

Congress of the United States
U.S. House of Representatives
Committee on Small Business
2361 Rayburn House Office Building
Washington, DC 20515-6315

Memorandum

To: Members, Subcommittee on Economic Growth, Tax and Capital Access, House Committee on Small Business
From: Committee Staff
Date: May 28, 2012
Re: Hearing: "Planning for the Death Tax: Can Small Businesses Survive?"

On Thursday, May 31, 2012 at 10:00 a.m., the Small Business Subcommittee on Economic Growth, Tax and Capital Access will meet in Room 2360 of the Rayburn House Office Building for the purpose of receiving testimony on the estate tax and its effect on small companies and family farms.

I. Introduction

The estate tax is frequently cited as one of the most important issues for small businesses.¹ Because many small businesses and farms are family-owned, they typically plan for the succession of the business in future years.

The current estate tax provisions² will expire on December 31, 2012. Current law reduces the maximum estate tax rate to 35%.³ The estate tax exemption is \$5 million,⁴ increased for inflation after 2011. Without Congressional action, beginning January 1, 2013, the estate tax will revert to pre-2001 levels, a 55% rate and a \$1 million exemption.

¹ National Federation of Independent Business, NFIB Issues, NFIB website, *available at* <http://www.nfib.com/issues-elections/taxes>.

² Pub. L. No. 107-16, § 901; 115 Stat. 150 (2010).

³ The 35% maximum estate tax was first enacted in § 2001 and § 2502 of the Tax Relief and Unemployment Reauthorization and Jobs Creation Act of 2010, Pub. L. No. 111-312, effective for the estates of decedents dying after December 31, 2009. Under the Economic Growth and Tax Reform Reconciliation Act of 2001, Pub. L. No. 107-16 as amended, the provision sunsets for the estates of decedents dying after December 31, 2012.

⁴ The \$5 million estate tax exclusion, indexed for inflation for years after 2011, was enacted in § 2010 of the Tax Relief, Unemployment Insurance Reauthorization and Jobs Creation Act of 2010, Pub. L. No. 111-312. The provision sunsets under the Economic Growth and Tax Reconciliation Act of 2001, Pub. L. No. 107-16 as amended, for the estates of decedents dying after December 31, 2012.

The estate tax is levied on the transfer of property from the decedent.⁵ It is imposed on the amount of a decedent's net wealth; that is, the fair market value of total assets less debts and expenses, that passes to his or her beneficiaries at death. A person could circumvent the estate tax by giving away property during his or her lifetime. As a result, the federal gift tax, which is levied when property of substantial value is transferred, was enacted.

Wealth transfer taxes, such as the estate tax, are not a significant source of revenue to the U.S. Treasury. Since 1945, estate and gift taxes have been about 2% of federal revenues.⁶ For Fiscal Year 2008, they represented 1-2% of federal government revenues.⁷

Historically, the primary function of the wealth transfer tax was to hinder the accumulation of wealth by families.⁸ These taxes affect many small businesses, since small businesses are often owned and run by family members, and passed from one generation to another. The estate tax can be substantial enough to require the sale of property, such as family farmland, to pay the tax. Sometimes the amount of tax levied necessitates the sale of the bulk of the firm's assets, so the firm is never transferred, and essentially is out of business.

II. Description of Current Law

In 2001, Congress enacted the Economic Growth and Tax Relief Reconciliation Act (EGTRRA)⁹ The estate tax and generation-skipping transfer tax were scheduled to be phased out over time. This was accomplished in several ways. First, the top tax rate was gradually lowered. Second, the exclusion amount was gradually raised. Third, the credit for estate taxes paid to a state was gradually lowered, and replaced with a deduction.¹⁰

Under EGTRRA, as scheduled, the estate tax and gift taxes were completely phased out in 2010. In the Tax Relief, Unemployment Reauthorization and Job Creation Act of 2010,¹¹ Congress reinstated them for 2011 and 2012. The estate tax exemption in 2012 is \$5 million, and the tax rate is 35%.¹² At the end of 2012, if Congress does not act, the rate and exemptions in 2013 will revert to the pre-EGTRRA levels: a \$1 million exemption and 55% tax rate.¹³

⁵ EPHRIAM P. SMITH, PHILIO J. HARMELINK & JAMES R. HASSELBECK, CCH FEDERAL TAXATION 22-3 (2009) (hereinafter "CCH Federal Taxation").

