S. HRG. 105–769

ESTATE AND GIFT TAXATION PROPOSALS

HEARING

BEFORE THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

ONE HUNDRED FIFTH CONGRESS

FIRST SESSION

APRIL 10, 1997

Printed for the use of the Committee on Finance

U.S. GOVERNMENT PRINTING OFFICE

52–444—CC WASHINGTON : 1997

For sale by the U.S. Government Printing Office
Superintendent of Documents, Congressional Sales Office, Washington, DC 20402
ISBN 0-16-057933-3

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THURSDAY, APRIL 10, 1997

U.S. SENATE,
COMMITTEE ON FINANCE,
Washington, DC.

The hearing was convened, pursuant to recess, at 10:04 a.m., in room SD–215, Dirksen Senate Office Building, Hon. William V. Roth, Jr. (chairman of the committee) presiding.

Also present: Senators Chafee, Grassley, Nickles, Moynihan, Baucus, Moseley-Braun, and Kerrey.

OPENING STATEMENT OF HON. WILLIAM V. ROTH, JR., A U.S. SENATOR FROM DELAWARE, CHAIRMAN, COMMITTEE ON FINANCE

The CHAIRMAN. The committee will please be in order. I do appreciate the time and effort that our panelists today have made to be with us. I believe that as these hearings proceed, we will see how important this area of our Tax Code is.

Current law is putting many family-owned farms and businesses in harm's way, forcing many to be sold or placed into bankruptcy. Likewise, the cost to our economy, to job creation, and economic opportunity are significant.

A Heritage Foundation study estimates that the estate tax costs our economy some 150,000 jobs. The Institute for Research on the Economics of Taxation puts the figure closer to a quarter of a million.

Now, the time has come for Congress to do something about this. Estate taxes are burdensome. They confiscate the life and means of families and businesses. They are outdated and onerous. The $600,000 Unified Credit Exemption has not been increased for a decade. Had it been indexed, it would now be worth approximately $838,000.

These facts concern me. It concerns me that the estate tax threatens the viability of family-owned businesses and farms. These are bedrock institutions, institutions upon which America has been built, and they must be sustained. Yet, under current law, valuable time, money and effort are being diverted from these enterprises to comply with the law and to pay estate taxes.

I am pleased to note that estate tax relief has increasingly become a bipartisan issue. Senator Lott has repeatedly voiced his support for estate and gift tax relief. The Republican bill which I introduced includes several estate tax provisions, including an increase in the Unified Credit Exemption from $600,000 to $1 million. It also includes relief for family-owned businesses and farms.

I an encouraged that Senator Daschle's Democratic leadership tax bill contains some estate tax relief. The administration's budget proposal also includes some estate tax provisions. This, in my opinion, offers a glimmer of hope that we can reach common ground on such an important issue.

I want to applaud Senator Grassley and Senator Baucus for introducing a bipartisan estate tax bill before the recess. This bill is sponsored by Finance Committee members Lott, Breaux, Nickles, Kerrey, Murkowski, and Hatch. It would increased the Unified Credit Exemption from $600,000 to $1 million, providing relief for family-owned businesses and farms, and other needed estate tax relief.

Many other members have also introduced various estate tax bills that we will review. We will hear some of it today from my good friends and colleagues, Senator Lugar and Senator Kyl, who have been persistent in their efforts regarding the estate and gift tax issue. Another leader, of course, has been Senator Collins. So, I thank each and every one of you for your leadership on this issue.[1]

At this time I would be pleased to call upon Senator Moynihan.

OPENING STATEMENT OF HON. DANIEL PATRICK MOYNIHAN, A U.S. SENATOR FROM NEW YORK

Senator MOYNIHAN. Thank you, Mr. Chairman. I very much look forward to the testimony we will hear today from our colleagues, Hank Gutman and other distinguished authorities in this area.

I would simply make the inconvenient point, but necessary, that the principal fiscal issue concerning our country is the deficit, a protracted fiscal crisis that has come about and has all but paralyzed this institution.

We are getting a reputation in this Congress of having done nothing and, indeed, we have done nothing. We have not done anything because we have not got any money with which to do it. To have less means, no doubt, to do less. But I am not sure that is really what we want in the long run.

The Joint Tax Committee, sir, estimates that in the next 10 years the estate tax will generate a quarter of a trillion dollars. Now, if we do not need that quarter of a trillion, or if we could do something about the cost of living index, we might have the basis of agreement here.

Thank you very much, sir.

The CHAIRMAN. As you know, I agree very much on the need to do something about CPI.

Senator Baucus.

OPENING STATEMENT OF HON. MAX BAUCUS, A U.S. SENATOR FROM MONTANA

Senator BAUCUS. Thank you very much, Mr. Chairman. Mr. Chairman, I first want to compliment you and thank you for hold-

[1] For further information on this issue, *see* Joint Committee on Taxation document: JCS–7–97—*Description and Analysis of Proposals Relating to Estate and Gift Taxation,* April 8, 1997.

ing these hearings. As you mentioned in your statement, I am the sponsor of—in fact, I am the leading Democratic sponsor—a bipartisan bill to reduce estate taxes, led by Senator Grassley.

As you mentioned, there are six other co-sponsors of that bill who are on this committee, which I think is a pretty good indication that this year we are finally going to get something done with respect to estate and gift taxes.

Just a couple of points, Mr. Chairman. Number one, this is something I hear about as frequently as anything I can think of from people back home, farmers, ranchers, small business. My State is very, very much a small business State. We are not a big business State, we are a small business State. We are also a very rural State, farms, ranches.

The value of land in my State has gone up at least 50 percent in the last, say, five or 6 years, where the most prosperous parts of the State, that is the most desirous parts of the State, which is all of the State, in Montana's views, is causing a significant problem.

I might add, too, that not only must there be relief for individuals, farmers, ranchers, small businessmen, but also relief will help promote the values which most folks, I think, in our country, particularly in rural America, want to continue.

That is, keeping the business in the family, whether it is a farm, ranch, whatever the business might be, and also protecting open space. The alternative for a lot of farmers and ranchers is to subdivide or to sell to a developer or sell to someone from the East Coast or West Coast with a lot of money, who spends only about two, three, or four weeks a year in our State and it does not add value, does not contribute to the community of the State near as much as the local resident does. There are a lot of reasons why legislation along these lines must pass.

Now, I very much understand and respect the point that Senator Moynihan made, that is balancing the budget. It is true this country is somewhat paralyzed. That is a bit strong maybe, but the country very much wants us to balance our budget, wants us to get that budget deficit down to zero.

But, at the same time, there are many Americans who are, themselves, paralyzed, who are, themselves, finding over time they are in a much greater economic pinch and just cannot keep the operation in the family.

I think we have a dual responsibility, that is, to balance the budget, but also figure out some way to deal with this problem, and the two are not mutually exclusive. There are ways to deal with both at the same time.

I grant to anyone listening that it is hard to do, and no one is going to be totally, completely satisfied. But we must not let perfection be the enemy of the good here. We must find a pretty good solution that achieves the twin goals of balancing the budget as well as we possibly can, as well as dealing with the problem that faces these people.

So again, Mr. Chairman, thank you very much.

The CHAIRMAN. And I look forward to doing that in a bipartisan way.

Senator Chafee.

OPENING STATEMENT OF HON. JOHN H. CHAFEE, A U.S. SENATOR FROM RHODE ISLAND

Senator CHAFEE. Mr. Chairman, I just want to call the attention of the committee to legislation that Senator Baucus and I have introduced, which I do not think the witnesses will be touching on this morning. This is S. 499, which is called the American Farm and Ranch Protection Act. S. 499 excludes land subject to qualified conservation easement from the estate tax.

I would like to call the attention of the ranchers and others here to that legislation, and call it to your attention, Mr. Chairman. I have a statement I would like to enter into the record, if I could, now. Thank you.

The CHAIRMAN. Without exception.

[The prepared statement of Senator Chafee appears in the appendix.]

The CHAIRMAN. It is now my great pleasure to call upon one of our most distinguished members, Senator Lugar, who of course has played such a key role in trying to do something about estate taxes as they impact on the family farm.

Senator Lugar.

STATEMENT OF HON. RICHARD G. LUGAR, A U.S. SENATOR FROM THE STATE OF INDIANA

Senator LUGAR. Thank you very much, Mr. Chairman and members of the committee. I applaud your work and I am honored to participate in this hearing.

As chairman of the Senate Agriculture Committee I recently held hearings on the impact of estate tax on farmers and ranchers. The effects of the inheritance taxes are far-reaching in the agricultural community and justified our committee's study.

We heard from many insightful witnesses citing personal experiences, how the estate tax discourages savings, capital investment, and job formation. Although the estate tax hinders entrepreneurial activity and job creation in many sectors of the economy, the estate and gift tax falls disproportionately hard on agricultural producers.

Ninety-five percent of farms and ranch operations are sole proprietorships or family partnerships, subjecting the vast majority of these businesses to the threat of inheritance taxes.

According to U.S. Department of Agriculture figures, farmers are 6 times more likely to face inheritance taxes than other Americans. Most important, Mr. Chairman, commercial farm estates, those core farms that produce 85 percent of our Nation's agricultural products, may be 15 times more likely to pay inheritance taxes than other individuals.

This hardship will only get worse as the agricultural community gets older, with the average farmer now above 60 years of age. Many farmers will shortly confront either capital gains taxes when they retire, or estate and gift taxes when they pass their farms on to the next generation. USDA estimates between 1992 and the year 2002, 500,000 farmers will retire.

The capital-intensive nature of farming and ranching makes the payment of inheritance taxes extremely difficult. Although the paper value of farm producers may be high, their assets are held largely in farm production and return on farm investment is low, approximately 4 percent on even well-managed farms.

