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Steve Leimberg's Estate Planning
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Subject: Linda Kotis on Minding the Gap - The Mismatch Between Maryland's 2019 Estate Tax Exemption and the New Federal Estate Tax Exemption

"Turnabout is fair play. At least the State of Maryland must think so. This spring, the Maryland General Assembly decided to decouple its state estate tax exemption from the "huge" new federal estate tax exemption created by the 2017 Tax Cuts and Jobs Act. The reversal from Maryland's previous plan begun in 2014 to match the federal exemption in 2019 [1] leaves Maryland's exemption now at $4 million in 2018 and $5 million in 2019. Maryland taxpayers should not fear this change, as there are still ways to achieve significant estate tax savings. Because Maryland does not impose a gift tax or require the use of estate tax exemption on transfers prior to death, lifetime gifting by Maryland couples is taking on a new significance. The addition of a Maryland state deceased spousal unused exemption (DSUE) could also help narrow the gap between the state exemption amount and the new $11.18 million federal estate tax exemption."

Linda Kotis provides members with commentary that analyzes the mismatch between Maryland's 2019 estate tax exemption and the new federal estate tax exemption.

Linda Kotis, is Of Counsel in the Washington, DC office of **Ivins, Phillips & Barker**, and a member of the District of Columbia, California, Indiana, and Maryland Bars. She advises clients on forming and revising their estate plans and analyzes estate, income, generation-skipping transfer, and gift taxation matters for high net worth individuals and families. Linda's significant experience also includes analysis of complex state trust administration and non-tax issues, the administration of high net worth estates, formation of private foundations, marital agreements, complex guardianships, post-mortem planning, probate matters and court pleadings regarding fiduciary administration issues. She also has assisted a private foundation in developing grant programs for approval by the IRS and creating grant agreements. She wrote *Reform School: Lessons on Rescuing an*

Undesirable Tax Plan after Death for LISI (April 27, 2017), and is author of articles in *Probate & Property* magazine, *Washington Lawyer*, *Bloomberg BNA Daily Tax Report*, and *Wealth Strategies Journal*. She has made presentations at the American Bar Association, the District of Columbia Bar, and law firm briefings.

Here is her commentary:

EXECUTIVE SUMMARY:

Jesse and Rebecca are thrilled to be living in their new Maryland home and consider themselves patriots. But, they are not keen on paying more than their fair share of taxes and are wondering what estate planning options are available to them, now that Maryland has changed its estate tax laws. This commentary discusses recent changes in Maryland law decoupling the state estate tax exemption from the new federal estate tax exemption and offers some strategies to reduce potential estate tax liability under the new law. While the article focuses on Maryland law, these strategies may also be useful for taxpayers in other states with an estate tax and an exemption amount that does not match the federal exemption.

FACTS:

Maryland SB 646, enacted on April 5, 2018, sets the state estate tax exemption amount at $5 million for the estates of decedents dying on or after January 1, 2019.[2] For decedents dying during 2018, the amount of the state estate tax exemption is $4.0 million.[3] The exemption amount will not be indexed for inflation.

Maryland has also added state-level portability of the decedent's remaining exemption amount for use by the surviving spouse.[4] As with the federal deceased spousal unused exemption (DSUE) now in place, this means that if the first spouse to die does not use his entire Maryland state estate tax exemption, the executor of his estate may permit the surviving spouse's estate to later use his unused exemption. What do these changes mean for Maryland couples?

COMMENT:

Let's take a look at Jesse and Rebecca, a husband and wife who moved in 2017 from Los Angeles to Baltimore City after Rebecca was offered her own

show, *Wake Up Baltimore*! Rebecca's "huge" signing bonus, plus Jesse's royalties from the smash success of his latest *General Hospital* soundtrack, have pushed their net worth to $60 million. The new Maryland law means that the state estate tax exemption amount is decoupled from the federal estate tax exemption, which is now $11.18 million due to the 2017 Tax Cuts and Jobs Act. Because of this gap, more of their estates may be subject to state estate tax than to federal estate tax.

Reduction of Maryland Taxable Estate During Lifetime

Six "Super" Ideas for Using that "Huge" New Exemption, an article in IPB's March 2018 Estates, Trusts, & Tax Newsletter,[5] describes some strategies for taking advantage of the change in the federal estate tax exemption. While the article is geared to planning at the federal level, the ideas for making gifts would also work for Jesse and Rebecca to generate state level tax savings in Maryland.

The ability to make additional lifetime gifts as a result of the increased federal exemption takes on particular significance for taxpayers who live in a state such as Maryland which does not impose a gift tax. No transfer by Rebecca or Jesse during lifetime requires either the payment of a state gift tax or use of any Maryland estate tax exemption. Any plan to remove assets from their estates now could result in greatly reducing the amount of the estate tax liability payable in the future. Below is more detail about how two gifting ideas would play out.

Giving to a Grantor Trust: Rebecca could establish a grantor trust to benefit their sons, Nicky and Alex, providing trust income and principal for expansion of the twins' taco truck business. Rebecca's gift of $5 million to the trust "freezes" the asset value on the date of the gift for purposes of the estate tax. Any appreciation in the value of the assets is free of gift and estate tax.

Rebecca could retain a "swap power" to substitute high-basis assets held outside the trust for low-basis assets held inside the trust. This provides two benefits. This would allow Rebecca to ensure that low-basis assets would be included in her estate and therefore receive a step-up in basis on her death. When an heir of her estate receives those assets and then later sells them, he or she would recognize less gain on the sale.

Creating Non-Reciprocal SLATs: If Jesse and Rebecca were concerned about losing access to their assets during their lifetimes, they could each create a Spousal Limited Access Trust (SLAT) for one another. To avoid the

"reciprocal trust doctrine,"[6] the SLATs should have different terms and beneficiaries.