⁶ CONGRESSIONAL BUDGET OFFICE, FEDERAL ESTATE AND GIFT TAXES 1, ECONOMIC AND BUDGET ISSUE BRIEF, December 18, 2009, available at http://www.cbo.gov/ftpdocs/108xx/doc10841/Estate_GiftTax_Brief.shtml.

⁷ Office of Management and Budget, Budget of the U.S. Government, Fiscal Year 2008.

⁸ JAMES W. PRATT AND WILLIAM N. KLUSRUD, FEDERAL TAXATION 1-13 (2009).

⁹ Pub.L. No. 107-16, 115 Stat. 38 (2001).

¹⁰ Pub.L. No. 107-16.

¹¹ Pub.L. No. 111-312, 124 Stat. 3298, 3300 (2010).

¹² *Id.* at 3300.

¹³ 124 Stat. 3301.

A. The Gift Tax

In 1976, Congress enacted legislation to link the taxes on estates and also gifts made during the donee's lifetime. These taxes are "unified;" that is, they have the same rate structure and one lifetime credit that is available for both taxes. For 2012, the unified credit amount is \$5 million.

The federal gift tax is imposed on the right to transfer property from one person to another for less than full and adequate consideration.¹⁴ The law provides a lifetime gift tax exemption for 2011 and 2012 of \$5 million.¹⁵ A donor must pay a gift tax on any amount over the exclusion. It applies only to property, and not to services. Under current law, in 2012, there is a \$13,000 annual gift tax exclusion; that is, a donor may give gifts worth \$13,000 per recipient during 2012 without paying a gift tax. Similarly, a married couple may donate \$26,000 per recipient without application of a gift tax. Gifts over the annual exclusion must be declared on IRS Form 709, the United States Gift and Generation Skipping Transfer Tax Return.¹⁶

B. The Federal Estate Tax

The federal estate tax is computed through a series of adjustments and modifications of a tax base known as the "gross estate."¹⁷ The gross estate is comprised of all property, real or personal, tangible or intangible, wherever situated, in which the deceased owned an interest on the date of death.¹⁸ The property and interests in property are valued at the fair market value on the date of death. Fair market value is the value of the property at which a fully informed, willing buyer would purchase the property and a fully informed, willing seller would sell it.¹⁹ In certain circumstances, the executor may elect to use an alternate valuation, such as the value of the property six months after the date of death.

Allowable deductions reduce the gross estate to the "taxable estate." The total of all lifetime gifts made by the decedent are added to the taxable estate, and after reduction for allowable credits, the amount of tax owed by the estate is reached. For 2012, the top rate is 35%, and the exclusion is \$5 million.²⁰

A decedent's estate is determined by reducing the gross estate by allowable deductions. These include estate administration expenses (such as funeral expenses), certain debts and losses, qualified transfers to a surviving spouse (the "marital deduction"), charitable bequests and state death taxes.²¹

Under the unified estate and gift taxes, computation of estate tax liability requires the combining of the decedent's lifetime taxable gifts and the decedent's taxable estate, to which the tax

¹⁴ CCH FEDERAL TAXATION at 22-39.

¹⁵ 124 Stat. 3301.

¹⁶ IRS Form 709 is available for 2011 on the IRS website at <http://www.irs.gov/pub/irs-pdf/f709.pdf>.

¹⁷ INTERNAL REVENUE SERVICE, ESTATE TAX, *available at* <http://www.irs.gov/businesses/small/article/0,,id=164871,00.html>.

¹⁸ 26 U.S.C. § 2031(a).

¹⁹ CCH FEDERAL TAXATION at 22-22.

²⁰ 124 Stat. 3301.

