

Department of Legislative Services
Maryland General Assembly
2014 Session

FISCAL AND POLICY NOTE

House Bill 276 (Delegate Afzali, *et al.*)
Ways and Means

Estate Tax - Qualified Family-Owned Business Interests - Exclusion

This bill exempts from the State estate tax up to \$5.0 million of qualified family-owned business interests. In order to qualify for the exemption, the business must meet certain qualifications and the interest must pass from a decedent to a qualified recipient. In addition, the bill generally limits the estate tax imposed on qualified business interests included in an estate to 5% of the value of the qualified business interests that exceeds \$5.0 million.

The bill takes effect July 1, 2014, and applies to decedents dying after December 31, 2013.

Fiscal Summary

State Effect: General fund revenues decrease significantly beginning in FY 2015 due to the exclusion of qualified business interests from the estate tax and the applicable tax rate specified by the bill. General fund expenditures may increase minimally in FY 2015 for one-time tax form changes at the Comptroller's Office.

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 interests. In order to qualify for the exemption, the interests must pass from a decedent to a qualified recipient. Qualified recipients include (1) specified

members of the decedent's family or (2) an employee of the trade or business to which the interests relate if the employee has been employed by the trade or business for at least 10 years before the date of the decedent's death. A member of the decedent's family includes (1) the decedent's spouse, specified individuals related to the spouse and decedent, and legally adopted children of the decedent; and (2) specified trusts. The bill also provides for the requirements necessary to be a qualified business interest.

In addition, the bill specifies that the estate tax imposed on an estate with qualified business interests 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 business interests exceeds \$1.0 million; and (2) 5% of the value of the qualified business interests 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 business interests within 10 years of the decedent's death if specified conditions are not met.

The bill applies to decedents dying after December 31, 2013.

Current Law: The State imposes a tax on property that passes at or after the death of an individual through an estate tax and an inheritance tax. In fiscal 2014, estate tax revenues are projected to total \$152.7 million and inheritance taxes \$50.6 million. Estates may generally claim a credit against the estate tax for the amount of inheritance taxes paid. 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 2014, the federal estate tax unified credit is equal to the amount that corresponds to an exemption amount of \$5,340,000. This amount is indexed to inflation.

Special rules apply under the Maryland estate tax for qualified agricultural land. Chapters 448 and 449 of 2012 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.

Estates with certain business interests 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.

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. 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.

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.

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. EGTRRA provided over a period of years for:

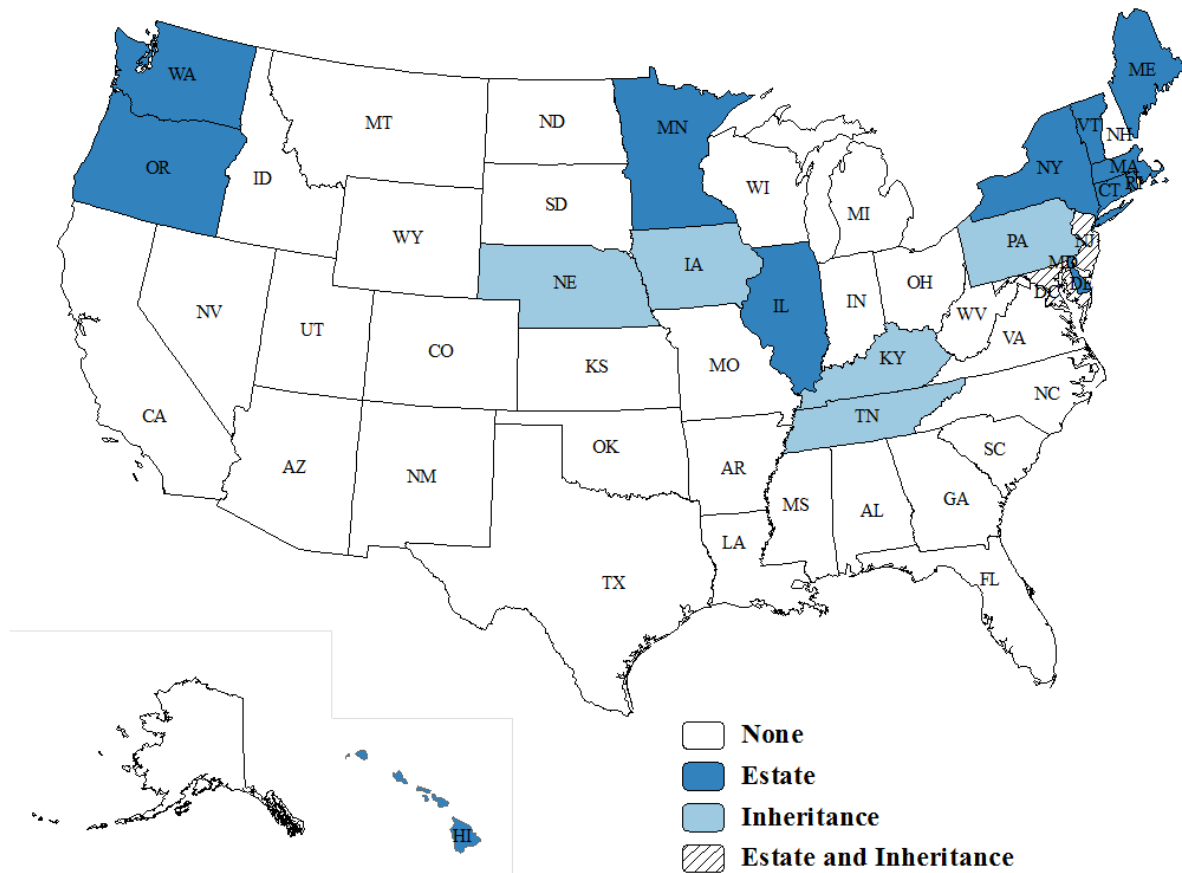
- a gradual increase in the estate tax exemption, increasing the exemption to \$1.0 million in 2002 and to \$3.5 million by 2009;
- a reduction in top marginal tax rates imposed; and
- a phase out of a credit allowed for state death taxes paid, replacing it with a deduction beginning in 2005.

