

The Impact of the Pennsylvania Inheritance Tax upon the Proceeds of Wrongful Death and Survival Actions

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The purpose of this article is to discuss the Pennsylvania inheritance tax consequences of proceeds recovered based on wrongful death and survival claims.

I. PENNSYLVANIA WRONGFUL DEATH AND SURVIVAL STATUTES

For a wrongful death action to be commenced, eligible persons must exist, and those persons must establish that they have suffered a pecuniary loss. The Pennsylvania wrongful death statute¹ allows only a decedent's spouse, children, parents or personal representative, whether or not they are citizens or residents of the Commonwealth of Pennsylvania, to recover damages for the death of the decedent caused by the wrongful act, neglect, or unlawful violence

¹ 42 PA. CONS. STAT. ANN. §8301 (West 2003).

Report of the Chair, continued

6. The new Policy Committee, chaired by Julia Fisher, will review and organize existing Section policies and, where appropriate, suggest new policies.

As you can see, there is a lot going on. However, if there is something else you would like to see happen, please let me hear from you.

of another. In addition to other damages, the statute entitles a plaintiff to recover damages for reasonable hospital, nursing, medical, and funeral expenses, as well as certain expenses of estate administration, necessitated by reason of injuries causing death. The statute provides for the damages to be distributed to the beneficiaries in the proportion they would take the personal estate of the decedent in the case of intestacy and without liability to the decedent's creditors. To avoid a duplicate recovery, such an action may not be pursued if the decedent obtained the same damages during his lifetime or commenced an action for such damages during his lifetime.²

Conversely, survival actions are brought by the administrator or personal representative of the estate to benefit the decedent's estate.³ Survival actions are designed to compensate the beneficiaries of the decedent's estate for the personal claims of the decedent. Under the Pennsylvania survival statute,⁴ any causes of action or proceedings survive the death of the

² 42 PA. CONS. STAT. ANN. §8301(a) (West 2003).

³ *In re Estate of Merryman*, 669 A.2d 1059, 1061 (Pa. Commw. Ct. 1995); *See Kiser v. Schulte*, 648 A.2d 1, 4 (Pa. 1994); 42 PA. CONS. STAT. ANN. §8302 (West 2003).

⁴ 42 PA. CONS. STAT. ANN. §8302 (West 2003).

decedent. A decedent may recover damages for pain and suffering, loss of gross earning power from the date of injury until death, and loss of earning power, less personal maintenance expenses from the time of death through decedent's estimated working life span.⁵

It is important to note that the Pennsylvania Department of Revenue will consider all proceeds of "out-of-court" settlements of wrongful death/survival actions to be attributable to the survival action absent proof of eligible wrongful death claimants.⁶

II. PENNSYLVANIA INHERITANCE TAX

Although most litigation commenced as a result of the death of an individual involves both wrongful death and survival actions, it is only the proceeds from the survival action that are subject to Pennsylvania inheritance tax in the estate of the decedent.

Wrongful death proceeds

⁵ *Walsh v. Strenz*, 63 F. Supp. 2d 548 (M.D. Pa 1999) (holding punitive damages not available under wrongful death actions in Pennsylvania).

⁶ Pennsylvania Inheritance and Estate Tax, 5th Ed., Grossman & Smith, Section 9107(b).

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are not taxable for Pennsylvania inheritance tax purposes, as such proceeds are not property owned by the decedent at death but rather are considered compensation to individual members of the decedent's family for the pecuniary loss sustained by the death of the decedent.⁷ Under Pennsylvania's inheritance tax provisions, awards pursuant to wrongful death actions pass outside of the decedent's taxable probate estate.⁸

On the other hand, survival action proceeds are taxable for inheritance tax purposes. In *Doris Parsowith v. Commonwealth*, 723 A.2d 659, 662 (Pa. 1999), the Pennsylvania Supreme Court held that a widow's settlement payment, which was receivable due to a survival action claim based on the wrongful death of her deceased husband, was taxable for Pennsylvania inheritance tax purposes at a rate of six percent, the rate of tax that was in effect at her husband's death.

Other cases have supported the taxability of survival action proceeds under the Pennsylvania inheritance tax regime. In *Walsh v. Strenz*, 63 F. Supp. 2d 548, 550 (M.D. Pa. 1990), the court held that punitive damages were not recoverable under Pennsylvania's wrongful death statute but instead recoverable under Pennsylvania's survival statute. The significance of the ruling lies in the imputed rule that only survival action proceeds are subject to the Pennsylvania inheritance tax.

⁷ *Doris Parsowith v. Commonwealth*, 723 A.2d 659, 662 (Pa. 1999); *Merryman*, 669 A.2d at 1061 (citing *Tulewicz v. Southeastern Pa. Transp. Auth.*, 606 A.2d 427 (Pa. 1992)).

