

**Department of Legislative Services**  
Maryland General Assembly  
2011 Session

**FISCAL AND POLICY NOTE**

Senate Bill 678

(Senator Brinkley)

Budget and Taxation

**Maryland Estate Tax - Unified Credit**

This bill specifies that the value of the federal unified credit used to calculate the Maryland estate tax is equal to the amount corresponding to an applicable exclusion amount of (1) \$2.0 million for a decedent dying in fiscal 2012; (2) \$3.0 million for a decedent dying in fiscal 2013; (3) \$4.0 million for a decedent dying in fiscal 2014; and (4) the value excluded under the federal estate tax after July 1, 2014. The bill also provides that, unless the federal State death tax credit is in effect at the time of a decedent's death, the federal credit used to determine the Maryland estate tax may not exceed 16% of the amount by which a decedent's taxable estate exceeds the applicable exclusions specified above.

The bill takes effect July 1, 2011, and applies to decedents dying after July 1, 2011.

**Fiscal Summary**

**State Effect:** General fund revenues decrease by \$20.3 million in FY 2012, which reflects the increase in the value of the federal unified credit and the impact of one-half of a taxable year. Future years reflect the estimated payment schedule of State estate taxes, the increased value of the federal unified credit as specified by the bill, the corresponding value of the federal unified credit after July 1, 2014, and the termination of applicable federal law. No effect on expenditures.

(\$ in millions)	FY 2012	FY 2013	FY 2014	FY 2015	FY 2016
GF Revenue	(\$20.3)	(\$58.3)	(\$82.6)	(\$58.8)	(\$12.6)
Expenditure	0	0	0	0	0
Net Effect	(\$20.3)	(\$58.3)	(\$82.6)	(\$58.8)	(\$12.6)

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

**Local Effect:** None.

**Small Business Effect:** Potential meaningful.

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## Analysis

**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 2011, the federal unified credit is equal to the amount that corresponds to an exemption amount of \$5.0 million. This amount is indexed for inflation after calendar 2011. These provisions do not apply to decedents dying after December 31, 2012, after which the unified credit is equal to the amount corresponding to an exclusion amount of \$1.0 million. The federal deduction for State death taxes paid expires December 31, 2012; after that date, the State death tax credit will apply.

## 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 of which 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 and pre-EGTRRA provisions (\$1 million exemption and a 55% maximum tax rate) would apply beginning in this year. In December 2010, President Obama signed the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, which generally extends EGTRRA tax reductions through 2012. The Act revives the estate tax, but with an exemption amount of \$5.0 million and a maximum rate of 35% and also maintains the repeal of the state death tax credit. Special rules apply for decedents dying in tax year 2010.

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 did not impose an increased tax burden on estates above and beyond federal estate tax liability, as any state estate taxes paid translated to a corresponding reduction in federal estate taxes. For example, an estate that owed \$800,000 in federal taxes and \$100,000 in state estate taxes paid \$700,000 in federal taxes and \$100,000 in state taxes. This provided substantial incentive for states to impose death taxes up to this limit; 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 taxes 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%.

There are currently 22 states and the District of Columbia that impose either an inheritance tax or estate tax. Fifteen states impose an estate tax, six impose an inheritance tax, and two (New Jersey and Maryland), impose both. Of the other

surrounding states, Delaware and North Carolina impose an estate tax while Pennsylvania imposes an inheritance tax.

### *Maryland Legislative Response to EGTRRA*

The Budget Reconciliation and Financing Act of 2002 (Chapter 440) (BRFA of 2002) 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.

BRFA of 2004 (Chapter 430) 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 a federal exemption amount of \$1.0 million. BRFA of 2004 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 limited the maximum tax liability of any estate to 16% of the amount by which the decedent's taxable estate exceeds \$1.0 million.

