

# The PA Inheritance Tax Exemption for Qualified Family-Owned Business Interests - 10 Years Later

## Does a Rental Real Estate Business Qualify for the Exemption?

By Charles Bender

It has been over ten years since Pennsylvania added Section 2111(t) of the Tax Reform Code, providing that the transfer of qualified family-owned business interests to qualified transferees is not subject to Pennsylvania inheritance tax. Since that time, the General Assembly has amended the statute to address trusts, one of the bigger shortcomings in the statute. Since the amendment, my group has filed inheritance tax returns claiming the Qualified Family-Owned Business Exemption to see how the Department of Revenue (DoR) is interpreting the statute. This article reviews the changes to the statute and how the it has been interpreted and administered by the DoR (based on my experience). In particular, it focuses on whether a rental real estate business qualifies for the exemption.



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2. lineal descendants,
3. siblings and the sibling's lineal descendants, or
4. ancestors and the ancestor's siblings.

The statute also has several requirements in order for the QFOBI to qualify for and maintain the inheritance tax exemption. These requirements include (i) the interest must be reported on a timely-filed Pennsylvania inheritance tax return, (ii) the interest must continue to be owned by a QT for seven years after the decedent's death, (iii) an annual certification must be filed by each QT for the seven-year period and (iv) recapture provisions if the interest is transferred to a non-QT during the seven year period.

For a more complete explanation and discussion of these statutory provisions, please refer to my article entitled *The New Pa. Inheritance Tax Exemption for Qualified Family-Owned Business Interests* published in the Summer 2013 edition of the Real Property, Probate & Trust Law Section Newsletter, referred to herein as my prior Article.

### 2016 Changes to Section 2111(t)

Pennsylvania Act 84 of 2016 replaced the concept of QT with the statutory definition of "members of the same family" and added language that permits trusts for the benefit of members of the same family to own QFOBIs.

By adding trusts for the benefit of members of the same family, the amendment addressed one of the major shortcomings of the statute as originally enacted. This change allows taxpayers to use typical estate planning vehicles while still having the transfer qualify for the exemption. In many cases, revocable living trusts, QTIP marital trusts, PA sole use trusts, trusts for children and grandchildren to protect from creditors and future ex-spouses, QSSTs, and ESBTs may be permissible transferees.

The change in the definition is taxpayer friendly. Members of the same family is defined in Pennsylvania Statutes, 72 P.S. § 9102:

**Members of the same family** - Any individual,

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### Summary of Section 2111(t)

The heart of the statute is the definition of qualified family-owned business interest (QFOBI) and qualified transferee (QT).

If the QFOBI is a **sole proprietorship**, it must be one that:

1. has fewer than 50 full-time employees,
2. has a net book value of less than \$5 million,
3. has been in existence for five years prior to the decedent's death, and
4. is wholly owned by the decedent or the decedent and members of the decedent's family that are QTs.

If the QFOBI is **an entity carrying on a trade or business**, in addition to having to meet the above four criteria, it must also be:

5. engaged in a trade or a business, the principal purpose of which is not the management of investments or income-producing assets owned by the entity.

QT is defined as:

1. husband and wife,

such individual's brothers and sisters, the brothers and sisters of such individual's parents and grandparents, **the ancestors and lineal descendants of any of the foregoing, a spouse of any of the foregoing and the estate of any of the foregoing.** Individuals related by the half blood or legal adoption shall be treated as if they were related by the whole blood. For a transfer made by a surviving spouse, the term shall include any individual considered to be a member of the same family of the decedent spouse. (Emphasis added).

This definition is much broader than the definition of QT. Ancestors and lineal descendants of any of the foregoing include children of aunts and uncles (i.e., cousins), who were not included in the definition of QT.

A spouse of any of the foregoing includes daughters/sons-in-law, who were not included in the definition of QT. The new definition also includes spouses of nieces/nephews and spouses of cousins, none of whom were included in the definition of QT.

Notwithstanding the change from QT to members of the same family, the DoR still occasionally uses the term QT. As recently as 2024, in a decision of the Board of Appeals in an estate I was handling, it used the term QT throughout its decision. In their defense, I used the term in the Protest I filed, so we were both guilty of the same infraction.

### Claiming the Exemption

Schedule C of the PA Inheritance Tax Return is used to report closely-held Corporations, Partnerships and Sole-Proprietorships. Any QFOBI interest should be reported on Schedule C. When claiming the exemption, the value of the interest will be listed at zero.

The DoR created a new Form Rev-571 for claiming the QFOBI exemption, Schedule C-SB.

