

Inheritance Tax - Part II

Part II of this series on the PA inheritance tax deals with the taxation of jointly owned property and of retirement benefits.

The Pennsylvania inheritance tax applies to jointly owned property. If Mom puts a \$100,000 CD in the joint names of herself and Son, when she dies, there is an inheritance tax due on half the value of the CD at six percent, that is \$3,000. If Mom dies within a year of putting the CD in joint names, then it is taxed 100%, as if she were the sole owner and the tax is then \$6,000. There is a trap for the unwary here. If Son dies before Mom, then Mom has to pay \$3,000 in PA inheritance tax ($\$100,000 \times \frac{1}{2} \times 6\%$) to get her own money back.

For PA inheritance tax, the rule is that when a joint owner dies, a fraction of the joint account is subject to the inheritance tax. The fraction is one over the number of joint owners. In our example with Mom and Son above, there were two joint owners, so on the death of either, half of the account was subject to inheritance tax. If there were three (3) joint owners, then one-third of the account would be subject to inheritance tax on the death of one of the three joint owners.

The rules for the federal estate tax are quite different. The Internal Revenue Code, as it applies to the federal estate tax, follows a contribution test. In our example if Mom put her \$100,000 CD in joint names with her son and it was all her money, then on her death, 100 percent of the value of the account would be subject to federal estate tax. It would be 100 percent taxable because she had contributed 100 percent of the funds for the acquisition of the asset. Conversely, on Son's death, none of the value of the account would be subject to federal estate tax.

Obviously, proving who contributed what funds can be extremely difficult, if not impossible. The approach of the Internal Revenue Code is to put the burden of proving the source of funds on the taxpayer. Thus if Son died, the Code presumes that it was all Son's money unless his executor can prove to the contrary. What would constitute proof? Can you prove where the money for the purchase of the CD came from? In many cases, it cannot be done. This could lead to a very bad result. As one of my law professors said when talking about these kinds of assets in estate planning, "Stay away from expensive joints."

Before 1981 and the advent of the federal unlimited marital deduction, there used to be many disputes about whether a husband or a wife contributed to the purchase price for jointly held houses and other assets. This problem, at least, was solved. Now when the joint tenancy is between a husband and wife, for federal purposes, each of the spouses is taxed as the owner of one-half. Since the other half passes to the surviving spouse anyhow, and is not taxed, this issue is now only important for income tax basis purposes. The asset in the hands of the survivor gets a step up in basis to the date-of-death value only in one-half of it. (There are a few exceptions to this which you tax professionals should be aware of and which are too "soporific" for this column.)

Assets in a retirement plan, whether it be a qualified pension, profit-sharing, 401(k) plan, IRA or other deferred compensation arrangement are subject to the inheritance tax only if they are

“available” to the participant before death. Available means “the right to possess (including proprietary rights on the termination of employment) enjoy, assign, or anticipate the payment of the benefit. The right to name a beneficiary of unconsumed benefits is not enough to make the benefit subject to inheritance tax. The right to receive a stream of monthly payments is also not enough to make the benefit taxable. If, however, the decedent could have withdrawn the balance in the plan with a less than 10 percent penalty, then it is taxable.

The regulations provide that if the decedent possessed the right to withdraw benefits but that right to withdraw is subject to a penalty of 10 percent or more, then the benefits are not considered available to the decedent before death and are therefore not taxable. Usually these plan assets are not available to anyone under the age of 59 1/2 without payment of the 10 percent penalty, so if death occurs before age 59 1/2 the benefits are not subject to inheritance tax. After that time, when there is no penalty, the plans are subject to inheritance tax unless there is no option for a lump sum withdrawal. Any benefits that are exempt from the federal estate tax (and, yes, there are still some of those around) are also exempt from the Pennsylvania inheritance tax.

If a surviving spouse is the named beneficiary, the benefits, while technically taxable, are taxed at the zero rate so no tax is due. If the beneficiaries are children, the rate is six percent. Of course, all distributions to the beneficiaries are also subject to income tax and may be subject to federal estate tax also. All of these taxes applied to a retirement plan can reduce the value to a small fraction of its date-of-death value.