EGTRRA repealed the federal 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.

The changes enacted by EGTRRA have had a significant impact on federal and state estate and inheritance taxes, leading to a decline in both federal and state tax revenues. 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 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.

After EGTRRA, numerous states reduced or repealed their estate taxes as the federal repeal of the state death tax credit eliminated the estate tax in those states that imposed an estate tax that was linked to the federal credit. For decedents dying in calendar 2014, 19 states and the District of Columbia impose an estate or inheritance tax, as shown in **Exhibit 1**. Maryland and New Jersey impose both types of taxes. Estates in New Jersey pay the higher of the two taxes, not both, and estates in Maryland can generally claim inheritance taxes paid as a credit against the estate tax.

Exhibit 1
State Estate and Inheritance Taxes
Calendar 2014



Source: CCH, Inc., Department of Legislative Services

The significant variation in estate and inheritance taxes among states is also evident when comparing Maryland to its surrounding states, as shown in **Exhibit 2**. Virginia and West Virginia do not impose any taxes on wealth transfers while estate and inheritance tax burdens in Pennsylvania, New Jersey, and the District of Columbia are among the highest in the nation. 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 2
Estate and Inheritance Taxes Imposed in Surrounding States

<u>State</u>	<u>Taxes Imposed in 2014</u>		<u>Estate Tax Exemption Amount</u>	<u>Top Tax Rate</u>	<u>Fiscal 2012 Revenue (\$ in Millions)</u>
	<u>Estate</u>	<u>Inheritance</u>			
Maryland	X	X	\$1,000,000	16%	\$197.9
Delaware	X		5,340,000 ¹	16%	12.0
District of Columbia	X		1,000,000	16%	n/a
New Jersey	X	X	675,000	16%	641.9
Pennsylvania		X	\$0	15%	804.7
Virginia					0.3
West Virginia					0.2

¹ Linked to federal exemption, which is indexed for inflation.

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

Maryland Legislative Response to EGTRRA

The Budget Reconciliation and Financing Act 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.