⁸ *Merryman*, 669 A.2d at 1061.

Furthermore, in *In re Estate of Merryman*, 669 A.2d 1059 (Pa. Commw. Ct. 1995), the Commonwealth Court found that only the survival action settlement proceeds were taxable for Pennsylvania inheritance tax purposes. Eventually, eighty percent of the total settlement proceeds were allocated to the wrongful death claim and twenty percent to the survival claim.⁹

III. ALLOCATION OF PROCEEDS BETWEEN WRONGFUL DEATH AND SURVIVAL CLAIMS

Since the Pennsylvania inheritance tax implications are distinctly different for wrongful death and survival action proceeds, there is a tax advantage to maximizing the wrongful death recovery and minimizing the survival recovery.¹⁰ The trial courts, however, have broad discretion in allocating the proceeds between wrongful death and survival actions.¹¹ The courts have found that each claim should have an amount apportioned to it that bears a relationship to the calculated values of the claims according to the evidence and the allowable elements of damages in each.¹² Although some practitioners believe that the

⁹ *Merryman*, 669 A.2d at 1063.

¹⁰ Vicki Ann Trimmer, Esq., *Allocation of Wrongful Death and Survival Action Litigation Proceeds For Pennsylvania Inheritance Tax*, available at www.pennattorneys.com/news397.

¹¹ *Trimmer*, supra note 10, (citing *Wilson v. Bensalem Township*, 367 A.2d 397 (Pa. Commw. Ct. 1976); *Wexler v. Philadelphia*, 3 D.&C.2d 122 (O.C. Phila. 1955)).

¹² See *Ringler Estate*, 29 Fiduc. Rep. 499, 514 (O.C. Somerset 1979).

courts generally assign two-thirds of the proceeds to the wrongful death claim and one-third to survival, the trend of the courts in wrongful death and survival action settlements is toward a case-by-case, fact-based apportionment of the proceeds.¹³

It is important to note that local rules of some courts require the Pennsylvania Department of Revenue's consent to the allocation of settlement proceeds between the wrongful death action and the survival action. Under the Pennsylvania Probate, Estates, and Fiduciaries Code, the Pennsylvania Department of Revenue is an interested party in any orphans' court proceeding along with any taxing authority whose interests would be affected adversely by the proceeding.¹⁴ As the Pennsylvania Department of Revenue is an interested party in the allocation of wrongful death and survival action proceeds for Pennsylvania inheritance tax purposes, some courts require by local rule that the Pennsylvania Department of Revenue consent (usually by letter) to the proposed distribution.¹⁵ If such consent is not sought, the courts will delay disposition of

¹³ Telephone Interview by Stephanie E. Sanderson with J. Paul Dibert, the Business and Trust Valuation Manager of the Inheritance Tax Division of the Pennsylvania Department of Revenue (Dec. 12, 2003). See also *Trimmer*, supra note 10.

¹⁴ 20 PA. CONS. STAT. ANN. § 767 (West 2003).

¹⁵ See Buck's County Orphans' Court Rules, Petition To Settle Wrongful Death and Survival Actions (where a true and correct copy of correspondence from the Pennsylvania Department of Revenue agreeing with the

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the petition.¹⁶

On the other hand, some courts, in policy or practice (rather than by rule), require the Pennsylvania Department of Revenue's consent to the allocation of the proceeds while other courts do not look for consent from the Pennsylvania Department of

proposed allocation must be attached as Exhibit "E"); Lehigh R.C.P. 2206(f)(8) (where the Petition for Allocation of Proceeds must include as an exhibit a written response from the Office of Chief Counsel on behalf of the Department of Revenue approving or disapproving the proposed allocation of proceeds between wrongful death and survival actions). Telephone Interview by Stephanie E. Sanderson with J. Paul Dibert, the Business and Trust Valuation Manager of the Inheritance Tax Division of the Pennsylvania Department of Revenue (Dec. 12, 2003) (Mr. Dibert named the following counties whose courts require the Pennsylvania Department of Revenue's consent to the allocation of the proceeds: Berks, Lackawanna, Lancaster, Northampton, Pike, Westmoreland, Wyoming, and York).

¹⁶ Mary Jane Barrett, *Probate and Estates Practice Tips for Litigators: Wrongful Death and Survival Actions, Compromises Re Minors and Incapacitated Persons, Select Estate Administration Issues, and Estate, Inheritance and Income Taxes*, Pennsylvania Bar Institute, 2002, at 93.

