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Welcome Changes in the Maine Estate Tax

This spring, Maine lawmakers amended Maine's estate tax system, bringing significant improvements to the tax structure. LeBlanc and Young lawyers were active in the process and we are pleased with the improvements. Some of the changes are already effective, while others will take effect in 2013. Before we tell you about these improvements, a brief review of the evolution of the Maine estate tax may be helpful.

Historically, the Maine estate tax equaled the former credit allowable to offset the federal estate tax for estate taxes paid to states. Life was fairly simple – if there was no federal estate tax liability, there was no Maine estate tax liability. And in situations where there was a Maine estate tax, the estate received a dollar-for-dollar credit ("State Death Tax Credit") on a federal estate tax return. However, as part of the 2001 federal estate tax overhaul, this credit was gradually eliminated, shifting this revenue-sharing system away from the states. Maine, like many other states, changed its estate tax regime in 2001 by "decoupling" from the federal system and levying an estate tax equal to the tax that would have been due under the old (pre-2001) system.

Decoupling led to a complicated estate tax system. First, because of the way the State Death Tax Credit was calculated, it became necessary to complete two different sets of calculations in order to compute the Maine estate tax on any given estate. This two-tiered system imposed a very regressive marginal rate structure that taxed estates that were slightly above the Maine filing threshold ($1 million) at much higher rates (41%) than larger estates (5.6% - 16%). In addition, although Maine has no gift tax, the two-tiered calculations could result in lifetime gifts affecting the Maine estate tax liability on smaller estates. Finally, decoupling meant that there were different exemptions for federal and state purposes and, as a result, Maine couples were faced with a difficult choice. At the death of the first spouse, they could shelter the lower (Maine) exemption amount in a bypass trust and qualify everything else for the marital deduction ("maritalize"), thereby avoiding Maine and federal estate taxes on the first estate altogether. However, this approach wasted some federal exemption and exposed additional assets to federal tax in the second estate. Alternatively, couples could put the larger (federal) exemption into a bypass trust in the first estate. This would cause the first estate to incur a Maine estate tax, but would reduce the assets subject to federal tax in the second estate.

Maine subsequently adopted a separate Maine marital ("Maine QTIP") election. This concept allowed Maine couples to take full advantage of their federal exemptions without having to pay a Maine estate tax on the first death by allowing couples to maritalize (for Maine purposes only) the difference between the Maine exemption amount ($1 million) and the federal exemption amount ($2 million from 2006 to 2008 and $3.5 million in 2009). While the Maine QTIP was taxpayer friendly, other changes were less so. Non-residents who own Maine property were adversely affected when Maine became one of the few states to disregard pass-through entities that own Maine property and impose a tax on the underlying property as if the entity did not exist. Maine also began adding back into the gross estate gifts made within one year of death to arrive at the amount taxable. In addition, the Maine Legislature enacted a provision to "freeze" the Maine estate tax in 2009, ignoring the impending phase-out of the federal estate tax. As a result, the Maine QTIP was capped at $2.5 million (the difference between the $1 million 2009 Maine exemption amount and the $3.5 million 2009 federal exemption amount). As you may recall, in December 2010, Congress amended the federal estate tax system (for 2010 - 2012) and increased the federal exemption amount to $5 million. As a result, Maine's 2009 "freeze" again left Maine couples having to choose – fully utilize the first spouse's federal exemption amount and pay a Maine estate tax, or avoid the Maine tax at the cost of not fully utilizing the federal credit.

Maine's 2011 Legislation

To address these issues, the Maine Legislature enacted several changes to Maine's estate tax system. Effective January 1, 2011, the Maine QTIP election once again covers the entire difference between the federal exemption (currently $5 million) and the Maine exemption amount (currently $1 million). Thus, married taxpayers are no longer faced with the uncomfortable choice of whether to pay tax early or not, trying to predict how best to reduce the total tax burden on the estates of both spouses. Maine has also clarified the rules on Maine property held in a pass-through entity. Under the new legislation, Maine will follow the general rule that when real estate or tangible personal property is held in a pass-through entity that is run as an active business for profit, the pass-through entity will be recognized and taxed as an intangible asset by the state of the taxpayer's domicile. However, when a nonresident decedent has Maine real estate or tangible personal property in a pass-through entity that is *not* run as an active business for profit (ownership of a vacation home, for instance), Maine will disregard the entity and impose an estate tax on the nonresident's estate. The critical distinction for nonresidents is between personal use property (taxable) and business property (not taxable) held in a pass-through entity.

