MARYLAND DEATH TAXES

An Incentive to Move Anywhere but Here

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"The only two certainties in life are death and taxes."

THESE WORDS, FAMOUSLY UTTERED BY BENJAMIN FRANKLIN, Mark Twain, and others, have also remained accurate throughout modern history, in which death has usually resulted in additional taxes. Yet, today, in most states, taxes do cease at death, and no estate or other death taxes are imposed. For Marylanders, that is not the case. Indeed, Maryland is one of only two states (together with New Jersey) that impose both an estate tax and an inheritance tax.

Since the first inheritance tax was passed in the U.S., there have been three general periods of state taxing regimes with respect to death taxes.

For the first hundred years, from 1826 to 1926, interstate competition prevailed. Many states chose to enact higher estate and inheritance taxes in search for tax revenues. Other states took the opposite approach, and positioned themselves as tax havens where wealthy Americans should spend their formative years.

The second era lasted from 1926 to 2001, when the state death tax would reduce the federal estate tax dollar for dollar, thus eliminating state competition. As long as any particular state's death taxes did not exceed 80 percent of the federal estate taxes, the total estate tax liability for any decedent would be (nearly) identical. As a result, 49 of the 50 states imposed a state death tax. During this time, even high tax states were not affected by death tax policy, as its impact was felt entirely by the federal government and not by the individual taxpayers.

The third era began in 2001 and its future is murky at best. The state death tax credit eliminating state competition has been abolished, but will return in 2013 if Congress does not act. In this era, some states have returned to using death tax policy to compete for residents. Some states have "decoupled" from the federal estate tax and have enacted independent state death taxes, while others have continued to use their lack of estate tax as a marketing tool to attract wealthy citizens to move.

During this latest era, Maryland was one of the first states to decouple from the federal estate tax. Currently, Maryland is one of just two states with both an estate tax and an inheritance tax. Thus, the Maryland legislature has made the state one of the highest-taxing jurisdictions at death, imposing a 16 percent estate tax on the value of an estate in excess of one million dollars. At the same time, Virginia imposes no estate tax, and Pennsylvania imposes an inheritance tax equal to 4.5 percent for transfers to lineal descendants. The estate tax in Washington, D.C. effectively mirrors that of Maryland but no separate inheritance tax is levied. Common second-home states, such as Florida, impose no state death taxes at all.

Throughout history, states have competed for residents using tax policy. Maryland's current high-tax policy drives away wealthy Marylanders and imposes administrative burdens on many modestly wealthy families, small business owners, and entrepreneurs. As technology allows individuals to be more mobile and work and live in different states, more Marylanders will make the choice, now or after retirement that it just makes sense to live in another state. Unless the federal credit is reinstated to eliminate interstate competition for death taxes, then Maryland can expect an exodus of its wealthiest residents to lower tax jurisdictions, undermining business growth and economic consumption.

HISTORY OF FEDERAL DEATH TAXES

Taxation of estates or their beneficiaries is not a new policy in the United States, where the history of federal and state death taxes has always been linked.

Use of the term "death tax" is not meant to imply any negative connotation in the concept of a tax imposed upon an individual's death. Rather, the term is consistently used in the tax laws to understand state taxation upon the transfer of assets in connection with a person's demise. Indeed, Title 7 of the Tax-General article of the Maryland annotated Code is entitled "Death Taxes" and includes the Maryland estate tax, generation-skipping transfer tax, and inheritance tax. Since not all state taxes applicable at death are "estate taxes" (i.e., taxes levied against the assets of an estate), the term "death taxes" is sufficiently broad to encompass any such taxes imposed at death.

The first federal death tax enacted in the United States was the 1797 " Act Laying Duties on Stamped Vellum, Parchment and Paper". This law generated revenues by requiring documentary stamps sold by the government be placed on probate inventories and receipts for transmitted property at an effective tax rate of 0.5 percent on smaller estates and 0.2 percent on larger estates.[1] In 1802, the death tax disguised as a stamp tax was abolished (by a bill more aptly named than the original) when "An Act to Repeal Internal Taxes" was passed.[2] Death taxes then remained dormant for 60 years.

The second version of the federal death tax came about to mitigate the costs of the Civil War in 1862 (and was later modified in 1864).[3] This two-tier tax imposed a stamp tax of just .05 percent as well as a "legacy tax" on the transfer of property to a successor ranging from 1 percent to 6 percent , depending on the relationship between the decedent and the recipient of the property.[4] Like its predecessor, the tax was repealed in under a decade, with the legacy tax abolished in 1872 and the stamp tax two years thereafter.

