

increased, so has the federal generation-skipping transfer tax exemption. Therefore, if your estate plan provided that the maximum generation-skipping transfer tax exemption would fund a trust for or be distributed to your grandchildren, you need to check to see whether the plan works as you intended. A widow with \$2,000,000 may have planned to leave \$1,000,000 to her children and \$1,000,000 to her grandchildren. If the language of the will is not changed, the entire generation-skipping transfer tax exemption amount (\$2,000,000) may go to the grandchildren, leaving nothing for the children to inherit.

State Level Estate Tax Changes

When it changed the federal estate tax laws, Congress changed what had been a *credit* for state estate taxes paid to a *deduction*. In the past, every dollar you paid to Maryland for estate taxes reduced the amount of estate taxes you paid to the U. S. Treasury. Now, you receive a deduction which reduces your federal estate taxes by 46%.

Maryland, like many states, had an estate tax collection system that set the state level tax at an amount equal to the federal credit. When the federal credit became a deduction, some states (notably Florida and Delaware) did nothing. The result is that Florida and Delaware have no state level estate tax. Maryland and other states determined that financially they could not give up the revenues from estate taxes. The general assembly established that Maryland would continue to collect an estate tax as if the federal credit was still in existence. It also froze the exemption level at \$1,000,000. In Maryland, if you die with assets worth \$1,000,000 or more, no federal estate tax is owed but you do owe a Maryland estate tax. Unlike the federal exemption, the Maryland estate tax is applied at the first dollar for those who are subject to the tax. A decedent with assets of \$999,999.99 owes no Maryland estate tax, but a decedent with assets of \$1,000,000 owes \$33,000 in Maryland estate taxes.

In addition, until recently the changes to Maryland law meant that if you fully fund-

ed the by-pass or credit-shelter trust in order to maximize the federal estate tax savings, then you had to pay estate taxes to Maryland at the death of the first spouse. Alternatively, you could decide to fund the by-pass or credit-shelter trust with only \$999,999.99, pay no estate tax on the death of the first spouse, but forego the available federal estate tax savings on the difference between the Maryland exemption limit and the federal exemption limit. The general assembly has now approved a solution to this dilemma which is explained in the article by Michael Stanley in this newsletter.

Tuition Exclusion

The IRS has ruled that a taxpayer did not make gifts when he prepaid multiple years of tuition for six grandchildren. The tuition payments were for elementary school through grade 12 and were not refundable even if a grandchild died or did not attend the school. Considering the cost of private school tuition a substantial amount can be transferred without estate, gift or generation-skipping transfer tax by fully funding tuition. The particular case did not address whether the plan would work if the school allowed a transfer of funds to another (non-profit) school if a grandchild failed to attend the first school. Stay tuned for developments.

Charitable Rollover

Under the new Charitable Rollover IRA rules an individual who has attained the age of 70 1/2 can contribute \$100,000 from his or her IRA to a "public charity" or "conduit private foundation" without reporting the distribution from the IRA as income. It is called a "Rollover" because the contribution must go directly to the charity from the IRA trustee or custodian. DO NOT MAKE A WITHDRAWAL FROM YOUR IRA. For individuals who have large IRAs and are already making significant charitable donations, this provides another option. The amount directed to charity avoids the phase out of deductions that affects taxpayers with income that exceeds \$150,500. The Charitable Rollover also avoids percentage limitations, and because it is not included in income, there is no need to itemize. Another big advantage is that the contribution to chari-

ty satisfies your minimum distribution requirement for that year. This means that you will have less reportable income. This option is available only for 2006 and 2007. Remember that your IRA assets grow income tax deferred so on an individual basis, contributing highly appreciated stocks may be more beneficial. Also, if you reduce the balance of your IRA, you may affect the ultimate distribution of your estate. Make sure your beneficiary designations are up to date for your IRAs and other retirement accounts.

Fractional Interest in Art

The Pension Protection Act was not so kind to museums and other charities that receive donated art. The Act requires donors who make fractional interest transfers of art to complete the donation of the entire work within ten (10) years of the initial gift or at the donor's death, if earlier. Also, the value of the artwork is fixed at the initial transfer value, so the donor does not receive a charitable deduction for any appreciation in value between the initial gift and the final gift.

