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**Congressional Testimony**

# How Repeal of theFederal Estate Taxes will Harm Small Businesses and how Repeal of AMT is Necessary

Testimony Before
The Subcommittee on Tax, Finance and Exports of the
Committee on Small Business of the
House of Representatives

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The Small Business Council of America (SBCA) is a national nonprofit organization which represents the interests of privately-held and family-owned businesses on federal tax, health care and employee benefit matters. The SBCA, through its members, represents well over 20,000 enterprises in retail, manufacturing and service industries, virtually all of which provide health insurance and retirement plans for their employees. The SBCA is fortunate to have the leading small business advisors in the country on its Advisory Boards.

Small businesses need certainty in the estate tax area. In order to immediately exempt small businesses from the federal estate tax, the estate tax exemption should be increased to the $3.5 million dollar level this year - not in 2009. The SBCA is in favor of reforming the existing estate tax system and is not in favor of the repeal of the estate tax law in 2010 and beyond, because repeal hurts so many small business owners.

- Increase the exemption amount immediately to $3.5 million and then increase it gradually over a number of years until it reaches at least $5 million and thereafter have it increase by COLA

- Preserve the step-up in basis at death for simplicity and fairness

- Reunify the estate and gift tax exemptions, increasing the gift tax exemption to immediately equal the estate tax exemption, for simplicity and flexibility

- Exempt retirement plan assets from the estate tax in an amount up to an additional $1 million if assets are going to a surviving spouse and up to an additional $500,000 if the assets are going to other heirs

By implementing these steps, small business owners who have worked a lifetime to build their company will be totally exempt from the estate tax system which is the real goal of Congress. Additionally, by implementing these proposals, many small business owners will find themselves in a better tax position than they would if the proposed repeal were to take place as scheduled in 2010. This is because total repeal would be accompanied with a loss of the step-up in basis and a continuing $1 million cap of the gift tax exemption. Further, enactment of our proposal exempting a certain portion of retirement plan assets from the estate tax would promote retirement plan savings at a time when it is essential for Congress to incentivize such savings in order to assist our country in dealing with the future health care and retirement income burdens which will be imposed on the country by the baby boomer generation.

The estate tax historically was imposed only on the very, very rich of this country as a way to avoid the problems that occur when a very small elite of the country is able to amass great wealth and pass this wealth down to the next generation; it was never intended to reduce the estates of working Americans who had built up a family business or a small business based on their own hard work.

Unfortunately, many small businesses will actually end up paying more taxes under the proposed repeal in 2010 and beyond than they would with the increased exemption proposed to be in effect in 2009. This is because a majority of small businesses actually do better under our current system of estate tax with the increased exemption ($3.5 million or more) than they would under repeal because of the loss of the step up in basis.

To understand the repeal proposal and our pro-small business proposal, there are a few basic concepts to our estate tax system that need to be explained.

## **Step-Up in Basis**

First, today any assets that a person receives from another person's estate receive a "step-up" in basis - this means that the person receiving them gets them with a tax basis increased to fair market value as of date of death. Thus, when the person decides to sell the property, he would be taxed on the difference between the sales price and the date of death fair market value (this would be subject to either income tax or capital gains tax depending upon the asset).

A step-up in basis is contrasted to a "carry-over" basis where the heirs receive the assets with the same basis that the deceased owner had. For example, assume a father bought an investment property for $20,000 and did not improve it in any way and that 35 years later at his death, the property is valued at $750,000. If the son received the property with a "carry-over" basis, his basis in the property would be $20,000. If the son then sold the property for $750,000, he would have $730,000 of gain which would be subject to capital gains taxes. If instead the son received the property with a stepped-up basis, his basis in the property would be $750,000 and there would be no gain subject to tax when he sold the property for $750,000.