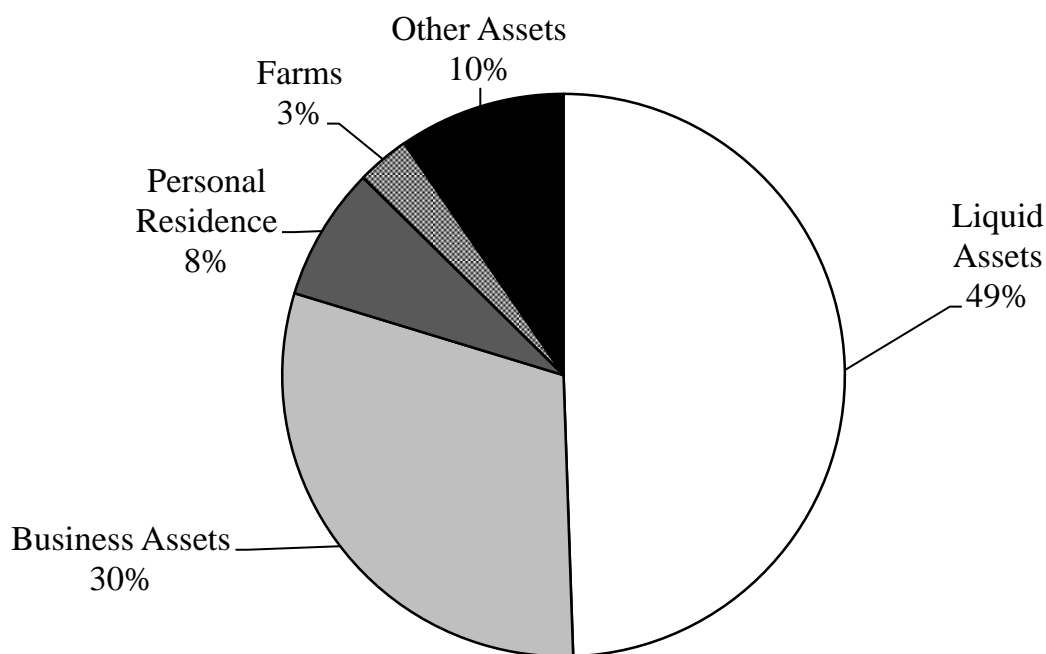
Given this decoupling of the State estate tax, the impact of future federal estate tax legislation will generally be limited to changes impacting the valuation of estates. Changes to or repeal of the state death tax credit, the increased unified credit, or lowered estate tax rates will not directly impact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

### *Composition of Estate Values and Maryland Estate Tax Data*

State-level data on the components of estate values are not available. Estate tax preparers are required to report inventories of decedent asset portfolios for federal estate tax purposes in order to substantiate reported values of total gross estates. The value of assets is the fair market value reduced by any applicable valuation discounts. Of the \$228.9 billion in total gross estate assets reported on all federal returns filed in 2008, almost one-half of the assets were composed of liquid assets such as publicly traded stock, cash assets, and bonds, as shown in **Exhibit 1**.

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**Exhibit 1**  
**Assets of Estates Filing a Federal Estate Tax Return in 2008**



Notes: Liquid assets include government and private-sector bonds, bond funds, publicly traded stock, cash assets, and insurance. Business assets include real estate (other than personal residence), real estate partnerships, closely held stock, mortgages and notes, limited partnerships (including private equity and hedge funds), and other noncorporate assets. Farms include farmland and assets used in conjunction with a farm or agricultural business. Asset values are after valuation discounts.

