers tax and interest
• Tax and interest become lien on property of QT who transferred the QFOBI
  – May be contrary to terms of decedent’s will
  – Tax clause may charge tax to a different beneficiary
Issues Related to Recapture of Tax

• Statute allows transfers between QTs
  – Transferee must be a QT with respect to the decedent
    • If QT is child, transfer to QT’s spouse triggers recapture
  – Recapture applies to each QT separately
    • If one QT transfers QFOBI to a non-QT, recapture only applies
ten to that QT, the other QTs do not have to pay tax
    • Doesn’t matter if the business interest would no longer be a
QFOBI because some interest is owned by non-QT
    • Once a QFOBI, always a QFOBI
Issues Related to Recapture of Tax

- What tax rate applies in event of recapture
  - If original QT transfers to non-QT, use QT’s tax rate
  - If original QT transfers to second QT with different rate
    - If second QT transfers to a non-QT, which rate do you use?
    - Example: if decedent’s son transfers QFOBI to decedent’s brother, and brother transfers to third party, is the tax rate 4.5% or 12%?
Issues Related to Recapture of Tax

• Recapture only if QT transfers QFOBI to non-QT
• Sale of assets does not trigger recapture tax
  – If the business sells assets, but QT retains QFOBI, there is no recapture under statute
• Does closing business trigger recapture?
• Does bankruptcy trigger recapture?
• Does change of active business to management of investment assets trigger recapture?
Other Issues

• The business must be in existence 5 years
• Decedent not required to own interest 5 years
  – You could buy interest in business for cash shortly before death
  – If business was in existence for 5 years, it could qualify as a QFOBI
Other Issues

- Transfers within year of death
  - Not exempt unless for business purpose
  - Avoids stuffing cash into business to avoid tax
- But statute exempts QFOBIs from tax
  - Assets of business are not subject to tax
  - So exemption does not apply to assets in business
- Statute should provide that transfers to a business within one year of death are subject to tax unless there is a business purpose
Other Issues

• Business purpose other than managing investments
  – Aimed at preventing decedent from putting cash in entity, buying securities and claiming exemption
  – FLP owning securities will not qualify as QFOBI

• This restriction does not appear to apply to real estate investments
Planning Opportunities

- Using $5M book value requirement
  - Client with low basis assets can pass substantial value free of PA inheritance tax
  - No limit to the PA inheritance tax savings
  - Also obtain step up in basis
  - Planners need to know book value as well as FMV
Planning Opportunities

• Create multiple QFOBIs
  – Put separate assets into separate entities
    • We do this for liability purposes anyway
    • Now there is additional PA inheritance tax benefit
  – Example:
    • If client owns 10 rental real estate properties in individual name, they may constitute one real estate business
    • But if each property is owned by a separate LLC, they could constitute 10 businesses, and all be exempt under the statute
Planning Opportunities

• Planning for transfers of QFOBI’s on first death
  – Consider giving QFOBIs up to federal estate tax exemption amount to QTs on first death
  – Consider giving QFOBIs outright to spouse rather than in trust, so spouse can transfer them as QFOBIs on second death
Don’t Let the Tail Wag the Dog

- Reasons for trusts may outweigh tax savings
  - Divorce
  - Creditors
  - Disability
  - Beneficiary lacks financial skills
- Federal tax savings may outweigh PA tax savings
  - QTIP/UCT planning
  - GSTT planning
Don’t Let the Tail Wag the Dog

• Business planning may outweigh PA tax planning
  – Capital structure
  – Need to raise funds from outside investors
  – Non-QT might be the right successor
    • Maybe the son-in-law should own the business
    • Success of business more important than tax savings

• QT could always choose to transfer QFOBI if needed, and just pay recapture tax
Conclusions

• Statute’s flaws create planning opportunities
• Potential for tax savings is unlimited
  – Statute could have capped benefit at $5M of value
• Structures to take advantage of statute make sense for other reasons
  – Limitation of liability
  – Step up in basis
• Expect to see changes to statute
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