Under current law, upon the full repeal of the estate tax in 2010, the current rule providing for a fair market value basis in property acquired from a decedent (i.e., the step-up in basis) is repealed. In lieu of this rule, the recipient of property acquired from a decedent will have basis in such property equal to the lesser of the decedent's adjusted basis in the property or the property's fair market value at the time of the decedent's death. However, recipients of property from a decedent will be entitled to an aggregate basis increase of $1.3 million (adjusted for inflation after 2010). In addition, the decedent's surviving spouse will be entitled to an additional aggregate basis increase of $3 million (adjusted for inflation after 2010). Accordingly, if a decedent is survived by the decedent's spouse and the value of the decedent's estate is $4.3 million, the full amount of the estate will pass to the spouse free of any estate tax and the surviving spouse will have a stepped-up basis for the entire estate. If there is no surviving spouse, then only $1.3 million of assets will receive the step-up in basis.

## "Exemption Level" (formerly the "Unwed Credit"

Second, any assets that a person owns up to the estate tax exemption level - $1.5 million this year, can be given away at death, free of estate taxes. This is referred to as the estate tax exemption or exclusion amount and it is scheduled to increase over the next several years until it reaches $3.5 million in the year 2009. This means with basic estate planning in the year 2009, a couple could leave $7 million to their heirs without the imposition of estate tax and with a step-up in basis on the entire $7 million of assets. Assuming a couple has assets in excess of $7 million in 2009, the excess would be subject to the maximum rate of 45%. '(This assumes that the couple has already sheltered $3.5 million at the earlier death of the first spouse).

In the 2001 Act, Congress was concerned that once the estate tax was repealed, taxpayers would refocus their efforts on shifting assets to lower income tax bracket taxpayers (such as their children or grandchildren). Accordingly, Congress capped the gift tax exemption (which had for a long time been "unified" (or in lockstep) with the estate tax exemption) at $1 million. Thus, although a person can pass up to $1.5 million estate tax free (scheduled to increase to $3.5 million in 2009), only $1 million can be passed during lifetime. Many estate planners have found that this artificial cap on giving has caused the senior generation owners of small businesses to resist passing ownership to junior generation members. As a result, it can be more difficult to retain and motivate junior generation family members, as the amount of ownership that can be passed to them during their lifetime is limited.

## Example - Whv Permanizing 2010 Would Be a Tax Increase on Many Small Businesses

Assume there is a small business owner who has $3.5 million of assets and no surviving spouse. He (or rather his heirs) are better off under the 2009 law rather than total repeal of the estate tax because of the loss in the step up in basis. This is how this works:

Under total repeal: $1.3 million of the assets receive a step-up in basis to the fair market value of those assets at date of death. The remaining $2.2 million have the basis that the decedent had in those assets. (As an aside, imagine if the decedent were an 85 year old man who

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' The maximum marginal rate is currently 47%, with decreases scheduled in 2006 (to 46%) and in 2007 through 2009 (to 45%). However, after application of the exemption and numerous available deductions, the IRS found that the average effective tax rate on taxable estates was only 18.8% in 2003. In addition, the Urban Institute Brookings Institution Tax Policy Center estimates that if the exemption were set at $3.5 million and the top rate at 45%, taxable estates would face an average effective rate of only 17.4%. (Source - April 12, 2005 Center on Budget's paper: HOUSE TO VOTE ON PERMANENT REPEAL OF ESTATE TAX: Estate Tax Reform, Rather Than Repeal, Could Preserve Much Needed Revenues And Help Restore Social Security Solvency. Report available on-line at http://www.cbpp.org/4-12-05tax.htm.).

acquired many of these assets more than 40 years ago... how anyone is even going to be able to figure out the carry over basis of those assets is beyond us. The burden would be on the heirs to prove any basis, and most would fail to have enough records, resulting in a zero basis. The step-up in basis was repealed back in 1976 and was then reinstated in 1980, though the carry-over rules never became applicable during that period, because Congress learned from attorneys and accountants who handled the probate process that it was almost impossible to determine the carry-over basis for many assets.)

Now when the heirs of this decedent sell this $2.2 million of assets, they will be subject to income tax or capital gains tax on the difference between the then market value of the assets and any basis they can prove the decedent had in those assets. For example, let's assume that the carry-over basis in the assets is $1 million - then the heirs will be taxed on $1.2 million (assuming the fair market value of the assets was still $2.2 million).

Under an immediate $3.5 million exemption:

All $3.5 million of assets receive a step-up in basis to the $3.5 million level (this is the fair market value of his assets as of his passing). Now when the heirs sell any of these assets - there would be no income tax or capital gains tax and no estate tax.