The first 'modern' federal death tax, imposing a progressive rate structure, was passed to help fund the Spanish-American War in 1898.[5] This iteration of the federal death tax used different rates depending on the nature of the relationship between the decedent and the recipient (which was similar to the 1862 tax) but used a top rate of 15 percent (although the rates for transfers to lineal descendents ranged from just 0.75 percent to 2.25 percent).[6] As with the previous two federal death tax versions, this tax was short-lived, and was repealed after just four years in 1902.

In what became a pattern, the next war brought the next federal death tax. This time, however, the tax became permanent. Moreover, this version of the federal death tax was a true estate tax.[7] The 1916 estate tax imposed graduated tax rates up to 10 percent with an exemption of $50,000, and was imposed on the value of the net estate.

It is with this background that the states enacted their own death tax regimes that at times worked to take money earmarked for federal tax collectors and at other times, to add an additional tax assessed on the decedent.

HISTORY OF STATE DEATH TAXES

Two types of death taxes are in force in various jurisdictions: estate taxes and inheritance taxes. An estate tax is a tax imposed on the value of a decedent's estate. An inheritance or succession tax is taxed upon the receipt of property by heirs or beneficiaries (and is often limited to non-family members).[8] The first state death tax was imposed by Pennsylvania on April 7, 1826, which assessed an inheritance tax upon the value of estates passing to non-family members equal to 2.5 percent on the value of the estate in excess of $250.[9] By 1916, when the permanent federal estate tax was passed, only six states did not impose any state death taxes.[10]

Earlier state death taxes were short-lived or repeatedly modified. Beginning in 1892, it appears that states viewed the estate tax as an integral piece of the revenue pie.[11] By 1916, 34 states had enacted state death taxes.[12] From 1886 through 1916, state death tax revenues increased by 4,400 percent (from $700,000 to $31 million in 1916).[13]

As the United States economy grew, states began to understand the impact of the estate tax on their own economies. On one hand, estate taxes provided material revenues to state governments. On the other hand, some states determined they would be able to grow more effectively if they could attract wealthier residents and business owners. Florida and Nevada, for example, by 1925 had passed legislation eliminating state death taxes in order to draw wealthy taxpayers from other states.[14] To counter this problem, states that did impose state death taxes felt compelled to act, but eliminating their death taxes was not the path they chose. Instead, the federal estate tax credit was born.

States do not always agree on matters of policy. Yet, most states can agree that if two or three states attract their wealthiest citizens, particularly those who continue to pay high-income taxes, own businesses that hire employees, and have children who will follow in their footsteps, it would be in their best interests to eliminate that competition — i.e., the state tax havens — from the law. The solution to this problem was relatively simple: provide a credit against federal estate tax for state estate taxes paid. Thus, an individual subject to the estate tax would not be subject to additional tax but would pay a portion of the estate tax to the state, and would pay the full federal estate tax less the amount paid to the state to the IRS.

To the extent that states enacted the state estate limits to be less than the maximum federal credit amount, no additional estate tax would be due beyond the federal estate tax liability amount. This type of tax was called a "pick-up tax" since the state would merely "pick-up" a portion of the federal tax and not impose any additional tax.

The original state death tax credit was enacted in 1924.[15] However, since the credit was capped at 25 percent of the federal estate tax due, it was ineffective at capping the aggregate estate tax due, since most state death taxes exceeded 25 percent of the federal tax.[16] The 'problem' of state tax havens remained. Unsurprisingly, many Americans opted to move to Florida, Nevada, and elsewhere to avoid additional taxes. After two years of conferences and debate, Congress relented and enacted a federal death tax credit equal to 80 percent of the federal estate tax liability in 1926.[17]

Consequently, even states with no previous estate tax or low estate taxes enacted estate taxes that re-directed tax revenues from the federal government to state governments. The only additional burden on state residents was to prepare and file a state tax return. Inheritance taxes also remained popular at this time, and many states therefore had both a state estate tax and a state inheritance tax.

