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Beware the Tax Trap: Maryland Estate Tax

Prudent and effective estate tax planning will require more attention this year, especially with the “help” that was just provided by our elected representatives in Annapolis. A tax trap created by the General Assembly a couple of years ago with the Maryland Estate Tax can now be avoided, but only with the assistance of professionals. Let me explain.

In prior years, the Maryland Estate Tax was applied to the taxable estate of a decedent only if the Federal Estate Tax was applied. For example, in 2002, if a taxable estate was valued at \$1.5 million, both the Federal Estate Tax and the Maryland Estate Tax would be levied against the amount of the estate that exceeded \$1 million.

At the federal level, the value of an estate that can be protected from the Federal Estate Tax continues to increase. In 2001, it was \$1 million; in 2004, the value increased to \$1.5 million; and, in 2006, the value increased to \$2.0 million. These protections were provided by the use of what is commonly called the “unified credit.” This is a tax credit that applies to transfers of assets during life or upon death.

Annapolis saw these increases in the amounts exempted from the Federal Estate Tax and acted. In 2004, to retain tax revenues for the State, the General Assembly “decoupled” the Maryland Estate Tax from the Federal Estate Tax. Now, the Maryland Estate Tax applies to any taxable estate that exceeds \$1 million.

Because homes, vacation homes, life insurance, retirement accounts, and investments are all included, taxable estates often exceed \$1 million. The tax trap that was created affects those married couples with estates in excess of \$1.0 million, so many couples in this area may be heading towards this trap.

Transfers of property between a husband and wife are usually never taxed. This is the good news. The bad

news is that to minimize the impact of the Federal Estate Tax for the children, many couples included tax-planning trusts in their Wills. The purpose for including these trusts was to provide a means that allowed a married couple to use both of their unified credits. Instead of leaving everything outright to a spouse, upon the death of the first spouse, the amount protected by the unified credit was transferred into this tax-planning trust.

How does the trap work? In order to maximize the protections afforded under federal law from the impact of the Federal Estate Tax, up to \$2 million can be transferred into these tax-planning trusts upon the death of the first spouse. Because the marginal tax rate for this tax is 43%, doing this is the only prudent thing to do for one’s children and loved ones.

However, the amount by which the transfer to the tax-planning trust exceeds \$1 million will be taxed under the Maryland Estate Tax, and this tax could now be as high as \$140,000, which, by anyone’s definition, is a high tax, especially when the surviving spouse is still living. Thus, the tax trap is sprung.

In 2006, our General Assembly came to the rescue, but only for those Maryland residents truly savvy enough to plan appropriately. Maryland residents may now use a separate tax-planning trust that can be used to defer the Maryland Estate Tax that would otherwise have been applicable until the death of the second spouse. This will require, however, changes in all of the affected residents’ estate planning documents.

Considering how few lawyers are now in the General Assembly, it is good to see our elected representatives still making sure that we estate planners keep busy.