TESTIMONY BEFORE THE UNITED STATES HOUSE OF REPRESENTATIVES

COMMITTEE ON SMALL BUSINESS

SUBCOMMITTEE ON ECONOMIC GROWTH, TAX AND CAPITAL ACCESS

"Planning for the Death Tax: Can Small Businesses Survive?"

Testimony of:

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Chairman Walsh, Ranking Member Schrader and the members of the Subcommittee. My name is Neil Katz and I am the managing partner of Katz, Bernstein & Katz, LLP, a law firm that specializes in tax matters, including estate planning and representing closely held and family businesses.

I appreciate the opportunity to address the subcommittee with regard to the difficulties faced by closely held business owners as a result of the imposition of the estate tax on the value of the business that those owners have worked tirelessly to create.

Introduction

Closely held businesses are an integral part of local economies throughout the country. Business owners spend their entire lives investing time, effort and capital into making their businesses a success. Most business owners, that you speak with, would like nothing more than to be able to pass the fruits of their labor and capital on to future generations. These future generations will then have "privilege" of spending their time, effort and capital to carry on the legacy that has been left to them and to try to grow the business so it will continue as a viable enterprise for them and those who follow them.

As business owners age the complexities of owning and running a closely held business often become overshadowed by the burden that the estate tax looming in the future will create on the business and to the business owner's family. Running a closely held business is becoming increasingly difficult with the rising costs associated with the business, combined with the tightening of available financing and the pressure that the economic times put on customers and collections. I have seen cases where the added burden of planning for or dealing with the estate tax burden has become so overwhelming that it can have an adverse and often devastating effect on the business.

Planning for the Estate Tax Impact

The issues faced by business owners and their families start long before death. With the threat of an estate tax looming, the family will often require sophisticated planning to attempt to reduce the exposure that the heirs will face. This planning does not come without a price. To design and implement an estate tax plan can cost an individual anywhere from $5,000 to $50,000 (or more). The end result of such planning is often the creation of trusts to hold business interests which makes the running of the business more complicated. To most, however, the cost of the planning is only a minor issue. A more significant problem may be created if part of the planning recommendation includes transferring interests in the business to future generations. Often, this decision is one that the owner may not be prepared, emotionally or economically, to make at the time.

Almost on a daily basis, in our practice, we are faced with the emotional issues that are part of the decision to transfer business interests to children or trusts for children's benefit. Where the decision is principally for tax planning reasons the emotions involved can become overwhelming and for many the decision is so difficult that they are paralyzed into inaction. Individuals who have built businesses with years of hard work are all too often reluctant to transfer interests to future generations unless there is

an overriding business or economic reason to do so. To those it is quite disconcerting to be faced with the decision of whether to pass interests on before they are ready to do so or risk the destruction of the business due to the imposition of the estate tax upon their death.

For many the emotional aspect is coupled with an economic concern. The business owners rely on their interest in the business as their sole source of income. Tax rules prevent businesses from paying excessive salaries and for many business entities distributions cannot be made in any manner other than pro-rata to the owners. These rules could combine to negatively impact the annual income of a business owner who is advised in planning to transfer business interests to others. Often this factor alone causes the planning to be abandoned.

Valuation Issues

Where transfers of business interests are not an option, or where the transfer is not sufficient to eliminate all of the potential impact of estate taxes, business owners are then faced with understanding how the tax system works. They need to be familiar with the concept of estate tax valuation and the family needs to be prepared for the expediency with which estate taxes must generally be paid.

Estate tax value is a concept that attorneys, accountants, Legislators and the Treasury Department have struggled with for decades. There is no clear definition in the statute and the only guidance we are given is the "hypothetical willing buyer/willing seller" language of the regulations. Business owners cannot comprehend this standard. The real value of small, closely-held businesses is often tied directly to the owners. Ask most business owners what their business is worth on the open market and they will say "without me the business is worth nothing." While it is clear that that statement is not 100% accurate and that businesses generally have some intrinsic value, the valuation concepts applied by appraisers and by the Treasury Department often stray dramatically from real world value. Family members often say to us "if the IRS thinks the business is worth that much, please have them write a check to us because we will take it". Where estate tax valuation differs from reality, it only makes the burden on the business owner and their family even greater. Anyone who has a collection of anything (stamps, baseball cards, dolls) has been told by someone else that their collection is not worth anything unless and until it is sold. To most small business owners the same principal applies. The only true value of their business is the income they receive from it, yet the estate tax is imposed on a value as if the business is sold. Something the business owner would not have wanted if they were still alive.

Funding the Estate Tax Payment

In addition, the estate tax rules call for payment of estate taxes within 9 months of the date of death. While certain extensions are available, they are often short term solutions to a long term problem. Internal Revenue Code §6166, the most significant estate tax extension has its problems as well and those will be addressed shortly. A general rule of 9 months to pay the significant estate taxes on business assets is an incredible burden. Most businesses do not have the cash reserves or cash flow

available to make this payment in that short a time frame. Even those that do have reserves, the use of those reserves for estate taxes can cause the business to suffer irreparable damage if the original intent of the reserve was ever to come to fruition. If a company were to reserve specifically for estate taxes, the accumulated reserves would add to the value of the entity and increase the estate tax due.

