HB 321

# Department of Legislative Services

Maryland General Assembly
2005 Session

## FISCAL AND POLICY NOTE

House Bill 321 (Delegate Krebs, *et al.*)
Ways and Means

**Maryland Estate Tax - Unified Credit Effective Exemption Amount and Deduction for State Death Taxes**

This bill repeals provisions of the Maryland Estate Tax that were enacted by Chapter 430 of 2004 by (1) recoupling Maryland estate tax law to the gradual increases in the unified credit allowed against the federal estate tax; and (2) repealing the provision relating to the deduction for State death taxes allowed under the federal estate tax.

The bill takes effect July 1, 2005 and applies to decedents dying after December 31, 2004.

## Fiscal Summary

**State Effect:** General fund revenues could decrease by approximately $14.2 million in FY 2006. Future year revenues reflect increasing unified credit amounts and the current estate tax revenue forecast. General fund expenditures could decrease by approximately $65,800 in FY 2006. Future year expenditure decreases reflect annualization and inflation.

| (in dollars) | FY 2006 | FY 2007 | FY 2008 | FY 2009 | FY 2010 |
|---|---|---|---|---|---|
| GF Revenue | ($14,151,000) | ($31,515,000) | ($37,338,000) | ($39,578,000) | ($56,350,000) |
| GF Expenditure | (65,800) | (89,000) | (93,100) | (97,400) | (101,900) |
| Net Effect | ($14,085,200) | ($31,426,000) | ($37,244,900) | ($39,480,600) | ($56,248,100) |

*Note:() = decrease; GF = general funds; FF = federal funds; SF = special funds; - = indeterminate effect*

**Local Effect:** None.

**Small Business Effect:** None.

## Analysis

**Current Law:** The Maryland estate tax is decoupled from the federal estate tax as discussed below.

**Background:** The federal Economic Growth and Tax Reconciliation Act of 2001 provided for the reduction and ultimate repeal of the credit allowed under the federal estate tax for state death taxes paid (federal credit). Maryland, like most states, had an estate tax that was linked directly to the federal credit. Without statutory changes by the General Assembly, the repeal of the federal credit under the 2001 federal tax Act would have automatically repealed the State estate tax because of the link between the State tax and federal credit.

As part of the Budget Reconciliation and Financing Act (BRFA) of 2002, the Maryland estate tax was partially decoupled from the federal estate tax, thereby continuing the State tax notwithstanding the phase-out and repeal of the federal credit. The State estate tax is now calculated as if the federal tax Act had not phased out the federal credit; however, it is calculated using other provisions of federal estate tax law in effect on the date of the decedent's death.

*Unified Credit*

The unified credit used to calculate the State estate tax, which effectively sets the threshold for taxability of an estate, is the unified credit in effect as of the decedent's death as set forth in federal law. Under the federal Act, the amount effectively exempted under the unified credit was increased from $700,000 to $1.0 million in 2002, and then phased up over a period of years to $3.5 million in 2009.

The 2002 BRFA did not, however, decouple the Maryland estate tax from the gradual increases in the unified credit allowed against the federal estate tax. The Maryland estate tax is calculated as the lesser of the federal estate tax after deducting the unified credit or the State death tax credit, reduced by any inheritance tax paid. As the unified credit increases, the amount of the Maryland estate tax will decline.

The BRFA of 2004 had the effect of freezing the amount of the unified credit at $345,800 so as to exclude $1.0 million from the federal estate tax for purposes of the Maryland estate tax calculation. The 2004 BRFA affected the estate tax returns filed for decedents dying after December 31, 2003.

*Deduction for State Death Taxes*

By remaining coupled to the federal estate tax base, the decoupled Maryland estate tax incorporated a provision of federal law effective beginning in 2005 that would have allowed a deduction for State death taxes paid, in lieu of the previously allowed credit for State death taxes paid. Allowing the deduction of State death taxes for purposes of determining the State death tax base would have resulted in a circular calculation, because the tax being calculated results in a deduction from the tax base, which then alters the calculation of the tax owed.

The BRFA of 2004 required that the Maryland estate tax be determined without regard to the deduction for State death taxes allowed for purposes of the federal estate tax. The BRFA of 2004 effectively created an addition modification to the federal taxable estate for Maryland estate tax purposes in the amount deducted for State death taxes paid. A similar addition modification to the federal tax base is required under the Maryland income tax for State and local income taxes for which a deduction is allowed for federal income tax purposes. This provision simplifies the calculation of the Maryland estate tax while preventing additional loss of revenue from the Maryland estate tax.

**State Fiscal Effect:** General fund revenues could decrease by an estimate $14.2 million in fiscal 2006 as a result of the bill. The estimated effect of each provision is discussed in greater detail below. As noted, this bill repeals provisions of the Maryland estate tax that were enacted by the 2004 BRFA. However, the revenue loss associated with the bill is greater than the revenue increase associated with the 2004 BRFA due to the most recent estate tax revenue forecast by the Board of Revenue Estimates in December 2004.

*Unified Credit*

As discussed above, Chapter 440 of 2002 decoupled the calculation of the Maryland estate tax liability from part of the calculation of the federal estate tax liability. However, Chapter 440 did not decouple the Maryland estate tax from the gradual increases in the unified credit allowed against the federal estate tax. The 2004 BRFA had the effect of freezing the amount of the unified credit at $345,800 so as to exclude $1,000,000 from the federal estate tax for purposes of the Maryland estate tax calculation.

However, the bill "unfreezes" the amount of the unified credit and recouples it to the gradual increases allowed against the federal estate tax.