In an interesting twist in the estate tax saga, Florida, which had led the movement away from state death taxes and marketed its tax haven status, filed to declare the state death tax credit unconstitutional in year?[18] While other states rushed to join the tax collection party being held by every state in the union, Florida spent the next five years challenging the state death tax credit law. The Supreme Court never even let the matter be heard, denying its petition for Certiorari. Florida responding by passing an estate tax that "picked up" its portion of the federal tax.[19]

Until 2001, the general trend remained the same. States continued to enact estate taxes designed to utilize the federal state death tax credit. Most states until the

1970s maintained the dual state death tax regime. States were hesitant to abolish inheritance and succession taxes that remained on the books in addition to state estate pick-up taxes.[20] Forty-four states retained separate death taxes at this time. Yet, states were much less hesitant to enact state estate taxes. Indeed, by 1975 only Nevada was without a state death tax.

Beginning with the Tax Reform Act of 1976 and continuing until 2001, states began to use just the state pick-up tax as the sole form of death tax in effect. Various commentators attribute this to two factors: interstate commerce; and reformation of state tax laws following the Tax Reform Act of 1976 and Economic Recovery Act of 1981.[21] Thirty-one states replaced the traditional state death tax regime with a pick-up tax utilizing the state death tax credit. As a byproduct of this approach, the pick-up tax regime ensured the future of the federal estate tax. Since the state statutes were written with a specific reference to the federal estate tax credit, elimination of the state death tax credit would eliminate the state estate tax revenues without additional action.

THE MODERN ESTATE TAX REGIME

In 2001, Congress passed the Economic Growth and Tax Relief Reconciliation Act (EGTRRA). With surprisingly little debate over the impact on the states, the state death tax credit was phased out from 2001 to 2004. The credit was replaced with a deduction for state death taxes paid, reducing the value of the benefit by more than half. This occurred despite at least one estimate that the repeal of the state death tax credit would cost the states more than $100 billion of revenue over 10 years.[22] Nonetheless, the combination of a Republican majority, a push towards incentives to spur economic activity, and an about-face on the 200 year-old death tax policy led to the extinction of the credit at the same time the federal estate tax was reduced. The states' free cut of the federal estate tax was finally eliminated after more than 70 years.

From a policy perspective, estate tax-friendly and estate tax-unfriendly jurisdictions would once again coexist, and estate tax ramifications would have to be considered (at least temporarily) when choosing a state of residency. As would be expected, states with high tax and redistributionist policies quickly adopted independent estate taxes, while states utilizing a conservative fiscal policy let the defunct estate tax remain dead.

Prior to the enactment of EGTRRA, as mentioned earlier, 49 states imposed some form of estate or inheritance tax. In practical terms, elimination of the state death tax credit eliminated the state estate tax in half of the states. In other states, the opposite occurred. Rather than eliminate the state death tax, the states imposed an estate or inheritance tax on top of the federal estate tax (with each taxpayer eligible for a deduction for state death taxes paid). In most of these cases, the estate taxes were repealed or modified.

Given the potential loss of tax revenues, states that used a high tax public policy enacted new death taxes to replace the loss of revenues resulting from the elimination of the state pick-up tax."[23] This concept is known as "decoupling" and reflects an independent state estate tax that exists independently of the federal estate tax. Not surprisingly, Maryland is one of the states that enacted a separate estate tax. Three states took the opposite approach and repealed their estate taxes that remained on the books entirely. Twenty-three states allowed their estate taxes to be eliminated with the passage of EGTRRA.

By 2005, the state death tax credit was completely eliminated. From 2005 to 2009, the states that decoupled imposed estate taxes. Moreover, some states with inheritance taxes remaining on the books retained those taxes (which are generally not imposed on transfers to lineal descendents or spouses). The remaining states had no death taxes at all.

In December 2010, Congress passed the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act. For federal tax purposes, the federal estate tax exemption was increased to $5 million ($10 million per couple). At the state level, little changed since the state death tax credit remained abolished and the deduction regime remains in effect.

However, in 2013, the entire estate tax regime reverts to pre-EGTRRA law.[24] For most states, the pick-up taxes that lapsed in 2001 will regain their effect. States that eliminated their income tax would need to pass new laws in order to impose any estate tax (even if such states only wish to take advantage of the credit). For those states that decoupled, the effects depend on the exemption amount beginning in 2013. If the exemption amount returns to $1 million per person, the state and federal estate taxes would effectively re-couple. Ultimately, most commentators believe that the estate tax exemption amount will be increased, even if the credit returns. Under those circumstances, the states that have decoupled will not only take advantage of the federal tax credit, but will also tax the residents of those states at the state estate tax rate on the amounts below the federal exemption amount and above the state exemption amount.

So where does that leave the federal and state estate tax? The future is clear as mud. Congress will not likely make any permanent changes prior to the 2012 election. Regardless if state legislatureswant to keep estate taxes at a minimum or increase them to the maximum, residents must wait on Congress before the state death tax picture will be clear.

