

# The Guttenberg Press

*Preserving Your Assets ... Planning Your Future*

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Dear Friend:

*We have devoted most of this issue to the new Maryland "decoupling" estate tax legislation which is likely to have a significant impact on many estate plans. This change needs to be addressed by almost all married couples who have Wills or Revocable Trusts containing "Bypass" or "Credit Shelter" Trusts designed to eliminate the federal estate tax when the first spouse dies. In the past, all taxes in the first estate — both federal and state— could be eliminated. Now, there could be a Maryland Estate Tax of as much as \$64,400. In 2006, this potential Maryland estate tax could rise to \$99,600.*

*Our office has been at the forefront in developing various action strategies and solutions to this decoupling legislation. Some solutions may require a tweak while others may be a bit more extensive. All solutions involve an estate tax structure which is designed to reduce the overall exposure to federal and Maryland estate taxes. We recommend that you call us so that we can review and determine the appropriate course of action for you.*

*Let's stay in touch!*

## **MARYLAND "DECOUPLES" ITS ESTATE TAX: A \$64,400 TRAP FOR THE UNWARY-- SOLUTIONS FOR YOU AND YOUR HEIRS**

On May 26, 2004, the Governor signed a general revenue measure freezing the Maryland estate tax exemption at \$1,000,000, even though the federal estate tax exemption has been increased to \$1,500,000 (Maryland has thus "decoupled" its estate tax from the federal estate tax). The change is effective for estates of individuals dying in 2004. The tax has enormous effects on the estate plans of married couples who planned for total federal and Maryland tax reduction through "Bypass" or "Credit Shelter" Trusts. The legislation imposes a classic "trap for the unwary," but, like many similar estate tax traps, there are strategies and solutions-- and even opportunities for the initiated. But action is needed.

### **BYPASS TRUSTS: A BASIC ESTATE TAX STRATEGY FOR MARRIED COUPLES**

Many married couples have created estate plans that were intended to postpone the payment of estate taxes until after the death of the second spouse while preserving both spouses' exemptions to maximize the amount of assets that can pass estate tax-free. This was often accomplished through the use of a "Bypass Trust."

The "Bypass Trust" which is set up in each spouse's Will or Revocable Trust, would be funded after the death of the first spouse with assets equal to the first spouse's federal estate tax exemption (\$1,500,000 in 2004 and 2005). The assets in the Bypass Trust are not part of the surviving spouse's estate and pass ultimately to the children/descendants estate tax-free. The Bypass Trust essentially is the tool for maximizing both spouses' exemptions (aggregate \$3,000,000 in 2004 and 2005) with significant estate tax savings (i.e., up to \$720,000 in 2004 and 2005). SEE EXAMPLE ON PAGE 2, COLUMN 1.

### **EFFECTS OF MARYLAND DECOUPLING LEGISLATION ON BYPASS TRUSTS**

As a result of Maryland's decoupling legislation which now freezes the exemption at \$1,000,000 for Maryland estate tax purposes, those existing Wills and Trusts with "Bypass Trusts" could cause payment of a significant Maryland estate tax on the death of the first spouse to die. If the Bypass Trust is fully funded at the first spouse's death to take advantage of the \$1,500,000 federal estate tax exemption, this will result in a Maryland estate tax of \$64,400 in 2004 and 2005.

Article Continues on Page 2, Column 2

IN THIS ISSUE:

- Maryland Decouples Its Estate Tax
- Bypass Trust Example (Before and After Decoupling)
- Practical Consequences and Solutions
- What We've Been Up To Lately

## EXAMPLE: BYPASS TRUST

### Results Before Maryland Decoupling:

Harry and Wilma, both Maryland residents, have an aggregate estate of \$3,000,000, with each owning \$1,500,000. Harry's Will provides for a "Bypass Trust" which would be funded with assets up to the federal estate tax exemption amount. The balance of Harry's estate would pass to his wife, Wilma. If Harry dies in 2004, when the federal exemption is \$1,500,000, his Bypass Trust would receive \$1.5 million, and there would be no federal estate tax due and no Maryland estate tax (since before decoupling, the Maryland exemption was tied to the federal exemption). At Wilma's subsequent death, say, in 2005, the assets in the Bypass Trust would pass to the couple's children with no further estate tax, and Wilma could leave an additional \$1,500,000 to the couple's children free of federal and Maryland estate taxes. Using the available federal estate tax exemption for both estates (\$1,500,000 in 2004 for Harry and \$1,500,000 in 2005 for Wilma), the couple is able to pass \$3,000,000 to their children free from federal estate tax.

### Results after Maryland Decoupling:

#### Estate Tax Result in 2004 Upon Harry's First Death:

No federal estate tax due to \$1,500,000 federal exemption.

Maryland estate tax of \$64,400 since the Maryland estate tax exemption is now \$1,000,000.

