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McNEES INSIGHTS
Asset Planning and Federal Taxation

QUALIFIED FAMILY BUSINESS EXEMPTION FOR INHERITANCE TAX *by Vance E. Antonacci*

The Pennsylvania Inheritance Tax Act was amended recently to exempt interests in a "qualified family-owned business" from the Inheritance Tax. The goal of this exemption is to preserve certain family-owned business enterprises in the event of the death of the owner. Although the exemption makes for a good sound bite, it will have limited application for business succession planning.

The exemption applies if (1) the transfer is to one or more "qualified transferees," (2) the qualified transferee(s) continue to own the business for a seven-year period after the date of death, and (3) the transfer is reported on a timely filed Inheritance Tax return. A "qualified transferee" includes the decedent's spouse, children and other descendants, siblings, the descendants of siblings (nieces and nephews), as well as the decedent's ancestors and the siblings of ancestors (so a decedent's parents and the siblings of parents are included).

Each qualified transferee must certify to the Department of Revenue each year for seven years, that the family business continues to be owned by one or more qualified transferees. The failure to make this certification will result in loss of the exemption. The consequence of the loss of the exemption is that the Inheritance Tax that was avoided is due plus interest on the amount due.

The definition of a qualified family-owned business interest (a "QFOBI") depends on whether the QFOBI is a sole proprietorship or an entity such as a corporation, partnership, or LLC, although there are requirements common to both a sole proprietorship and an entity, all of which are evaluated as of the date of death. First, there must be fewer than 50 "full-time equivalent" employees. Second, the net book value of the business must be less than $5,000,000. Third, the business must have been in existence for five years.

If the QFOBI is an entity, there are two additional requirements. First, the entity must be wholly owned by the decedent and qualified transferees. Second, the entity must be engaged in a trade or business which is not the management of investments or income-producing assets.

There are a number of issues (and perhaps opportunities) with the QFOBI exemption. For example:

- The definition of "qualified transferee" does not include a trust that benefits one or more qualified transferees. Trusts are often an important part of a client's estate plan, such as providing the surviving spouse with creditor protection or consolidated asset management, so this definitional limitation will restrict planning for certain clients.

- A QFOBI that is an entity must be wholly owned by the decedent and qualified transferees. Therefore, businesses that are owned in any part by an unrelated person are not QFOBIs. For example, a partnership or corporation owned by two unrelated persons does not satisfy the definition. Similarly, based on the definition of a qualified transferee, it appears that in-laws are not qualified transferees, so a business owned by two brothers-in-law would not qualify. Furthermore, the definition excludes businesses that have rewarded valuable, unrelated employees with minority ownership interests.

- There are no exceptions to the annual certification requirement. The penalty for failing to meet this requirement is harsh, and a reasonable cause exception would be a fair accommodation.

- The definition of "entity" requires that the entity be in existence for five years. What if as of the decedent's

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3.8% MEDICARE TAX ON NET INVESTMENT INCOME *by Andrew S. Rusniak*

Beginning in 2013, Section 1411 of the Internal Revenue Code imposes a 3.8% "net investment income tax" ("NIIT") on the net investment income (a specifically defined term) of individuals, estate and trusts that have income above certain statutory threshold amounts. Many clients are concerned with whether or not they will be impacted by the new tax, and others are unsure of the application of the tax to income received from their businesses.

The NIIT is an entirely new tax system, which is imposed in addition, and generally without regard to, all other applicable income taxes. Similar to the alternative minimum tax, Section 1411 requires the computation of a dual tax base in order to determine its applicability. For individuals, the statute imposes a 3.8% tax on the lesser of (1) net investment income, or (2) modified adjusted gross income ("MAGI") in excess of (a) $250,000 for Married, Filing Jointly and Surviving Spouses, (b) $125,000 for Married, Filing Separately, and (c) $200,000 for all others (Single, Head of Household, etc.) For estates and trusts, the statute imposes a 3.8% tax on the lesser of (1) undistributed net investment income, or (2) adjusted gross income in excess of the dollar amount at which the highest tax bracket applicable to trusts and estates begins (currently $11,950).