THE MARYLAND DEATH TAX REGIME: PRESENT AND FUTURE

As the foregoing discussion makes clear, relative differences between state death tax regimes are predicated on federal tax laws. Maryland's legislature has consistently demonstrated a desire to increase the death taxes consistent with the highest taxing jurisdictions in the country. Indeed, Maryland is one of only two states that currently impose both an estate tax on taxable estates and a separate inheritance tax (which is imposed on non-lineal descendent recipients of property transfers at death) on the recipients of property transferred by a decedent at death.

PRESENT LAW

The Maryland estate tax is decoupled from the federal estate tax. Amendments made by the Maryland legislature in 2002, 2004, and 2006 has led to the current version of Section 7-309 of the Tax-General Article. In effect, the current law imposes a tax up to 16 percent on estates in excess of $1 million.[25] The effective rate of the tax is 0-11 percent on the first $4 million of a taxable estate. Thereafter, since a deduction is allowed for state estate taxes paid, the Maryland estate tax escalates from 11 percent to 16 percent and will have a marginal rate ranging from 7.15 percent (at $5 million) to 10.4 percent (at $10 million and above).[26]

In addition, Maryland imposes an inheritance tax equal to 10 percent of the value of any property that is transferred to any person other than a spouse, sibling or lineal descendant of the decedent.[27]

FUTURE LAW

The future of estate tax law is uncertain. The most likely options are presented below:

1. No Federal Estate Tax Law is Passed; Pre-2001 Rules Effective as of January 1, 2013.

If no new law is passed, the pre-2001 rules will apply. Accordingly, the federal and Maryland estate tax exemption amounts will both equal $1 million and the state death tax credit will be available. As a result, Maryland's estate tax will equal that of any other state because it will solely be a pick-up tax that reduces the federal estate tax liability. Maryland will have effectively recoupled with the federal estate tax.

2. The State Death Tax Credit is Reinstated; Federal Tax Exemption Amount is Increased.

The state death credit may be reinstated but the exemption amount will increase above the $1 million Maryland exemption. For example, the federal exemption amount could be set to $3.5 million. Under this example, an estate worth $3.5 million will be subject to Maryland estate tax on all amounts in excess of $1 million (about $240,000 in tax) but will not be subject to federal estate tax. If an estate is worth more than $3.5 million, any further Maryland estate taxes would reduce the federal estate tax, resulting in the same estate tax on the overage that would be due even if no Maryland estate tax were in effect.

3. The State Death Tax Credit is Eliminated.

In the event the state death tax credit is eliminated, regardless of the federal exemption amount, Maryland will become one of the highest-taxing jurisdictions in the country. Even if the federal exemption amount is set at $1 million, and a deduction is allowed for state death taxes paid, the effective rate of the Maryland estate tax would equal 8.8 percent (assuming a 45 percent federal estate tax rate) to 10.4 percent (assuming a 35 percent federal estate tax rate). Accordingly, the total federal and state effective rate would equal 45.4 percent to 53.8 percent if the federal rate were between 35 percent and 45 percent.

Various commentators believe their option is the most likely to occur (although option one will be effective for at least some time until Congress can agree on a long-term proposal).

EFFECT OF DEATH TAX POLICY ON THE STATE OF MARYLAND

The Maryland death tax regime creates excessive taxes on those Marylanders with the most portability (i.e., retired and semi-retired wealthy individuals) and causes costly administrative burdens for many families and small business owners. Moreover, the advent of technology has allowed individuals to change residency without impacting their ability to travel or work.

The individuals with the most to lose from an additional Maryland estate tax are older and wealthier. They frequently own second homes in low tax states. Empirical data concerning Maryland estate tax are compelling. Maryland estate planners frequently help their clients establish Florida residency. These clients are worth millions of dollars, and some have a net worth in the tens of millions or hundreds of millions.

Since 2001, Maryland has consistently ranked as one of the highest tax states in the country. As a result, many wealthy Marylanders sought residence elsewhere. *The Baltimore Sun* has written that millionaires are fleeing the state as a result of the estate tax, and that wealthy Marylanders are "bugging out because of Maryland's estate tax."[28] The data bear this out. Since 2004, Maryland has had a net outflow of people, with 65,000 fewer residents than in the late 1990s.[29]

For those residents who cannot easily move but who are still subject to the estate tax, the administrative and regulatory burdens are quite costly. For example, a small business owner with an estate of approximately $2 million is required to file a Maryland estate tax return but not a federal estate tax return. If this individual owns two homes, a small business that is being left to the family, and a small art collection, the appraisal and valuation costs alone could be tens of thousands of dollars, while the attorneys and accounting fees required for probate, filing an estate tax return, filing an income tax return for the estate, and related costs could equal another $50,000. After paying the tax, the costs of complying with Maryland law could be nearly $100,000. In other words, taxpayers will need to spend more to comply with the tax law than the tax itself on these amounts.