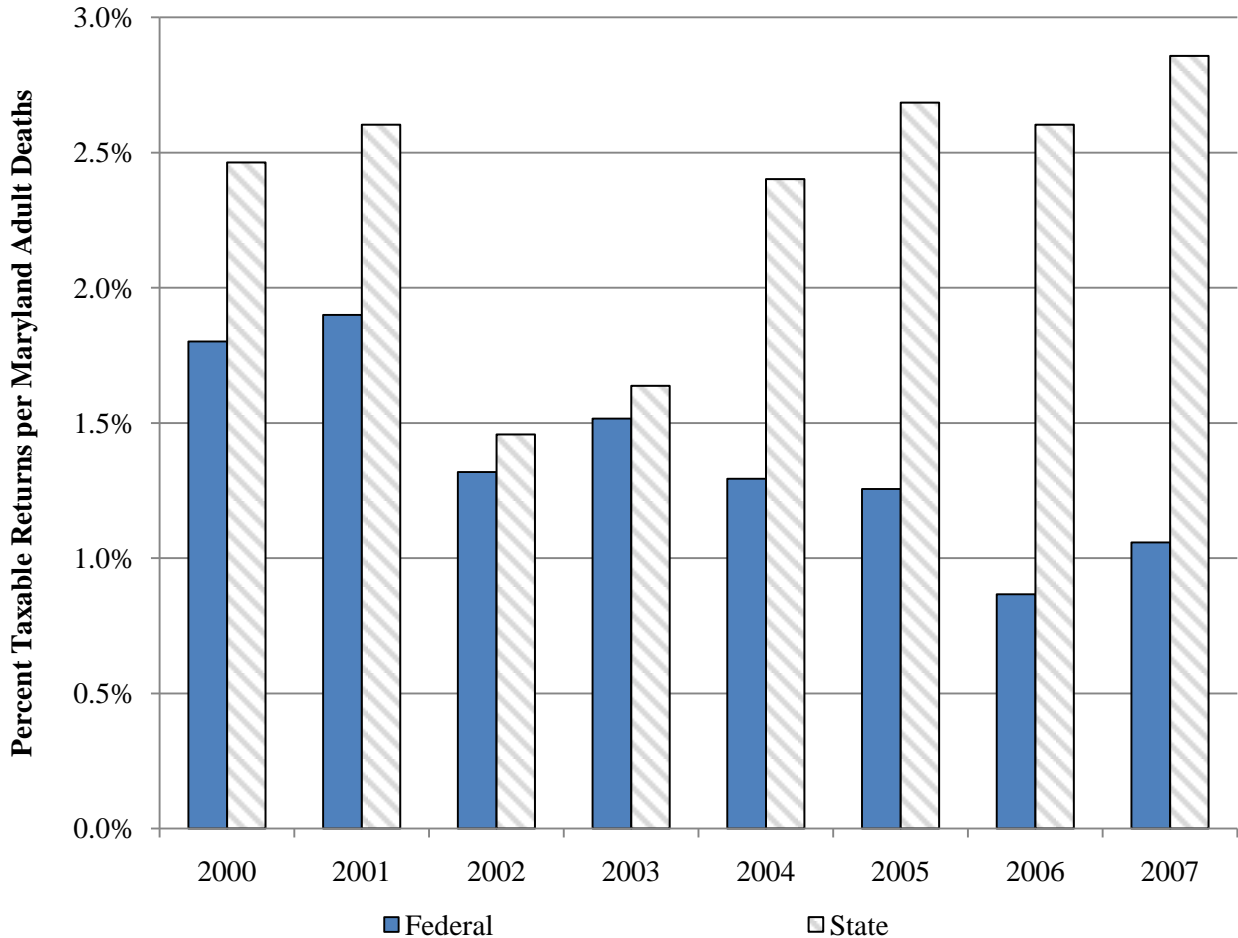
Source: Department of Legislative Services, *IRS Statistics of Income*

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**Exhibit 2** shows the estimated percentage of taxable State and federal estate tax returns filed as a share of Maryland adult deaths. 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 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.

