The Maine Estate Tax; Our Brave New World[1]

October 22, 2012

Abigail King Diggins, Esq.
Elizabeth T. High, Esq.
LEBLANC & YOUNG
TWO CANAL PLAZA, SUITE 400
POST OFFICE BOX 7950
PORTLAND, MAINE 04112-7950

January 2013 heralds a whole new world with the total transformation of the Maine estate tax! A simplified structure, a higher exemption and lower rates promise to make planning easier and may persuade some of our residents to remain here instead of seeking residency in other states. Maine lawmakers amended Maine's estate tax system in the spring of 2011, bringing significant improvements to the tax structure, most of which become fully implemented this next January.[2] Before discussing these improvements, a brief review of the evolution of the Maine estate tax may be helpful.

A Bit of History

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. One was a credit at lower rates based on what the states might accept as their tax, and the other, applicable to small estates, was the preliminary calculation of the federal estate tax itself, which would often be paid to the states under the prior system if it was a lower number than the first calculation. 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% to 16%). This is because for estates just over the filing threshold by about $70,000 ($1,070,000), the tax was calculated as if it were the federal estate tax; the rate was thus 41%! 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

---

[1] A version of this article is scheduled to appear in the *Maine Bar Journal*. This version, significant revised, is copyrighted by the authors.
[2] <u>See</u> 36 M.R.S. §§4061 *et.seq.* and §§4101 *et. seq.*

(Maine) exemption amount in a bypass trust and qualify everything else for the federal 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 estate tax on the death of the second spouse if that second estate was over the federal estate tax threshold. 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). The Maine QTIP property was added back into the estate of the surviving spouse upon his or her subsequent death as “Maine Elective Property.” While the Maine QTIP was taxpayer friendly, other changes were less so. Nonresidents who owned 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. In addition, Maine 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). In December 2010, Congress amended the federal estate tax system (for 2010 through 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.

Current Maine Tax - 2012

To address these problems, Maine enacted several changes to its estate tax system. Effective January 1, 2011, the Maine QTIP election once again covers the entire difference between the federal exemption ($5 million in 2012) and the Maine exemption amount ($1 million in 2012). 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. The Maine Elective Property concept captures the Maine QTIP in the Maine taxable estate of the surviving spouse to the extent the spouse was a Maine resident, or in the case of nonresidents, if the Maine QTIP held Maine real or tangible property. The calculation of the tax still relies on the two-tiered state death tax credit calculation, including a one year look-back for gifts. Because of the complexity of Maine’s two-tiered estate tax calculation, taxable gifts made more than one year before death can result in an estate tax on estates having a total date of death value below $1 million and will continue to disproportionately affect estates with values just over $1 million. Further, the tax calculation remains proportionate, not taxing out of state real estate or tangibles for Maine residents, and seeking to tax the proportion of Maine real or tangible property for nonresidents. The 2011 legislation 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 example), 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. Maine offers a credit for the tax paid to other states levied on certain property that is taxed both in Maine as an intangible and in another state if it is deemed to be real estate.

2013 – and Beyond?

Effective January 1, 2013, Maine's estate tax statute changes dramatically and will include a true exemption and new tax rates as a result of the comprehensive restructuring done in the spring of 2011. The Maine estate tax law has been completely rewritten and is contained in 36 M.R.S. Sections 4101 through 4118. As a general overview, the exemption increases from $1 million to $2 million. The calculation is simplified and eliminates the regressive nature of the two-tiered calculation under current Maine law; the tax will be calculated only on the amount of estate assets in excess of the exemption, starting at a rate of 8% on assets over $2 million and up to $5 million, with a 10% rate on additional assets between $5 million and $8 million, and a 12% tax rate on amounts in excess of $8 million. The new Maine QTIP rules encompass the entire gap between a lower Maine exemption and a <u>higher</u> federal exemption, and the new pass-through entity rules remain the same. Taxable gifts made within one year of death are added back to the estate tax base, as is Maine elective property. Maine does not have a gift tax. This means that, other than gifts made within one (1) year of death, complete gifts made during one's lifetime will escape the Maine estate tax at death.

