

Inheritance Tax - Part III

Part III of this series on the Pennsylvania inheritance tax deals with the taxation of future interests, deductions, and the Pennsylvania “sponge tax.”

The Pennsylvania inheritance tax is an excise tax on the receipt of inherited property by a beneficiary. The rate that applies depends on the beneficiary’s relationship to the decedent. The tax for spouses is zero. For lineal descendants--mother, father, grandmother, grandfather, wife or widow of a child, husband or widower of a child--the rate is 4.5 percent, for siblings 12 percent and for all others, the rate is 15%.

This is easy enough to calculate when Sister gets \$10,000 and Son gets \$40,000. But what if Father leaves \$50,000 in his will to pay the income to Sister for life, and on her death, to pay the remainder to Son. How do we compute the tax? Sister doesn’t get all the property. She is only entitled to the income. Son eventually gets the entire remainder but not for many years, until Sister dies. What is that worth now?

When property passes to a trust, like the above example, or a life estate is given to one person and the remainder to another, the interests of the beneficiaries who receive the property at some later date are called “future interests.” In our example, Father created a trust which is to pay the income to his Sister, and on Sister’s death, to pay the remainder to his Son. Son’s right to the remainder is a future interest. Property passing to a Sister is taxed at the 12 percent rate. Property passing to a Son is taxable at the 4.5 percent rate. We do not know how much income the trust will generate, how long Sister will live, or whether there will be any capital appreciation in the trust’s assets. Nevertheless, the tax on both Son’s and Sister’s interests in the trust property is due nine months from the decedent’s death.

The executor is required to value the interests of Sister and Son in accordance with methods of computation and actuarial assumptions that are the same as those used for the federal estate tax. The IRS publishes life expectancy tables from which we can determine Sister’s life expectancy. The IRS also publishes a monthly rate, called the applicable federal rate, which is an interest rate assumption of the income production of assets. Using these published numbers, the executor computes the present value of Sister’s life estate, and the present value of Son’s remainder interest. These sums are then taxable at the 12 percent and 4.5 percent rates respectively. Sounds complicated? It is, unless you are familiar with doing these calculations. The Department of Revenue will provide the factors to compute the valuation of the interest as a service to taxpayers.

There is an added complication if the person receiving the life interest is the decedent’s surviving spouse and the trust is for the “sole use” of the surviving spouse. Then the tax on the remainder interest is not due until the death of the surviving spouse, at which time the entire property passing to the remaindermen is taxed at the appropriate rate. The executor may elect to pay this tax early, that is, nine months from the decedent’s death. If the “pay early” election is not made, then the tax won’t be due until the surviving spouse dies. The decision should be made with the advice of competent counsel. Once made, it cannot be changed.

A number of deductions are allowed in computing the inheritance tax. Deductions reduce the taxable value of the property passing to beneficiaries. Expenses of estate administration including probate fees, appraisal fees, and attorney and executor's fees are deductible. Funeral and burial expenses are deductible. Debts of the decedent including, for example, unpaid bills, expenses of the last illness, income taxes due, and mortgage balances are deductible.

There is a deduction for the family exemption up to \$3,500. The amount must be claimed by and paid to a surviving spouse or to child or parent who lived in the same household with the decedent. It is payable only out of assets that pass under a will or by intestacy.

After the determination of all taxable property, taking deductions, and calculating the tax, one arrives at the amount of Pennsylvania inheritance tax that is due. But that isn't the end of the story.

Pennsylvania has another death tax - the Pennsylvania Estate Tax. This applies to some estates when they are taxable federally. When an estate is taxable federally, the computation of the tax for federal purposes arrives at a tentative tax. Subtracted from this tentative tax is the Unified Credit and the State Death Tax Credit. The Unified Credit is what generates the \$1,500,000 "free pass" or "exemption" from the federal estate tax. The State Death Tax Credit is another credit against the federal tentative tax whose aim is to give a credit against the federal tax due for taxes paid to any of the 50 states. Since the states have various taxation systems, the federal State Death Tax Credit is calculated on a table and is the same regardless of which state you live in.

If your state inheritance tax is less than the State Death Tax Credit allowable on the federal return, then the PA estate tax "picks up" the difference. For example, if the federal state death tax credit was \$45,000 and the PA inheritance tax was \$30,000, the PA estate tax would be \$15,000. The tax is sometimes called the "pick-up tax" because it "picks up the difference between the state death tax credit and the inheritance tax. Sometimes it is called the "sponge tax" because it "soaks up" the difference between the federal state death tax credit and the inheritance tax. And there are those who call it the "slack tax" because it "takes up the slack."

Many states (Florida is one) have only a pick-up tax. States which have other systems of death tax (like PA which has an inheritance tax) also have a pick-up tax. The pick-up tax does not usually increase overall taxes. If Pennsylvania did not have a pick-up tax, then the full state death tax credit would not be allowed on the federal estate tax return and federal estate taxes would increase. The effect of the pick-up tax is just to shift dollars from the federal government to the state government - sort of like revenue sharing.

The IRS is phasing out the state death tax credit (to pay for its other "tax cuts") with only 25 percent of the state death tax table value allowed in 2004 and the state death tax paid being a deduction instead of a credit in 2005 and beyond. All of this is subject to change, and we see a major tax change every inauguration year.

