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PENNSYLVANIA INHERITANCE TAX SAVINGS FOR FAMILY OWNED BUSINESS

A practical guide from the Artell Law Group team

A major concern for many family owned businesses is deciding when and how to transfer the business to the next generation in way that will allow the business operations to continue. In ideal circumstances, ownership in the family business is transferred to the next generation through strategic estate planning, such as gifting shares or other ownership interests over a period of time. However, in the absence of a strategic estate plan or when such plans are disrupted by the untimely passing of the family business owner, Pennsylvania has provided a way to allow a family-owned business to pass to the surviving family members with no inheritance tax impact.

In order to appreciate the impact of such an exemption, it is helpful to understand that the Pennsylvania Inheritance Tax applies to every dollar that is transferred through an individual's estate (with only a very few limited exceptions). The applicable inheritance tax rates in Pennsylvania are based off of the beneficiaries' relationship to the decedent and are structured as follows:

- Surviving Spouse – 0%
- Parents, children and grandchildren – 4 ½ %
- Siblings – 12%
- All other beneficiaries – 15%

The Pennsylvania Inheritance Tax may have a dramatic impact to family-owned businesses that, on the books, appear very valuable, when in actuality the business's real value is comprised of mostly non-liquid assets such as real estate or machinery. If there were no exemption to the Pennsylvania Inheritance Tax for family-owned businesses, upon the death of the owner, the beneficiaries could owe a substantial amount of inheritance tax on the fair market value of the business at time of the owner's death. In the not so distant past, many family-owned businesses were hit with a large inheritance tax bill, which required the surviving family members to sell off business assets that were necessary for the continued operations of the business. Alternatively, some families paid the inheritance tax by liquidating their own individual assets or encumbering the business through various forms of financing. In some instances, the burden of the inheritance tax caused family-owned business to their shut their doors.

In recognizing the burden that the Pennsylvania Inheritance Tax places on many family owned-business and their families, the Pennsylvania legislature created the specific exemption from Pennsylvania Inheritance Tax for a "Qualified Family-Owned Business Interests".

Qualified Family-Owned Business Interests

The Qualified Family-Owned Business Interests exemption (herein "QFOBI") applies to any sole proprietorship or any entity conducting a trade or business that meets each of the following criteria:

1. has fewer than 50 full-time equivalent employees;
2. has a net book value of assets less than $5 million;
3. is wholly owned by the decedent or by the decedent and members of the decedent's family that meet the definition of a "qualified transferee";
4. is not engaged in the management of investments or income producing assets as the business's primary purpose; and
5. has been in existence for at least 5 years prior to the decedent's death.

In order to fully qualify for the QFOBI exemption, the transfer of the business interest must be made to a "qualified transferee" (herein "QT"). For purposes of the QFOBI exemption, a QT is (1) a spouse, (2) a linear descendant, (3) a sibling, (4) a sibling's lineal descendants, (5) a parent or grandparent, and/or (6) a parent's or grandparent's siblings. The applicable relationship must be relative to the decedent who owned the business interest.

Once a QT has ownership of the business interest after the death of the deceased business owner, the business must continue to be owned by a QT (or multiple QTs) for a period of seven years beyond the date of the deceased business owner's death. If at any time during these seven years the business fails to qualify for the QFOBI exemption, the transfer of the business interest will be subject to inheritance tax, in the amount that should have been paid if the exemption did not apply (plus interest since the date of deceased business owner's death).

In order to properly claim the QFOBI exemption, the exemption must be included on a timely filed Pennsylvania Inheritance Tax Return for the deceased business owner's estate. Furthermore, the law requires the business claiming this exemption to certify to the Pennsylvania Department of Revenue on an annual basis that the business continues to qualify for the exemption.

The proper use of the QFOBI exemption may result in substantial tax savings and allow family-owned businesses to remain profitable and in operation after the passing the business's owner. Please contact us if you have any questions or need assistance with qualifying a business interest for the QFOBI exemption. We can also provide assistance with business succession planning, estate planning as well as probate and estate administration.