Maine Residents

The Maine estate tax calculation for Maine residents is fairly simple, 36 M.R.S. § 4103. The Maine tax base, which is the Maine Taxable Estate defined in 36 M.R.S. § 4102(7), is subject to the following rate table:

Maine Taxable Estate	Tax
0 - $2 million	0
Assets over $2 million to $5 million	8%
Assets over $5 million to $8 million	$240,000 plus 10% of amount in excess of $5 million
Assets over $8 million	$540,000 plus 12% of amount in excess of $8 million

The Maine taxable estate is a fairly simple calculation based on the federal taxable estate, decreased by the Maine QTIP property, increased by Maine elective property and increased by <u>taxable</u> gifts made within one year of death. For these purposes, the state death tax deduction is ignored. If a decedent owns real or tangible personal property that is located out of state, the tax is a proportion of the total tax to reduce the tax attributable to the value of the assets taxable by the other state. This is calculated by multiplying the total tax with no adjustments for the situs of assets, as a fraction as follows:

$$\frac{\text{real and personal property located in Maine plus all intangible property wherever located}}{\text{all of the decedent's adjusted federal gross estate}}$$

There is a nuance for residents who might own property in an entity that renders the property an intangible and thus taxable by Maine, but might otherwise be taxable by the state of location if it has a law similar to Maine that pierces certain business holding entities and taxes the underlying assets. This would only be applicable for constitutionally appropriate taxes, and it provides a credit that is intended to compensate the estate for taxes paid to another state. Thus, for example, if a Maine resident owned residential real estate in Florida, even though Florida has no estate tax, there would be an adjustment based on the fraction noted above. In contrast, if a Maine resident transfers title to his or her residential real estate located in Florida to an LLC, Maine would tax the LLC as an intangible, and there would be no offset because Florida has no estate tax that would give rise to a credit. It is not even clear that Florida real estate held in certain trusts would escape this treatment.

Nonresident Concerns

The new Maine estate tax retains a symmetry in the manner of calculating the Maine estate tax for residents and nonresidents alike; that calculation remains a proportional calculation that would seek to tax only the value of certain real estate and tangible personal property located in Maine for nonresidents, M.R.S. § 4104. First, the initial tax is calculated as if the decedent were a Maine resident, as above. That initial tax is then multiplied by a fraction, the numerator of which is the value of the Maine real estate and tangible personal property in the adjusted federal gross estate, and the denominator of which is the total adjusted gross federal estate. For example, if a 2013 nonresident decedent had a Maine taxable estate valued at $5 million, including a $500,000 home in Maine, the calculation would be as follows:

Gross Federal Estate	$5,000,000
Initial Tax	$240,000
Maine %	10% ($500,000 ÷ $5,000,000)
Maine Estate Tax	$24,000

It does not matter if the Maine property passes to a spouse, whether by bequest, formula or joint tenancy, because the full tax is calculated and then the proportion applies whether or not the property in Maine is the subject of a marital deduction. The only way for a nonresident to eliminate the tax is to qualify the estate much as if it were the estate of a resident, to have no tax due on the taxable estate. This would be no problem for a small estate in which the size of the bequest or joint tenancy of the Maine property brings the total estate to less than $2 million, but for a larger estate as above, the formula or arrangement must render enough of the estate eligible for a federal marital deduction or a Maine QTIP election (assume $3 million in the example above, being the difference between the gross estate and the new state exemption) to reduce the Maine taxable estate to $2 million or less. 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 if they wish 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.

The other nuance is the retention of Maine's statute to pierce a pass-through entity, such as a trust, partnership, LLC or S corporation that owns non-business real estate. This retains its three-prong test under 36 M.R.S. § 4104: (i) did the entity actively carry on a business for profit or gain; (ii) was the property owned by the entity for a valid business purpose; and (iii) was the property acquired by a bona fide sale for full and adequate consideration? These are difficult questions. Apparently, they have arisen infrequently but any property that is held in a pass-through entity owned by a nonresident should be examined with these criteria in mind.

Filing Issues – The When, How and What

Maine estate tax returns remain due nine months after the date of death. Any estate that must file a federal estate tax return will need to file a Maine tax return if it has assets subject to Maine tax. Further, if the estate, increased by adjusted taxable gifts and a rare specific gift tax exemption, exceeds the $2 million exclusion amount, the estate must file a tax return. All of these details are in 36 M.R.S. § 4107. It would appear that Maine Revenue Services will likely no longer require the use of the 2009 federal estate tax return pro forma to accompany its tax returns, for the pertinence of 2009 tax law and the state death tax credit calculation is no longer a consideration. Instead, the expectation is that Maine Revenue Services may permit the filing of a contemporary federal estate tax return if the federal estate tax laws remain appropriately pertinent. Of course, if the federal return forms are unduly delayed in their release, Maine Revenue Services may need to reconsider this helpful position.