Conservation Easements

Conservation easements are typically a promise not to develop land. If the easement is perpetual in nature, is made to a "qualified organization," and is for a "conservation purpose," the landowner receives a charitable deduction and an estate tax exclusion. A "conservation purpose" includes: the preservation of land areas for outdoor recreation by, or the education of, the general public; the protection of a relatively natural habitat of fish, wildlife, plants, or similar ecosystem; the preservation of open space (including farmland and forest land) where such preservation is for the scenic enjoyment of the general public, or pursuant to a clearly delineated federal, state, or local governmental conservation policy, and will yield a significant public benefit; or the preservation of an historically important land area or a certified historic structure. In addition to the federal benefits, Maryland offers a tax credit for the value of the easement, limited to \$5,000 per year with a fifteen-year carry-forward.

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The Pension Protection Act increased deduction limits for 2006 and 2007. Taxpayers will enjoy a deduction limited to 50% of adjusted gross income rather than the usual 30%. For farms and ranches, the benefit goes up to 100% of adjusted gross income and the excess can be carried forward for fifteen years. The Act also increased the penalties for easement overvaluation, and imposed penalties directly on appraisers.

What to Do

All of these changes require action on your part. You must take out your last will and testament and other estate planning documents, look at the current value of your assets, and determine if the original plan still works for you and whether the documents still give effect to your plan. Call us if you have questions or need to make changes; we are happy to be of assistance.



Wright, Constable & Skeen LLP is proud to announce that the Bar Association of Baltimore City recognized, David Skeen, for his thirteen-year support of the Baltimore City Drug Court program. The Baltimore City Drug Treatment Court, in operation since 1994, is a treatment-based program for non-violent addicted offenders in the District and Circuit Courts of Baltimore City which has diverted thousands away from incarceration and through comprehensive drug treatment restored them to their families and jobs. David recently retired from his position as chair of a committee that brought together representatives from the courts, the state's attorneys office, the public defenders office, the division of parole and probation and various drug treatment organizations to work together to make the Drug Court a success. Congratulations, David, for the recognition you so richly deserve.

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Recent Changes in Estate Planning

By Mary Alice Smolarek



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Recent estate tax changes at the federal level have created a haphazard patchwork of state laws that have dramatically increased the complexity of estate planning. In addition, the Pension Protection Act of 2006 added still more changes. Included in this newsletter is information that you need in order to evaluate your estate planning.

Increased Federal Exemption

The federal exemption from estate taxes increased in 2006 to \$2,000,000 per individual. That change means that a married couple with assets of less than \$2,000,000 may be able to drastically simplify their estate plan. When the federal exemption was \$600,000, many married individuals created a by-pass trust, sometimes called a credit-shelter trust or a residuary trust. This trust was created at the first spouse's death and funded with the first spouse's personal exemption (up to \$600,000). The trust would usually benefit the surviving spouse but, because the assets were in trust, the assets would not be taxed when the second spouse died. In this way, regardless of which spouse died first, the personal exemption of both spouses would be fully utilized, sheltering the maximum amount from estate taxes. Typically this trust would last for the lifetime of the surviving spouse and at his or her death be passed to the children. If estate tax protection was the only reason for creating this trust, a couple with less than \$2,000,000 in assets can now elimi-

nate this trust provision (but see comment concerning state level estate tax changes).

One problem with the rising federal estate tax exemption is that most estate plans were drafted with language that automatically increased the trust to the highest level of exemption. If your estate plan is intended to balance your estate

between what amount is distributed directly to your surviving spouse and how much remains in trust, you need to adjust your will or other estate planning document to make sure that your trust is not over-funded. For example, a woman with assets of \$3,500,000 may be happy to have her husband receive \$1,500,000 outright and \$2,000,000 in trust. But a woman with assets of \$2,000,000 may not want the entire amount to be held in trust for the benefit of her surviving husband. Likewise, the same woman with children from a prior marriage may have planned for the exemption amount to go to her children, and the rest to her surviving husband. When the federal exemption was \$1,000,000, \$1,000,000 would pass to the children and \$2,500,000 to (or in trust for) the surviving husband. With the increased exemption the numbers would be reversed; \$2,000,000 would pass to the children and \$1,500,000 would pass to (or in trust for) the surviving husband.