Revenue.¹⁷ Philadelphia county has a unique situation where the courts do not require the Pennsylvania Department of Revenue's consent to the allocation of the proceeds, but instead the Pennsylvania Department of Revenue is not bound by the court's determination of the allocation.¹⁸

Where a jury has allocated the proceeds between the wrongful death and survival actions, the Pennsylvania Department of Revenue does not usually object or disagree with such determination.¹⁹

¹⁷ Telephone Interview by Stephanie E. Sanderson with J. Paul Dibert, the Business and Trust Valuation Manager of the Inheritance Tax Division of the Pennsylvania Department of Revenue (Dec. 12, 2003) (Mr. Dibert named the following counties whose courts, in practice, require the consent of the Pennsylvania Department of Revenue before allocation of the proceeds: Dauphin, Lebanon, Montgomery, and Schuylkill) (Mr. Dibert also named the following counties whose courts do not require consent from the Pennsylvania Department of Revenue: Allegheny, Chester, and Delaware). See also Barrett, *supra* note 16, at 93.

¹⁸ Telephone Interview by Stephanie E. Sanderson with J. Paul Dibert, the Business and Trust Valuation Manager of the Inheritance Tax Division of the Pennsylvania Department of Revenue (Dec. 12, 2003).

¹⁹ Telephone Interview by Stephanie E. Sanderson with J. Paul Dibert, the Business and Trust Valuation Manager of the Inheritance Tax Division of the Pennsylvania Department of Revenue (Dec. 12, 2003).

IV. PENNSYLVANIA INHERITANCE TAX: VALUATION OF SURVIVAL ACTION PROCEEDS

For inheritance tax purposes, the expected proceeds from a survival action are valued at the decedent's date of death.²⁰

A recent decision of the Court of Common Pleas of Montgomery County, Orphans' Court Division, outlined a date of death valuation method for the value of survival action proceeds. In *Leonard Pearlstein Estate*, 23 Fiduc. Rep. 2d 301 (O.C. Div. Montg. 2003), a wrongful death and survival action was settled five years after the decedent's date of death. That court approved the allocation of settlement proceeds between the wrongful death and survival action, with \$4,076,023 representing the proceeds of the survival action received by the estate. A supplemental inheritance tax return was filed, reporting the value of these proceeds at the date of the decedent's death as \$1,823,115. The original return did not include the claim. The Pennsylvania Department of Revenue appraised the value of the survival action at the actual proceeds of \$4,076,023 and the Department's Board of Appeals affirmed the appraisal. The Montgomery County Orphans' Court found that the survival claim had a date of death value of \$1,120,887.

The court interpreted the definition of "value" in Title 72, Sections 9121(a) and 9102 to mean that the expected proceeds of a survival action must be valued at the decedent's date of death and con-

²⁰ See PA. STAT. ANN. tit. 72, §9121(a) (West 2003); *Leonard Pearlstein Estate*, 23 Fiduc. Rep. 2d 301 (O.C. Div. Montg. 2003).

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cerned itself with how to determine the date of death value. The estate's expert witness testified that by using factors that were known as of the date of death, with a reasonable degree of professional certainty, the expected proceeds could be valued at the date of death. The following factors were used in the expert's analysis:

- a. Liability was questionable and disputed;
- b. The decedent's income tax returns showed income of seven to eight million dollars – a significant portion of the income was from an S Corporation;
- c. Venue was in Philadelphia;
- d. The identity of the attorney who would represent the Estate was unknown, but was expected to be above average because of the size of the estate and because the executor was knowledgeable;
- e. Results of discovery, not being known, were neither favorable nor unfavorable;
- f. Delay damages were not considered;
- g. There were close questions of law and evidence that could greatly affect the damage outcome of the case;
- h. The identity of the judge was unknown; and
- i. The composition of the jury was unknown.

The court held that the method of valuation utilized by the estate's expert witness was correct and, in doing so, adopted a new valua-

tion method for the date of death value of survival action proceeds. However, there is speculation that the *Pearlstein* decision will be strictly construed to apply **only** in Montgomery County. Therefore, it is important to note that the Pennsylvania Department of Revenue might not acquiesce to such valuation methodology in other counties.

V. REPORTING REQUIREMENTS

Under Section 9136(a)(1) of the Pennsylvania Inheritance and Estate Tax Act, a personal representative is required to file a return concerning "property of the decedent administered by him and additional property which is or may be subject to inheritance tax, of which he shall have or acquire knowledge." (emphasis added.) Thus, before litigation commences, it may be advantageous for the practitioner to engage the services of a valuation expert to determine the value of and allocation between wrongful death and survival actions of any potential claims. This approach would enable an estimate to be included in the Pennsylvania inheritance tax return, thereby avoiding the potential need for the estate to seek a refund of monies at a later point in time.