The average farm consists of 75 percent non-liquid assets such as land and equipment. Raising cash while still maintaining a farm's integrity is extremely difficult. Estate tax bills often require a fire sale of integral farm capital, threatening the farm's very existence.

Inflation continues the harmful effects of the estate tax on farmers, eroding the vast majority of gain on farm property, and subjecting the farm estate to taxation of illusory gains. Census figures indicate that farmers own their land for long periods of time, estimated over 30 years, on average.

The Chief Economist of the USDA, Mr. Keith Collins, testified to the Agriculture Committee that over the last 30 years the average value of farmland has increased from $158 an acre to $890 an acre. But three-fourths of this $732 increase was the result of 30 years of inflation, not real appreciation of land values.

In essence, although the farmer is only slightly better off than he was 30 years ago, the paper value of the farm is significantly higher and the estate tax, which is blind to inflation, is levied on this imaginary wealth.

I point this out because it goes to the heart of the agricultural tax problem, both for capital gains and estate taxes. A great majority of what a farmer saves is reinvested back into the land.

For most farmers, the land is their total savings. There are no pensions or retirement accounts to speak of. To tax not only real gains but inflationary build-up is devastating to farmers. Mr. Chairman, the policy is unfair and should be addressed in your reform considerations.

I know firsthand about the dangers of this tax to agriculture. I have a 604-acre corn, soybean and tree farm in Marion County, Indiana. My father died when I was 24. I helped manage the farm, which had incurred substantial debt during his illness. Fortunately, after a number of years we were successful in working out the financial problems and repaid the money. We were lucky.

That farm remains in our family because I have been practicing active estate planning and execution of the plan, along with profitable farming, for each of the last 40 years.

But many farmers and small business owners are not so fortunate. The estate tax began as a temporary tax in 1916, limited to 10 percent of one's inheritance. It was designed to prevent the accumulation of wealth in the hands of a few families.

Journalists and social commentators now frequently lament the death of thousands of family farms and the substantial concentration of land ownership, but the estate tax literally forces many farmer-owned situations and small businesses to sell to larger corporations.

Death should not be a taxable event, both for economic and moral reasons. With the highest marginal rate of 55 percent, the estate tax has mushroomed to an exorbitant on death that hinders our country's economic growth. It thwarts family efforts to save, invest, and provide for their children. Fortunately, our country has discovered the necessity of saving and investment if we are to enjoy better jobs.

The inheritance tax punishes the behavior we should be encouraging, namely hard work, thrift, and family. The estate tax, by definition, blocks the accumulation of entrepreneurial capital and breaks up businesses and farms for which families have sacrificed.

Mr. Chairman, although I advocate complete repeal, I support all good-faith efforts, including those put forth by distinguished members of this committee, to raise the Unified Credit and focus tax relief on small business owners and farmers.

I have introduced a set of three bills aimed at minimizing the impact of inheritance taxes. My first bill would repeal the estate tax entirely upon enactment, the second would phase it out over 6 years, and the third would raise the exemption amount of the Unified Credit from $600,000 to $5 million.

That increase, I would point out, would represent the first adjustment of the exemption since 1987, and it would free 96 percent of farm estates and 90 percent of closely-held businesses from the estate tax burden.

Today I have introduced two pieces of legislation to provide additional relief in this area. I would want to mention them, briefly. The first bill provides Americans with a powerful estate tax planning tool by raising the tax-free gift limit to $25,000 from $10,000. Inflation has eaten into this former amount, which has not been adjusted since 1982.

The second bill would correct a longstanding agricultural problem that disqualifies farm heirs for special-use valuations when they cash-lease their farm to other members of their family. Specifically, Section 2032A of the Tax Code I would reference, and ask for your consideration.

As the committee considers repeal or reform of the estate tax, I contend the estate tax is a prime example of how our income-based tax system has become divorced from the most fundamental needs of our economy. We have forgotten that taxation, like surgery, is at best a necessary evil.

Just as the surgeon seeks to minimize damage to the patient, our goal in reconstructing the tax system must be to raise the necessary revenue in a manner that does the least violence.

Mr. Chairman, I deeply appreciate this opportunity to testify before your committee.

[The prepared statement of Senator Lugar appears in the appendix.]

The CHAIRMAN. Thank you, Senator Lugar. Let me just ask you one question. Critics of estate tax repeal or relief say that it only benefits a few farmers and, therefore, estate tax is not a big burden on agriculture in general.

Doesn't that argument miss the point of what farm families have to do to manage their estate tax liability? In other words, is it not fair to say that the cost of the estate tax for an individual is usually greater than the amount of the check he or she has to write to the IRS?

Senator LUGAR. Mr. Chairman, I would make two points. First of all, I will elaborate just a bit on the statement that I made that farmers generally are 6 times more likely than average Americans to pay the estate tax, and even more particularly, that those farmers that have viable family operations, that is, are fairly self-sustaining, about 400,000 in Mid-America, are 15 times more likely.

The reason is, the concentration of assets in land and in equipment means that the situation is usually cash poor, or at least has very little cash involved in it. So the farmer, whether he is large or small—and I say this from my own personal experience—has the option of, prudently, attempting to stay liquid and not expand operations or not deal with operations as efficiently as possible simply as a hedge against untimely death or difficulty, or take risks to be an efficient farmer.

That is, actually to expand operations, to get state-of-the-art equipment, to go into site-specific farming and very careful use of inputs and nutrients. That is very risky, given the estate tax and the possibility of untimely death.

The other difficulty for farmers who have been prudent, and I cite my own 40-year experience in this. Forty years is a long time, and I have the good fortune that my mother is still alive and she is 90. That was an integral part of the plan. If she had passed away in the meantime, the plan would not have worked.

I am fortunately still alive, and so is my brother and various other people. In other words, our whole operation depended upon, thank goodness, our longevity and the ability to execute the plan against 30 years of inflation, of illusory gains.

So it is a total distortion of the operation as a rule if you are not lucky as we have been, and you do not efficiently farm. Second, if you are lucky, for 40 years you spend a disproportionate amount of your time in record-keeping, in legal fees, in all of the machinations that are very difficult for the average family farmer to do.

The CHAIRMAN. Well, thank you, Senator Lugar. Let me say, the Nation is better off for your longevity as well.

Senator LUGAR. Thank you.

The CHAIRMAN. Unless there are further questions, I will turn to Senator Kyl. I know the Senators and member of Congress are very busy people, so please feel free to leave at your will.

It is a great pleasure to have you here, Senator Kyl. I know that you, too, like Senator Lugar, have been a persistent advocate of reducing the burden of estate taxes. Please proceed.

STATEMENT OF HON. JON KYL, A U.S. SENATOR FROM THE STATE OF ARIZONA

Senator KYL. Thank you, Mr. Chairman. I think all of us appreciate Senator Lugar's longevity, in addition to his perspicacity and wisdom, and I fully associate myself with his remarks.

I guess what I have to add is perhaps frosting on the cake, but he has certainly made the case. I, too, thank you for holding this important hearing to consider estate and gift taxes.

Senator CHAFEE. Yes, Senator. I was going to comment, I think it is very astute estate planning to include within it longevity. [Laughter.]

Could you pass that on, Senator? I am not sure how you worked that out.

The CHAIRMAN. The older you get, the more important it is.

Senator KYL. I am going to be deviating from my prepared text, which I know you will include in the record. I am going to be making the point a little bit later on that not everyone is as fortunate. There are families who I have asked to write letters to this committee to explain their own personal situations to illustrate how pernicious this tax can be.

As important as the point is that Senator Moynihan made, and we all recognize it is important, we have got to get our budget balanced, we also know that we have to do what we do based on what we perceive is right and wrong. None of us would argue, for example, that we should eliminate all welfare programs because that would help us balance the budget. That would be wrong. This tax is wrong.

The last point that Senator Lugar made in his prepared remarks makes the point eloquently. A physician's first admonition is: do no harm; be careful in the surgery and do only that which is necessary.

Extracting this tax at the time of death on assets that have already been taxed at least once or twice is wrong. It is antithetical to economic growth, which is the best way to provide the revenues we need to balance our budget.

Therefore, I respectfully make the point that, while we must be focused on balancing the budget, we also must examine our Tax Code to make decisions based upon what is right and what will promote the economic growth which we all support.

I have concluded, Mr. Chairman and members of the committee, that, while there are many ways that we can improve the Tax Code, that in the end we are going to have to repeal this estate tax or so-called death tax. That is the most efficient way to resolve the problem.

That is why, on January 21st, I introduced the Family Heritage Preservation Act, which is S. 75, which would do just that. We now have 27 co-sponsors, which is more than any other freestanding estate tax bill that has been introduced.

Companion legislation has been introduced in the House of Representatives by Representative Cox, and he will tell you the status of that legislation there. But it has got, I think, over 130 co-sponsors right now.

I would note that our legislation has been endorsed by the U.S. Chamber of Commerce, the National Federation of Independent Business, the National Association of Manufacturers, and the American Farm Bureau Federation.

In all, about 60 family, business, and taxpayer organizations have come out in favor of total repeal, and I will submit a complete listing of those groups for the record.

This mailgram alone, about 5 inches thick, includes the names of 54,858 senior citizens across the country who support the Family Heritage Preservation Act and want the death tax repealed.

Mr. Chairman, it has been said that only two things in life are certain, death and taxes, and leave it to the Federal Government to find a way to combine the two and create a death tax that can be devastating to families and businesses.

I wish I could tell you with all of the emotion that I feel how wrong this tax is. A very good friend and constituent of mine wrote in a letter to me the following. "Since my father died, our lives have been a nightmare of lawyers and trust companies with the common theme: you have to protect the family business. It was hard enough trying to recuperate after my father's long illness, and then adjusting to the reality that he was gone."