In order to deal with this significant burden, planners often recommend that a business owner acquire life insurance to provide liquidity to pay the ultimate estate tax that will be due. Obviously this creates an added expense to the business. Depending upon the amount of insurance that is required the premiums can run tens of thousands of dollars. The business may not be able to afford to make these payments each year. To some the expense is not a concern, rather the use of insurance is not available due to the uninsurability of the business owner. To those that are not insurable and for those to whom the cost is prohibitive there may be no option.

Following the death of the business owner the imposition of the estate tax creates a myriad of problems to the family or successor owners of the business.

Where the business is equipment or real estate intensive, the business may not have the cash or cash flow to cover the tax payments. To deal with this, Congress has enacted §6166 to provide a 15 year extension of time to pay the estate taxes. However, this solution is not always available in all circumstances. To utilize this provision, the business must be over 35% of the value of the estate. That is not always the case. Many would say that if the business is not over 35% of the estate then the other assets would be available to pay the tax. However, that would only be the case if the beneficiary of the business were to also be receiving liquid assets from the estate. Often in family businesses there is one member of the family who is involved in the business with other members not active. The business owner parent may decide to leave the business assets to one child and the liquid assets to other children. In this situation, if the business does not qualify for the extended the payment then the beneficiary faces an incredible burden with no relief.

Even where the relief under §6166 is available, it is far from true “relief”. The estate tax due becomes a debt against the business which the business may not be able to service. If you look at basic accounting principles, when a business borrows money (and thus creates a requirement to service a debt) a corresponding asset (the cash proceeds from the loan) is created and the net worth of the business is not adversely affected. However, a long-term estate tax payment liability creates no offsetting asset and thus is a direct reduction of the value of the entity, a reduction that is often too burdensome for the business to survive. We are presently representing an estate with a significant estate tax payment due which has been extended under §6166. For the first few years, during the interest only period, the cash flow is sufficient to cover the required payment. However, when the tax debt becomes self-amortizing it is not. The new owner is trying to create cash reserves to be available to reduce the tax burden, but business exigencies have caused the use of much of those reserves. As we near the time that the debt must be amortized the business owner is faced with having to find

a bank to lend them money (to provide a longer term payout and an amortization that is workable given the cash flow) or to begin to sell off the business assets. Bank loans are unfortunately difficult to obtain in the present economic times, and even where they are obtainable the terms are often not favorable and the costs associated with the loan can be excessive. The decedent started this business over 50 years ago and the thought of having to liquidate this business to pay estate taxes is devastating to his daughter.

Businesses today are operating on very tight margins. Adding the burden of estate taxes to the cash flow of the business is often not feasible. The new owner of the business can often not afford to pay the taxes and still have money to pay expenses of the business and make a profit. Most individuals do not see business ownership as solely about working to pay off an estate tax obligation. There is no “benefit” to the beneficiary if the asset that they inherit provides them with nothing other than the opportunity to work with no expectation of income. There needs to be some incentive for the owner. For pass-thru entity owners this burden is heightened by the fact that they may need to use business profits to pay estate taxes but first have to pay income taxes on those profits with no deduction for any of the estate taxes paid.

The Problem of Multiple Owners

Where there are multiple owners of an entity, the estate tax burden created by the death of one owner can often have an impact on other owners as well. We recently completed the representation of the daughter of an individual who passed away. The bulk of the assets that this daughter inherited were business assets which the father owned as partners with his nephew. The daughter who inherited the assets had no liquid assets with which to pay her share of the estate taxes and §6166 was not available to her. Her options were limited. She could borrow against the business assets or she could sell all or some of the business assets. Her preference was to not sell the assets, however, in order to borrow against the assets she would need the cooperation of her cousin (the co-owner of the business). Each bank that she went to would have required the cousin to provide a personal guarantee for the loan. One individual’s estate tax burden would now create a situation where a person not involved as a beneficiary would have to provide a personal guarantee of a loan from which that individual received no proceeds.

If the cousin in the above example had not been willing to provide the guarantee that client would have been faced with only one option. An option that too many people are forced to pursue: the sale of the business assets. This is the greatest burden (both emotionally and economically) that is caused by the imposition of the estate tax against small businesses. Family members are forced to liquidate business assets that their relatives spent their entire lives building. The market for closely held business interests is often limited and where a sale is available, often the only buyers are those looking for a bargain. With the estate tax payment needed to be made family members are in a terrible position to make a deal and often have to sell at forced or “fire sale” prices. Unless done quickly, this forced sale price often bears no relationship to estate tax value causing the family to have to pay estate taxes on a business valued at significantly more than what it is sold for. While the family may have a resulting capital

loss on the sale, this loss cannot be used to reduce the estate tax burden and is often unusable by the family members on their income tax returns.

Conclusion

Small businesses are struggling in today's economy to meet their obligations and provide for the business owners and their families. Adding the burden of an estate tax to be due, or one currently due as a result of the death of the former business owner, can make the operation of a small business a nearly impossible task.

While the estate tax can cause an incredible burden on the small business owner, the constant changes in the estate tax law over the last 12 years, coupled with the uncertainty of the future rules, have made it even more difficult. This point cannot be overemphasized. If Congress could establish rules that business owners could be assured would survive for a period of 10-15 years then they would at least have a chance (albeit a difficult battle) to plan for the tax burden. The world of the unknown that Congress has created since the enactment of EGTRRA, in 2001, has created an unworkable scenario for business owners.

Thank you for the opportunity to address the Subcommittee. I appreciate you taking your time to understand and address the issues that small business owners face.