**Basically, a single person with assets greater than $1.3 million up to $3.5 million is better off without total repeal of the estate tax and is in a better tax situation under the estate Iaw as it stands in 2009. Similarly, a decedent who is married with assets greater than $4.3 million up to** $7 **million does better under the law as it would stand in 2009 than he would under total repeal. This covers a significant amount of taxpayers based on the data that illustrates how many taxpayers drop off of the estate tax rolls as the exemption amount increases.** Based on data set forth in a March 16, 2005, issue paper from the Center on Budget and Policy Priorities':

- If the estate tax exemption were $1 million in 2011, then 53,800 estates would be subject to the estate tax (this represents about 2% of the 2.6 million people expected to die in that year). Of the 53,800 estates that would be taxable, nearly half (46%) would have assets of less than $2 million and nearly three fourths would be valued at less than $3.5 million.

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[2] This paper is entitled, "Estate Tax Reform Could Raise Much-Needed Revenue: Some Reform Options with Low Tax Rates Raise Very Little Revenue" by Joel Friedman and Ruth Carlitz

- If the exemption level in 2011 were $2 million instead of $1 million, then the number of taxable estates would shrink to 21,000. This is a reduction of 61% in the number of estates that would face the estate tax.

- **If the exemption amount in 2011 were $3.5 million instead of $2 million, then the number of taxable estates would drop to 8,500** (84% of the estates would be exempt compared to the number that would have been subject to estate tax if the exemption amount were to be $1 million in 2011). **This amount represents about 0.3% of all the people who are expected to die in 2011.**

**These numbers clearly show how many small business owners would be worse off under total repeal than if the law were frozen at 2009 (with the $3.5 million exemption and the step-up in basis).**

The reason why most small businesses owners (particularly where they have assets which under repeal will have a carry over basis versus a stepped up basis if the $3.5 million exemption were in effect) do not understand that they are worse off under repeal, is that they do not understand the impact of the carry over basis and the ultimate imposition of capital gains tax on those assets.

If Congress really wants to protect small business owners then it should do so by not only increasing the exemption amount immediately up to $3.5 million, retaining the step-up in basis, and reunifying the gift and estate tax exemptions.'

## Promote Retirement Savings

The SBCA also believes that giving an exemption for up to $1 million in retirement plan assets that are left to a surviving spouse and up to $500,000 for retirement plan assets that are left to others would go a long way towards promoting retirement plan savings by small business owners and others. Right now the incentives towards locking up money in a retirement plan are being diminished by the lower tax rates on capital gains and dividends that do not apply to funds coming out of a retirement plan. If the administration's LSA proposal were to be enacted it

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If Congress determined that there were still small businesses or family owned businesses that needed protection from the estate tax then it could create a true small business exemption. Such an exemption would not bear any resemblance to the Qualified Family Owned Business Interest (QFOBI) exemption that came into law a few years back. This rule was not only complicated, but suffered from the most severe planning defect - a business owner would not be able to know if he qualified for the exemption until death occurred. Rather Congress could create a very simple exemption - for example, *any* business interests owned by a decedent in an active family or small business that was passed on to a family member would be exempt from the estate tax, or alternatively estate tax rates would be reduced to 15% on any small business or family owned business interests.

would also provide an incentive for people to save in the LSA vehicle tax free with the ability to access the funds at any time, rather than contributing to a qualified retirement vehicle which forces the savings to be maintained in the vehicle until retirement.

## **Repeal** AMT

AMT is basically a second tax system that sits on top of our regular system and in effect the taxpayer has to end up paying the higher tax generated by each of the systems. Viewing this from a bare bones approach, it means that many of the deductions allowed by the regular tax system are rendered meaningless by the AMT. This particularly harms small business owners. This is another tax that was never designed to hit the working American but instead was designed to apply to a very few, very rich taxpayers who one way or another seemed to be able to dodge their tax bill every year under the regular tax code - they did it legitimately, but it did not sit right with Congress that the very richest taxpayers often paid the smallest amount of tax. Today, the AMT affects more and more Americans and it is time that it be rolled back entirely. A repeal of AMT will simplify our tax system and will make it more fair for the American worker and small business owner.