Section I contains the information needed to show that the business interest is a QFOBI. For entities, I use the net book value from the balance in Schedule L of the entity's federal Form 1065, 1120 or 1120-S. For sole-proprietorships, I use the adjusted tax basis of the assets used in the business. In each estate where I have claimed the QFOBI exemption, the book value I listed was accepted by the DoR.

For the date of death value, I have used Schedule C-1 for each QFOBI, and valued the interest as if it were not a QFOBI. In the alternative, a third party business valuation could be used. In each estate where I have claimed the

QFOBI exemption, the date of death value I listed was accepted by the DoR. In the estates where the QFOBI exemption was disallowed, the inheritance tax was calculated using the date of death valuation that was reported on Form C-SB.

Section II provides the DoR with the contact information of the beneficiaries receiving the QFOBI. Assuming the QFOBI qualifies for the exemption, the DoR will mail these beneficiaries the annual Certification which must be filed by the beneficiary for seven years after the decedent's death.

### Does a Real Estate Business Qualify for the QFOBI Exemption

In my experience, the most controversial issue with the QFOBI exemption is whether a real estate business qualifies for the exemption. As of the date of this article, the DoR website's Q&A section has the following questions and answer:

"If the sole purpose of the **business** is the management and leasing of real estate, does the **business** qualify for the exclusion?"

Originally, the answer was simply "No." In November of 2022, they changed the answer to:

"No. If the principle (sic) purpose of the entity is the management of investments or income-producing assets, including leased or rental property, it would not qualify for the business exemption."

It is interesting that the question asks if the sole purpose of the **business** is the management and leasing of real estate, does the **business** qualify for the exclusion, while the answer refers to an **entity**, not a **business**. I believe this is an intentional distinction. If you refer the definition of QFOBI above, you will see the requirement that the business "is engaged in a trade or a business, the principal purpose of which is not the management of investments or income producing assets" only applies to entities. Sole-proprietorships are not required to meet this test.

If the distinction in the Q&A is intentional, and the DoR's response is read to mean that its position is that an entity engaged in the rental real estate business does not qualify for the exemption, I take it to mean that a sole-proprietorship engaged in the rental real estate business **does qualify for the exemption.**

But don't take my word on this. Let's look at six estates that claimed the QFOBI exemption and how the DoR handled each. They are listed in chronological order to show the

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progression of the DoR's position.

#### **Estate #1**

The estate reported three businesses it claimed were QFOBIs entitled to the exemption. The first business was an LLC that operated a surgical center. The second business was an LP that owned the real estate used by the surgical center, and the third was a sole-proprietorship that consisted of another rental property owned in the decedent's individual name.

The PA inheritance tax return was accepted as filed, with all three business interests qualifying for the exemption. Thus, an LLC operating the surgical center (non-real estate business) qualified for the exemption, a real estate business operated through an entity (limited partnership) qualified for the exemption, and a real estate business operated as a sole-proprietorship qualified for the exemption. The resulting tax savings was \$301,410.

#### **Estate #2**

The estate reported two businesses it claimed were QFOBIs entitled to the exemption. The first business was an LP that owned the real estate where the partners were the decedent and her daughter. The second business was a sole-proprietorship that consisted of a 50% tenant in common interest in a rental property owned by the decedent with her daughter as the other 50% tenant in common.

The PA inheritance tax return was **accepted as filed**, with both business interests qualifying for the exemption. Therefore, a real estate business operated through an entity (limited partnership) qualified for the exemption, and a real estate business operated as a sole-proprietorship in the form of a 50% tenant in common interest qualified for the exemption. The resulting tax savings was \$129,712.

#### **Estate #3**

The estate reported one business it claimed was a QFOBI entitled to the exemption. The business consisted of a corporation that operated a drive-in movie theater. The corporation owned the real estate where the drive-in theater was located.

The PA inheritance tax return was **accepted as filed**, with the business interests qualifying for the exemption. The resulting tax savings was \$289,341. The qualifying family member here was a nephew, taxable at 15%.

This result was expected since no real estate business was involved. But it is interesting to compare a corporation that owns the real estate that it uses for its business to an entity that rents the real estate that it uses from another entity

owned by the decedent, as in Estate #1 above. You would think they should receive the same tax treatment, and in fact they did.

#### **Estate #4**

The estate reported two businesses it claimed were QFOBIs entitled to the exemption. The first business was a corporation that operated a paint can manufacturing business. The second business was a sole-proprietorship that consisted of the real estate where the corporation operated its business that was owned in the decedent's individual name.

The PA inheritance tax return was **accepted as filed**, with both business interests qualifying for the exemption. So, a corporation operating a manufacturing business (non-real estate business) qualified for the exemption, and a real estate business operated as a sole-proprietorship qualified for the exemption. The resulting tax savings was \$107,781.