It would also appear that Maine Revenue Services is adopting a more liberal reading of what the filing requirement might be if there is no tax liability and no full return is required but a personal representative wishes to make a filing to discharge the estate tax lien on real or tangible property under 36 M.R.S. § 4112. Right now such estates must file a Maine Form 706ME-EZ and the preparation of that return requires accumulation of much specific data that then requires substantiation and a representation that the value of the assets is accurate. This can often be a frustrating and expensive exercise for what would otherwise be an exceptionally simple matter. Starting in 2013, Maine Revenue Services will likely require a statement of value that will simply permit the personal representative in those estates under the return filing threshold to file a simple declaration that the entire value of the estate as adjusted for taxable gifts and the Maine Elective Property is under the filing threshold. This should make obtaining a discharge of lien simple and inexpensive for many. See 36 M.R.S. § 4107(3).

Maine remains able to challenge the values of assets reported, even if a federal determination letter is received. Further, the state has one year after the final federal determination to challenge the inclusion of an asset in the estate for the allowance of deductions, 36 M.R.S. § 4111. The Personal Representative of an estate is responsible for payment of the tax up to the value of the assets he or she controls (36 M.R.S. § 4105), but the Personal Representative can discharge his or her liability even before obtaining a closing letter, by filing an application requesting a determination of the tax under 36 M.R.S. § 4106 that will limit the liability to one year of exposure.

Dovetailing with the Federal Estate Tax

The Federal government imposes a tax on certain transfers made during life (gift tax) or at death (estate tax); and it assesses an **additional** tax on certain transfers made to or for the benefit of persons two or more generations below that of the transferor (generation-skipping transfer tax). As a result of legislation enacted in December 2010[3], these three tax regimes changed significantly, albeit temporarily, for years 2011 and 2012. Under the federal 2010 legislation, the estate, gift, and generation-skipping exemption amount increased to $5 million per taxpayer in 2011 and $5.12 million per taxpayer in 2012. In addition, the tax rate on transfers over the exemption dropped to 35%.

The federal estate tax currently in place will expire at the end of 2012, and without further legislation, the estate tax regime that would have been in place in 2001 would spring back into existence, complete with its $1 million exemption and the higher marginal rates topping out at 55%. As there was in 2009 and 2010, there has been an enormous amount of speculation in the past year as to whether Congress will permit our current estate tax regime to expire and roll back to law that is more than 10 years old. There are several possible outcomes. One possibility is that the Congress will do nothing in 2012, we will face a roll-back, at least temporarily, in 2013 to a federal exemption of $1 million, and Congress will attempt to tackle the problem in 2013 with perhaps a renewed vigor after the election and the appearance of new faces in our Capitol. Another possibility is that our post-election Congress will act in 2012 and either completely change the estate tax regime permanently or, more likely, simply extend it by another year or so, allowing their lucky successors to tackle the issue.

If the federal exemption declines to the point that it is less than the state exemption, many estate planning documents with outdated formulas may not work appropriately. At that point, it is quite certain that there would be no Maine QTIP available (see 36 M.R.S. § 4102(6)) because the QTIP is defined as the amount by which the federal exclusion amount <u>exceeds</u> the state exemption. Documents that hold the state exempt amount in a trust that does not otherwise qualify for the marital deduction may expose an estate to federal estate tax if a lower federal exemption is actually enforced. Although this seems unlikely, it is something that might, at least for a short period of time, be theoretically possible if Congress does not act promptly and any remedial legislation comes later in 2013, whether it dates back to January 1, 2013 or not.

If the federal exemption decreases permanently, and it is either lower than or approximates the Maine exemption, the federal audit process could become more meaningful for

[3] Public Law 111-312； TAX RELIEF, UNEMPLOYMENT INSURANCE REAUTHORIZATION, and JOB CREATION ACT OF 2010

more estates, and this could mean that the Maine audit process will become a less difficult one if Maine Revenue Services concludes it can rely more comfortably on a federal audit. This should be challenging in view of how many fewer federal estate tax auditors are employed at this writing, compared to five years ago. Thus the fate of the tax statutes might significantly impact the process that punctuates the filing of estate tax returns.

Should we plan on the federal concept of portability? 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 – it is called “DSUEA” for Deceased Spousal Unused Exclusion Amount. This concept could be very useful in many situations, but it is subject to some complex and odd rules and it is not at all clear that it will exist in future federal legislation. 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. Further, as part of the recent federal changes, portability is scheduled to expire at the end of 2012, and it is not clear whether it will survive beyond 2012. It would be imprudent to rely on portability at this point; if it does become a permanent part of federal law, those Maine residents who do not wish to provide for generation-skipping planning in their estate plans will be able to have simpler trust plans that simply seek to shelter the Maine exemption amount to reduce the total exposure to Maine’s estate tax.