

Department of Legislative Services
Maryland General Assembly
2008 Session

FISCAL AND POLICY NOTE

Senate Bill 165 (Senator Haines)
Budget and Taxation

Maryland Estate Tax - Exclusion for Family Farm or Family-Owned Business

This bill alters the determination of the Maryland estate tax by excluding from the value of the gross estate up to \$1.0 million of “qualified real property” as defined by the Internal Revenue Code (IRC). The bill also requires the Comptroller to provide, by regulation, for the imposition of additional State estate taxes if specified conditions are not met which would lead to imposition of additional federal estate taxes.

The bill takes effect July 1, 2008 and is applicable to decedents dying after December 31, 2007.

Fiscal Summary

State Effect: Potential significant reduction in general fund revenues beginning in FY 2009. Expenditures would not be affected.

Local Effect: None.

Small Business Effect: Potential meaningful. Small businesses, including farms, could significantly reduce or eliminate State estate taxes.

Analysis

Bill Summary: Qualified real property is property used as a farm for farming purposes or used in a trade or business that passes to a member of the decedent’s family, including grandparents, parents, spouse, children of the decedent or children of a lineal descendent of the decedent and their spouses, and siblings, under specified conditions.

Current Law/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by the General Assembly, the repeal of the federal credit under the 2001 federal tax Act would have automatically repealed the State estate tax because of the link between the State tax and federal credit.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.

Unified Credit

The Maryland estate tax is calculated as the lesser of the federal estate tax after deducting the unified credit or the federal credit, reduced by any inheritance tax paid. 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. 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.

2006 Legislation

Chapter 225 of 2006 limited the amount of the federal credit used to calculate the Maryland estate tax to 16% of the amount by which the decedent's taxable estate exceeds \$1.0 million. Chapter 225 also clarified Maryland estate tax law to reflect the partial decoupling of the Maryland estate tax from the federal estate tax by (1) clarifying that the person responsible for filing a federal estate tax return is also responsible for filing a Maryland estate tax return; (2) providing for the filing of an amended Maryland estate tax return under specified conditions and the timeframe within which this must be accomplished; (3) establishing criteria under which an individual may receive an

extension on the deadline to file a Maryland estate tax return; (4) allowing a Maryland estate to elect to treat property as marital deduction qualified terminable interest property in calculating the Maryland estate tax; and (5) providing that such an election on a timely filed Maryland estate tax return must be recognized for the purposes of calculating the Maryland estate tax even if an inconsistent election is made for the same decedent for federal estate tax purposes.

Federal Estate Tax

Federal law allows estates to value farms (and other closely held businesses) at their current use value rather than their highest and best use value if the heirs agree to keep the property in its current use for at least 10 years; however, the current use valuation may only reduce the value of the estate by up to \$940,000 (for decedents dying in 2006). The law provides for the recapture or payment of estate taxes if these conditions are not met.

Federal law also allows farmers, under certain conditions, to exclude the value of a qualified conservation easement from a taxable estate and to pay estate taxes in installments.

State Fiscal Effect: General fund revenues could decrease by a significant amount because the bill exempts up to \$1.0 million of qualified real property from the gross value of an estate. However, the amount of any annual decrease cannot be reliably estimated and depends on the number of farm or small business owners with qualified real property under IRC 2032A and when they die; the value of the qualifying real property; the value of other assets held by the decedent; the relationship of beneficiaries to the decedent; and the length of time the qualifying property is used for its intended purpose after the death of the decedent.

Two factors serve to mitigate the effect of the bill on estate tax revenues. While not specifically exempted from the calculation of gross estate value, land subject to agricultural preservation easement would not be subject to the estate tax if the value of the total estate is less than \$1.0 million. To the extent that the total estate has a value of over \$1.0 million and is reduced as a result of the exemption granted by the bill, general fund revenues would be reduced because some estates would no longer be subject to the Maryland estate tax, and others would have the total amount of their estate tax reduced. However, the number of times that this might happen cannot be reliably estimated. In addition, to the extent that all the property in an estate is passed directly to the surviving spouse of the decedent, the “marital deduction” allowed under the federal estate tax would reduce the taxable estate to zero, so there would be no federal estate tax and therefore no Maryland estate tax.

Additional Comments: With regards to the recapture provision specified in the bill: the bill specifies that State estate taxes must be paid when a circumstance arises when the property fails to meet the requirements of IRC 2032A and additional federal estate taxes must be paid. However, due to the different filing thresholds, \$1.0 million for State purposes and \$2.0 million (\$3.5 million for 2009 and 2010) for federal purposes, there could be instances where an estate would have to file a Maryland estate tax, but not a federal estate tax.

Additional Information

Prior Introductions: None.

Cross File: None.

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