What is net investment income for purposes of Section 1411? The statute and the recently released Treasury Regulations relating to Section 1411 provide that net investment income is the sum of three "categories" or "buckets," less properly allocable deductions. Included with the first category is gross income from interest, dividends, annuities, royalties and rents (unless earned in the course of an active trade or business); included within the second category is other gross income from passive activities and trading in financial instruments or commodities; and included within the third category is the net gain from the disposition of property, including property held for use in passive activities and trades or businesses of trading in financial instruments or commodities. Importantly, the statute does not include the following in the calculation of net investment income: wages, unemployment compensation, operating income from a non-passive business, social security benefits, tax-exempt interest, self-employment income and distributions from qualified retirement plans, such as 401(k)s and IRAs. However, because of the dual tax basis calculation required by the statute, the inclusion of these items in a taxpayer's MAGI can result in the application of the 3.8% tax to other items of income that may have otherwise avoided the imposition of the new tax.

At this point, an example may be helpful. Assume that a taxpayer, a single filer, has wages of $180,000 and $15,000 of dividends and capital gains. The taxpayer's modified adjusted gross income is $195,000, and his net investment income is $15,000. The 3.8% NIIT is applied to the lesser of (1) the taxpayer's net investment income ($15,000), and (2) the taxpayer's MAGI in excess of $200,000 ($0). This taxpayer will not currently be subject to the 3.8% tax.

Assume instead that the taxpayer still has $180,000 of wages, but also has $90,000 of rental income and $10,000 of dividends. The taxpayer's modified adjusted gross income is $280,000, and his net investment income is $100,000. The taxpayer's MAGI exceeds the threshold for single taxpayers by $80,000, and his net investment income is $100,000. The NIIT is applied to the lesser of $80,000 (the amount that the taxpayer's MAGI exceeds the $200,000 threshold) or $100,000 (the taxpayer's net investment income, assuming there are no exceptions to the passive activity rules). The taxpayer will owe net investment income tax of $3,040 ($80,000 x 3.8%) in addition to all other generally applicable taxes.

Although the statute specifically exempts distributions from retirement accounts from the NIIT calculation, the dual base approach to the application of the tax can have the effect of taxing such distributions. For example, if a single filer taxpayer has $10,000 of interest income and $190,000 of wages, his MAGI is $200,000. Thus, the taxpayer will pay no NIIT. However, if the taxpayer had received a $5,000 distribution from an IRA or rolled over a $5,000 IRA to a Roth IRA, that distribution will not be included in net investment income, but it would increase the taxpayer's MAGI. Thus, the taxpayer's MAGI is now $205,000 and his net investment income is still $10,000. The NIIT is applied to the lesser of net investment income ($10,000) and the excess over the $200,000 threshold ($5,000); as a result, the taxpayer will pay the 3.8% NIIT tax on $5,000, even though all that has changed was that the taxpayer received a distribution from an IRA. Thus, although the retirement account distribution was excluded from the net investment income calculation, the dual base application of the tax had the effect of taxing the distribution.

With regard to income received from the ownership of a business, the statute applies the 3.8% NIIT to income earned from passive activities (other than rental income, which will, absent limited exceptions, always be included in net investment income). In general, a passive activity is one in which the taxpayer does not materially participate. A taxpayer only materially participates in an activity if the taxpayer is involved in the operations of the business on a regular, continuous and substantial basis. There are a number of tests in the regulations to check for material participation, but, in general, a taxpayer materially participates in an activity if he participates for

more than 500 hours during the taxable year. Thus, if a taxpayer works more than 500 hours per year (or an average of 10 hours per week) in a business, the income received from that business will be non-passive, and will not be included in his net investment income. However, it will continue to be included in the taxpayer's MAGI, and because of the dual bases explained above, may result in the application of the NIIT to income that would not have otherwise been subject to the tax.