This young woman told me this last weekend, that this whole effort has been consuming their family since her father died. That now, in order to protect the estate, the small business that they have created, they have literally had to put everything into trust, which has meant that they do not have the collateral left to go to the bank to get the loan to continue to modernize the business, another point made by Senator Lugar.

So it is not only emotionally destructive, it is economically destructive. The family that I am talking about right here started with one man, moving from New York to Arizona, who built a small printing company that gradually, over the years, was built up to the point that it now employs about 220 people.

The patriarch of the family, now gone, was one of the most generous people I have ever known. He had a heart so big, he could never say no to any charitable cause in our community. Boys and Girls Club buildings are named in his honor, and so on. He helped to build our community. His family will not be able to continue to contribute to our community if this tax continues on the books.

So this is not just about revenue, it is about not penalizing people for what they have earned and what they contribute to our community.

Let me, as I said, skip over a lot of my statement here and just get to a couple of other important statistical things, I think. It used to be that the idea was this tax applied only to the wealthiest of Americans. We now know that that is not true.

In fact, because of inflation, a nice house, insurance policy, and some fixed assets, even people of modest means are gripped by this tax. The rate starts at 37 percent and goes to the confiscatory rate of 55 percent. This is income, as I said, that has at least been taxed once already.

There is another point. The wealthiest Americans do hire the lawyers and the accountants to try to figure out ways to get around it or to extend the time for payment of the tax, but a lot of people I know do not have the means to do that or have not figured out how to do it. Therefore, the irony is that the burden of the tax really falls mostly on those with newly-acquired wealth, or families like the ones that I have mentioned here.

Another point that supporters of the tax have made is that it helps break up concentrations of wealth. Again, the irony is that when these businesses have to be sold because of the death of the originator, it is usually a big conglomerate of some kind that buys up the small family business. So you are not eliminating concentrations of wealth, you are actually creating more of a problem there.

Again, because the point Senator Moynihan has made is obviously one that has to always be a focus here, this is one of the most inefficient taxes on the books. It takes about 7 cents on the dollar to collect this, as compared with the income tax of between 1-2 cents to collect a dollar. Moreover, the cost of compliance is devastating. There is a 1994 "Seton Hall Law Review" article which notes that compared to the $11 billion that was collected in 1992, the cost of compliance was $7.5 billion.

So we should consider not only the cost to the United States Government of collecting this tax, but also the cost to the people who are trying to comply with it. If it is that inefficient a tax, maybe this is not the tax that we ought to be focusing on to collect the revenues that we need to run our government.

Mr. Chairman, I will just conclude by noting that there are a lot of statistics about what happens to the small businesses that end up having to pay this. According to information that has been developed by a 1993 study by Princeton and Associates from Stratford, Connecticut, 9 out of 10 family businesses that failed within 3 years of the principal owner's death said that it was trouble paying the estate tax that caused their companies' demise. In fact, 6 out of 10 family-owned businesses failed to make it to the second generation, and 9 out of 10 never make it to the third generation.

So, in addition to the economic arguments, there is to me the argument of what is right and wrong, and finally the argument of whether or not this is the most efficient way to be funding our government. I think on all of those grounds, this is a tax that is going to be very difficult to fix, which is why I suggest that it ought to be repealed outright.

I thank the committee for its attention.

The CHAIRMAN. Thank you, Senator Kyl.

[The prepared statement of Senator Kyl appears in the appendix.]

The CHAIRMAN. It is now my pleasure to turn to Senator Collins. I appreciate your weighing in so heavily in your new career. Please proceed.

STATEMENT OF HON. SUSAN M. COLLINS, A U.S. SENATOR FROM THE STATE OF MAINE

Senator COLLINS. Thank you very much, Mr. Chairman. I am delighted to have the opportunity to testify before you today. It is no accident that the very first bill that I introduced in the Senate was a bill to reform the estate tax.

This reflected my belief and my experience as the director of the Center for Family Business at Hudson College in Bangor, Maine, a job I held prior to running for the Senate, and it also reflects my experience as a member of a family that has owned a small business in Aroostook County in far Northern Maine since 1844. It is a fifth-generation family business.

I would like to share with the committee my experiences as the director of the Center for Family Business, where I actually held a seminar on estate tax planning. I found that those family businesses that understood the estate tax simply could not comprehend why the Federal Government imposes such an onerous tax that undermines the very type of activity it says it wishes to encourage.

Second, many small business owners and family farmers do not take the extreme measures required to prepare for the estate tax, often with devastating and totally unexpected consequences for their families.

Ever mindful of the budget deficit that we face, and Senator Moynihan's reminder to us today of how critical that problem is, I introduced a limited bill that I believe would focus relief for those who need it most, while minimizing the revenue impact.

My bill would increase the credit from $600,000 to $1 million and lower the top rate from 55 percent to 27.5 percent for the next $1.5 million in assets. That way we would be focusing our relief for the smaller and medium-sized businesses and minimize the revenue impact.

I am very sympathetic, however, with the arguments that have been made by my colleagues for outright repeal. I think a compelling case can be made, but in the interest of minimizing the revenue impact I chose to go a different route, which I would commend to the committee.

I want this morning—and I am going to submit my full statement for the record, with the permission of the committee—to put a human face on this tax, based on my own experiences in working with family businesses and family farms in the State of Maine.

One involves a successful trucking firm in Bangor, Maine. The owner of this firm had spent his whole lifetime, and his father before him, in building a successful business.

He then grew ill with cancer, and he told me that he made the painful decision to sell his family business to a large, out-of-State corporation because he did not want to burden his children with having to borrow money to pay the estate tax. That is a terrible dilemma for any family business owner to be in.

This is a typical example of many family businesses. They tend to have assets so their paper value may be fairly considerable, but they are cash poor. They do not have the liquidity to pay a burdensome estate tax.

Adding insult to injury, the large, out-of-State corporation that this firm was sold to promptly closed down all the front-office operations in Maine, moving 80 good-paying jobs out of State. That is the job impact of this tax.

Another example involved a family business in Maine that had owned a chain of restaurants. They started with one in Portland, Maine, and eventually had 25 restaurants up and down the East Coast.

The owner died and the family was faced with a staggering estate tax bill of over $1 million. The only option they had was to sell all of the businesses, except the one that they started with in Portland, Maine.

Now, some businesses understand the estate tax better and do a lot more to plan for it, but there is a significant cost in terms of jobs, of planning for the estate tax and minimizing its impact.

There is a sixth-generation lumber business in Maine that recently told me that they spent $150,000 a year in life insurance and have spent over $100,000 in estate tax planning for accounts, lawyers, and other guidance.

As the owner said to me, Susan, I could create 10 good jobs with the money that I am spending every year just to plan to avoid or minimize the impact of the estate tax so that this business can stay in our family.

Those are the kinds of stories that I hear every day and I know from personal experience. Mr. Chairman, members of this distinguished committee, I believe it is time for our actions to match our rhetoric. If we believe in promoting family business as we always say that we do, if we believe in saving our family farms as we say we do, we must change a tax policy that takes the family out of family business and family farms.

Mine is not a call for government assistance or for special treatment, mine is simply a call to reform an unfair, destructive, and confiscatory tax. Mr. Chairman, thank you so much for the opportunity to testify this morning on an issue that is my top priority. Thank you.

The CHAIRMAN. Thank you, Senator Collins, for a very eloquent statement.

[The prepared statement of Senator Collins appears in the appendix.]

The CHAIRMAN. I am very pleased to welcome Representative Cox here, who has been a leader in this area of estate tax reform in the House. We are looking forward to your statement.

Representative Cox.

STATEMENT OF HON. CHRISTOPHER COX, A U.S. REPRESENTATIVE FROM THE STATE OF CALIFORNIA

Representative COX. Well, you are very kind, Mr. Chairman, to allow me this opportunity to speak before the panel. I have introduced estate tax repeal in each of the last three Congresses. As Senator Kyl just mentioned, that legislation just introduced in the 105th Congress already has 138 sponsors, as of this morning, in the House of Representatives.

I think you are to be commended for considering this issue as seriously as you are, because we are in a season when reducing government spending and reducing the burden of taxes are all part of a bigger picture, which is getting our fiscal house in order and balancing our budget. So, we do need to be mindful of the revenue impact of any tax law changes that we make.

We ought to be empiricists as we approach this. We ought to ask ourselves whether or not this particular part of the Internal Revenue Code works. We have got a lot of experience with it.

It has two main goals: the redistribution of wealth and the collection of revenue. It has not accomplished either. As Senator Kyl points out, it has probably done the opposite with respect to redistribution. It has probably been a major cause of the demise of small business and family business on the one hand, and the migration of those assets to multinational corporations on the other hand. It certainly has not been very successful in raising revenue. Despite a hefty rate of 55 percent, it accounts for less than 1 percent of our Federal revenues.

The White House Council on Small Business, the conferees all having been appointed by President Clinton, made repeal—not amending it, but ending it—their number four on the list of over 50 items that were absolutely essential to the survival of small business in America. They did that because this tax is not levied on the rich. Nominally it is, but that really is not the incidence of the tax.

As all of our panelists have pointed out, the very wealthy are the same class that can afford the lawyers and the accounts who structure around this problem and who are the reason that 65 cents out of every dollar collected goes to compliance, not to the Federal Government, but nonetheless subtracted from the economy in a huge waste and dead-weight loss.

The very rich have generation-skipping trusts. We do not need to go into all of the details about all of the ways that you can postpone nearly forever the full impact of this tax.

But the people who do not have liquid assets, who cannot lay out for the fancy lawyers and the accounts, do pay this tax. That tends to be also the kind of person, family, or small business whose wealth is in a non-liquid asset, a ranch, a farm, machinery, someplace where they are employing people.

So this tax really is not an income tax so much as a property tax. It is embedded right in the middle of our Income Tax Code, but if we think of it as a property tax it is a lot easier to understand the damage it is causing, because the only way to satisfy the tax man is to liquidate the asset.