Note: If Harry's death occurred in 2006-2008 and Harry's Will was not changed, there would be no federal estate tax due but a Maryland tax of \$99,600! If Harry's death occurred in 2009, the Maryland estate tax would be \$229,200! See Chart Below.

#### Effect of Maryland Decoupling

The following table illustrates the way in which the decoupling problem will grow in the next few years even for an estate plan which was designed to be tax-free at the death of the first spouse. For the purposes of the Table, assume that the Bypass Trust is fully funded with the federal exemption amount.

Year	Federal Exemption	Maryland Exemption	Maryland Estate Tax
2004	\$1,500,000	\$1,000,000	\$64,400
2005	\$1,500,000	\$1,000,000	\$64,400
2006	\$2,000,000	\$1,000,000	\$99,600
2007	\$2,000,000	\$1,000,000	\$99,600
2008	\$2,000,000	\$1,000,000	\$99,600
2009	\$3,500,000	\$1,000,000	\$229,200

Continued from Page 1: MARYLAND "DECOUPLES" ITS ESTATE TAX

## WHY DID MARYLAND "DECOUPLE?"

Until recently, Maryland's Estate Tax, as well as the estate tax in most other states, was tied to the federal estate tax. Specifically, the federal estate tax gave each decedent's estate a dollar-for-dollar credit against the federal estate tax for amounts paid to the state as estate tax, up to a specified limit. Most states, like Maryland, took full advantage of this rule by imposing a "sponge tax" or a "pick-up tax" exactly equal to the amount of the federal credit available. This essentially created a revenue sharing system in that there was one tax— with most paid to the federal government and a portion directed to the states.



In 2001, Congress enacted legislation (called "EGTRRA") increasing the exemption from federal estate tax – from \$675,000 in 2001 to \$1,000,000 in 2002 and to \$1,500,000 in 2004 and 2005 (see chart opposite), with a proposed repeal in 2010. To help pay for the cost of lower estate tax and possibly estate tax repeal, Congress provided that the state death credit would be phased out completely by 2005. These two changes had a major effect on the state estate tax revenues. The increase in the federal exemption reduced the tax payable to both the state and federal government. And, the phase-out of the state death tax credit would result in the federal government keeping a greater portion of the tax imposed on decedent's estates at the expense of the states.

Maryland and many other states have responded by rewriting its estate tax laws to replace this lost revenue.

## MARYLAND'S "DECOUPLING" CHANGES

Here are the highlights of the new Maryland Estate Tax.

*Exemption Limited to \$1,000,000.* A Maryland estate tax will be due if a decedent dies with a "taxable estate" over \$1,000,000.

#### *Regressive Tax Rates.*

The tax rate for estates between \$1,000,000 and \$1,093,785.32 is 41%.

Tax rates for amounts over \$1,093,785.32 range between 5.6 % and 16%.

*Retroactive Effective Date.* Although legislation was signed by the Governor on May 26, 2004, the tax applies to estates of decedents dying after December 31, 2003.



# Practical Consequences of Decoupling and Solutions

Maryland Estate Tax may be due even if an estate does not owe federal tax. This is a radical change from the past and is due to the lower Maryland exemption of \$1,000,000.

Married couples with Wills or Revocable Trust Agreements designed to eliminate the federal estate tax when the first spouse dies will now owe Maryland Estate Tax at the first death. As depicted by the chart (page 2, column 1), this tax can be as much as \$64,400 in 2004, \$99,600 in 2006 and \$229,200 in 2009. Also as noted, this tax will impact even smaller estates since the tax rate for estates between \$1,000,000 and \$1,093,785.32 is 41%!

Estates of between \$1,000,000 and \$1,500,000 which are exempt from federal estate tax will now be burdened with the cost of preparing a new Maryland estate tax return.

All estate plans of married couples will now require review.

## Solutions:

We have been designing various solutions to the "decoupling" problem. Here are some solutions to counteract the "decoupling" legislation.

**Option #1: Cap the amount funding the Bypass Trust at \$ 1,000,000.**

**Result:** No federal or Maryland estate taxes on first spouse's death.

**Purpose:** This would prevent the imposition of Maryland estate tax at the death of the first spouse.

**Use:** This solution could be used for estates of married couples under \$2,000,000, where there is no need for use of the full \$1,500,000 exemption in each estate. For larger estates, this option would result in wasting a portion of the first spouse's federal estate tax exemption.

**Note:** This technique can even be tweaked by empowering the surviving spouse to add to the trust through a disclaimer.

**Option #2: Fully fund the Bypass Trust (for example with \$1,500,000 in 2004).**

**Result:** Pay no federal estate tax upon first spouse's death but pay \$64,400 in Maryland estate tax upon first spouse's death.

**Purpose:** Possibly save federal estate taxes at second spouse's death due to full use of exemption. Pay the Maryland estate tax as the first spouse's death, because in doing so the family might save a much greater amount in federal estate tax at the second spouse's death.

