Department of Legislative Services

Maryland General Assembly
2012 Session

FISCAL AND POLICY NOTE

House Bill 154 (Delegate Afzali, *et al.*)
Ways and Means

Estate Tax - Exclusion of Qualified Agricultural Property

This bill exempts from the State estate tax up to $5.0 million of qualified agricultural 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 farming purposes after the decedent's death. In addition, the bill generally limits the estate tax imposed on qualified agricultural property included in an estate to 5% of the value of the qualified agricultural property that exceeds $5.0 million.

The bill takes effect July 1, 2012, and applies to decedents dying after December 31, 2011.

Fiscal Summary

State Effect: General fund revenues decrease by $1.8 million in FY 2013 due to the exclusion of agricultural property from the estate tax and the applicable tax rate specified by the bill. Future years reflect annualization and the estimated amount of eligible agricultural property. General fund expenditures increase by $22,000 in FY 2013 for one-time tax form changes at the Comptroller's Office.

($ in millions)	FY 2013	FY 2014	FY 2015	FY 2016	FY 2017
GF Revenue	($1.8)	($2.4)	($2.6)	($2.7)	($2.8)
GF Expenditure	$.0	$0	$0	$0	$0
Net Effect	($1.8)	($2.4)	($2.6)	($2.7)	($2.8)

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

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 agricultural 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 farming purposes after the decedent's death. Qualified agricultural property includes real and personal property that is used primarily for farming purposes, as defined in Section 2032A(E)(5) of the Internal Revenue Code. As defined in this section of IRC, farming purposes means cultivating the soil or raising or harvesting any agricultural or horticultural commodity (including the raising, shearing, feeding, caring for, training, and management of animals) on a farm.

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

The Comptroller is required to adopt regulations providing for the recapture of the estate tax benefits provided to qualified agricultural property if the property ceases to be used for farming purposes during the lifetime of the qualified recipient.

The bill applies to decedents dying after December 31, 2011.

Current Law: The Maryland estate tax does not explicitly provide for an exemption for agricultural property. However, estates may generally exclude up to $1.0 million in assets, including agricultural property, from the Maryland estate tax. In addition, estates with agricultural property qualify for deductions under the federal estate tax that are available to all taxpayers, which lower estate tax liabilities, as well as special treatment under the federal estate tax. Several of these provisions flow through to the Maryland estate tax, resulting in a lower tax liability.

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, 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 and would have applied pre-EGTRRA provisions ($1.0 million exemption and a 55% maximum tax rate) 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 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. 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%.

As of December 2011, 22 states and the District of Columbia impose an estate or inheritance tax. Fourteen states and the District of Columbia impose an estate tax, six states impose an inheritance tax, and New Jersey and Maryland impose both. The most common filing threshold among states imposing an estate tax is $1.0 million, with three states imposing a lesser filing threshold and seven states imposing a higher threshold.

The significant variation in estate and inheritance taxes among states is also evident when comparing Maryland to its surrounding states, as shown in **Exhibit 1**. Virginia and West Virginia do not impose any taxes on wealth transfers while tax burdens in Pennsylvania, New Jersey, and the District of Columbia are among the highest in the nation. In fiscal 2010, the Maryland estate tax burden was the seventh highest in the nation. Delaware reinstated its estate tax effective July 1, 2009, after several years in which there was no tax. Although there is no taxation of wealth transfers in Virginia and West Virginia, those states continue to receive a minor amount of revenue reflecting the payment of taxes from decedents who died in previous years.

Exhibit 1
Estate and Inheritance Taxes Imposed in Surrounding States

	Taxes Imposed in 2011		**Fiscal 2010 Revenues**			**Fiscal 2010 Ranking**	
State	**Estate**	**Inheritance**	**($ millions)**	**Per Capita**	**% Total Taxes**	**Per Capita**	**% Taxes**
Maryland	X	X	$173.5	$29.98	1.14%	7	7
Delaware	X		0.2	0.26	0.01%	25	28
District of Columbia	X		39.3	65.02	0.78%	2	14
New Jersey	X	X	581.6	66.08	2.24%	1	2
Pennsylvania		X	728.7	57.34	2.42%	3	1
Virginia			5.7	0.71	0.03%	23	23
West Virginia			0.1	0.05	0.002%	32	34
United States			**$3,890.4**	**$12.58**	**0.6%**		

