Pa. Inheritance Tax – The Fix Is In!

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Having spent my career struggling with constantly changing tax laws seemingly designed to make matters as difficult as possible, I was pleasantly surprised by a recent Pa. Dept. of Revenue policy change that stands to remedy a long-standing problem with the way inheritance tax works. The problem concerns the consequences of the prohibition against filing an amended return. You're still not allowed to call one an "amended" return (as before, only "supplemental" returns are permitted), but the conceptual distinction between *changing or eliminating something on* (amending) and *adding something to* (supplementing) an originally filed return is now gone.

To illustrate the problem, suppose you scheduled "10 shares of ABC Corp. @ $15.00 per share" for a value of $150.00 on your originally filed return and later discovered that the date-of-death value was $25.00 per share. Until the recent policy change, you couldn't correct it. But now, you can file a supplemental return and schedule "10 shares of ABC Corp. originally valued @ $15.00 per share but revalued @ $25.00 per share" and schedule the value as being the $100.00 increase (you could also schedule a negative value for a decrease). The Dept. of Revenue will issue a combined assessment for both returns that values the 10 shares of stock at $250.00.

While this might not seem earthshaking, it takes on greater significance when the stock is sold and the transaction reported for income tax purposes. This is so, because the date-of-death value of a decedent's asset becomes its new "basis" for income tax purposes (from which capital gain or loss is determined). Since that new income tax basis is presumed to be the value stated on the decedent's death tax returns, being stuck with a basis of $150.00 for the stock will result in a $100.00 capital gain (taxed at a combined Pa. / Federal rate of perhaps 20%) whenever the stock is sold. Revaluing the stock by filing a supplemental inheritance tax return increases the inheritance tax but eliminates the capital gains tax. Most estates pass from parent to children at a 4.5% inheritance tax rate. If you are going to pay tax on $100.00, you would obviously rather pay $4.50 of inheritance tax than $20.00 of income tax. Now, you might not consider a savings of $15.50 to be particularly earthshaking either, but assume we're dealing with real estate and multiply everything by 1,000. Welcome to San Francisco!

There is another consideration with real estate. Inheritance tax deductions not allowed absent a sale become available to be claimed on a supplemental return. Such deductions include not only expenses of sale (brokers' commissions and other closing costs), but also the expenses of maintaining the property for sale (utilities, taxes, insurance, etc.) following the decedent's death. Before the new policy change, estates were economically forced to do everything in their power (obtain extensions and stall once they expired) to try to avoid having to file before sale, which naturally often led to animosity (litigation, penalties) with the Dept. of Revenue. Now (in theory, because it's still too early to tell from experience) those problems have been completely fixed. You can file an original return by the nine-month filing deadline (or fifteen-month extended filing deadline) and pay tax based upon that original return. Then, once all necessary sales have occurred, you can file a supplemental return that adjusts values to match sales prices and claims deductions for maintenance and sales expenses. Unnecessary capital transactions for income tax purposes won't happen.

From the Commonwealth's point of view, inheritance tax is better than income tax, because the tax rates are higher (Pennsylvania income tax rates for individuals and estates are the same). However, the Dept. of Revenue can be expected to have to process a lot more supplemental returns because of the new policy change, and newly available deductions might more than offset any increase in inheritance taxable real estate values overall. The overall result could be a lessening in revenue. So, if you consider the added uncertainty of tax paid on original inheritance tax returns under the new policy, it is somewhat remarkable that the Dept. of Revenue is willing to take on the administrative burden and financial risk of doing this. In my opinion, they are to be praised, and that's something I never thought I would be saying about any taxing authority!