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

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# Background

- 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:

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

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# 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

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# 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

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

# Potential Tax Savings

- At state level
  - PA inheritance tax generates $804M/year
  - QFOBI provision expected to cost $3.8M/year
  - Less than ½ 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
  - ***<u>Net book value less than $5M</u>***
  - 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:

| | |
|---|---|
| Husband/wife: | $10M x 0% = $0 |
| Child/grandchild: | $10M x 4.5% = $450,000 |
| Brother/sister: | $10M x 12% = $1,200,000 |
| All others: | $10M x 15% = $1,500,000 |

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# 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 **<u>not</u>** 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 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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