²¹ *Id.*

rate schedule is applied. Any available credits are then deducted, and what remains is the decedent's estate tax liability.

III. The Estate Tax and Small Businesses and Family Farms

A 2009 Tax Foundation poll²² of tax attitudes found that the estate tax is viewed as the most unfair federal tax. A study by the American Family Business Foundation concluded that if the estate tax is allowed to revert back to its scheduled rate in 2011, as many as 500,000 jobs could be lost. A separate study by the National Center for Policy Analysis found that repealing the estate tax would add \$119 billion to the GDP and boost labor income by \$79 billion.²³

Evidence is limited on the effect of the estate tax on small businesses. There have been few studies, and existing tax data make it difficult to determine which estates are those of small business owners or farmers. According to a 2005 Congressional Budget Office report, in recent years, as few as 2% of estates have had to pay estate taxes.²⁴ Yet we know from anecdotal evidence that small business owners and farmers tend to save substantial amounts of their personal income in their business or land.²⁵ These firms often have disproportionately thin operating margins, and frequently have illiquid assets that can't easily be sold. As a result, to pay the estate taxes, the heirs may have to sell the land and equipment that are essential to the company's operation, and the business is essentially rendered as liquidated. The estate tax is a tax on property that has been taxed already, sometimes repeatedly.

Although some have said that small businesses have the option to purchase life insurance to help offset future estate taxes, a small firm may not have the cash flow needed to fund the cost of premiums. In addition, the proceeds from life insurance are taxable unless the policy owner establishes an irrevocable life insurance trust.²⁶

The estate tax could lead small business owners or farmers to invest less in their business than they would have otherwise. As the CBO report notes, a large body of research has found that any taxes may discourage entrepreneurship.²⁷ Because the estate tax has been viewed as equivalent to an additional income tax, one could suggest that estate taxes would likewise discourage entrepreneurship.

According to NFIB, the estate tax creates a disincentive to expand a business, create jobs, and can tax a family business right out of the family. In addition, much of the cost of the estate tax comes before the tax is ever paid, because family businesses must arrange for expensive estate planning if they want to try to keep their businesses in the family. In many cases, they must purchase insurance or establish trusts to ensure the future viability of the business. If they do not, they may be forced to liquidate the business to pay the estate taxes.

²² TAX FOUNDATION, 2009 Survey of U.S. Attitude on Taxes, Government Spending and Wealth Distribution, available at <http://www.taxfoundation.org/news/show/24600.html>.

²³ Stephen Entin, *The High Marginal Cost of the Estate Tax*, National Center for Policy Analysis 2, available at <http://www.ncpa.org/pub/ba688>.

²⁴ CONGRESSIONAL BUDGET OFFICE, EFFECTS OF THE FEDERAL ESTATE TAX ON FARMS AND SMALL BUSINESSES (July 2005) available at <http://www.cbo.gov/ftpdocs/65xx/doc6512/07-06-EstateTax.pdf> (hereinafter "CBO REPORT").

²⁵ C. Eugene Steuerle, *Contemporary U.S. Income Tax Policy*, 2005, p. 24-5.

²⁶ With irrevocable insurance trusts come restrictions on the owner's involvement with the trust, and prohibitions on borrowing against it.

²⁷ CBO REPORT *supra* note 25.

Many small businesses are undercapitalized. Their owners often earn low profits but are deemed wealthy by the government because they own valuable land or equipment. In many cases, particularly with family farms, the heirs must sell the property and other assets to pay the estate tax.