**Exhibit 2**  
**State and Federal Estate Tax Returns, as a Share of Maryland Adult Deaths**  
**2000-2007**



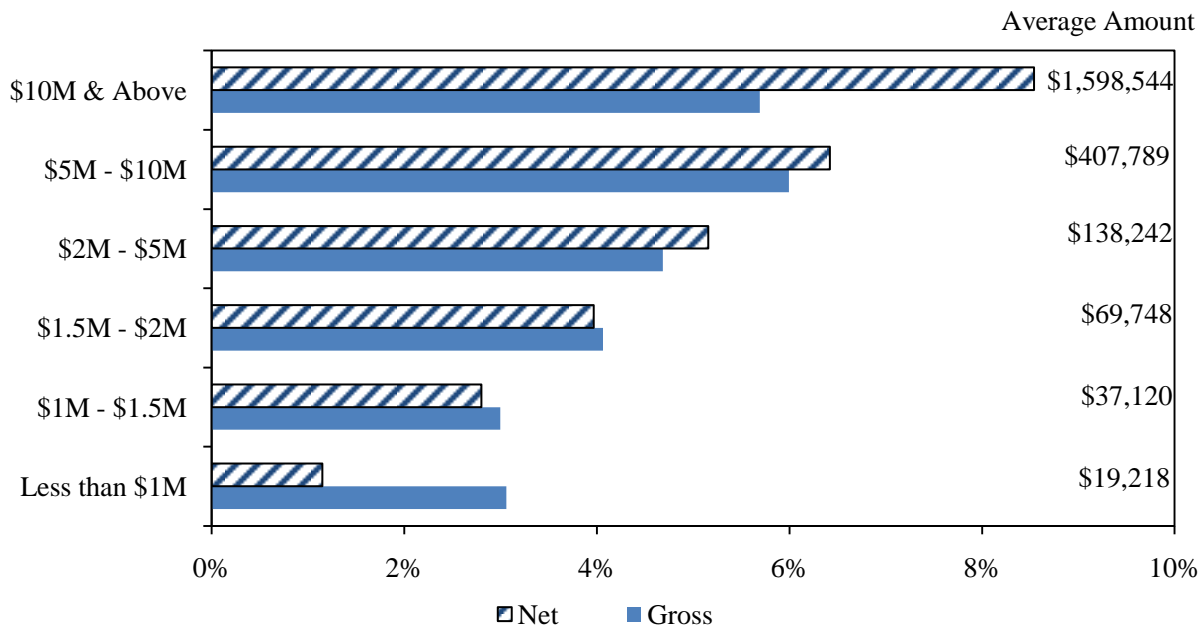
Notes: Based on data from the Comptroller’s Office, it is assumed that 3% of taxable State estate tax returns are filed by nonresidents. IRS state-level data is only available by year of file, and it is assumed that federal returns are filed one year after date of death. The percentage of total federal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

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 net estate plus taxable gifts. **Exhibit 3** shows the average tax paid and tax rate by the amount of gross estate apportioned to Maryland. Exhibit 3 also shows the percentage of estate and inheritance taxes paid by the amount of gross estate and net estate.

**Exhibit 3**  
**Average Estate Taxes Paid and Taxation Rate**  
**By Size of Apportioned Gross Estate 2000-2008**



Source: Department of Legislative Services; Comptroller's Office

*Estate Tax and Farms and Small Businesses*

Although business and farm assets compose a small 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 estate 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.

### *Special-use Valuation*

The value of the property for federal estate tax purposes, and the basis for the State estate tax, is generally the fair market value at the time of the property owner's death. Under certain circumstances, farm and closely held business real property can be valued at its current farm or business use rather than the fair market value. Special-use valuation can reduce the value of the real property portion of estates by up to a maximum reduction of \$1 million, which translated to a maximum federal tax reduction of \$450,000 in 2009. The U.S. Department of Agriculture (USDA) estimates that special valuation reduced the value of qualifying farm estates by an average of 50% in 2001. USDA notes that the largest reductions under this provision occur for farmland having the potential for residential or commercial development, which is typical of many Maryland farms. Special use tax benefits must be repaid if certain conditions are not met, such as the property being sold to a nonfamily member or ceasing to be used as a farm within 10 years of the decedent's death.

This valuation method is similar to property tax assessments for agricultural land, which value the land at its current use instead of at its potential market value at its highest use, which is typically much higher.