When you have to sell the property and that property is an ongoing business of any kind, you also risk destroying the jobs in the process. Who pays the tax in that case? Who really pays the tax? Well, the estate of the person nominally pays it, but that person is dead.

There is a 100 percent rate of tax levied on the person who loses his or her job, 100 percent, and it is paid time, and time, and time again. That is the human part of that statistic that you have heard quoted a couple of times this morning, that two-thirds of small businesses in America do not survive the death of the founder.

What happens to those jobs? Well, either the people go on unemployment, or they try and find something else, or the scrimp. Maybe they get reemployed after a few months or years, we do not know. But that is a very, very expensive tax. That is not a compliance cost, so that is not even included in the 65 percent of the dollar that we are collecting that we already know is wasted.

When you hear, therefore, that somehow repealing death taxes is destined only to benefit the wealthy, ask yourself why it is then that in the most populous State in the Union, all of the people of California would have repealed death taxes by an initiative of the people. We repealed them. We did not amend it, we ended it. Sixty-five percent of the people of California voted to eliminate this tax.

And they went further. They did not just abolish estate taxes in California, but they said that the legislature cannot reimpose them without a new initiative of the people. It is not just in California where this has happened, it has happened in Israel, it has happened in Canada, it has happened in Australia. These nations are repealing their estate taxes because of the social and economic costs. Those are all very, very important for this panel to consider.

Finally, I ask you to think about the enormous benefits in terms of tax simplification that will be gained from repealing this tax. I do not know if you are aware, but there are 82 pages of the Internal Revenue Code taken up just by this one tax that accounts for less than 1 percent of our revenues, and over 200 pages of regulations on top of that.

Before I was in Congress I taught Federal income tax for a while, and estate and gift. It was a second-year MBA course at Harvard Business School. I gave a very hefty exam. It was a five-hour exam, two questions. People filled up a lot of blue books.

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But one student filled out only one blue book, and only the first page in the blue book, and he wrote the following: "Dear Professor Cox: What I have learned in your course is that Federal income tax is enormously complicated, and when I go into business I will be sure to hire someone who knows this subject very well." It was the most creative answer that I got out of several hundred students, but I flunked him nonetheless. [Laughter.]

Representative COX. That is also a lesson in real life. [Laughter.]

We can do a lot for tax simplification by repealing this tax because it is enormously complex. One of the reasons those compliance costs are so high, is litigation. After you die, your estate gets in litigation with the government. There are thousands, literally, of active lawsuits in America right now over the value of the estate because it is always up in the air.

So the government has to pay that money out as well in order to collect the tax man's revenue. We do not net it in our statements, so when you look at those Treasury statements it may look like we are getting more money than we are, but the Justice Department is laying out at the same time, which ought to be viewed, from a policy standpoint, as an offset against that tax.

Senator Kyl closed with a story from one of his constituents, and I would like to share with you something that one of my constituents told me. He is a city councilmember in Southern California and I met with him on a recent break, as I meet with all my mayors and city council people.

In his part-time public role he is on the city council, but in real life he is an estate tax lawyer. He said, I want to thank you for your bill to repeal estate taxes. I said, would that not put you out of business? He said, yes, but I can do other kinds of tax law.

What happened to me last week really makes me say this. He said, last week one of my clients—this happens from time to time in my practice—was dying and I went over to his house. I spent over an hour at his bedside, trying to complete the documentation that I had been working on with him for his estate plan.

Now, the only effect of signing these documents was that he could avoid paying estate taxes. If he did not sign the documents he would pay the tax, if he signed them he could avoid it. No other economic effect. His wife and some of the rest of his family were waiting in the next room, but I had to spend that time with him, filling out these papers. He passed away that same afternoon.

We signed the documents and his estate was in order, but is it not a tragedy that our Federal Government makes one of our citizens, makes many of our citizens, spend their last hours on earth in this way. That is just one of many stories that Senator Collins, Senator Kyl, and Senator Lugar can tell you, and I think all of you know these tragic consequences of this very pernicious tax as well.

If we take tax policy into account, if we are empiricists and ask whether this works, I think we will want to repeal it. The death tax deserves to die.

The CHAIRMAN. Well, thank you very much, Representative Cox.

[The prepared statement of Representative Cox appears in the appendix.]

The CHAIRMAN. I say to all of you, as you know, we did take a significant step forward in our Balanced Budget Act of 1995. Unfortunately, that was vetoed. I do hope that in the tax reduction that I want to see move ahead, this will be a key part of that legislation.

Are there any questions?

Senator CHAFEE. I have a couple of questions. Mr. Chairman, thank you.

It is true, Representative Cox, that the total amount brought in by the estate tax is rather small. I think it is something in the order of $15–18 billion a year. However, as Senator Moynihan stressed, with the need to balance the budget and every nickel counts.

Indeed, everyone on the first panel is dedicated to eliminating or reducing drastically the estate tax, and there will be future panel coming in later on lowering the capital gains tax and on it goes.

I really have some trouble with eliminating the estate tax totally. I think that, as Senator Collins has suggested, bringing the top rate down, or certainly increasing the $600,000 exemption to, I think you said, $1 million is a reasonable way to proceed. Senator Lugar, did you say $5 million; was that your suggestion?

Senator LUGAR. Yes, $5 million.

Senator CHAFEE. But I do worry about the concentration of wealth in our country by certain families and so I think there is a certain virtue in the estate tax. So, I am not enthusiastic about eliminating the tax totally. What do you say to that, Representative Cox?

Representative COX. Well, I am familiar with the concept of sin taxes. I think that I would call the estate tax, as presently written, a virtue tax because, rather than taxing something that is sinful, like smoking, or prostitution, or using drugs, or what have you, it is taxing virtue. It is a tax on job creation, it is a tax on savings, it is a tax on work. On the other hand, it gives people an incentive to not work. If you are wealthy, it is a reason not to work. It is a reason to conspicuously consume. It instills bad behavior.

To answer directly the money side of the question, I do not think there is any empirical evidence that we have been successful with the estate tax and redistributing wealth. I think we have had plenty of data to look at since 1913 to satisfy ourselves on that subject. I do believe there is a significant risk that the opposite is occurring as a result of this tax.

In terms of money, I would say two things. First, the President's budget calls for an additional $186 billion of spending on top of the fiscal year 1997 budget resolution, so simply by trimming our sails on new spending, I think we can find ample room for tax relief, particularly the modest kind of tax relief that would be represented by eliminating this tax.

When it comes to capital gains, I hope we will be mindful of our experience in 1978, 1981, and all the way to 1986 when we kept reducing rates and gaining revenue from capital gains, moving from $9 billion to $50 billion in the face of Joint Tax estimates that the opposite would occur. We have those same estimates right now, but I think capital gains needs to be looked at rather differently than this.

Finally, I would mention that we had testimony over on the House side when we listened to experts on this subject, that if we take a "mend it, do not end it" approach to estate taxes, that in the first year we would probably impose an additional $3 billion in compliance costs on Americans as they restructure their estates to comply with the new law.

Senator CHAFEE. All right. Well, thank you. Thank you, Mr. Chairman.

The CHAIRMAN. Yes. Senator Kerrey. The time is moving on. We have a vote at 11:00, so I would ask that it be kept brief.

Senator KERREY. Yes, Mr. Chairman. If I could just, along the lines of what Senator Chafee was asking there, I do support the Grassley-Baucus legislation, which excludes estates up to $1 million from tax and provides additional significant relief to qualified small business and farm estates handed down to relatives. But following on Senator Chafee's comments, one of the later witnesses in the second panel talks about the number of people who file. There were 2.3 million deaths in 1995, and only 31,000 of those subject to estate taxes.

I have a small business and I insure against the possibility that I might die, and I do it for a whole range of reasons, including the estate tax provisions.

But one of the things that has been pointed out, is that we have other provisions in the Income Tax Code that benefit people who are trying to accumulate wealth, including exclusion of the unrealized appreciation of property held at death.

I can pass on the basis of the property at the moment that I die, some estimate that this is about $30 billion a year of exclusion of income tax that is passed on to heirs without having to pay a tax. Interest on municipal obligations are also excluded, a deferral of tax on income that is earned through life insurance, as well as annuity contracts are excluded. So there are other mechanisms in our Tax Code that benefit those of us who are, through our businesses, accumulating wealth.

I am wondering if those of you who are advocating the complete elimination of the estate tax, do you support income tax changes that would more level the playing field for Americans who are not in the category of accumulating wealth through these businesses?

Representative COX. Well, if you would like me to address that, first. I think you are making my case for me, that all of the things that you just ticked off, which are, in all likelihood, a subset of an even larger list, are the kinds of things that my students filled up so many blue books with.

A system that imposes a tax on the one hand and then gives you all sorts of exclusions an so on on the other hand rather than reaching the result more simply by saying you do not have to pay the tax in the first place, is a very expensive—needlessly so—system.

Second, with respect to the 31,000 filers, I would mention again the point that I think each of us made in our formal testimony, and that is, that if we look only at the filing estate we miss the true incidence of this tax. It really does not fall there.

That is why the White House Conference on Small Business made this number four on their list of survival matters for small business in America. The incidence of the tax is better viewed as the man or woman who loses his or her job because the small business is liquidated. When two-thirds of small business in America does not make it past the death of the founder, that is a lot of jobs going down the drain. That is what we are really concerned about.

Senator KERREY. A piece of that, certainly as you must know, is not a consequence of the estate tax, but is a consequence of the unique relationship of the founder to the business. So even if you eliminate the estate tax and the founder dies, it is likely that many of those businesses are not going to survive.

Representative COX. Well, that is true, although the data suggests that the preponderant reason in each of these cases is, in fact, the necessity to liquidate assets to pay the estate tax.