The following estimate is based on estate tax returns filed for individuals dying during calendar 2002. Each year was calculated alternatively with the decoupled current unified credit under the Maryland estate tax ($345,800) and the credit amount allowed under federal law. The difference, as a percentage of current law, was applied to the official estimates of estate tax revenues. It is assumed that 75% of revenues from those dying in a particular calendar year will come in the following fiscal year and the balance in the next fiscal year.

**Exhibits 1** and **2** show the estimate in greater detail.

**Exhibit 1**
**Estimated Percentage Increase due to Limiting Unified Credit Exemption Amount**

| Year of Death | Exclusion Amount under Current Law | Exclusion Amount under HB 321 | Unified Credit under Current Law | Unified Credit under HB 321 | Estimated Percent of Revenue Decrease |
|---|---|---|---|---|---|
| 2005 | $1,000,000 | $1,500,000 | $345,800 | $555,800 | |
| 2006 | 1,000,000 | 2,000,000 | 345,800 | 780,800 | 24.8% |
| 2007 | 1,000,000 | 2,000,000 | 345,800 | 780,800 | 41.3% |
| 2008 | 1,000,000 | 2,000,000 | 345,800 | 780,800 | 41.4% |
| 2009 | 1,000,000 | 3,500,000 | 345,800 | 1,455,800 | 41.4% |
| 2010 | 1,000,000 | 3,500,000 | 345,800 | 1,455,800 | 69.2% |

**Exhibit 2**
**General Fund Revenue Increase Resulting from Recoupling of Unified Credit**

| Fiscal Year | Current Estate Tax Estimate[1] | Estate Tax Revenue under HB 321 | General Fund Revenue Decrease |
|---|---|---|---|
| 2006 | $113,519,000 | $104,891,000 | ($8,628,000) |
| 2007 | 119,780,000 | 96,980,000 | (22,800,000) |
| 2008 | 126,967,000 | 99,195,000 | (27,772,000) |
| 2009 | 134,585,000 | 105,143,000 | (29,442,000) |
| 2010 | 142,660,000 | 95,454,000 | (47,208,000) |

[1]Bureau of Revenue Estimates

*Deduction for State Death Taxes*

By recoupling to the federal estate tax base, the "decoupled" Maryland estate tax will incorporate a provision of federal law effective beginning in 2005 that will allow a deduction for State death taxes paid in lieu of the previously allowed credit for State death taxes paid. Allowing the deduction of State death taxes for purposes of determining the State death tax base will result in a circular calculation, because the tax being calculated results in a deduction from the tax base, which then alters the calculation of the tax owed. When the federal provision allowing a deduction for State death taxes takes effect, a series of calculations will be required to calculate the Maryland estate tax.

The bill repeals an addition modification that was created under the 2004 BRFA to the federal taxable estate for Maryland estate tax purposes in the amount deducted for State death taxes paid. (A similar addition modification to the federal tax base is required under the Maryland income tax for State and local income taxes for which a deduction is allowed for federal income tax purposes.)

Under prior law, beginning with estates in which the decedent died on or after January 1, 2005, State estate tax revenues would have declined due to the provision of a federal deduction for State death taxes. For an individual return, the value of the deduction would depend on the highest marginal rate to which the estate is subject, which can range up to 16%. On an aggregate basis, the impact on the State will depend on the number and size of estates for which estate tax was paid in the given fiscal year.

The Department of Legislative Services and the Comptroller's Office examined estate tax returns for individuals dying in calendar 2002 and found that the potential revenue loss resulting from the pre-2004 BRFA calculation – as proposed by the bill – of the Maryland estate tax was a little over 10%. This revenue loss would not be realized until September 2005, when returns would be filed associated with deaths occurring on or after January 1, 2005. In fiscal 2006, estimated estate tax revenues could decline by approximately $5.5 million (or approximately 75% of the full year loss), based on estimated filing patterns. In fiscal 2007, estimated estate tax revenues could decline by $8.7 million, the first year of the full impact. Future year decreases reflect the current estate tax revenue forecast.

*General Fund Expenditures*

Due to the changes to the Maryland estate tax made by the bill, the Comptroller would no longer need two positions and related expenditures that are provided in the proposed fiscal 2006 budget in response to the 2004 BRFA. The proposed fiscal 2006 budget provides for two auditors to uncover and audit the estates that, due to the decoupling from the federal unified credit as of January 1 2004, have to file a State estate tax return but not a federal estate tax return. The amount included in the budget for these positions is $65,820 for fiscal 2006.

As a result, general fund expenditures would decrease by approximately $65,820 in fiscal 2006. Future year expenditure decreases reflect annualization and inflation.

*Total Revenue Decrease*

**Exhibit 3** shows the total revenue decrease resulting from the bill. As noted previously, the revenue decrease associated with the bill is greater than the revenue increase estimated in the 2004 BRFA due to a higher estate tax estimate by the Board of Revenue Estimates in December 2004.

**Exhibit 3**
**Total Revenue Effect of HB 321**
**($ in Thousands)**

| | FY 2006 | FY 2007 | FY 2008 | FY 2009 | FY 2010 |
|---|---|---|---|---|---|
| Unified Credit | ($8,628.0) | ($22,800.0) | ($27,772.0) | ($29,442.0) | ($47,208.0) |
| Deduction for State Death Taxes | (5,523.0) | (8,715.0) | (9,566.0) | (10,136.0) | (9,145.0) |
| GF Expenditures | (65.8) | (89.0) | (93.1) | (97.4) | (101.9) |
| **Total** | **($14,085.2)** | **($31,426.0)** | **($37,244.9)** | **($39,480.6)** | **($56,248.1)** |

## Additional Information

**Prior Introductions:** None.

**Cross File:** SB 99 (Senator Greenip, *et al.*) – Budget and Taxation.

**Information Source(s):** Comptroller’s Office, Department of Legislative Services

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