Although the application of the Section 1411 rules can be complex, certain planning opportunities do exist to work within the boundaries of the statute. For example, you may be able to manage your modified adjusted gross income through the use of like-kind exchanges, above-the-line deductions, tax-exempt bonds, and Roth IRAs. You may be able to avoid the imposition of the net investment income tax to income received from your business by "materially participating" in the activity. Because all of these changes may have an effect on other aspects of your financial, business and estate planning needs, it is important to consult with your advisors regarding the "big picture" prior to making any immediate changes. However, planning techniques do exist to lessen or eliminate exposure to the net investment income tax, and these techniques should be used in conjunction with your current investment, income and estate planning arrangements. ■

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PAYABLE ON DEATH ACCOUNTS – PROS AND CONS *by David M. Watts, Jr.*

Many banks encourage the use of payable on death ("POD") accounts, in part because such accounts do not have to go through the estate administration process. If someone in a bank asks who should receive a bank account at your death, that bank account is more likely than not going to be a POD account, whether you know it or not.

The advantages of a POD account are clear – the funds or investments in the account go directly to the named beneficiary without having to be handled by the executor. However, a POD account does not save any taxes, as the owner of the POD account remains the owner until he or she dies. At such time, the named beneficiary of the account can be liable for whatever death taxes, such as the PA Inheritance Tax, are due.

On the con side, quite often a POD account creates more problems than it solves. A POD account is a very inflexible estate planning device. For example, if someone names her three children as the beneficiaries of a POD account, and one child predeceases the account owner, the predeceased child's children will not inherit the predeceased child's share of the account, as would normally be the case if the account had passed pursuant to a will. POD accounts can cause problems for the executor, who may be surprised to find no cash in the estate to pay estate expenses and taxes, with the executor then having to go to those who received the POD accounts and ask for money back to pay estate bills (and good luck with that!). There are ways to recover funds diverted from an estate through the POD designation, but without the cooperation of the account beneficiaries it is an expensive legal process.

There is also the situation where just one child is designated as the POD beneficiary. This might happen when someone says to a bank "I want to put X child on the account," thinking that will give X the right to sign checks on behalf of the account owner. At the account owner's death, X gets the entire balance in the account, often much to the surprise of X's siblings. Sometimes X and his or her siblings are willing to rearrange estate distributions to account for the transfer of funds due to the POD designation, but frequently siblings are not willing to make this accommodation, thus aggravating family disharmony at a difficult time.

If you have POD accounts, make sure that you tell your estate planning attorney, so they can be factored into your overall estate planning. Otherwise, the best-laid plans may go astray! ■

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QUALIFIED FAMILY BUSINESS EXEMPTION *continued from page 1*

date of death the entity existed for three years and the entity's creation was preceded by three years of a sole proprietorship? Logic would dictate that the QFOBI exemption would apply, but this is not clear from the definition.

- What is a "full-time equivalent employee"? This definition will be important for certain businesses that have part-time employees, such as restaurants and seasonal businesses.

- How will the Department of Revenue approach family limited partnerships? A family limited partnership generally will be owned exclusively by qualified transferees, but disputes may arise over whether the partnership was "engaged in a trade or business which is not the management of investments or income-producing assets."

- The $5,000,000 book value requirement favors service oriented businesses (such as consulting) over capital intensive businesses (such as manufacturing or construction).

- There is no "common holding" limitation. Therefore, for certain businesses that do not meet the QFOBI definition, a spinoff of a division into a separate entity may be considered to divide employees and equity to ensure that both entities qualify as QFOBIs.

Although the QFOBI exemption will benefit some business owners, the exemption has limited application. In addition, many business succession plans involve the lifetime transfer of business interests, such as a sale to a third party or a transfer to one or more family members. This lifetime planning should not be affected by the exemption. Also, the growth and success of a family business should not be constrained by trying to maintain QFOBI status. Many planning techniques exist to mitigate or eliminate exposure to the Inheritance Tax (and the Federal Estate Tax), and these techniques can be employed to allow for the growth of a family business beyond the definitional limitations. ■

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