Effective in 2013, Maine's estate tax statute will include a true exemption and new tax rates, with the exemption increasing from $1 million to $2 million. The calculation is simplified and eliminates the regressive nature of current Maine law; the tax will be calculated only on the amount of assets in excess of the exemption, starting at a rate of 8% for estates with assets over $2 million and up to $5 million, with a 10% rate for additional assets between $5 million and $8 million, and a 12% tax rate on amounts in excess of $8 million. These changes do not affect the already effective Maine QTIP rules or the new pass-through entity rules. In addition, although gifts made within one year of death will still be added back to the estate of decedents, completed gifts made earlier than one year before death will no longer be included in the taxable estate, thereby eliminating an oddity under current law caused by the two-tiered calculations.

Non-Resident Concerns. The 2011 changes to the Maine estate tax do not affect the manner of calculating the Maine estate tax for nonresidents. That calculation remains a proportional calculation, and thus nonresidents who own real or tangible property includable in their Maine taxable estate (including personal use real property held in a pass-through entity) still need to include Maine-specific provisions in their estate planning documents to avoid, or at least minimize, the amount of Maine estate tax due. It is important to remember that there may be a Maine estate tax liability on Maine real estate owned by a nonresident couple when the first spouse dies, even if they owned the Maine property as joint tenants and may have expected that the marital deduction would avoid the Maine estate tax.

Remember all of those changes to the federal estate tax last year?

As noted in an earlier newsletter, the federal estate tax has changed significantly, albeit temporarily, for years 2011 and 2012, as a result of legislation enacted in December 2010. There have been no legislative changes to the federal transfer tax system in 2011, a much needed slow news year on that front! Under the federal 2010 legislation, the estate, gift, and generation-skipping exemption amount increased to $5 million per taxpayer, or $10 million per couple, and the tax rate on transfers over the exemption dropped to 35%. Thus the amount that an individual can give away during his or her lifetime without paying any gift tax (although a gift tax return will have to be filed and the gifts recorded for future calculations) is $5 million, which is a significant increase from prior law.

In addition, a new concept called "portability" was introduced in the 2010 federal legislation. Portability allows one spouse to pass his or her unused estate and gift tax exemption amount on death to his or her surviving spouse. This concept could be very useful in many situations, but it is subject to some complex and odd rules, it is not at all clear that it will exist in future federal legislation, and it does not help certain situations (like generation-skipping) that we still address in many estate plans.

It is not clear, unfortunately, how much we may rely on the current federal exemptions, the tax rate, and portability as now written, because the 2010 changes described above, as positive and taxpayer-friendly as they may be, are effective for years 2011 and 2012 only. After 2012, the law will revert back to what it would have been under the pre-2001 tax rules ($1 million federal exemption and progressive rates up to 55%), unless Congress enacts new legislation to the contrary. This is a pattern that is eerily familiar. The last time the federal transfer tax system was due to expire, Congress did not act until December 17, just fourteen days before chaos was to settle in. We are hopeful that our legislators and their executive counterparts will be more considerate this time around and attend to business with a more diligent, serious, and less politically-charged approach. Yet we are realistic enough to recognize that negotiations are often resolved at the eleventh hour. During a presidential election year, there may be pressure to resolve some of these pending issues before the time voters cast their ballots; and we fear that tax legislation pushed forward to achieve political gain (without careful consideration of policy issues examined under the lens of the long-term common good) may be short-sighted, hastily drafted, and prone to generate unforeseen consequences. Thus, planning must still be done against a backdrop of legislative uncertainty, and few will want to make predictions about what might happen with regard to federal estate, gift and generation-skipping taxes between now and 2013.

Alert! As this newsletter goes to the printer we have heard about concerns that the Congressional Super Committee charged with developing a plan to reduce the federal deficit might propose a significant reduction of the $5 million exemption, which could become effective before the end of this year. Some pundits are speculating that such a change could occur as soon as Thanksgiving! At this point, it is unclear how serious this possibility really is; nor do we know what the actual timetable and specific provisions might turn out to be, given the speculative nature of this latest news.

What should you do in view of the changes and the uncertainty?

