

Inheritance Tax - Part I

Pennsylvania has two death taxes. One is the inheritance tax. The other is the Pennsylvania estate tax, sometimes called the “sponge tax,” the “pick-up tax” or the “slack tax.”

The Inheritance Tax is an excise tax on the receipt of inherited property by a beneficiary. The rates are:

1. For property passing to spouses, zero percent. (I know this sounds odd, but the law is written in such a way so that property passing to surviving spouses is taxable but at a zero rate. Go figure.) Prior to 1995, transfers passing to spouses were taxable at the six percent rate. This was a very controversial tax and was finally repealed so that no tax is due on property inherited by a widow or widower.
2. For property passing to lineal descendants, mother, father, grandmother, grandfather, wife or widow of a child, husband or widower of a child, the rate is four and one half percent. Lineal descendants include children and more remote descendants. Children includes stepchildren and adopted children.
3. For siblings the rate is 12 percent
4. For property passing to all others, the rate is 15 percent.

There is no exemption for property passing to family members. This is a harsh measure. This means that no matter what the size of the estate, if there is taxable transfer, inheritance tax is due. Small estates are given no relief. This means that the first dollar passing to a child is taxable.

The inheritance tax does not apply to the proceeds of life insurance (in any amount) on the life of the decedent. Property passing to a qualifying charity is exempt from the application of the inheritance tax. The tax must be paid within nine (9) months of the decedent’s death. If the tax is paid within three months of the date of death, there is a five percent discount available for early payment.

The executor of the decedent’s will is responsible for reporting assets and paying the tax on all assets in the estate or any other assets subject to inheritance tax that are known to him. Otherwise, the recipient of property is responsible for filing a return and paying the tax. For example, if a child receives a bank account because it was in joint names with the decedent and the account was not reported by the executor, it is that child’s responsibility to make sure the account is reported properly and the tax is paid.

What property is subject to tax? First, all property passing under the will or by intestacy is taxable. This includes real estate, bank accounts, stocks and bonds, mutual funds, partnership interests, sole proprietorships, collectibles, jewelry, household furnishings. All items must be valued as of the date of death. This means appraisals for real estate, businesses, jewelry, furnishings and the like. Only real estate and physical objects located in Pennsylvania are subject

to the tax. Real estate and physical objects located in other states cannot be taxed by Pennsylvania. (But be cautious, they may be taxed by the state in which they are located.)

Some transfers of property that were made during the decedent's lifetime are subject to the inheritance tax. Gifts made within one year of death are subject to the inheritance tax to the extent they exceed \$3,000 per donee. For example, if Dad gives his children each \$10,000 and then dies within 12 months, \$7,000 of the gift to each child is subject to tax at the six percent rate. Gifts in any amount made more than one year before the date of death are not subject to the tax.

Here is another lifetime transfer subject to tax - a transfer with a retained life estate. Let's assume Mom transfers her home to her daughter by a deed in which she retained the right to use and occupy the home for her life. Even though she has transferred the remainder interest in the home to daughter, the whole value of the home is subject to inheritance tax at the six percent rate on Mom's death.

Some folks think they can avoid this result by transferring the home from Mom to daughter by deed with no reservation of a legal life estate. If Mom continues to occupy the home, the value of the home is still subject to the inheritance tax if there is an "implied" agreement between mother and daughter that Mother can continue to live in the home. Such an agreement need not be in writing. Many people are unaware of this provision of the law and do not pay inheritance tax on such property. Unless an inheritance tax return is filed and the reviewed in detail by the Department of Revenue, or the matter is otherwise brought to the Department's attention, this failure to pay tax may never be discovered.

Lifetime transfers made by the decedent which are revocable are also subject to the inheritance tax. An "in trust for" bank account is an example of this. (This kind of bank account is sometimes referred to as a "Totten" trust.) If Grandfather opens a bank account in his name "in trust for" grandson, on Grandfather's death, this account passes to grandson. However, during his life, Grandfather could have closed the account, changed the beneficiary, and was in full control of the money. The date-of-death balance of this account on grandfather's date of death is subject to inheritance tax at the six percent rate.

Similarly, if the decedent had transferred all of her assets to a revocable trust during her life, the full value of the trust assets on her date of death are subject to inheritance tax. These trusts are sometimes called "living trusts." No inheritance taxes or estate taxes are saved by such trusts.

Part II of this column's series will continue with a summary of the Pennsylvania Inheritance Tax including the treatment of jointly-held property and retirement plans.