As the federal estate tax exemption has

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Prenuptial Agreements: For Better or For Worse for the Elderly?

By Mollie G. Shuman

According to the National Center for Health Statistics, in 2005, there were 2,230,000 marriages in the United States. The National Center for Health Statistics calculated that, for last year, the rate of marriage was 7.5 for every 1,000 people and the rate of divorce was 3.6 for every 1,000 people. In Maryland in 2005, there were a total of 37,572 marriages and 17,111 divorces. So what do these statistics mean? Bottom line—unfortunately, many marriages fail and divorce is a troubling, yet probable outcome to those who marry.

For those who are contemplating marriage, it is very unsettling to consider these statistics. In light of these figures, a prenuptial agreement is a good idea. While it is important for everyone who is getting married to consider a prenuptial agreement, it is particularly important for the elderly. First, an older person is likely to have accumulated significant assets. Second, an older person is likely to be entering a second marriage, and children may have been born as a result of a prior marriage. As a result, the older person may seek to protect his or her significant assets for the inheritance of descendants. Though the idea of entering into a prenuptial agreement may not be the rosiest, it can provide comfort to those getting married to know that their concerns about divorce and inheritance have been addressed.

In Maryland, prenuptial agreements are recognized as legally binding instruments as to rights and obligations between the couple. These agreements relate to alimony, support, property rights, and/or personal rights. In order for a prenuptial agreement to be valid, it must be fair and equitable in procurement and result; the parties must make frank, full and truthful disclosure of all assets; and the agreement must be entered into voluntarily, freely and with full knowledge of its meaning and effect. In sum, the standard for determining if a prenuptial agreement is valid is whether there was “overreaching”—in other words, whether in the atmosphere and environment of the confidential rela-



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tionship, there was unfairness or inequity in the procurement or effects of the agreement. Maryland courts have emphasized the importance of independent legal counsel in determining whether an agreement was entered into voluntarily and with full understanding.

Should the elderly couple decide to marry, it is a perfect time to consider how future medical and other health care expenses will be paid. For example, Medical Assistance, also known as Medicaid, pro-

vides comprehensive medical insurance for long-term nursing care to persons who meet the financial and medical eligibility criteria established by federal and state law. For financial eligibility purposes, Medicaid considers the income and resources of both the applicant for Medicaid and his or her spouse. While a prenuptial agreement may not be binding for Medicaid eligibility purposes, a prenuptial agreement which includes a provision that waives any obligation of support for long-term nursing care expenses provides more options if the situation arises. A prenuptial agreement can also provide that each party will secure a long-term care insurance policy as a means to protect the non-nursing home spouse.

Lastly, an elderly couple that has decided to marry should review their estate planning documents, such as a will, power of attorney, and advanced medical directive. It is likely that these documents will need to be revised. An executed prenuptial agreement, along with revised estate planning documents, may help pave the way toward an elderly couple's lifetime of happiness by fostering communication and addressing disagreements early. **WCS**

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C E L E B R A T I N G 1 0 0 Y E A R S

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The Maryland Qtip Election: A Complicated Solution to the Maryland Estate Tax Problem

By Michael A. Stanley



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In 2004, amidst a major budget crisis, the Maryland General Assembly enacted legislation that fully “decoupled” the Maryland estate tax from the federal estate tax system. Prior to this legislation, the Maryland estate tax was linked to the federal regime, and, in reality, there was little estate planning done to avoid the Maryland estate tax. This is so because the personal exemption from the Maryland estate tax was always identical to the personal exemption from the federal estate tax, and the Maryland estate tax was historically a “soak up tax” or “pick-up tax,” whereby only a small portion of the overall estate tax burden was paid to the Comptroller of Maryland, and, for each dollar paid to the Comptroller of Maryland, the estate was given a dollar for dollar credit against the federal estate tax. So, essentially, the Maryland estate tax was merely a carve-out of the overall estate tax burden – a slice of the pie, if you will.