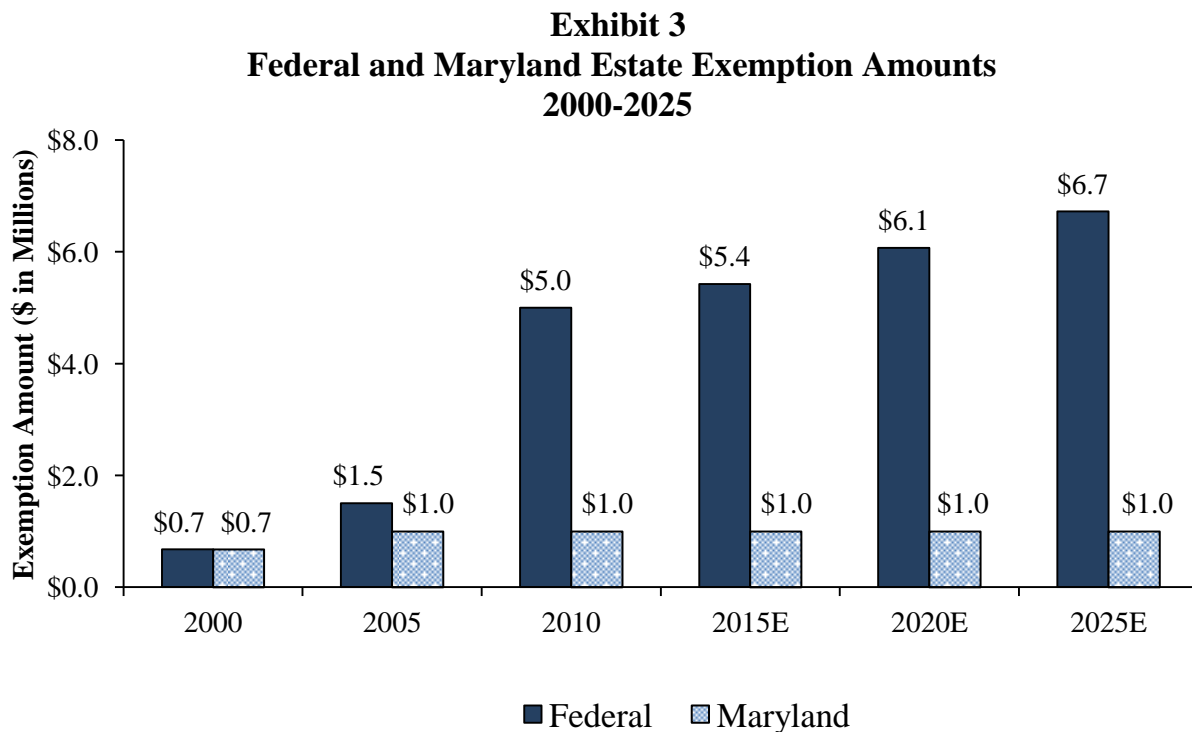
Chapter 430 of 2004 decoupled the State estate tax from the gradual increase in the unified credit, thus freezing the value of the credit to \$345,800 and equating to an exemption amount of \$1.0 million. Chapter 430 also required calculation of Maryland estate tax without regard to the deduction for 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 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.

The difference in the exemption amount under the federal and State estate tax has grown in the 10 years since Maryland decoupled, and will continue to do so since the federal exemption is indexed to inflation. **Exhibit 3** reflects the increase in the federal estate tax exemption amount through 2025 as compared to Maryland's amount of \$1.0 million.

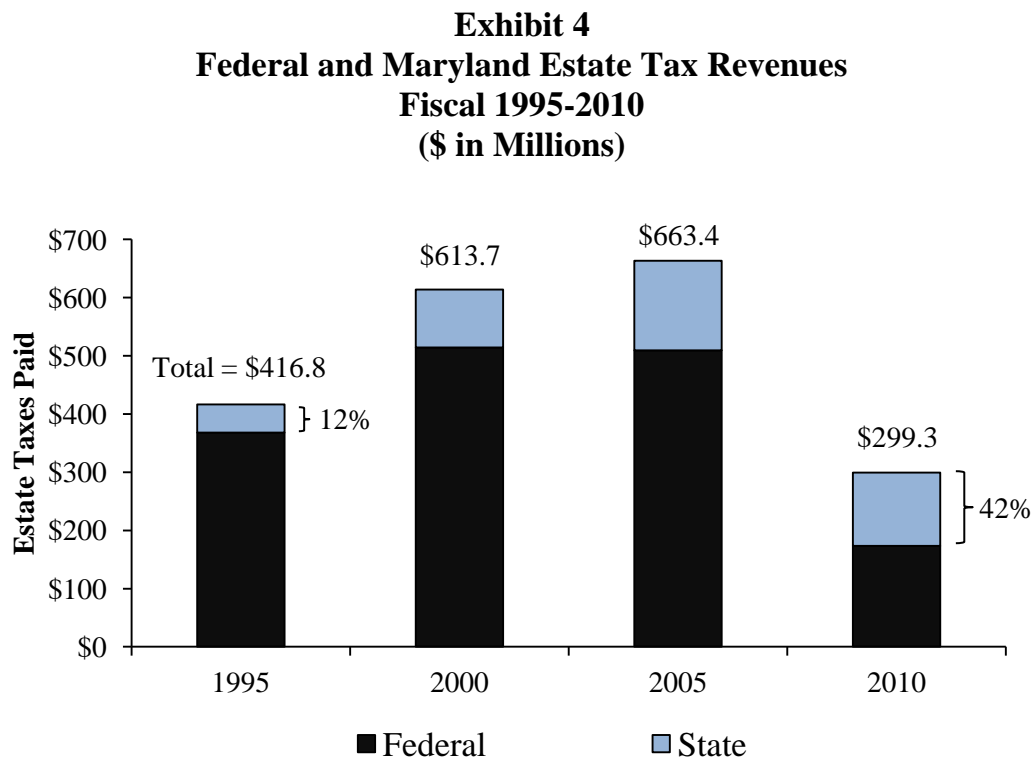


Source: Internal Revenue Service, Comptroller's Office, Department of Legislative Services