Another important point is that litigation proceeds do not earn interest.²¹ However, interest on unpaid tax will start thirty days after the estate receives the proceeds.²²

In addition, unlike under federal law, the Pennsylvania inheritance tax does not provide a definite statute of limitations. Under Title 72, Section 9137:

²¹ PA. STAT. ANN. tit. 72, § 9143 (West 2003).

²² Barrett, *supra* note 16, at 26.

The department shall have supervision over, and make or cause to be made, fair and conscionable appraisements of property the transfer of which is subject to tax under this article. The appraisement, unless suspended until audit, shall be made within six months after the return has been filed and, if not so made, shall be made within an additional period as the court, upon application of any party in interest, including the personal representative, shall fix.

The Pennsylvania Commonwealth Court, however, held that the Pennsylvania Department of Revenue could not assess tax eight and a half years after the relevant inheritance tax return was filed because the department had not sought a court appointed new time period for assessment, and because of the equitable defense of laches.²³

VI. CONCLUSION

For Pennsylvania inheritance tax purposes, only survival action proceeds are taxable. The courts tend to allocate the proceeds of wrongful death and survival actions based upon the facts of the case and the evidence presented, with some counties requiring notice to or approval by the Pennsylvania Department of Revenue of the allocation, or both. The survival action proceeds received by the estate are valued as of the date of death of the decedent and the *Pearlstein* court has adopted definitive factors to determine this amount. However, the Pennsylvania Department of Revenue may choose to narrowly construe the *Pearlstein* valuation method to apply only to Montgomery County estates.

²³ *Estate of Leitham*, 726 A.2d 1116 (Pa. Commw. Ct. 1999)

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Interplay Between Final Regulations' Definition of "Income" under Sec. 643(b) and the Pennsylvania Principal and Income Act of 2002

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The Internal Revenue Service ("I.R.S.") has issued final regulations revising the definition of "income" under the Internal Revenue Code ("I.R.C.") §643(b) for fiduciary income tax purposes for tax years ending after January 2, 2004. This article discusses the highlights of the final regulations and the implications of the final regulations as they are applied to trusts governed by Pennsylvania's Principal and Income Act.

The New Final Regulations

The final regulations reflect recent changes in state laws defining trust accounting income, enacted in response to both the significant decline in dividend yields and the changes in investment philosophies in recent years. In addition, the final regulations accommodate the administration of trusts under the prudent investor standard adopted by many state legislatures, including Pennsylvania.

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Lastly, for reporting purposes, the practitioner should consider employing the services of a valuation expert to determine an estimate of the value of the survival action for death tax return purposes, assuming the litigation has not been disposed of prior to the filing deadlines.

"Income" under §643(b) is defined as the amount of income "determined under the terms of the governing instrument and applicable local law." Treas. Reg. §1.643(b)-1. However, trust provisions that depart fundamentally from traditional principles of income and principal accounting will not be recognized. Otherwise, the final regulations recognize computations of income that comply with the governing state statute, but only if such statute provides for a "reasonable apportionment between the income and remainder beneficiaries of the total return of the trust for the year, including ordinary and tax-exempt income, capital gains, and appreciation" as discussed below. *Id.*

Power to Adjust

One such "reasonable apportionment" between income and principal recognized by the final regulations is a trustee's adjustment between principal and income that treats the income and remainder beneficiaries impartially as long as the apportionment is allowed under both the governing instrument and an applicable state statute. Pennsylvania's 2002 enactment of the Principal and Income Act has afforded trustees of Pennsylvania trusts the power to adjust between income and principal as well as the option of converting the trust to a unitrust. Specifically, 20 Pa. C.S. §8104(b) requires a trustee to consider a number of factors before making

such an adjustment such as the nature, purpose and expected duration of the trust, the intent of the settlor, the circumstances of the beneficiaries, the economic conditions, the anticipated tax consequences of the adjustment and other factors. *See* 20 Pa. C.S. §8104(b). Once the power to adjust is implemented, a trustee can allocate all or some of the capital gains to income.

Conversion to a Unitrust

The final regulations recognize a trustee's conversion to a unitrust if permitted by the governing instrument and state statute but limits a "reasonable" unitrust amount to a range of three to five percent of the net fair market value of the trust assets. Pennsylvania's Principal and Income Act provides for conversion to a unitrust amount of four percent of the net fair market value of the trust assets and is therefore squarely within the range prescribed by the final regulations. *See* 20 Pa. C.S. §8105(d)(3).

As for what constitutes a permissible calculation of the fair market value of the trust assets for a unitrust, the final regulations require a redetermination of the fair market value, either annually on a particular date or on a multiple-year basis, using an average of the trust's assets

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