The primary goal of the “decoupling” legislation was to freeze the personal exemption from the Maryland estate tax at \$1,000,000, thereby allowing the State of Maryland to continue to receive estate tax revenue from those estates that had assets exceeding that threshold. In 2004, as the Maryland General Assembly was freezing the personal exemption from the Maryland estate tax, the personal exemption (Exemption Equivalent) from the federal estate tax increased from \$1,000,000 to \$1,500,000. In 2006, the personal exemption from the federal estate tax increased to \$2,000,000. Thus, the net effect of the “decoupling” legislation is that it created “gap estates,” which are estates that are above the \$1,000,000 filing threshold for the Maryland estate tax, but beneath the filing threshold for a federal estate tax return. The existence of these “gap estates” not only wrought some major administrative problems, but also created estate planning concerns for married individuals.

Prior to 2004, if an individual wanted to take full advantage of his or her personal exemption from the federal estate tax, but also wanted to provide for a surviving spouse, the individual would likely opt to create a credit-shelter trust (also commonly referred to as a by-pass trust) under his or her will. This credit-shelter trust would be funded with the maximum amount that could pass free of any federal estate tax, thereby using the individual's entire personal exemption, while the remainder of the individual's estate would be earmarked for outright distribution to the spouse, or be used to fund a Qualified Terminable Interest Property (QTIP) Trust. Since all assets passing outright to a surviving spouse or used to fund a QTIP Trust qualify for the unlimited marital deduction, there would be no estate taxes due upon the death of the first spouse.

Following the passage of “decoupling” legislation, a married individual was faced with a unique dilemma. In the 2004 and 2005 calendar years, if a married individual opted to take the traditional approach of fully funding a credit-shelter trust with \$1,500,000 to take full advantage of his or her personal exemption from the federal estate tax, the individual's estate would have to pay a Maryland estate tax of \$64,400. This tax would be assessed on the

\$500,000 difference between the \$1,500,000 federal exemption and the \$1,000,000 filing threshold for the Maryland estate tax. Alternatively, instead of fully funding a credit-shelter trust with the maximum amount that could pass free of any federal estate tax, the married individual could fund the credit-shelter trust with that amount of assets that could pass free of any estate tax (federal or state), which means that the credit shelter trust would be funded with only \$1,000,000. While this modified approach allowed the married individual to avoid any estate taxes upon his or her death, the married individual was not able to take full advantage of his or her personal exemption from the federal estate tax.

At the beginning of the 2006 calendar year, the federal exemption increased to \$2,000,000, and, as a result, the stakes were raised for married individuals. A married individual could opt to use his or her entire personal exemption from the federal estate tax to fund a credit-shelter trust with \$2,000,000, thereby triggering a Maryland estate tax of \$99,600. In the alternative, to avoid paying any estate taxes upon the death of the first spouse, the credit-shelter trust could be funded with only \$1,000,000, but \$1,000,000 of the first spouse's personal exemption from the federal estate tax would be lost.

In an attempt to solve this dilemma, a few months ago, the Maryland General Assembly passed Senate Bill 2 (SB 2), which was signed into law by Governor Robert L. Ehrlich, Jr. Although this new piece of legislation has many elements that impact the Maryland estate tax, such as a 16% cap on the marginal rates of the Maryland estate tax, a significant aspect of the legislation is the recognition of a Maryland (or a state-only) QTIP Election. Like its federal counterpart, a Maryland QTIP Trust has the following requirements: 1) all the net income

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must be distributed to the surviving spouse on an annual basis or in more frequent installments; 2) the surviving spouse must be the only beneficiary of the trust; and 3) an election must be made on a timely filed estate tax return to qualify the trust for QTIP treatment. In reality, the QTIP Election is not a tax avoidance technique, rather it is a tax deferral mechanism. The QTIP Trust is designed to allow the decedent to have ultimate control over the disposition of assets following the death of the surviving spouse, while still realizing the tax deferral benefits associated with the unlimited marital deduction. At the death of the surviving spouse, the assets held in the Maryland QTIP Trust (including all appreciation) will be taxed in the surviving spouse's estate for Maryland estate tax purposes.

