The Pennsylvania Inheritance Tax
In comparison with the Federal Estate Tax

The American Taxpayers Relief Act, passed Jan. 2, 2013, brought a degree of stability to the Federal Estate Tax. The Act professes to reflect permanent changes in the Internal Revenue Code transfer tax provisions that affect estates. These changes should be regarded as permanent, even though history says revisions could once again be proposed someday.

The Pennsylvania Inheritance Tax, on the other hand, has not changed recently. It continues to be applicable to all estates, and probably will continue to be a substantial source of revenue for the Commonwealth.

This brochure compares current Federal Estate Tax provisions with current Pennsylvania Inheritance Tax rules to increase awareness of the similarities and differences between the taxes. The information in this brochure is not all-inclusive. Therefore, any planning should be done in consultation with a professional knowledgeable in estate planning.

All references to Federal Estate Tax will be in regular type. All references to Pennsylvania Inheritance Tax will be preceded with this symbol 🟢.

Property Included in the Gross Estate
The Federal Estate Tax is based on the total assets of a U.S. citizen or resident, regardless of the location of these assets.

铋 There is no Pennsylvania Inheritance Tax on real estate or tangible personal property located outside the state.

Alternate Valuation
For Federal Estate Tax purposes, the legal representative of the estate may elect to adopt an alternate valuation, the object of which is to reduce the amount of estate tax otherwise payable when, within the six-month period following the decedent’s death, the gross estate has suffered a decrease in its aggregate value. In that situation, the legal representative may value all the property in the gross estate on the date of the decedent’s death or on the date that is six months after the date of death.

铋 If alternate valuation is adopted, any property sold, distributed, or otherwise disposed of during the six-month period is to be valued as of the date of disposition. The alternate valuation cannot be used to establish a higher income tax step-up in basis. Thus, the election cannot be made unless the estate’s total value and tax thereon are reduced as a result of the election.

铋 For Pennsylvania Inheritance Tax purposes, assets are valued as of the date of death. There are no alternate valuation provisions.

Transfers in Contemplation of Death
For Federal Estate Tax purposes, gifts made prior to death are not included in the gross estate, unless they are made within three years prior to death and are includable under Sections 2036 (retained life estate), 2037 (transfer taking effect at death), 2038 (revocable transfer), or 2042 (life insurance). However, all gifts made within three years of death are included for purposes of qualifying for special use valuation, deferred payment of estate tax, qualified redemptions to pay estate tax, and estate tax liens. The law also requires that any gift tax paid on includable gifts must be included in the decedent’s gross estate. Those gifts required to be in the gross estate will be valued at full fair market value as of date of death or the alternate valuation date.
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For inheritance tax purposes, transfers made prior to one year of the date of death are excluded from taxation. Gifts made within one year of the date of death are included and are taxable to the extent they exceed $3,000 per donee.

Retirement Benefits
For estates of decedents dying after Dec. 31, 1984, all retirement benefits are includable in the gross estate for Federal Estate Tax purposes, regardless of the form of payment. There are limited exceptions for benefits that had commenced prior to 1985.

Proceeds from qualified employee benefit plans that are exempt for Federal Estate Tax purposes are exempt from the Pennsylvania Inheritance Tax. Since the federal exclusion was eliminated for estates of most individuals dying after Dec. 31, 1984, this exclusion is no longer significant. Payments are also exempt to the extent that the decedent (prior to death) did not otherwise have the right to possess (including proprietary rights at termination of employment), enjoy, assign, or anticipate the payment of proceeds.

Powers of Appointment
For Federal Estate Tax purposes, the gross estate includes the proceeds of life insurance that are receivable by the estate or are receivable by other beneficiaries if the decedent possessed any incidents of ownership at time of death. Rights, which constitute "incidents of ownership," include the right to change the beneficiary of the policy, the right to borrow against the policy, the right to assign the policy, the right to revoke an existing assignment of the policy, and a reversionary interest which exceeds 5 percent of the value of the policy at the date of death.

Joint Interests
Property jointly owned by spouses: For Federal Estate Tax purposes, the estate of the first spouse to die will include one-half of the value of property jointly owned with right of survivorship, regardless of which spouse furnished the consideration for the property.

Other joint interests: For Federal Estate Tax purposes, the gross estate includes the value of property held jointly by the decedent and the other joint owner. If acquired by gift or inheritance, only the decedent’s fractional share of the property is included. In all other cases, the entire value of the property is included except to the extent that the executor or administrator can prove that consideration for the acquisition of the property was actually furnished by the surviving joint tenant.

Powers of Appointment
In general, for Federal Estate Tax purposes, the gross estate includes property over which the decedent (at the time of death) had a general power of appointment created after Oct. 21, 1942, regardless of whether it is exercised or with respect to which the decedent released such a power of appointment prior to death. Property subject to a limited power of appointment is not includable, even if exercised.

Proceeds from life insurance policies are exempt from Pennsylvania Inheritance Tax, even if paid to the estate or if the decedent possesses incidents of ownership.

Charitable Deduction
For Federal Estate Tax purposes, a deduction is allowed for charitable bequests. However, split-interest bequests cannot be deducted unless they comply with the specific rules of Section 2055(e), imposing manda-
tory annual pay-out requirements. If a residuary estate is left to charity, the deduction for charitable bequests is reduced by the amount of federal and state death taxes payable out of the residuary estate.

