

Department of Legislative Services
Maryland General Assembly
2013 Session

FISCAL AND POLICY NOTE

House Bill 722
Ways and Means

(Delegate Afzali, *et al.*)

Estate Taxes - Qualified Family-Owned Business Property - Exclusion

This bill exempts from the State estate tax up to \$5.0 million of qualified family owned business property. In order to qualify for the exemption, the property must pass from a decedent to a qualified recipient who enters into an agreement to use the property for business purposes after the decedent's death. In addition, the bill generally limits the estate tax imposed on qualified family owned business property included in an estate to 5% of the value of the qualified family owned business property that exceeds \$5.0 million.

The bill takes effect July 1, 2013, and applies to decedents dying after December 31, 2012.

Fiscal Summary

State Effect: General fund revenues decrease by a potentially significant amount beginning in FY 2014 due to the exclusion of family owned business property from the estate tax and the applicable tax rate specified by the bill. The amount of the decrease depends on the number of estates affected by the bill and the value of family owned business property excluded from the calculation of the estate tax.

Local Effect: None.

Small Business Effect: Potential meaningful.

Analysis

Bill Summary: The bill exempts from the State estate tax up to \$5.0 million in qualified family owned business property. In order to qualify for the exemption, the property must pass from a decedent to an individual who enters into an agreement to use the property for business purposes after the decedent's death. Qualified family owned business property includes real and personal property that is used primarily for a business that is owned wholly by members of the same family prior to the decedent's death; is located in the State; and was owned by the decedent prior to death or in which the decedent materially participated prior to death.

In addition, the bill specifies that the estate tax imposed on an estate with qualified family owned business property valued in excess of \$5.0 million cannot exceed the sum of (1) 16% of the amount by which the decedent's taxable estate excluding the value of qualifying family owned business property exceeds \$1.0 million and (2) 5% of the value of the qualified family owned business property in excess of \$5.0 million.

The Comptroller is required to (1) adopt regulations to implement the bill and (2) recapture the estate tax benefits provided to qualified family owned business property if within 10 years after the decedent's death the property ceases to be used for business purposes; there was no material participation by the qualified recipient or any member of the qualified recipient's family in the operation of the business; or the property is no longer devoted to the same business.

Current Law: The Maryland estate tax is decoupled from the value of the unified credit under the federal estate tax. When calculating Maryland estate tax liability, an estate is required to use the value of a unified credit that may not exceed the amount that corresponds to an applicable exclusion amount of \$1.0 million. An estate is required to determine estate tax liability without regard to the deduction for State death taxes allowed under Section 2058 of the Internal Revenue Code. Unless the federal credit for state death taxes paid is in effect on the date of a decedent's death, the federal credit used to determine the Maryland estate tax may not exceed 16% of the amount by which the decedent's taxable estate exceeds \$1.0 million. A Maryland estate tax is imposed on the estate of a decedent without regard to whether or not the federal estate tax is in effect as of the date of the decedent's death.

For decedents dying in calendar 2013, the federal unified credit is equal to the amount that corresponds to an exemption amount of \$5,250,000. This amount is indexed to inflation.

Special rules apply under the Maryland estate tax for qualified agricultural land. Chapters 448 and 449 of 2012 (SB 294/HB 444) exempt from the State estate tax up to

\$5.0 million of qualified agricultural property. In addition, the estate tax imposed on qualified agricultural property included in an estate is generally limited to 5% of the value of the qualified agricultural property that exceeds \$5.0 million.

Background:

Federal Estate Tax

The federal government has imposed a linked system of taxes on the transfers of wealth both at the time of death as well as transfers between living individuals including an estate tax on the net worth of assets transferred to other individuals when the person dies. According to the Internal Revenue Service (IRS), the scope of this tax system, as measured by the size of the population directly affected by the system, has recently been quite narrow. The number of taxable estate tax returns filed in most years has represented less than 2% of all adult deaths. For deaths after 1954, a growing percentage of estates were taxed, reaching a peak of almost 8% in 1976. However, the Tax Reform Act of 1976 (TRA-76) significantly decreased the number of taxable estates, with subsequent periodic filing threshold increases limiting the affected decedent population to less than 2% of all adult deaths. In addition, federal estate and gift taxes since World War II have been a minor revenue source, generally comprising between 1% and 2% of federal budget receipts.