### *Exclusion for Land Subject to Conservation Easement*

Farmers and other landowners can exclude for federal estate tax purposes up to 40% of the value of land subject to a qualified conservation easement. The maximum exclusion of \$500,000 does not include the reduction in the land's value resulting from the easement and as a result the combined reduction resulting in the estate from the easement can be significantly higher. USDA notes that donating easements can be especially beneficial for farmers near urban areas. In 2005, estates made 2,307 conservation easement donations totaling \$1.8 billion.

### *Valuation Discounts*

Reported asset values may be reduced through the use of valuation discounts for certain characteristics or qualities like minority ownership or lack of marketability. These discounts are generally reported on assets associated with a privately held business



(including farms) and reflect the fact that holding a fractional, noncontrolling share in a business reduces the value of that ownership share and that these fractional shares are more difficult to sell. According to IRS, 5,909 returns filed for decedents in 2004 included a valuation discount, comprising 14% of all returns. Of the \$6.5 billion reduction from the value of estates, a little more than one-half was for stock, followed by real estate (about one-fifth), limited partnerships (13%), farms and farmland (5%), and noncorporate business assets (3%). Overall, discounts reduced the total gross estate by 3.4% but varied significantly by asset type with limited partnerships having the highest discount (15%).

### *Installment Payment of Estate Taxes*

Congress enacted legislation allowing certain businesses to spread out estate taxes over several years out of concern that the heirs of small businesses and farmers might have difficulty paying taxes on estates with illiquid assets such as land and business assets, thus forcing heirs to sell assets or sell the business. Certain businesses, including qualifying farms, are allowed to pay estate taxes over a 15-year period, with interest due only for the first 5 years (at 2% on the first \$1.33 million). According to USDA, this provision, combined with an increase in the amount of property that can be transferred tax free, greatly reduced the liquidity problem that some farm heirs might experience as a result of federal estate tax liability. In 2005, only 382 estates in the United States, or about 2% of all estates with tax liability, elected to defer federal estate taxes.

Maryland enacted similar legislation in 2010 allowing for the deferral of estate taxes for certain agricultural property. Chapter 554 of 2010 requires the Comptroller to allow a payment deferral for up to three years for the Maryland estate tax imposed on qualified agricultural property that passes from a decedent to or for the use of a qualified recipient. The provision allowing an interest free deferral of estate taxes of up to \$375,000 expires June 30, 2014.

**State Revenues:** The bill increases the value of the federal unified credit used in the calculation of Maryland estate taxes to \$2.0 million for decedents dying in fiscal 2012, \$3.0 million in fiscal 2013, and \$4.0 million in fiscal 2014. As a result, general fund revenues decrease by \$20.3 million in fiscal 2012, \$58.3 million in fiscal 2013, \$82.6 million in fiscal 2014, \$58.8 million in fiscal 2015, and by \$12.6 million in fiscal 2016.

This estimate is based on a microsimulation of the proposed tax changes for 2005 decedents and the estimated difference between the date of a decedent's death and the payment of estate taxes.

Under current federal law, the increased value of the federal unified credit and the State death tax deduction expire after December 31, 2012. The deduction will be replaced by the State death tax credit. The interaction of these provisions and the changes proposed by the bill lead to ambiguity as to the value of the applicable federal unified credit and applicability of the 16% limitation specified by the bill in fiscal 2013. The estimated revenue loss occurring in fiscal 2013 is calculated as the average of the estimated possible revenue losses.

For decedents dying after July 1, 2014, the value of the federal unified credit for Maryland estate tax purposes is conformed to the value under the federal estate tax. Under current federal law, this provision will not impact State revenues as the value of the federal unified credit will be equal to an exclusion amount of \$1.0 million, the amount currently specified for the Maryland estate tax.

**Small Business Effect:** Small 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.

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### **Additional Information**

**Prior Introductions:** None.

**Cross File:** None.

**Information Source(s):** Comptroller's Office, Congressional Budget Office, U.S. Department of Agriculture, Department of Legislative Services

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