## **Fiscal Responsibility**

Data cited by the Center on Budget and Policy Priorities notes that:

- The Joint Committee on Taxation estimates that extending repeal beyond 2010 would reduce revenues by $290 billion through 2015, including $72 billion in 2015 alone.

- But the Joint Tax Committee's estimate essentially captures only the cost of four additional years of estate tax repeal. The revenues losses associated with 10 more years of repeal - for the period from fiscal year 2012 through fiscal year 2021 - are much higher, about $745 billion.

- When the associated $225 billion in higher interest payments on the debt are taken into account, the total cost of repealing the estate tax for a decade would be nearly $1 trillion.[4]

At the end of the day, the proponents of repeal have won over the small business community with flashy slogans - "Kill the Death Tax" or "Is it fair that you have to pay taxes when you die?" (Of course, most of the owners did not realize that the estate tax never would have applied to them in the first place because the estate tax exemption is higher than their total assets.) Nor has anyone explained to them that a great number of small business owners will be worse off if repeal is enacted and only an extraordinarily few will be better off.

4 See the Center on Budget's April 12, 2005 paper cited above.

Small business are being used to make repeal "respectable" - it is far easier to talk about how outrageous it is for a farmer to lose his farm to pay estate taxes than to talk about how unfair it is that a billionaire will have to pay a portion of his assets to the government and/or charities. The SBCA believes that it would be far better to use the dollars that would be "saved" by the 2009 estate tax law being enacted with our changes instead of estate tax repeal[s] on a total repeal of AMT which really does hurt small businesses. By enactment of our estate tax proposals, small businesses will be removed from the reach of the estate tax. In sum, if small business owners truly understood how the estate tax repeal could adversely impact them, they would walk away from it - for now the 30 second sound bite has the edge. But this Congress owes it to our country to use our precious dollars to assist where they are needed most by small business - in promoting retirement savings and repealing the AMT; not in reducing estate taxes on the nation's largest taxpayers.

Ms. Calimafde is the current Chair, past President and a member of the Board of Directors of the Small Business Council of America, Inc., the only national non-profit organization which has represented the interests ofprivately owned businesses exclusively in the Federal tax, retirement, health care and employee benefits areas for the past twenty-five years. She received her B.A. from Swarthmore College and her J.D. from Catholic University.

She is a partner in the Bethesda, Maryland law firm, Paley Rothman, where she chairs the firm's Retirement Plans Practice Area and the Employee Benefits Practice Area. Ms. Calimafde has nearly 30 years of experience advising small businesses and closely held businesses in tax areas and also concentrates on estate planning. For nearly 30 years, she has been a legislative advocate for small and closely held businesses in the Federal tax, health care and employee benefits arena.

In 1986, Ms. Calimafde was elected at the Maryland State Conference to serve as a delegate to the White House Conference on Small Business. She was subsequently appointed by the White House Conference to serve as one of eleven National Commissioners of the 1986 White House Conference on Small Business. As such, she chaired the Payroll Costs Session at the National Conference, which covered qualified retirement plans, employee benefits and social security, among other issues. In 1995, Ms. Calimafde was appointed by the White House to serve as a Presidential Delegate at the 1995 White House Conference on Small Business.

She is also a member of the Board of Directors of the Small Business Legislative Council (1992-), Past Chair (1988-1990) and Vice Chair (1986-1988) of the Closely Held Committee of the ABA Tax Section, Advisory Board of the Journal of S Corporation Taxation, 1989-1994, Employee Benefits Council, Chamber of Commerce of the United States, 1986-1994, 1996-, and Small Business Council ofthe U. S. Chamber, 1995-1998 and the Washington, D.C. Estate Planning Council, 1994,

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[s] The March 16, 2005, Center on Budget's paper referred to above states that if the exemption were set at $3.5 million and the top tax rate were 45% (i.e., this is the 2009 law), the total estate tax revenue raised would be $17 billion in 2011 according to the Tax Policy Center. Even at the $3.5 million exemption level, which would exempt 84 % of taxable estates from estate tax in 2011, 44% of the revenue that would be lost under total repeal would still be preserved. These numbers reflect the fact that some of the taxable estates remaining would have enormous wealth which would generate significant estate taxes.