In this time of continued change and uncertainty, one of the most common questions we hear is, "How does all of this affect my estate plan and what, if anything, should I do?" For clients who have revisited their plans within the past two or three years, it may be that no changes are needed; for those who have not had their plans reviewed for many years, it is likely that an update is in order. In performing a review of your plan, it is important that we have current information about asset ownership and values, any recent changes in family circumstances, and a sense of your general planning objectives. If information previously provided to us is out of date, filling out a new questionnaire would be a good idea; but if that previous information is essentially correct (with a need to simply update values), then sending us an updated version of the summary page of our package, or simply sending your own one-page breakdown of value changes in the various categories of assets, should suffice so long as you provide us with correct titling information (i.e., who owns which assets and what is owned jointly). Please contact us if you would like a new estate planning questionnaire to complete.

Issues to Consider Under the New Landscape

• **Opportunities for Gifting.** The substantial increase in the federal exemption to $5 million, and the integration of the federal estate, gift and generation-skipping exemptions at the same historically high level, have created some potentially remarkable planning opportunities for people of significant wealth. Indeed, this may be an historic, and potentially short-lived, opportunity for individuals to make substantial non-taxable gifts to family members that may not be permitted in the future. Further, because Maine has no gift tax, any amount that is given by an individual who then lives for more than one year after the gift, will escape Maine estate taxes completely – the savings can be quite substantial. There are a number of complicated factors that should be considered to determine what should be given, when and how, along with considering the level of risk that the additional amount given may be taxed later upon death if the exemptions actually decrease and Congress decides to recapture the foregone tax. We will need to look at the cost basis of assets, whether a gift should be in trust, generation-skipping or not, and if there is any particular technique that may improve the leveraging of the gift. Extremely useful leveraging techniques that may not be available in future years include valuation discounts on intra-family transactions, grantor-retained annuity trusts (GRATS) and low-rate loans to family members. Some of these strategies work particularly well in a low interest rate environment. Several of our clients have determined that they would like to proceed with such a gift program now, fearing that our presidential election year might result in a reduction in the exemptions. Such gifts can be complex to arrange and we invite clients who would like to discuss these issues with us to call soon so we can help arrange the details in a timely and well-planned manner. The end of the year can be hectic. We all want our year-end festivities to be unencumbered by last minute planning, if possible, and a little forethought can make that happen! We have more elaborate materials in our office addressing these issues and describing various gift techniques if you would like a more detailed explanation.

• Changes to Estate Planning Documents. Most estate planning documents rely on formulas that are linked to the various exemption amounts, and these amounts have been changed significantly by the recent federal and state legislation. Consequently, clients may want to review their documents to determine whether the amount of assets to be held in continuing trust (for example, for the benefit of a surviving spouse in a Maine QTIP trust) represents a greater portion of the estate than was originally intended. With the increased federal exemption, a Maine QTIP trust funded in 2011 could receive up to $4 million – perhaps an amount far greater than originally contemplated. Further, the generation-skipping exemption amount is now $5 million per taxpayer, or $10 million per couple, so it is possible that a generation-skipping plan that relies on formulas may leave a larger amount or proportion of the estate in lifetime trusts for children than was intended. Occasionally we still see some documents that do not include any Maine QTIP estate tax planning at all, which could result in the otherwise avoidable payment of Maine estate tax upon the death of the first spouse to die; for most clients, relying exclusively on federal tax planning, without creating the opportunity for Maine estate tax planning, seems short-sighted and imprudent.

• Should We Plan on Portability? The short answer to that question is "not yet," and if we ultimately do, its utility will be limited. "Portability" means that a deceased spouse can allow his or her surviving spouse to use his or her unused federal estate and gift tax exemption – it is called "DSUEA" for Deceased Spousal Unused Exclusion Amount – another catchy estate planning acronym! Although it sounds simple, and may have a positive impact for many couples, it does not address Maine estate tax planning, does not apply to generation-skipping exemption planning, and does not limit the appreciation in the value of assets in the survivor's estate or limit access by creditors. Also, in order to obtain portability, one must file a federal estate tax return for the first spouse's estate, imposing a significant burden and expense. As noted above, portability, as part of the recent federal changes, is scheduled to expire at the end of 2012, and it is not clear whether portability will survive beyond 2012. It would be imprudent to rely on portability at this point. If portability becomes a permanent and thus more viable option, we will certainly incorporate it in future plans; it will allow a more relaxed asset ownership structure for many couples. We will also discuss the pitfalls of portability, which are numerous.