In essence, the creation of the State-Only QTIP Election was designed to alleviate the problem facing married individuals in the wake of the "decoupling" legislation. The key component of the State-Only QTIP Election is that a married individual no longer has to choose between using his or her full exemption from the federal estate tax, or, alternatively, foregoing a portion of his or her personal exemption from the federal estate tax to avoid a Maryland estate tax on the death of the first spouse. In creating this State-Only QTIP Election, the Maryland General Assembly has expressly authorized an estate to make an inconsistent QTIP Election in connection with the "gap amount," i.e., the amount of assets between the Maryland exemption and the federal exemption.

To appreciate the potential impact of the State-Only QTIP Election, it is useful to put this new planning technique in context.

EXAMPLE

John Doe and Jane Doe, a married couple in their 50's with two (2) adult children, (namely, Jack Doe and Jill Doe), have a combined net worth of \$4,000,000, which includes the value of their home and the face value of all life insurance policies held by the couple. For estate tax purposes, John's taxable estate consists of \$3,000,000, while Jane's taxable estate equals \$1,000,000. In developing his estate plan, John has identified three (3) goals: 1) to avoid all death

taxes on his death; 2) to provide support for his surviving spouse, Jane; and 3) to ensure that, at Jane's death, all remaining assets are distributed to Jack and Jill.

To achieve his planning objectives, John can avail himself of the benefits of the State-Only QTIP Election. Essentially, John will need to create three (3) testamentary trusts under his Will.

Trust	Funding Amount	Guidepost	Federal QTIP Election	Maryland QTIP Election
Family Trust (Credit-Shelter Trust)	\$1,000,000	Not to exceed Federal or Maryland Exemption	No	No
Marital Trust A ("Gap Trust")	\$1,000,000	Funded with an amount equal to the remaining Federal Exemption	No	Yes
Marital Trust B	\$1,000,000	Excess over Federal Exemption	Yes	Yes

By employing this distribution scheme, so long as Jane survives her husband, there will be no estate taxes due on the death of John. Upon the death of Jane, the assets held in Marital Trust B will be included in Jane's taxable estate for federal estate tax purposes. For Maryland estate tax purposes, the assets held in Marital Trust A and Marital Trust B will be included in Jane's taxable estate. By fashioning his estate plan in this way, John can accomplish all of his estate planning goals.

With the advent of the State-Only QTIP Election, married individuals have been afforded some relief from the perils of the Maryland estate tax. However, as is often the case with tax legislation, this relief is accompanied by some pitfalls. First, from an administrative perspective, a married individual, like our John Doe, may be forced to fund three (3) separate trusts (the "three bucket approach") at the time of his death, instead of merely creating a credit-shelter trust and a QTIP Trust under his will. This will likely result in an increase in administrative expenses, as the trustees of each trust may have an obligation to prepare annual accountings and fiduciary income tax returns. In addition, at this point, there is

no statutory guidance to address the question of whether the State-Only QTIP Trust is subject to Maryland estate tax in the surviving spouse's estate in situations where the surviving spouse leaves the State of Maryland, and, subsequently, dies as a resident of another State. Although the prevailing rules governing the tax situs of property would seem to indicate that such assets would be outside the reach of the Maryland estate tax, the Comptroller of Maryland may attempt to initiate remedial legislation that would subject such assets to the Maryland estate tax, which will likely take the form of some sort of consent provision.

In the final analysis, although SB 2 and the creation of a State-Only QTIP Election represent a legislative victory for the taxpayer, the reality is that estate tax planning for married individuals is now more complicated than ever. Unfortunately, until the Maryland General Assembly enacts legislation that "recouples" the Maryland estate tax with the federal regime, the Maryland taxpayer will continue to do battle with a relatively new enemy, the "decoupled" Maryland estate tax.