The Economic Growth and Tax Relief Reconciliation Act (EGTRRA) of 2001 enacted substantial changes to several federal taxes, including the estate tax; the most significant change was the eventual one-year repeal of the estate tax for tax year 2010. EGTRRA provided over a period of years for:

- a gradual increase in the estate tax exemption, increasing the exemption to \$1.0 million in 2002 and to \$3.5 million by 2009;
- a reduction in top marginal tax rates imposed; and
- a phase out of a credit allowed for state death taxes paid, replacing it with a deduction beginning in 2005.

EGTRRA repealed the estate tax for decedents who died in tax year 2010; however, all of EGTRRA's provisions were to expire in tax year 2011. Subsequent legislation maintained the estate tax but with an exemption amount of \$5.0 million (indexed for inflation) and a maximum rate of 40% beginning in calendar 2013, while maintaining the repeal of the state death tax credit.

Under the state death tax credit, a dollar-for-dollar credit was applied to an estate's federal estate tax liability, up to a specified amount. State death taxes imposed up to the federal credit amount did not impose an increased tax burden on estates above and

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beyond federal estate tax liability, as any state estate taxes paid translated to a corresponding reduction in federal estate taxes. This provided substantial incentive for states to impose death taxes; according to the Congressional Budget Office (CBO), every state prior to the enactment of EGTRRA levied death taxes that were at least equal to the maximum federal credit allowed.

The repeal of the state death tax credit and increase in the federal estate tax exemption had a substantial and rapid impact on death taxes imposed by states. In fiscal 2001 through 2004, the period in which EGTRRA began to impact revenues, total state death tax revenues averaged about \$8.14 billion, or 1.1% of all state revenues. Total death taxes decreased in the next four fiscal years by an average of one-third. The overall decline in state death tax revenues was greater than the decline in federal estate tax revenues; over a similar period total federal estate tax revenues decreased by only a little more than 7%.

Maryland Legislative Response to EGTRRA

The Budget Reconciliation and Financing Act of 2002 (Chapter 440, SB 323) partially decoupled the Maryland estate tax from the federal estate tax for decedents dying after December 31, 2001, thereby continuing the tax notwithstanding the phase out and repeal of the federal credit. The State estate tax is calculated as if the federal tax act had not phased out this credit; however, it was calculated using other provisions of federal estate tax law in effect on the date of the decedent's death. This includes the gradual increase of the unified credit, which would exempt an increasing number of estates over time. In addition, a Maryland estate tax return was required only if a federal return was filed; the temporary repeal of the federal credit in 2010 would have also temporarily repealed the State estate tax.

Chapter 430 of 2004 (SB 508) decoupled the State estate tax from the gradual increase in the unified credit, thus freezing the value of the credit to \$345,800 and equating to an exemption amount of \$1.0 million. Chapter 430 also required calculation of Maryland estate tax without regard to the deduction for State death taxes paid, thereby eliminating a circular calculation and preventing a revenue decrease.

In response to concerns that the decoupled Maryland estate tax imposed a higher rate of taxation on lower-valued estates, Chapter 225 of 2006 (SB 2) limited the maximum tax liability of any estate to 16% of the amount by which the decedent's taxable estate exceeds \$1.0 million.

Given this decoupling of the State estate tax, the impact of future federal estate tax legislation on the State estate tax will generally be limited to changes impacting the valuation of estates. Changes to or repeal of the State death tax credit, increased unified credit, or lowered estate tax rates will not directly impact the State estate tax.