Transfers to qualified charitable organizations are exempt from Pennsylvania Inheritance Tax.

Marital Deduction
For Federal Estate Tax purposes, a marital deduction is allowed for property interests that are considered to have passed from the decedent to the surviving spouse as defined in the statute and regulations. Any property transferred to a spouse during lifetime or at death can be transferred free of gift and estate taxes. Transfers to a spouse can be outright or can be made in trust – either to a power-of-appointment trust, an estate trust, or a qualified terminable-interest trust. Property held in trust for which a marital deduction is allowed in the decedent’s estate will be includable for estate tax purposes in the estate of the surviving spouse.

State Death Taxes
The federal tax credit for state death taxes was eliminated for the estates of decedents dying after Dec. 31, 2004. For those estates, it was replaced by a deduction from the gross estate.

Exclusion
The Federal Estate Tax is computed by allowing a credit for the amount of tax computed on an exclusion amount. For 2002 and 2003 this amount was $1,000,000. For 2004 and 2005, the amount was $1,500,000. For 2006, 2007 and 2008, the amount was $2,000,000. For 2009 the amount was $3.5 million. For 2010 and thereafter, the exclusion is $5 million, adjusted for inflation after 2011. So for 2013, the inflation-adjusted amount is $5.25 million. In addition, for the estates of decedents who die after 2010, the exclusion for spouses is portable. In other words, if one spouse dies and does not use the full exclusion amount, the unused amount may be used by the surviving spouse in addition to the surviving spouse’s own exclusion amount.

Pennsylvania Inheritance Tax is computed at four levels, depending upon the relationship of the transferee to the decedent.

<table>
<thead>
<tr>
<th>Pa. Rate</th>
<th>Transferee</th>
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<tbody>
<tr>
<td>0%</td>
<td>Spouse and parent of a child who dies prior to age 22</td>
</tr>
<tr>
<td>4.5%</td>
<td>Grandparent, parent (unless the 0% rate applies), lineal descendants, (stepchildren and their descendants are considered lineal descendants), and spouse (including widow or widower) of a child.</td>
</tr>
<tr>
<td>12%</td>
<td>Sibling (including a half-sibling)</td>
</tr>
<tr>
<td>15%</td>
<td>All others</td>
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Computational Differences
The Federal Estate Tax is computed on the transfer of assets both during life (if the transfer took place after Dec. 31, 1976) and at death. The computed tax is then reduced by any gift tax paid on lifetime gifts and by the credit for the exclusion amount. Other credits that may reduce the estate tax are the estate tax on a prior transfer of assets from other estates received by the decedent within 10 years of death and foreign death taxes on assets taxed by other nations.

The rate tables for the Federal Estate Tax are found in Section 2002 of the Internal Revenue Code. The maximum rate presently applicable to the estates of decedents is 40 percent.

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Special Valuations

For Federal Estate Tax purposes, if certain conditions are met, real property used in a closely held business or used as a farm may be valued in a decedent’s gross estate on the basis of its actual use, rather than on the usual basis of “highest and best use.” The purpose is to benefit the estates of farmers and owners of closely held businesses by reducing the estate tax and, therefore, encouraging qualified heirs to continue the use of the property for farm and other small business purposes. This special use valuation cannot, however, reduce the value of the property by more than $750,000, adjusted for inflation, in the case of a decedent who died after 1998.

For Pennsylvania Inheritance Tax purposes, no special valuation or exclusion is applicable to closely held businesses. There is an exception for real estate devoted to the business of agriculture and transferred between members of the same family, which is not subject to tax in the estates of persons dying after June 30, 2012. In addition, special provisions allowing a reduced valuation apply generally to land used for an agricultural purpose or held in an agricultural reserve or forest reserve. Real estate that qualifies under this latter provision may be valued at its worth for agricultural use or as devoted to agricultural reserve or forest reserve rather than its fair market value.

Generation-Skipping Transfers

A federal tax is imposed on a generation-skipping transfer. A generation-skipping transfer is a taxable distribution, a taxable termination, or a direct skip. A taxable distribution is any distribution from a trust to a skip person. A taxable termination occurs at the time of the termination of an interest in property held in trust where no non-skip person thereafter has an interest in the property. The termination may be by death, lapse of time, release of a power, or otherwise. A direct skip is a taxable transfer to a skip person. A skip person generally is an individual who is two or more generations below the generation of the transferor or is a trust in which all of the interests are held by skip persons.

The tax is designed to be substantially equivalent to the estate tax that would have been imposed if the property had actually been transferred outright to each generation, except that the rate is determined by reference only to the maximum Federal Estate Tax rate instead of the estate tax progressive rate table.

There is a generation-skipping transfer tax exemption allowed to every individual. The exempt amount is the same as the general exclusion amount for Federal Estate Tax purposes. (See the Exclusion section.)

Pennsylvania does not impose a separate generation-skipping transfer tax.

Filing and Paying the Tax

The due date for filing the return and paying the Federal Estate Tax is nine months after the date of death. An extension for filing may be granted for an additional six months. To the extent the tax is paid within three months after death, a discount of 5 percent is allowed.

Installment Payment Election

For Federal Estate Tax purposes, if certain conditions are met, the payment of estate tax attributable to an interest in a closely held business can be made in installments over a 15-year period.

For Pennsylvania Inheritance Tax purposes, tax due on qualifying small business transfers can be paid in 20 quarterly installments with interest.

To find out more, contact:

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