Jesse could create SLAT#1 for Rebecca, Nicky, and Alex. Rebecca could create SLAT#2 for Jesse. This trust could also make discretionary distributions to Jesse's nieces, D.J., Stephanie, and Michelle, and D.J.'s BFF, Kimmy, whom Jesse rescued from marrying Duane in a Freddy Krueger-themed Vegas wedding at age 18. SLAT#1 could authorize the Trustee to make income and principal distributions for the health, maintenance, education and support of the beneficiaries. SLAT#2 could require quarter-annual distributions of income to Jesse. Danny, Jesse's brother-in-law, could serve as trustee of the trust created for Rebecca and the twins. Jesse could serve as trustee of the trust created by Rebecca for his benefit.

Each SLAT could permit the appointment of an independent trustee, such as a family friend or a trust company. The independent trustee could make discretionary distributions of principal for big-ticket items, such as the down payment on a summer home or a luxury vacation.

An advantage of these trusts is that any income or principal distributions to Jesse from SLAT#2 would be indirectly available to Rebecca as well. Jesse could use distributions made to him for the couple's household costs, mortgage payments, vacations, or other expenses Rebecca might have paid for or contributed to had the assets still been held in her own name. And the same advantages would apply to Jesse with respect to distributions from SLAT#1 to Rebecca.

"Porting" to Enhance Total Maryland Exemption

The advent of the Maryland DSUE could be used to enhance the total state estate tax exemption amount available on the second spouse's death. This could help narrow the gap between the state estate tax and federal estate tax liability.

Unlike the federal exemption amount, the Maryland exemption amount would not be applied to lifetime gifts.[7] This is because there is no state gift tax from which gifts need to be sheltered.

Jesse's and Rebecca's estate planning documents could create a federal and state QTIP Marital Trust for the benefit of the first spouse to die. This would postpone all estate tax liability until the second spouse's death. This plan would not use any of the first spouse's federal or Maryland exemption

amounts. Rather, the first deceased spouse's federal DSUE amount ($6.18 million = $11.18 million exemption – $5 million allocated to the lifetime gift described above) and the Maryland DSUE amount ($5 million exemption) would be "ported" to the second spouse's estate. He or she would then have $10 million in Maryland estate tax exemption, and $17.36 million[8] in federal estate tax exemption ($6.18 million exemption amount + his or her own $11.18 million exemption amount if he or she died before 2026). Other options exist for using the Maryland DSUE amount if the couple would prefer to use some federal estate tax exemption at the death of the first spouse.[9]

Planning Ahead to Use New Exemption

The change in Maryland law may disappoint those who were hoping for a "huge" new state estate tax exemption to match the federal exemption amount. Still, there are opportunities to reduce state estate tax liability under the new law. These include (1) making lifetime gifts to reduce the state estate tax on the amount gifted plus its appreciation and (2) using the new Maryland deceased spousal unused exemption amount to reduce state estate tax liability on the death of the second spouse. With proper planning now, Maryland couples can realize significant tax savings and achieve their goals to assist family members both now and in the future.

HOPE THIS HELPS YOU HELP OTHERS MAKE A *POSITIVE* DIFFERENCE!

Linda Kotis

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CITATIONS:

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[1] New Tax Changes for 2014. The General Assembly passed the following changes affecting Maryland tax laws for 2014: Estate Tax HB 739 – Maryland Estate Tax – Unified Credit. "The bill gradually conforms the Maryland estate tax to the value of the unified credit under the federal estate tax, thereby increasing the amount that can be excluded for Maryland estate tax purposes. . . . . The bill took effect July 1, 2014." Accessed on May 18, 2018 at http://taxes.marylandtaxes.gov/Resource_Library/Tax_Publications/ReveNews/Archives/2014_Summer.pdf

[2]Md. Code, Tax-General § 7-309(b)(3)(i)(6). The act takes effect on July 1, 2018.

[3] Md. Code, Tax-General § 7-309(b)(3)(i)(5).

[4] To take advantage of state level portability, (i) for the last predeceased spouse dying on or after January 1, 2019, a Maryland estate tax return for a spouse must be timely filed for the last predeceased spouse, on which the deceased spousal unused exclusion amount is calculated and an irrevocable election is made. If the last predeceased spouse died before January 1, 2019, or was not a Maryland resident and no property with Maryland estate tax situs was includible in the gross estate of the last predeceased spouse, the portability election must be made on such deceased spouse's federal estate tax return. Md. Code, Tax-General § 7-309(b)(9).

[5] http://www.ipbtax.com/publications-419.html

[6] A trust created by a settlor for her husband, with substantially identical provisions to a second trust created by the husband for his wife, and which puts each settlor in approximately the same economic position as if he or she had retained a life estate in the other spouse's trust, are considered to be reciprocal trusts. Pursuant to Section 2036(a)(1) of the Internal Revenue Code (the "Code"), the trust created by the settlor for his or her spouse would be includible in such settlor's gross estate at death. *U.S. v. Grace et al.*, 395 U.S. 316 (1969).

[7] Sections 2010(c)(4)(B)(ii) and 2001(b)(1) of the Code.

[8] This amount would be adjusted for inflation. Section 2010(c)(3)(B) of the Code.

[9] Maryland also permits a state-only QTIP election. This allows the creation of a marital trust for purposes of the Maryland estate tax marital deduction, but not the federal estate tax marital deduction. *See* Md. Code, Tax-General § 7-309(b)(5),(6). This strategy would be used to defer all Maryland estate tax without increasing the potential federal estate tax when the second spouse dies and could be used in conjunction with the creation of a credit shelter trust using some amount of federal estate tax exemption.