The increased federal exemption amount, as well as a decrease in rates and other changes, has reduced the number of individuals required to file and pay federal estate taxes and average tax burdens. Federal estate taxes paid by Maryland estates in 2010 have decreased by a little more than one-half in real terms since 1995. In contrast, the amount of federal income taxes paid by Maryland residents has increased by 124% over a similar period and Maryland estate tax revenues are now 2.6 times larger. The total amount of

federal and State estate taxes paid by Maryland estates decreased from \$416.8 million in 1995 to \$299.3 million in 2010, a reduction of about 25%. State estate taxes now comprise 42% of the total federal and State estate tax burden, compared to 12% in 1995. The amount of federal estate taxes paid by Maryland residents peaked at \$514.6 million in 2000. In 2010 the amount of federal estate taxes paid was lower by two-thirds, totaling \$173.3 million. Most of this decrease is attributable to federal legislation (beginning with EGTTA which was effective beginning in 2002) that increased the federal exemption amount and established lower tax rates.

Exhibit 4 shows the change in federal and State estate tax revenues paid by Maryland estates from fiscal 1995 to 2010.



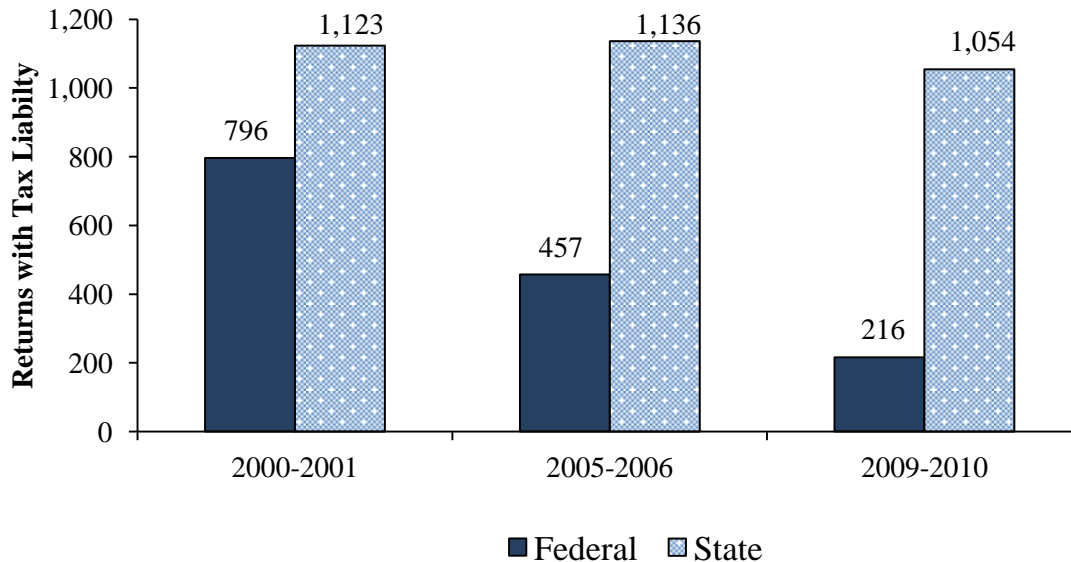
Note: Revenues are adjusted for inflation and expressed in constant 2014 dollars.

Source: Internal Revenue Service, Comptroller's Office, Department of Legislative Services

Although State estate tax revenues have increased since 2000, the number of estates required to file a State return has decreased from about 2,400 to 1,900 in 2010. The average number of estates with a State tax liability over time has remained relatively constant, averaging 1,100. Over the same period, the number of Maryland estates with a

federal estate tax liability decreased from about 800 in 2000 to a little more than 200 in 2010, as shown in **Exhibit 5**.