Under current law, generally family members who inherit a business must pay up to 45% in taxes on all assets received, including land, buildings and all other forms of property. In addition, the temporary nature of the estate tax repeal in 2010 means that small businesses do not have certainty and cannot plan for the future of their companies. Historical research has found that the estate tax encourages small business owners to sell, or merge with larger firms.²⁸

The estate tax has a very broad effect, even beyond those with large estates. Although the estate tax is one of the least significant sources of revenue, it is very significant economically. According to the National Center for Policy Analysis, the estate tax reduces capital formation, and lowers productivity, wages, employment and federal revenues from payroll and income taxes. Some researchers found that the tax discourages work, savings and investment.²⁹ In addition, it may encourage high income individuals to transfer their assets to their lower-bracket children or tax-exempt charities sooner than they may have otherwise.³⁰

Because many estates have been burdened with considerable estate tax liabilities, current law provides a special use valuation for farmland and closely held business realty. This was partly due to the requirement that estate property be valued at its "highest and best use." As a result, Congress enacted a special use valuation for farms and closely held businesses allowing them to be valued at their current use.³¹ Estates may use this valuation provided that the decedent was a U.S. citizen at the time of death; the property is qualified real property; the estate's executor uses the valuation on the estate tax return; and a written agreement is filed with the estate tax return.³² Even with this special valuation, many families who own businesses are burdened by the estate tax.

The Small Business Committee held a hearing on the estate tax burden in 2009.³³ Owners of small businesses testified that the estate tax hits family-owned businesses at the time when they are at their weakest – immediately following the death of the company's head.³⁴ Many business owners are forced to hold life insurance policies³⁵ or spend thousands of dollars in financial planning and/or legal fees to plan as best they can for the business' succession.³⁶ One fifth generation small business owner testified that her family spends \$5,000 annually on estates tax planning and over \$730,000 to date.³⁷ As

²⁸ Douglas Holtz-Eakin, David Joulfaian and Harvey Rosen, "Sticking It Out: Entrepreneurial Survival and Liquidity Constraints," *Journal of Political Economy*, col. 102, no. 1 (February 1994), pp. 53-75. *See also* Patrick Fleenor and J.D. Foster, *An Analysis of the Disincentive Effects of the Estate Tax on Entrepreneurship*, Tax Foundation (1994).

²⁹ Edward J. McCaffery, University of Southern California, *The Political Liberal Case Against the Estate Tax* *Philosophy and Public Affairs*, Vol. 23, No. 4, pp. 281-312, (1994)

³⁰ *Id.*

³¹ 26 U.S.C. § 2032A.

³² *Id.* at §2032a(a)(2). The decrease in the property's value may not be greater than \$960,000.

³³ *Small Business and Estate Tax: Identifying Reforms to Meet the Needs of Small Firms and Family Farms Hearing Before the House Comm. on Small Business, 111th Cong. Nov. 4, 2009 (hereinafter "Estate Tax hearing").*

³⁴ Estate Tax hearing, *supra* note 44 (statement of Mr. Christy Spoa, Sr., President/Owner, Elwood City Sav-A-Lot) at 1.

³⁵ *Id.* at 1.

³⁶ *Id.* at 2.

³⁷ Estate tax hearing, *supra* note 44 (statement of Meredith L. Mayes, ColorCraft of Virginia) at 2.

these witnesses pointed out, the continued operation of these companies means economic growth and job creation.³⁸ A cattle producer testified that 97% of America's farms are operated by families, many for generations, and when you include land, equipment and escalating property values – which are non-liquid assets – the estate's value can exceed the exclusion.³⁹

IV. Conclusion

There is not a great deal of credible evidence about the effect of the estate tax on small businesses or farms. However, there is anecdotal evidence that for some of these businesses, the estate tax may pose such as hardship that the heirs would not have sufficient liquid assets to pay the tax, and would be forced to fully or partially liquidate the business. Small firms have very thin margins, and typically invest substantial sums of their own savings into their companies. As a result, some entrepreneurs may be unable to leave their company to heirs, or may be discouraged from starting a business altogether.

Small businesses and farmers who are already suffering with a difficult economy and who are threatened with tax increases would benefit from estate tax relief and certainty. This hearing will provide an opportunity for Committee Members to learn more about the effect of the estate tax on small businesses.

³⁸ Estate Tax hearing, *supra* note 44 (statement of Mr. Christy Spoa at 2 and statement of Meredith Mayes at 2.

³⁹ Estate tax hearing, *supra* note 44 (statement of Arthur Uhl, Chairman of the National Cattlemen's Beef Association) at 3.