Senator KYL. Because of the shortness of time, Mr. Chairman, let me just make two very quick points.

The CHAIRMAN. Senator Kyl.

Senator KYL. The legislation which I supported last year, which Majority Leader Dole had introduced, was another attempt to provide a fix for a certain number of people. It would have helped only 400 businesses.

I think we can make this as complicated as we want to, and we can make it as simple as we want to. If our policy is to tax savings and wealth accumulation and job creation in certain ways, that can be done without doing it through an estate tax.

So if, Senator Kerrey, there should be an adjustment to some of the income tax policies, and I do not speak to whether it is good or bad, though I probably would not like to see it, if that is important to do, if that is necessary, we can do it on that side.

I think we ought to make it less complicated, not more complicated, because in the end it becomes an extraordinarily inefficient tax, both in the economy and for the Federal Government to collect.

Senator KERREY. I do not disagree with that. I just want to make it clear that there are provisions in the Tax Code that benefit those of us who are in business who are accumulating wealth, that there are provisions in the Income Tax Code that costs taxpayers who are not accumulating wealth as a consequence of having to pay a higher rate in order to maintain these provisions.

I am not advocating those provisions be eliminated because I do think they are incentives for the creation of jobs and I think they are important to have in there. However, I just want to make it clear that there are some favorable provisions in the Tax Code right now and that all is not doom and gloom for those of us who have businesses that are accumulating wealth.

The CHAIRMAN. We are going to have to proceed, because it is 11:00 and we have a vote.

Senator MOYNIHAN. Mr. Chairman, could I just take one moment——

The CHAIRMAN. Certainly.

Senator MOYNIHAN [continuing]. To give some hope to our splendid witnesses that Senator Kerrey pointed out the alternate source of revenue, which is the non-taxation of capital gains, which might make possible the kinds of provisions that you are talking about. So we have some room around here. I do not think we will tend to, but we could.

The CHAIRMAN. Thank you very much. We appreciate your being here today.

The next panel consists of Mr. William W. Beach, who is the John M. Olin Senior Fellow in Economics at The Heritage Foundation; Mr. Harry L. Gutman, who of course was a former Chief of Staff for the Joint Committee on Taxation, now a partner at the Washington office of King and Spalding; and finally, Mr. Drew Mendoza, who is the executive director of the Family Business Center at Loyola University Chicago.

We appreciate your being here. I would ask that each of you summarize your full statement. Your full statement, of course, will be included in the record as if read.

Mr. Beach, we will be pleased to start with you.

STATEMENT OF WILLIAM W. BEACH, JOHN M. OLIN SENIOR FELLOW IN ECONOMICS, THE HERITAGE FOUNDATION, WASHINGTON, DC

Mr. BEACH. Thank you very much, Mr. Chairman. I am William W. Beach, the John M. Olin Senior Fellow in Economics at The Heritage Foundation. I want to join the members in congratulating this committee for having these hearings on the estate and gift generation-skipping tax, the so-called death tax.

It seems to me that there are really four arguments behind repeal and reform. Rather than read my testimony, I am just going to touch on a few items this morning. The moral and ethics in public policy argument, which I believe the members did a very nice job of touching upon and describing, is the moral dimensions of the tax.

The second argument, is what I call the consistency in public policy argument. I have devoted the majority of my written testimony to this particular part, and I will read a little bit of that just to highlight the reason why that is a very compelling argument and I think should be center before the Committee on Finance of the Senate.

The third, is the economics of the estate tax argument, on which I have done some writing and others have done some writing. There is a growing consensus that there is an economic cost associated with the estate and gift tax.

The fourth, are the revenue considerations. I would be very happy to talk about those with the committee on various bills that we have looked at.

The consistency in public policy argument is a compelling and interesting argument that I think has received less attention than it deserves, and it goes to the central reason why we have an estate and gift tax, the original goal and objectives of that tax.

So let me briefly read just a few paragraphs from the paper to highlight this particular argument. Between 1913 and 1916, the Congress deployed a system of income taxation with two principal objectives: to raise revenue for the Federal Government and to contain the economic power of wealthy individuals through taxation.

This latter objective dominated Congress' discussion of income taxation and inspired support among a host of political activists during the ratification process of the 16th amendment.

In its common translation, Congress intended the containment objective to address the following problem: the increasing concentration of wealth in the hands of a few individuals prevents many Americans from enjoying the economic opportunities that this country was founded to provide, and that our fundamental law protects.

Now, as Representative Cox, Senator Kyl, Senator Lugar and Senator Collins have pointed out, what we have here is a classic case of unintended consequences, fully-blown. Intergenerational wealth taxation has produced a set of effects almost completely opposite its original purpose.

We now know that the estate tax actually bears down most heavily on the intended beneficiaries of wealth containment, not the tax policy's apparent targets. It places unnecessary and damaging burdens on the following four groups: on owners of small- and medium-sized business who often are ethnic and female, and who discover too late for remedy that their legacy of hard work and frugality will not pass to their children, but instead will fall victim to taxation and liquidation. It is the intent of public policy, as I read it over the last 80 years, to provide special protection and encouragement for those groups who are disadvantaged.

On farmers, many of whom are descendants of the very Populists who rallied at the end of the 19th century in support of wealth taxation and who lose their farms today not because of wealth agrobusinesses or capitalist robber barons but because of Federal Government demands for a tax payment upon death from people who have invested their earnings back into their family legacy and have maintained meager liquid savings.

Third, on workers who suffer when small- and medium-sized businesses are liquidated to pay the estate tax and when high capital costs depress the number of new business creations, the chief engine of job creation in the current economy.

Finally, interestingly enough, on poor people who are harmed by the estate tax not only because the general economy is weakened by the estate tax's rapacious appetite for family-owned businesses, but also because the estate tax discourages savings and encourages consumption, particularly among wealthy individuals, thus undermining the Federal income tax from which the funds are raised to support the programs for disadvantaged Americans.

That leads me to the following observations on the economic impact. Let me stress that I think this argument that the estate tax encourages consumption and thus undermines the income tax is worthy of considerable more research, because it goes back then to the question of, what is the true revenue impact of having the estate tax in place, estate taxes, as this committee well knows, are lifetime liabilities, they accumulate over a lifetime? As a consequence of that, what happens is that the price of labor and the price of capital suddenly, but significantly, rises.

When we increase the price of labor and the price of capital, we have predictable effects on macroeconomic performance. We employ two very standard, center, middle-of-the-road models, well-respected models, to assess the impact of the estate tax.

One, the Washington University macro model was designed by Lawrence Meyer, who is now sitting on the Federal Reserve Board, and the other, the WEFM model, the Wharton Econometric Forecasting Model.

In both cases, the models gave us similar insight. That is, the estate tax, if it were repealed, would be a job creator, that is, without the estate tax the macroeconomic performance would increase.

The revenue feedbacks were very encouraging. It looked to us that they were similar to a 50 percent reduction in the capital gains tax. That is, we would be essentially revenue neutral by the fifth or sixth year. On the area of incomes, household income would grow significantly. We have summarized these results in the written testimony.

I have a paper on this, which I believe has been sent to all the committee members, going into detail about the macroeconomic simulations, which I think give us some encouragement that if we were to move forward on estate tax repeal or on estate tax reform of substance, say a long phase-out period, we should do so without the major trepidation which normally faces us, that we are moving into a tunnel at which there is no light at the end. There is, and I think that the economics of this issue, as well as the sociology of this issue, is giving us some encouragement for moving forward with substantive reform.

Thank you very much.

[The prepared statement of Mr. Beach appears in the appendix.]

The CHAIRMAN. Thank you, Mr. Beach.

Mr. Mendoza.

STATEMENT OF DREW S. MENDOZA, EXECUTIVE DIRECTOR, FAMILY BUSINESS CENTER, LOYOLA UNIVERSITY, CHICAGO, IL

Mr. MENDOZA. Thank you, Mr. Chairman. Mr. Chairman, members of the committee, Mr. Moynihan, Ms. Braun, it is an honor to be before you all.

I am the founding director of the Loyola University Chicago Family Business Center. Our mission at the center is to understand how family businesses grow and develop across generations.

Our day-to-day focus is through research and programming the study and development of solutions to the unique and distinct opportunities presented in family businesses.

I find much of the discussion today upsetting, because some of it can lead to a very divisive situation, I think, in the country among business owners and among families. I was honored a few days ago to receive a phone call inviting me to address you all.

The family business is the backbone of the American economy, and I will be addressing you as someone who studies family businesses and will try to be a resource to you in that vein, not trying to support an argument one way or another. To that end, I get to keep my academic hat on.

It is a precious component, I believe, of the communities we live in. Based on the research of Shanker and Astrachan, depending on how we define what a family business is—indeed, that is really one of the best places to start, what is a family business.

There are anywhere from 10–20 million family firms in the U.S. They make up approximately 91 percent of all businesses in the United States, 60 percent of all the privately-held businesses, 49 percent of the GDP. They employ about 60 percent of the U.S. work force.

It seems to me that our society places a high value on the concept of family. We encourage family unity. We certainly praise family contributions to our communities. Ironically, though, transfer taxes and the too low level of relief that they provide to family firms I think challenge and make it extraordinarily difficult for many business-owning families to achieve those values we hold most dear by confiscating their business assets at a time of generational transfer. It is critical, I think, that we differentiate between assets of the business and assets that are liquid, cash, if you will.

Family businesses tend to rely on life insurance to prefund part or all of their expected tax liability. Sixty-seven percent of respondents to a survey we did at Loyola University in Chicago in conjunction with Kennesaw State University in Atlanta, funded by Arthur Andersen and MassMutual, found that life insurance represents the primary source of funds to cover estate and gift taxes. Great, they can afford to buy life insurance.