#### **Estate #5**

The estate reported one business it claimed was a QFOBI entitled to the exemption. The business consisted of a corporation that owned a commercial real estate building that contained seven separate rental units. The potential inheritance tax savings was \$84,002.

The PA inheritance tax return **denied the QFOBI exemption**, stating:

The Qualified Family-Owned Business Exemption has been disallowed as the principal purpose of the business is to manage rental/leased properties.

Based on the results of the first four estates described above, the estate filed an appeal with the Board of Appeals. The estate argued that the commercial real estate business is not the management of investments or income producing assets, and that other entities operating rental real estate businesses have qualified for the exemption.

The **Board of Appeals denied the Appeal**, stating:

Upon review of Departmental records and documents submitted, the Board finds that the business is commercial real estate rental properties. The petitioner has not provided any evidence to rebut that this is not the management of investments or income-producing activities.

The estate appealed the Board of Appeals decision to the Court of Common Pleas. Its Petition consisted of a 576-page filing, citing legislative history, rules of statutory construction

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and equal protection arguments, i.e., other entities operating rental real estate businesses have qualified for the exemption. Failure to allow the exemption to this estate represents an incorrect, unfair and unequal application of the law.

In addition, we found one reported case dealing with the application of the QFOBI exemption to a real estate business. In the Estate of Isabel Carrasquillo-Rivera, the decedent owned what the Court described as a “real estate empire.” Although the issue decided in the case was not whether the real estate business qualified for the exemption, the DoR granted the exemption to the estate, and the court acknowledged that the estate qualified for the exemption. Estate of Isabel Carrasquillo-Rivera, Deceased, No. 1817 DE of 2014, (Phila. O.C. 2017), aff’d In re Est of Rivera, 194 A.3d 579 (Pa. Super. 2018).

The DoR, through its Office of Chief Counsel, filed an Answer requesting that the Court deny the QFOBI exemption and dismiss the Petition.

Shortly after filing its Answer, Counsel for the Commonwealth contacted the estate to inform it that the DoR decided to allow the QFOBI exemption, effectively ending the Appeal.

The estate spent approximately \$50,000 in legal fees to achieve a tax savings of \$84,002. But the executors were adamant that they should be entitled to the exemption and had the fortitude to deal with the litigation to make their point.

The estate later filed a supplemental inheritance tax return to claim a deduction for the additional legal fees for the appeals. The DoR approved the additional deduction and issued a refund.

#### **Estate #6**

The estate reported two businesses it claimed were QFOBIs entitled to the exemption. The first business was a corporation that owned rental real estate. The second business was a sole-proprietorship that owned several rental real estate properties operated under a fictitious name. The potential inheritance tax savings was \$236,802.

The PA inheritance tax return **denied the QFOBI exemption**, stating:

The exemption’s (sic) have been disallowed. A transfer under 72 P.S. Section 9111(t) must be engaged in trade of business in where the principle (sic) purpose of which is not the management of investments/securities or income

producing assets.

This estate was originally represented by another attorney. The executor found my prior Article and presented it to the original attorney, who refused to claim the QFOBI exemption, telling the executor it was illegal. Based on this attorney’s advice, the estate made an inheritance tax pre-payment based on the full fair market value of the business interests, in order to qualify for the 5% discount. Before the attorney filed the return, the executor engaged my firm to prepare and file the return claiming the QFOBI exemption and requesting a refund of the tax paid.

By the time the estate received its Appraisal denying the exemption, we had already settled Estate #5. We again filed an appeal with the Board of Appeals.

Once the appeal was filed, we contacted the attorney in the Office of Chief Counsel who handled Estate #5. We described the facts and circumstances of Estate #6 in light of the result in Estate #5. He agreed to review the file with the Board of Appeals examiner handling Estate #6.

A few weeks later, I receive a call from the examiner indicating he fully understood our position and asked if I was willing to forgo a hearing on the appeal. Reading between the lines, I readily agreed.

On March 6, 2024, the Board of Appeals issued its **Decision and Order granting the exemption for both business interests**, and directing that a full refund, plus interest be paid the estate (less any discount that had been applied to the pre-payment). A refund check for the full amount of the overpayment, plus interest, arrived within two weeks.

The result is that we now have a written Decision and Order from the Board of Appeals, and therefore the DoR, that both an entity that operates a rental real estate business and a sole proprietorship that operates a rental real estate business qualify for the PA inheritance tax QFOBI exemption. Going forward, any estate that includes such an asset should claim the QFOBI exemption. And any estate that was denied the exemption and is still within the applicable time for appeal should consider filing an appeal.

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