Source: U.S. Census Bureau, Department of Legislative Services

Maryland Legislative Response to EGTRRA

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

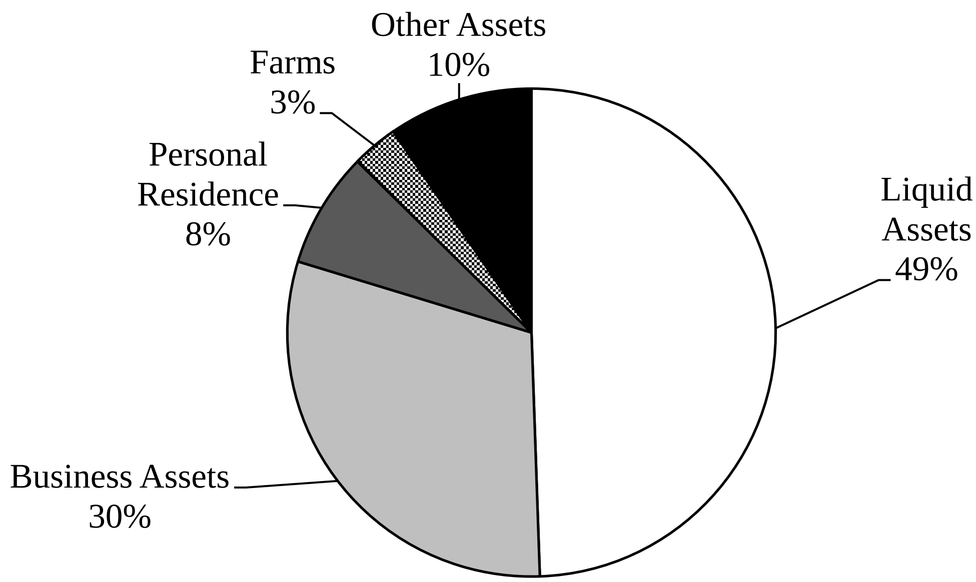
In response to concerns that the decoupled Maryland estate tax imposed a higher rate of taxation on lower-valued estates, Chapter 225 of 2006 limited the maximum tax liability of any estate to 16% of the amount by which the decedent's taxable estate exceeds $1.0 million.

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, 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 estate. 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 2**.

Exhibit 2
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*

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 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 $1.0 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, thus, the combined reduction 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 five 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, 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.

Chapter 241 of 2011 authorized the Comptroller's Office to grant an extension of the deferred estate tax payment period if the recipient has a pending application to place the land on which the deferred estate tax is due under a permanent land conservation easement with (1) the Maryland Agricultural Land Preservation Foundation; (2) the Rural Legacy Board; or (3) a similar easement purchase program.

State Revenues: The bill exempts from the estate tax up to $5.0 million in qualified agricultural property and also limits the tax that can be imposed on the remaining amount of qualifying agricultural property included in an estate to no more than 5%. As a result, general fund revenues will decrease by $1.8 million in fiscal 2013 and by $2.4 million in fiscal 2014. Future revenue losses increase by 5% annually.

This estimate is based on a microsimulation of the proposed tax changes for 2006 decedents. The Comptroller's Office advises that it cannot provide data on the number of estate tax returns with agricultural property or the value of this property included in estate tax returns. The estimated number of returns impacted by the bill is based on the amount of farm assets reported on federal estate tax returns, adjusted for the Maryland estate tax based on differences in applicable exemption amounts, and USDA estimates on the number and value of farms in the State and the United States.

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 be significantly higher to the extent an estate tax return reports a significantly higher than expected amount of qualifying agricultural property. For example, in 2008 about 25% of all farm assets were reported on a federal estate tax return with an estate in excess of $20 million.

State Expenditures: The Comptroller's Office reports that it will incur a one-time expenditure increase of $22,000 in fiscal 2013 in order to alter the processing of estate tax returns.

Small Business Effect: Small businesses with qualifying agricultural property will benefit from the reduction in estate taxes. According to the USDA, the median wealth of farm households is about five times higher than that of all U.S. households. As a result, a larger share of farm estates owe estate taxes. However, USDA estimated that in 2009, 97.1% of all farm estates were not required to file a return under the federal estate tax, which had an exemption amount of $3.5 million in that year. A total of 1.3% of farm estates were required to file a return but owed no taxes, with the remaining 1.6% of returns having an estate tax liability.

USDA estimates that in 2007 there were 12,834 farms in Maryland. About 70% of these farms had a market value of less than $1.0 million and would not be required to file a Maryland estate tax return unless the estate had sufficient nonfarm assets to require a return. It is estimated the bill may reduce the tax liabilities of up to an average of 50 tax returns in each year, a portion of which would be considered a small business.