What is terrifying about that though is that business owning families rarely do outside appraisals and evaluations of their businesses, so that in fact the net result is that when the decedent's estate is valued we frequently find that the life insurance that they were paying for is insufficient to cover the estate tax. Again, they end up having to go back to assets of the business.

A tax criterion which would seem reasonable is that the tax and its relief be easily understood. Payne research, which is referenced in my written testimony, references a General Accounting Office study which estimated 44 percent of the penalties assigned by the IRS in 1990 were wrong.

It seems to me that taxpayers should be able to not only easily comprehend what is expected of them, but also fulfill their legal tax obligations without extraordinary expenses being incurred.

Family firms have to invest considerable amounts of capital which otherwise would absolutely be used for investment in their businesses to pay their estate tax liabilities and to plan for those.

In fact, some research showed that $35,000, on average, is spent by a business owning family to plan for estate taxes. I mean, there is an entire industry out there whose job it is to help family businesses plan for avoiding the tax. The tax avoidance industry is the name that is colloquially used.

It is fascinating to me when I give speeches and run workshops with business owning families, oftentimes there is an estate tax planner or estate tax attorney or expert on the program with me.

I have done scores of these workshops attended by thousands of family business owners who, for the price of admission, hope to gain an understanding of estate and gift taxes. The look in their eyes goes from keen interest to dazed confusion, much like that of a deer caught in a car's headlights, as they try to understand what these taxes are all about.

Let me just close with this comment. I know of no better or more compelling evidence of the importance of family businesses to our communities than that of the Feuerstein family's well-publicized decision to continue to pay workers after their plant had been destroyed by fire in the fourth generation family business, Malden

Mills, in Lawrence, Massachusetts. This is a fourth generation family business.

Had Malden Mills been a non-family owned and managed company, I doubt whether management of a non-family business faced with rebuilding the charred remains of the factory in the rust-belt north would have elected to keep the idle workers on the payroll for as many months as they have.

It seems to me that the question before the committee is this. Do we stand to gain more as a Nation by preserving the American family business? Should our tax policies encourage appropriate planning for family business continuity or rob families of the opportunity, families in all of our communities, not just farms, not just the wealthy, but in our inner cities as well, to continue the legacy and all the economic and societal benefits these firms bring with them. Thank you.

The CHAIRMAN. Thank you.

[The prepared statement of Mr. Mendoza appears in the appendix.]

The CHAIRMAN. Mr. Gutman.

STATEMENT OF HARRY L. GUTMAN, PARTNER, KING & SPALDING, WASHINGTON, DC

Mr. GUTMAN. Thank you, Mr. Chairman and members of the committee. I am Hank Gutman. I am a partner in the law firm of King and Spalding. I am very happy to be here this morning. I want to make clear that the views that I am expressing this morning are mine, not that of my firm or my clients.

Let me, first, summarize my views. I am a bit of the contrarian this morning. The Federal wealth transfer tax structure is not perfect. Marginal rates may be too high, exemption levels may be too low. The tax applies unevenly and it may cause payment problems for estates that hold illiquid assets, particularly closely-held businesses and farms. But despite its structural flaws, the wealth transfer tax plays a very important role in the overall progressivity of our tax system, the point that Senator Kerrey made in addressing his questions to the prior panel.

The estate tax, or the wealth transfer tax, serves as a backstop to our income tax by taxing wealth that taxpayers are able to accumulate through excluded or deferred income sources, the principal one of which is the failure to tax unrealized appreciation in property that passes at death, a $30 billion annual item which, if subject to tax, could obviously be the source for significant estate tax reform, or perhaps even repeal. But unless that is done, we need to have a wealth transfer tax as a pragmatic alternative to assure that the owners of those assets that have been accumulated without the payment of income tax, in fact, bear some fair share of the tax burden of the country.

A few factual items that I think are important for the context in which we are discussing this. Again, as Senator Kerrey pointed out and the Joint Committee pamphlet published in connection with this hearing has noted, the estate tax affects only 1.37 percent of decedents dying each year.

Transfer tax revenues were $17.2 billion in 1996. That is a small percentage of Federal revenues. But, as the members of the committee recognize, it is a huge number in absolute terms in a day when we are trying to balance the budget.

Data just published in the Statistics of Income Bulletin indicate that relatively few taxable estates contain farm or closely-held business assets. Farm assets comprise less than one-half of 1 percent of all assets reported on taxable returns. Closely-held businesses were 6.5 percent of the total.

Now, that is not to say that estates that have these assets have no problems. It is, however, to emphasize that problems with respect to farms and closely-held businesses should not be used as a rational for repeal of the transfer tax, or even for major structural changes to the tax.

The proposals that are before the committee run the gamut from repeal to reducing the scope of the tax, providing exclusions for family-owned businesses, et cetera. They are all discussed in the committee pamphlet. I have said why I do not think repeal is appropriate.

I have little to say about the question of an appropriate exemption level or rate structure. That, it seems to me, is a decision that you all have to make, keeping in mind what you think the objectives of the tax are. Historically, the tax has affected about 1 percent, or a little bit more than 1 percent, of the taxpaying public. That may be the right number. It is up to you to decide. Also, the rate structure may be too high. But marginal rates and bracket widths, again, are uniquely political decisions as to which I think I cannot help you very much.

With respect to issues that involve the structure of the tax, I do have a few things to say. First, I believe in horizontal equity. That is to say, I believe that if a tax is going to be imposed on the value of property transferred all property that is transferred ought to be valued and subject to the same tax, otherwise you have a preference.

The cost of that preference is going to be borne by somebody who has to make up the tax revenue that is lost due to the existence of the preference. In that context, the question whether closely-held businesses and farms ought to be subsidized gets raised. I think that has to be understood and debated. But I would also point out that these preferences create enormous complexity in the Code—just take a look at Section 2032A—and they require anti-abuse mechanisms, et cetera.

In summary I think that unless and until the income tax base is broadened, we ought to retain the estate tax or the wealth transfer taxes. If the tax applies unevenly, we ought to get rid of the reasons why it applies unevenly. If it applies unfairly to those estates that do not have liquid assets, the answer is to devise a fair payment program to allow the tax to be paid in a way that does not interfere with the normal business decision of whether to sell or not. But mostly, I think, this committee ought carefully to consider eliminating the income tax preferences that give rise to the structural justification for the estate tax. Perhaps then it can be reduced or repealed. Thank you.

[The prepared statement of Mr. Gutman appears in the appendix.]

The CHAIRMAN. Let me ask the other gentlemen, I think it is pretty obvious we really do not have the option of entirely doing away with the estate tax. Recognizing that, are we better off concentrating on giving across-the-board tax relief, or should we target just small business and family farms? Mr. Beach.

Mr. BEACH. Yes, Senator. I have a view on that.

The CHAIRMAN. Or should it be a combination?

Mr. BEACH. Right. Not being an estate tax lawyer, and I would completely agree with Mr. Gutman's comments about tax preferences. That is a fruitful area of work and I think moves us along to a simpler, fairer, and flatter system.

But I would strongly urge that we look at rates, bringing down rates, and increasing in a thoughtful, strategic, and targeted way the Unified Credit, with the objective of eventually having this part of the Tax Code melded in, perhaps to the capital gains side, so that we have taken the estate tax as a complicated area and sort of eliminated that complication.

I like phase-out very much, as long as it is direct, committed and quick. If we can move today from 55, to 40, to 35 percent, we have reduced tax arbitraging between the capital gains structure and the estate tax structure.

One of the things that is complicated—and I will end on this with my answer—about doing revenue estimating of the estate tax and answering Senator Moynihan's question about, how much would it cost, is that we know that a number of otherwise taxable estates or entities are choosing to pay, under the capital gains structure, before they have to hit the estate tax structure.

So to figure out, what is the total revenue impact, we have to figure out, what is the choice structure between these two tax systems. But because the top rate for individuals on the capital gains is 28 percent and the top rate is 55 percent, we have tremendous and fruitful opportunity for tax arbitraging. You see it all the time.

So rate reduction, increasing Unified Credit, a quick move to getting the estate tax properly sized. Remember, in 1993 there were only 195 returns that had taxable estates above $10 million. If we cannot handle 195 returns, then there are some difficulties somewhere else. I would urge you to look in that direction.

The CHAIRMAN. Mr. Mendoza.

Mr. MENDOZA. Could you repeat your question, Mr. Chairman?

The CHAIRMAN. Yes. As I said, if full repeal is not feasible, should tax relief be targeted or should we be increasing the Unified Credit?

Mr. MENDOZA. Well, as I mentioned, I am very uncomfortable when I am asked questions that ask me to play attorney or tax advisor. But it seems to me that the idea of discriminating among assets is not a good one, ostensibly.

On the other hand, it would seem to me that family businesses oftentimes do have their assets tied up in that business and that any tax that forces a family business, large or small, to sell off or be rid of parts of that business to provide liquidity to pay a tax just does not make much sense to me, because in the long run I think the business will provide more assets, I think, to the community and to the tax base of the country as a whole than would be collected through the estate tax.

The CHAIRMAN. Mr. Gutman, do you want to add anything at this stage?

Mr. GUTMAN. No, I think I have made my views clear, Mr. Chairman.

The CHAIRMAN. Senator Moynihan.

Senator MOYNIHAN. Sir, I find myself thinking here that we may be dealing with a tax which, while defensible enough, is thought to be indefensible, and you have to be sensitive to that. Does it occur to our distinguished panelists that we might have a very close trade-off here? I think the Joint Tax Committee estimates that the estate tax brings in about $19 billion, and that the exemption of capital gains costs about $20 billion.

Now, there is an exchange here. Hank, you have helped us so often in these matters. Is there some opening?

Mr. GUTMAN. I think it is a very fruitful area to explore, Senator Moynihan. First of all, the Canadians, as you know, did repeal their estate tax. But what Representative Cox failed to mention, was that they also imposed gains at death, which meant that they were going to tax the unrealized appreciation in property at that time.