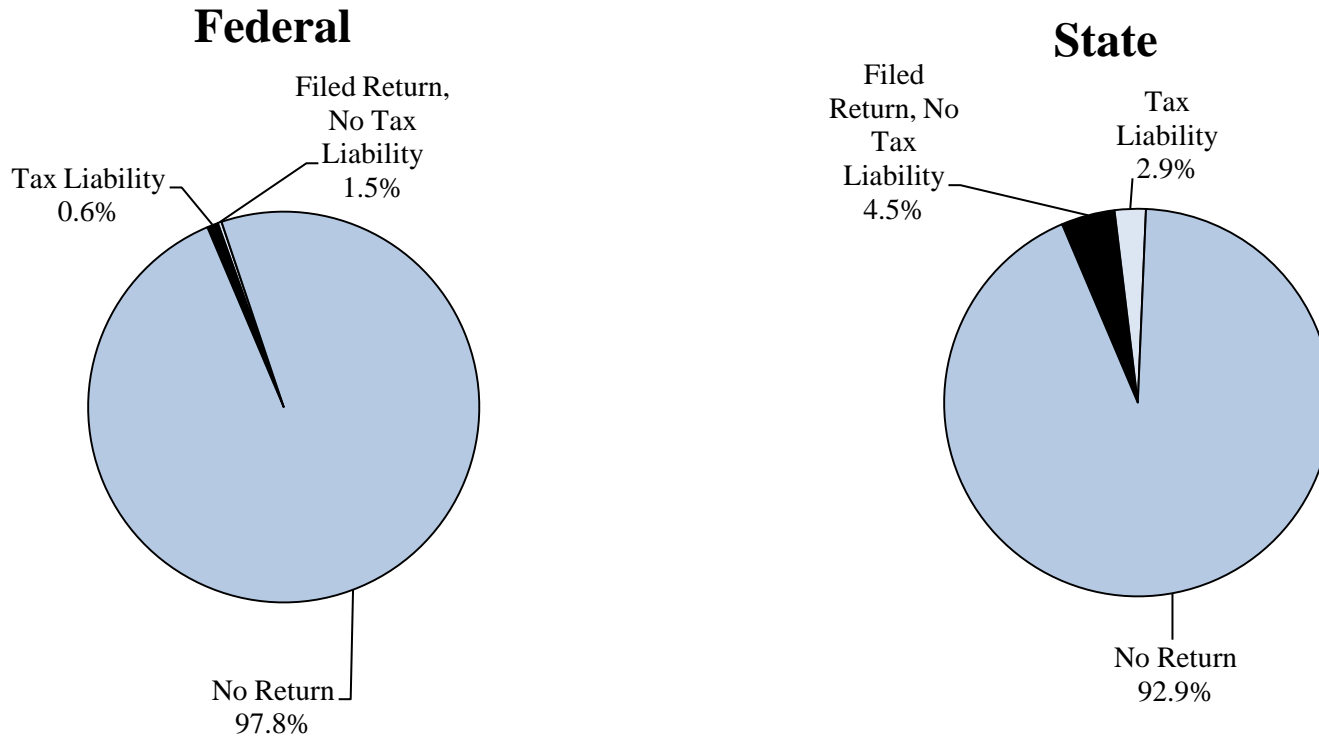
Exhibit 5
Number of Federal and Maryland Estate Tax Returns
With Tax Liability



Source: Internal Revenue Service, Comptroller's Office, Department of Legislative Services

In recent years, about 93% of Maryland decedents were not required to file a State estate tax return. A total of 4.5% of all Maryland decedents were required to file a return but did not owe any taxes, and about 3% of all decedents had a tax liability. **Exhibit 6** contrasts the average percentage of Maryland decedents who are required to file or pay federal and State estate taxes.

Exhibit 6
State and Federal Estate Tax Returns, as a Share of Maryland Adult Deaths
2008-2010



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. Adult deaths are deaths of residents age 19 or older.

Source: Comptroller's Office, Internal Revenue Service, *IRS Statistics of Income*, Centers for Disease Control and Prevention, Department of Legislative Services

State Revenues: The bill exempts from the estate tax up to \$5.0 million in qualified business interests and also limits the tax that can be imposed on the remaining amount of qualifying business interests included in an estate to no more than 5%. As a result, general fund revenues will decrease significantly beginning in fiscal 2015.

The amount of the revenue loss depends on the amount of qualifying business interests excluded in each year and the extent to which the exception may create additional estate tax planning opportunities. The Comptroller's Office cannot provide an estimate of the amount of total business interest property that could qualify for the proposed tax benefit.

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.

Additional Information

Prior Introductions: HB 722 of 2013 was referred to interim study by the House Ways and Means Committee.

Cross File: None.

Information Source(s): CCH, Inc., U.S. Census Bureau, Centers for Disease Control and Prevention, Comptroller's Office, Congressional Budget Office, U.S. Department of Agriculture, Internal Revenue Service, Department of Legislative Services

Fiscal Note History: First Reader - February 3, 2014
mc/jrb

Analysis by: Robert J. Rehrmann

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