Finally, as portable devices and technological advances allow for a mobile workforce, the same tools allow for mobile management of a workforce. Many wealthy business owners spend half their time in Florida or other similar jurisdictions. They work from home, and spend as much time in Maryland as needed, as long as it is less than 180 days per year.

The effect of the estate tax law on Maryland residents is significant. According to one commentator, estate-planning attorneys have an ethical duty to discuss with estate planning clients the virtues of moving out of state.[30] Maryland legislators have a choice. They can keep the state death taxes or drive the wealthy residents to Florida, Virginia, or elsewhere. Unfortunately, if the past decade reflects on future actions, the choice they make will be the wrong one.

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1 Ch. 11, 1 Stat 527, 1797.

2 § 1, 2 Stat 148, 148, 1802.

3 See "An Act to Provide Internal Revenue to Support the Government and to Pay Interest on the Public Debt," § 110, 12 Stat. 432, 483 (1862); "An Act to Provide Wages and Means for the Support of the Government, and for Other Purposes," § 1, 13 Stat. 218, 218, 1864.

4 Jeffrey A. Cooper, *Interstate Competition and State Death Taxes: A Modern Crisis in Historical Perspective*, 33 Pepp. L. Rev. 835, p. 844, 2006.

5 "An Act to Provide Ways and Means to Meet War Expenditures, and for Other Purposes," § 29, 30 Stat. 448, 464-65, 1898.

6 Ibid.

7 "An Act to Increase the Revenue, and for Other Purposes," Pub. L. No. 64-271, § 1, 39 Stat. 756, 777, 1916.

8 Cooper, *Interstate Competition and State Death Taxes*, n. 1.

9 Max West, *The Inheritance Tax,* Columbia University Press, 1908.

10 The states that did not impose any state death taxes were Alabama, District of Columbia, Florida, Mississippi, New Mexico, and South Carolina.

11 Cooper, *Interstate Competition and State Death Taxes*p. 847.

12 Ibid.

13 Ibid.

14 Ibid, p. 852.

15 Revenue Act of 1924, Pub. L. No. 68-176, § 301(b), 43 Stat. 253, p. 304.

16 Cooper, *Interstate Competition and State Death Taxes*, p. 856.

17 Revenue Act of 1926, § 301(b), 44 Stat. 9, p. 70.

18 Cooper, *Interstate Competition and State Death Taxes,* p. 861.

19 Ibid., 8561-63. I highly recommend the Cooper article for a gripping account of the history of the various battles waged in the estate tax history. Cooper does an admirable job in describing the nationwide interplay among the states and between the states and the federal government.

20 Ibid., p. 873.

21 See Cooper, n.234.

22 Jonathan Blattmachr, "Wealth Transfer Tax Repeal: Some Thoughts on Policy and Planning," *Trusts and Estates*, February 2001, p. 49.

23 Cooper, *Interstate Competition and State Death Taxes*, p. 877.

24 See Sec. 901, P.L. pp. 107-16.

25 The rate is based on the federal death credit in effect prior to 2001. Accordingly, the rate increases from just 0.8 percent on the first $40,000 to 16 percent on amounts in excess of $10 million. The marginal rate at $1 million is 5.6 percent and 8.8 percent at $3 million.

26 Since there is no federal estate tax under present law on estates with a value below $5 million, the effective rate of tax on a $5 million estate would be the table rate assessed on the $4 million that is taxable. Thereafter, the effective rate will equal [state rate] - ([state rate] × (1- federal estate tax rate).

27 Section 7-201, et. seq. of the Tax-General Article of the Maryland Annotated Code.

28 Jay Hancock, "State Income Tax Isn't Why the Millionaires are Fleeing," *The Baltimore Sun*, May 22, 2009.

29 Jerome Tuccille, "Maryland residents aren't just fleeing taxes; it's the least free state in the Country," *Baltimore Examiner,* May 28, 2009.

30 See Cooper, *Interstate Competition and State Death Taxes*, p. 880.