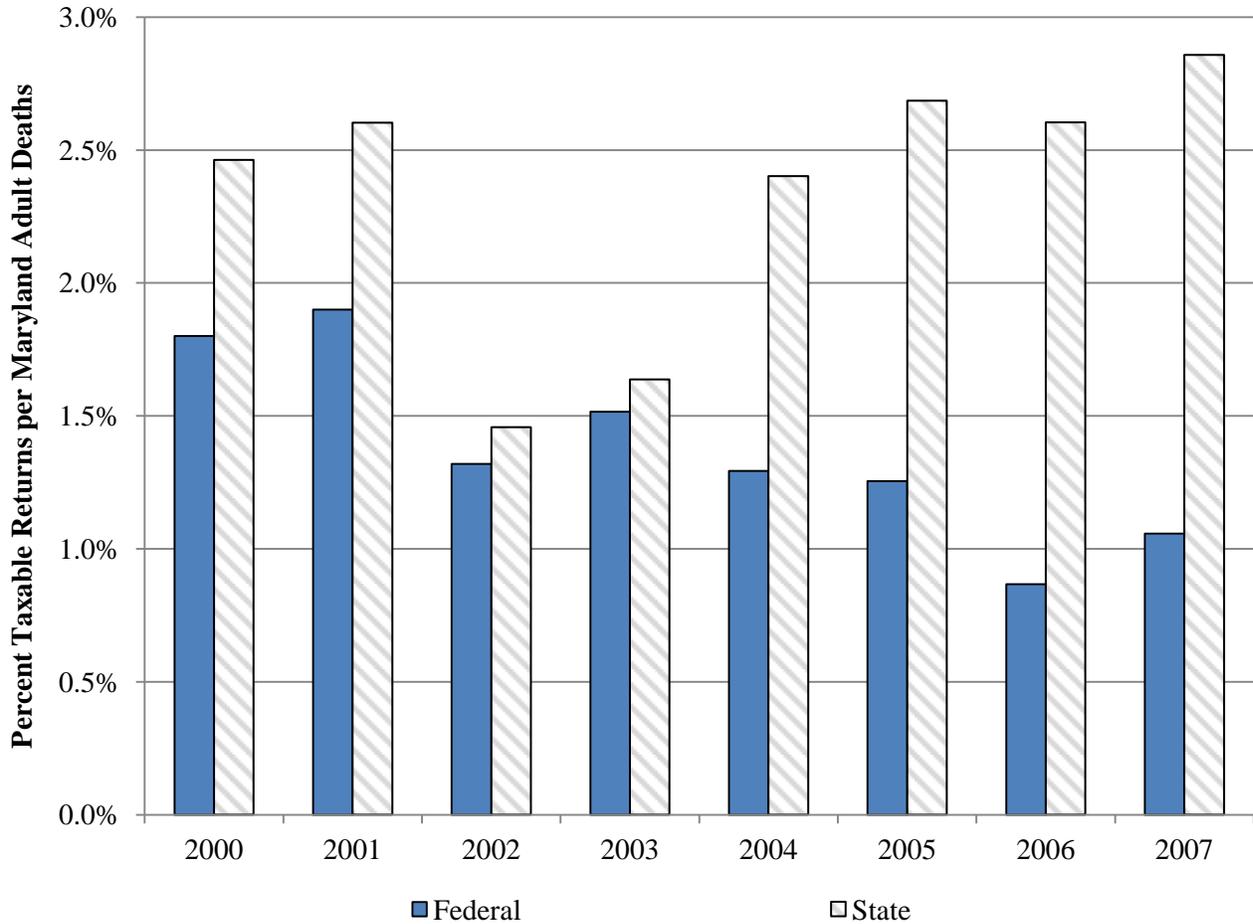
Exhibit 1 shows the estimated percentage of taxable State and federal estate tax returns filed as a share of Maryland adult deaths from 2000 to 2007. The rate of Maryland decedents with a State estate tax liability increased by 15%, to 2.8% of all decedents compared with a 41% decrease (to less than 1 return per 100 decedents) in Maryland decedents with a taxable federal estate. Although the number of taxable returns filed fluctuates with economic cycles, the divergence in taxable federal and State tax returns largely reflects the decoupling of the State estate tax from changes enacted by EGTRRA.