Senator MOYNIHAN. Yes. Yes.

Mr. GUTMAN. The Australians repealed their transfer taxes, but they provided for a carry-over basis of assets held at death. In other words, that unrealized appreciation has not been taken out of the system. I think that is a very fruitful thing to explore.

If you look at the preferences that are in the income tax system, I mean, there are others beyond the unrealized appreciation in property held at death, but that is a major one. The non-residence assets that have that unrealized appreciation in them tend to be held by the same people who are subject to the estate tax. We ought to look at distribution, because I think it is going to look pretty good. We ought to look at revenue. I think that is going to look pretty good as well.

Another benefit that one gets out of considering treating unrealized appreciation as recognized at death is that lock-in is definitely alleviated.

Senator MOYNIHAN. Right.

Mr. GUTMAN. There will be no reason to hold on to highly-appreciated assets because you are going to get a step-up at death. I think that there are very significant advantages that ought to be explored here.

Also, it helps out a lot with the farms and closely-held businesses, because one of the things you can do is provide a carry-over basis for those types of assets, assuring that the appreciation will at some time be subject to tax, but also assuring that there is no liquidity problem at death. I think there are a lot of advantages to doing this.

Senator MOYNIHAN. Mr. Beach, if I could just ask you. You have obviously thought about this, as an economist.

Mr. BEACH. Senator, I have been an advocate of this position that you have outlined for some time. There are two things that I could add to what Mr. Gutman has already said.

First of all, from an economic standpoint it is the tax wedges on labor and capital that I am most concerned about. It is a lifetime tax burden that the estate tax imposes. However, capital gains is not in that same category. So you are, in fact, doing a lot to the tax wedges on labor and capital when you eliminate the estate tax.

Again, the estate tax is the sum of the revenues, the sum of the compliance, and the sum of the foregone opportunities. So it is a substantial amount of tax wedge as a percent of total tax wedge. That is the first thing.

The second thing, is that I would urge you to go one step further. That is, not only think about what we could do with unrealized capital gains, our unrealized basis here, but also perhaps read again, or have one of your staff members dig up, the testimony that was given before this committee of Alan Sinai just about, I guess, a month ago, in which he indicated some very hopeful numbers and what would happen if you reduced the tax on capital gains.

Now, here is the sort of odd thing. Suppose we were to take the estate tax and move those unrealized gains into capital gains, reduce the tax rate on capital gains. The total revenue effect would be very positive. I think it might be greater than zero, positive over 5 years. The economic long-term effect is very good.

The job creation effect of combining the macro effects of estate tax repeal or elimination to the other side would create probably in excess of 200,000 jobs a year, just guessing off the top of my head about how these macro models work.

Senator MOYNIHAN. Thank you.

Mr. Mendoza, if you might give us a statement in writing, I see my time is up. But I thank you very much for your comments, too.

Mr. MENDOZA. Thank you.

The CHAIRMAN. If I might, I have one more question which I did not ask.

Senator MOYNIHAN. Mr. Chairman! [Laughter.]

The CHAIRMAN. The administration of estate tax proposal does not actually reduce estate taxes, it liberalizes the rules for installment payment of estate tax attributable to closely-held businesses. I would like to know, what is your view of this proposal? While it does not actually reduce estate taxes, does it address your concerns, Mr. Mendoza?

Mr. MENDOZA. It seems like a halfway measure. Certainly anything is helpful, but I would hate to see us settle for less than what we really are aiming for. I think that would fall short of our expectations. It disturbs me, as someone who studies the science of business management, that we are approaching this kind of from the back door.

It would seem to me to make more sense to look at, if family businesses—family businesses can be quite large. Thirty percent of the Fortune 500 are family firms. But if family businesses did not have to be faced with not only the payment of estate taxes, but also the payment of all the advisory services and steps they must go through in order to protect those businesses' assets, step-up or otherwise, that those dollars would actually generate much more—much more—for the country than the tax itself does.

Just to give an example, if $100,000 is reinvested back into the business, we could probably see a business produced close to $500,000 in taxable sales additionally every year, and create five new jobs paying $25,000 each, which would yield $15,000 more in personal income tax annually. I mean, it goes on and on. It just seems to me that we are going about this wrong.

It is not about, how do we cover the $18 billion, the question is about, gee, if we took that $18 billion and put it in the hands of entrepreneurs and entrepreneurial families who have proven their success over multiple generations, that the return on the investment to our communities would be much, much greater, I think, that we are realizing now. Thank you.

The CHAIRMAN. Senator Moseley-Braun.

Senator MOSELEY-BRAUN. Thank you very much, Mr. Chairman. I thank you again for this hearing. This is a really good panel, and it has shed some light on a complicated subject.

I am very much interested in tax simplification. The fact is, the Code is just so complex and it just causes people conniptions just trying to get through it. Particularly when you are speaking about small businesses and family farms, the complexities here really work an injustice all their own.

So my question to you is, have you any suggestions about avoiding what I call estate tax surprise? Many of the proposals, even that we are looking at, just add another twist to an already convoluted system and a system which, it has been argued here this morning, may or may not achieve our tax goals in any event. Are there any suggestions for giving taxpayers, families, or the owners of these businesses some guidance before the taxable event of death occurs?

Mr. MENDOZA. One idea that we might consider, and I certainly want to hear from Mr. Gutman and Mr. Beach, that if we keep, say, the estate tax but eliminate the gift tax, entrepreneurs do not like to plan, for a lot of reasons that we can talk about at great length. But they generally are not very good planners.

I think that if there was some incentive for them to transfer assets in the business to the next generation in small pieces in ways that would give them opportunities to test the competencies, the skills, and the passions and the interests of the next generation of leaders, that that would go far to helping them plan for the preservations of those businesses across generations.

Mr. GUTMAN. I am a little struck by the notion that individuals who are in business are capable of planning for their business affairs, but they are incapable of planning for their demise. So I have a little problem with the premise, Senator.

Senator MOSELEY-BRAUN. But aren't we all?

Mr. GUTMAN. Well, I do not know the answer to that. I think there are a lot of people who are, and there are a lot of people who are not. But these are people who are charged with making business decisions all the time. It is hard for me to understand why this is not part of their business decisionmaking.

Having said that, that does not mean that the tax has to be complicated, or it may be that the tax can be eliminated. But to structure the tax, or to try to structure the tax, in a way that is going to increase awareness, seems to me to be putting it a little bit backward. People need ought to understand this tax is there, and most of them do understand that it is there.

Remember, also, the scope of the people that it hits. Presently, for a married couple, until wealth exceeds $1.2 million, they are not even in this system. It is entirely up to you to raise that exemption level, if you think that is appropriate. But remember again, we are talking about a very small population who are affected by this, and I would have thought a population that should and could be concerned about it.

Mr. BEACH. This is an area in which research needs to be done. I love estate tax surprise. I have been calling this the nightmare of the American dream. It is, I think, a larger problem. Farmers oftentimes do not know the value of their land until it is time to be disposed.

I interviewed a recent farmer down in North Carolina who had a marvelous farm, would not have been taxed in the estate tax, until Bell Atlantic put a cellular cell tower on his land, and it went from, I do not know, a couple thousand dollars to $5,000 an acre. He suddenly had an estate tax problem. Now, here is what I have to say about it. First of all, it is the price of the estate tax that is the price of the surprise. You might still be surprised. If you lower the rates, it is not as bad of a problem.

Repeal is a good way of eliminating surprise entirely. Moving the problematical parts into the capital gains part of the Income Tax Code simplifies, people know about capital gains more than they know about estate tax. That is what the surveys show. That also helps eliminate surprise.

So, any way we can simplify and reduce rates, I think that is the direction we ought to go rather than carve-outs or targeting certain things, because you never know where you are going to qualify or who you are going to be in 25 years. Most people think they are going to be millionaires.

Senator MOSELEY-BRAUN. And live forever.

Mr. BEACH. Yes.

The CHAIRMAN. Senator Grassley.

Senator GRASSLEY. I think I am going to make some comments rather than ask questions. The first would be in regard to one of our panelist's comment about farms being a small part of the number of estates.

That could be in the country as a whole, but in a large part of the country, like where the Senator from Illinois and I come from, and other rural States—downstate Illinois, at least, is rural—it is a very significant issue for my constituents. It has a very significant impact on the economy. We are not in the stage now where widows might be selling farms to satisfy estates. I am sure there is some of that today.

But if you go back only 16 years, before we raised the exemption from $250,000 up to $600,000, there were cases where you could be a spouse working beside your husband on the family farm for an entire lifetime, pouring all of your resources back into the farm, reinvesting it, living poor, dying rich, until all of a sudden you found you did not have a unit, or at least an efficient unit, to continue operating. All of a sudden you are all alone, and you have no source of income from something you had been a part of for your entire life.

We saw estates go from a historic low of about 1 percent of the estates being taxed from 1940 until the late 1970's, until it got up to a point of about 10 percent of the estates being taxed. Then we increased the exemption to $600,00, and now it is down to a very small percentage.

But with the inflation in land and property values could be getting ourselves back into that same position now—hence, the reason for reestablishing the estate tax exemption at a higher level.

I was not here because I was chairing the Aging Committee earlier today, and I should have been here when our colleagues were suggesting the type of legislation they propose. I have a bipartisan bill that is sponsored by eight of the members of this committee. It is not anything new; much of it was in the bill in 1995 that the President vetoed.

But it is bipartisan and there is a commitment to the wrong that the estate tax brings particularly to family operations. I hope that if we have a tax bill, estate tax reform is a very significant part of that.

Last, Mr. Chairman, I would comment on your last question to the panel in which you cited the administration's proposal. They have testified before the Agriculture Committee—I do not know whether they have testified before this committee or not—that the administration does not want to suggest any changes in the estate tax laws beyond what you have suggested here.