**Use:** Should be used only by wealthier clients whose assets are greater than \$5,000,000. Clients between \$2,000,000 and \$5,000,000 should consider Option#4 below.

**Option #3: Set up the Bypass Trust as a Disclaimer Trust**

**Result:** Upon the death of the first spouse all assets would pass to the surviving spouse pursuant to the Will. Surviving spouse would have option to disclaim after death of the first spouse. Any property disclaimed would be used to fund the Bypass Trust.

**Purpose:** Provide surviving spouse with flexibility to determine after the first spouse's death what amount of assets, if any, should fund the Bypass Trust. With the ability to analyze the situation after the first spouse's death, the surviving

spouse, upon the advice of counsel, would be able to determine whether it is more or less advantageous to fully fund the Bypass Trust and pay any Maryland estate tax.

**Use:** For combined estates under \$2,000,000. For estates over \$2,000,000, Wills should contain more sophisticated options-see below.

**Option #4: Optimum Solutions for Estates Expected to Be In Excess of \$3,000,000.**

There are a variety of sophisticated solutions which involve a multi-trust structure. Here is one solution we have developed to date:

1. Create a Bypass Trust (Trust A) capped at \$1,000,000.

2. Balance is then divided into 2 portions:

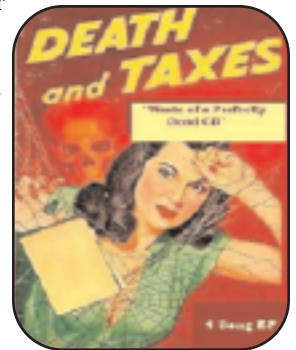
a. A Marital (QTIP) Trust (Trust B) equal to the remainder of the federal exemption not used in Trust A (i.e., in 2004, this would be \$500,000). The Personal Representative can either elect "QTIP" treatment and not pay Maryland tax, or not elect it and pay the Maryland tax and maximize the federal exemption.

b. A second portion (amount over \$1,500,000) which could either be a second Marital Trust or an outright bequest to the surviving spouse.

**Possible Bonanza:** The IRS has issued a Revenue Procedure which may even allow a further windfall with use of this technique upon the death of the surviving spouse.

The key facet of this and other sophisticated options is to ensure that your documents are sufficiently flexible to provide for optimum tax savings after the death of the first spouse.

It is important to remember that, while there are solutions, each situation is unique. The key is that your objectives be implemented at the lowest possible tax cost. We believe that this legislation can even present opportunities for your overall estate planning.



## Other Planning Opportunities After Decoupling

**Gift Program** - limit state estate taxes by using \$11,000 annual exclusion and/or the \$1,000,000 exemption. Significant planning opportunities exist in Maryland since Maryland has no gift tax - only an estate tax!

**Life Insurance Trusts** - to remove life insurance from estate.

**Generation-Skipping Trust/Perpetual (Dynasty) Trusts** - to save estate taxes in estates of next generation. Remember that under Maryland law, these trusts can be perpetual. Your documents will need to integrate the decoupling provisions with generation-skipping provisions.

**Qualified Personal Residence Trusts** - to remove valuable vacation home from estate.

**Charitable Gift Planning** - set up private foundations or donor advised funds to establish charitable gifting or bequests.

## Things We've Been Up to Lately

Sandy and I thank you for your well-wishes on the recent marriage of our son, Gary, to Leba Krupka of Far Rockaway, New York. The wedding took place on August 30, 2004. Gary is a graduate rabbinic student at Yeshiva University and plans to attend law school. Leba is a pediatric nurse at Columbia Presbyterian Hospital.



Congratulations to Amanda Hunt Franklin on her graduation from University of Baltimore School of Law in May, 2004, with a concentration in estate planning. We are pleased to announce that Amanda will be staying on as an associate in our office.



Our office has been studying, and has participated in, several professional conferences, addressing strategies in response to the new "decoupling" of Maryland estate tax. We are also developing appropriate responses for our clients. Aryeh is presently rewriting the necessary Will and Revocable Trust forms for his Maryland Estate Planning book. Copies of this new chapter on decoupling will be available to clients.

The privacy and disclosure laws contained in the new Health Insurance Portability and Accountability Act ("HIPAA") make it necessary that all General and Health Care Powers of Attorney be revised to include "HIPAA" language. We have drafted such language for our clients. Please call if your Powers of Attorney were signed before 2004.



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### ESTATES AND TRUSTS

- Estate and Trust Planning
- Will and Trust Preparation
- Estate and Trust Administration
- Charitable Gift Planning

### BUSINESS

- Formation – Corporations, Partnerships, Limited Liability Companies
- Planning and Structuring
- Business Succession Planning
- Business Agreements
- Mergers and Acquisitions

### TAX

- Planning and Structuring
- Representation Before IRS and Federal Courts
- Private Foundations

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