Federal estate tax collections from Maryland returns filed in 2008 totaled \$440.4 million, which is virtually unchanged from returns filed in 2001; this is in contrast to a substantial increase in total State estate taxes over this same time period. As a result, although the federal estate tax imposed a larger total tax burden on Maryland residents, the State estate tax has become a greater share of total estate taxes paid.

In each year a little more than one-half of all State estate tax returns do not owe any estate tax liability. The typical taxable estate for a decedent in 2008 had a Maryland gross estate of \$1.8 million and paid \$61,845 in estate and inheritance taxes. A little more than 25% of all estates paid \$100,000 or more in estate and inheritance taxes.

The average amount of taxes paid and the effective tax rate varies with the size of the estate. In general, the amount of tax paid is equal to far less than the maximum 16% rate imposed. For example, estates between \$1.0 million and \$1.5 million in apportioned gross estate value, which comprised 38% of all returns, paid \$37,120 in estate and inheritance taxes per return. This equates to an average tax rate of 3% of the gross estate and 2.8% of the value of the net estate. At the higher end, estates over \$10 million paid almost \$1.6 million in taxes per return, equating to 5.7% of the gross estate or 8.5% of the net estate plus taxable gifts. Overall, an average of \$140,826 in taxes was paid per return, which equates to 4.9% of the gross estate and 5.2% of the net estate plus taxable gifts.

Exhibit 1
State and Federal Estate Tax Returns, as a Share of Maryland Adult Deaths
2000-2007



Notes: Based on data from the Comptroller’s Office, it is assumed that 3% of taxable State estate tax returns are filed by nonresidents. IRS state-level data is only available by year of file, and it is assumed that federal returns are filed one year after date of death. The percentage of total federal estate tax revenues is a two-year average to smooth annual fluctuations. Adult deaths are deaths of residents age 19 or older.

Source: Department of Legislative Services; Comptroller’s Office; Internal Revenue Service, *IRS Statistics of Income – Estate Tax Returns Filed By State 2001-2008*; Centers for Disease Control and Prevention, *Deaths, Final Data for Years 2000-2007*

Estate Tax and Farms and Small Businesses

Although small business and farm assets compose a low percentage of total assets reported by estates, CBO notes that considerable debate has focused on the potential

negative impact of the estate tax on these operations. Federal law provides for additional estate tax relief for small businesses and farms to address concerns that the federal estate tax could hinder families who wish to pass on a farm or small business to their heirs. Most of these provisions allow for a reduction in the value of the estate for federal estate tax purposes; this reduction generally flows through to the Maryland estate tax and results in a reduction in State tax liability as well.

State Revenues: The bill exempts from the estate tax up to \$5.0 million in qualified family owned business property and also limits the tax that can be imposed on the remaining amount of qualifying family owned business property included in an estate to no more than 5%. As a result, general fund revenues may decrease by a potentially significant amount beginning in fiscal 2014. The amount of the decrease cannot be reliably estimated and depends on the number of estates affected by the bill and the value of family owned business property excluded from the calculation of the estate tax.

Estate tax revenues are volatile due to the limited number of returns and large variations in assets. Much of this volatility is due to fluctuations in the number and assets of large estates. The amount of revenue loss in a year could vary significantly depending on the amount of qualifying family owned business property that is reported on estate tax returns.

Small Business Effect: Small family owned businesses that pay estate taxes will benefit from the reduction in estate taxes. CBO estimates that the estates of small business owners comprised about 1% of all federal estate tax returns filed in 2000. Of the estates of small business owners required to file a return, about one-third had a federal estate tax liability.

Additional Information

Prior Introductions: None.

Cross File: None.

Information Source(s): State Department of Assessments and Taxation, Comptroller's Office, Register of Wills, Department of Legislative Services

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Analysis by: Michael Sanelli

Direct Inquiries to:
(410) 946-5510
(301) 970-5510