Appendix 1 shows the number of Maryland farms in 2007 in each county with a market value in excess of $5.0 million. **Appendix 2** shows the percentage of farms within each county with a market value of $5.0 million or greater. About one-half of these higher-value farms were located in Carroll, Queen Anne's, Talbot, Caroline, Frederick, and Kent counties.

Additional Information

Prior Introductions: Similar bills were introduced in the 2011 session. SB 764 received a hearing in the Senate Budget and Taxation Committee, but no further action was taken. Its cross file, HB 721, received a hearing in the House Ways and Means Committee, but no further action was taken.

Cross File: SB 324 (Senator Young, *et al.*) - Budget and Taxation.

Information Source(s): Maryland Department of Agriculture, Comptroller's Office, Department of Legislative Services

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mm/jrb

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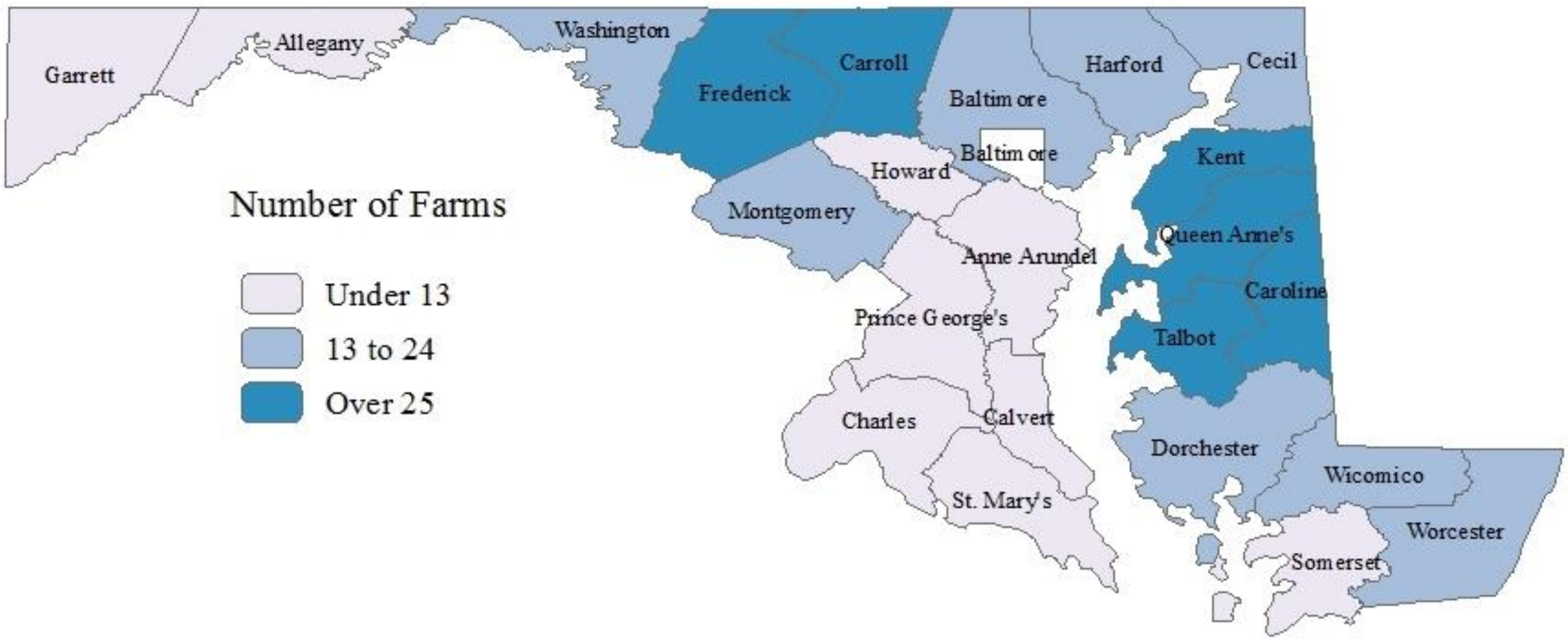
Appendix 1
Number of Farms with a Value of $5 Million or Greater
Calendar 2007



Note: Market value of farms as of 2007, includes all farms including farms organized as corporations
Source: USDA, Department of Legislative Services

Appendix 2
Percentage of County Farms with a Value of $5 Million or Greater
Calendar 2007