That really is no change at all, in the sense that you are still going to pay the same amount of tax, only you have a longer period of time to spread out the payment, assuming you qualify for the special-use exemption. I think you have to qualify for that in order to even make use of that provision.

So I still see the administration locked into an old philosophy of their political party: that it is the job of government to redistribute wealth rather than taxing for the purposes of enforcing government policy.

I am not proposing that we entirely eliminate the estate tax. But I hope for those who are more conservative than I am and want to eliminate the entire estate tax they would see our bipartisan proposal as a very significant step in that direction. Thank you.

The CHAIRMAN. I would point out to the distinguished Senator that Senator Baucus did discuss your legislation.

Senator GRASSLEY. All right. Well, I thank Senator Baucus.

The CHAIRMAN. So it did come to the attention of the panel.

Senator GRASSLEY. I thank you.

The CHAIRMAN. Senator Nickles.

Senator NICKLES. Mr. Chairman, thank you very much, and Senator Moynihan, and our panelists as well. I have had the pleasure of talking to some of our panelists on this issue.

Let me just make a couple of comments. I will not ask questions, except to follow up on what Mr. Beach said. He said maybe what we should do is reduce the rates. I have spent some time looking at that. I co-sponsored the effort, with Senator Grassley and others, to increase the exemption, and I think that is good.

But the rates are too high. If you have a taxable estate of $1 million, you are at a 39 percent marginal rate. If you have a taxable estate of $3 million, you have a marginal rate of 55 percent. That is too high. Why should government be entitled to take over half of someone's property because they are trying to pass it on to their kids?

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I learned about this the hard way. My father passed away, and we had a machine shop. All of a sudden, the government said it was worth a lot more than we thought it was. We did not know and we did not want to sell it.

We had a heck of a hassle determining the value, because we did not sell it. How do you know what the value of a privately-held company is that has zero book value unless you are going to sell it? Some things are not marketable unless they are for sale. So things are hard to determine, many times.

But why should Uncle Sam get 39 percent of anything above $1 million, or get 55 percent of a taxable estate above of $3 million? Mr. Gutman said, you have to have a taxable estate of $1.2 million. That is if somebody plans to have half of that estate go to their spouse and half go to their kids. That does not always happen. It does not always happen that way. A lot of people are surprised.

A lot of people die unexpectedly and they did not get their will wrapped up. A lot of people have inherited a 640 farm, and they added another 640 acres. The one that they bought or they inherited had very little value, the one they purchased 15 years ago did not have that much value.

All of a sudden, there is a new shopping center down the road, all of a sudden they have a $3.5 million estate and Uncle Sam says they want 55 percent of it. That is wrong.

So my point is, Mr. Chairman and Senator Moynihan, I really believe that we need to be working on rate reduction. I strongly believe that. We should have a zero rate up to $1 million. I am going to be introducing legislation that would have a 20-percent rate from $1 million to $10 million, and possibly a 30 percent rate above $10 million.

I just do not see how government should be entitled to take 55 percent of somebody's property because they are trying to pass it on to their kids. Frankly, the people that have the more generous estates, they work a long time to avoid it because they do not want to get caught in that problem.

I will give you another personal example. Since I ran this manufacturing company and we got burned one time very significantly and had to pay a lot of taxes on something that really was not making any money and it almost put us out of business I did not want that to happen. So then I started putting stock in my kids' names. Guess what? The kids did not go in the business. So then you have got to get it back. [Laughter.]

Senator NICKLES. I mean, there are lots of games going on to avoid estate taxes. I thought I was so wise. I am going to put this in the kids' names while it is low value and it will appreciate, and boy we avoided a lot of taxes. My point being, there are ways to get around it.

A 55 percent rate is way too excessive and it is way too progressive. It should not be a 39 percent marginal rate at a $1 million estate. You have got a lot of people now that are investing in 401(k)s because this committee created 401(k)s and savings accounts, and hopefully we will do more of that so they will be saving for their own retirement.

And they are going to have a home, and maybe it is in Cook County, or maybe it is in rural Illinois, or New York. They are going to have estates of $1.5 million or $2 million. A $2 million estate is a marginal rate of 45 percent. Uncle Sam should not be entitled to that.

So we do need to be working on rate reduction. I think there are a lot of people and businesses saying, why should we build, grow and expand? I am already in my late 50's. Why should I build another restaurant if I am the stage now where, to pass this on, the taxes are going to be so high I do not think I will bother.

I think there is a lot of disincentive in people's productive years, 50 and on. They are saying, why bother, because Uncle Sam is going to try and come in and take half of it and I do not want to put that kind of burden on my family, or to have my survivors fighting over the property. So, the heck with it, we will just let them sell it and divide up what is left of the proceeds.

Senator MOSELEY-BRAUN. Will my colleague yield?

Senator NICKLES. Certainly.

Senator GRASSLEY. Go ahead.

Senator MOSELEY-BRAUN. I just want to make the point that I thought that part of this hearing was for us to explore options here. Most European countries tax the recipient at what they inherit. And there have been some proposals around, we will just get rid of the estate tax altogether and just tax it as income to the recipient. I do not know that anybody here is ready to go along with anything like that.

But I just want to say to my colleagues on the other side, this is not a partisan issue. This is something that affects the well-being of the American people, and I think Democrats and Republicans alike want to see fairness and we want to do this right.

Senator NICKLES. Good.

Senator MOSELEY-BRAUN. Forgive me, my partisan hackles kind of went up because I heard, you Democrats want Uncle Sam to take all this money, and that is not the truth. The truth is, this is an area that we ought to have some bipartisanship, we ought to be able to stop talking about those things that are just flailing around and dividing Americans on a partisan basis, and saying how can we work out something that is fair to the American people, that is consistent with our interest in fairness, that makes our Tax Code work better, that makes it simpler, and gives people confidence that their government is a reflection of our collective will as Americans. This is not a partisan issue.

Senator NICKLES. I appreciate that.

Senator MOSELEY-BRAUN. And I would very much appreciate that we keep it on the level that this debate should be.

Senator NICKLES. I do not think I made any partisan comments. I know that we have bipartisan support on the legislation that Senator Grassley, and Senator Baucus, Senator Torcelli and others have co-sponsored.

So I think we have the initiation. In that legislation we had a $1 million exemption, and then we said for family businesses we are going to exclude 50 percent, up to $10 million, which I think is good. I like it. I came from a family business. But I think the real solution is to reduce the rates.

Senator MOYNIHAN. Mr. Chairman, could I say that the vote that we have been expecting has come. But before we leave, I wanted to thank Mr. Beach for reminding us that the whole idea of estate taxation came from those Iowa farmers in that progressive era. [Laughter.]

Senator GRASSLEY. You are being partisan. [Laughter.]

Senator MOYNIHAN. As you say, you have a little bit of that left in you, do you not?

Senator GRASSLEY. Let me say to Senator Moseley-Braun that I was partisan in that I was a little bit irritated about the White House not having a proposal other than what they had put before us.

I know that you understand. From downstate Illinois, you have got to understand what the problem is. I know you do, and I know you are not pursuing it in a partisan way. But I do not think the White House understands that or they would have come up with a better suggestion than what they had. That was my point.

I will call the panel, if you will watch the clock for me.

Senator MOYNIHAN. Thank you very much.

Senator GRASSLEY. I will dismiss this panel and then the Chairman did ask me to get started with the next panel. [Pause.]

For the third panel, we have just agreed we are going to recess for about seven minutes for the vote.

[Whereupon, at 11:49 a.m., the hearing was recessed to reconvene at 11:56 a.m.]

The CHAIRMAN. The committee will please be in order. I would like to call up the third panel. This panel consists of individuals who will share their experiences regarding the estate tax and how it affects their lives and businesses.

The panel consists of Mr. John Dudley of Comanche, Texas; Ms. Lee Ann Ferris, of Ketchum, Idaho; and Mr. Gordon Perkins, of LaPeer, Michigan.

Mr. Perkins, my condolences for your mother, who passed away in March. Thank you for being here with us.

Mr. PERKINS. Thank you, Senator.

The CHAIRMAN. Mr. Dudley, would you please begin.

STATEMENT OF JOHN DUDLEY, VICE PRESIDENT, TEXAS AND SOUTHWESTERN CATTLE RAISERS ASSOCIATION, COMANCHE, TX

Mr. DUDLEY. Yes. Thank you very much. Mr. Chairman, I appreciate the opportunity to be here. I am John Dudley and I am a rancher from down in Central Texas. The proverbial family farm, has been referred to many times this morning, and I qualify. I have lots and lots of relatives, and we all live right up and down the road on that same ranch. I do appreciate the opportunity to share how the death tax has affected me personally and my family.

We run a big old Hereford operation down in Central Texas, Mr. Chairman, and it has been in the family for a long, long time. We work pretty hard at it to keep it going.

By way of introduction of myself, I am an officer with Texas and Southwest Cattle Raisers, with a membership of 14,000 ranchers. I also speak for the National Cattlemen's Beef Association, which has a quarter of a million people involved in the production of food and fiber in the beef industry.

I am a director of a bunch of other ranch-related organizations down in my part of the world, and stay pretty busy with that.

My wife and I have been married a long time, and we really do enjoy the ranching business. We came back there consciously to do it. We have some real bright sons. They are in college, and I will tell you that it is my dear desire to encourage them to come back and be a part of this family business, but it is really getting hard to do it. Of course, the death tax is the reason for it.

My family's history in the ranching business goes way, way back, but a partnership formed in 1938 is what we are really talking about here. My dad and his two brothers and their wives formed a partnership. They continued to expand that business, which was pretty difficult throughout the years down there. They borrowed a lot of money from the Federal Land Bank and paid, and worked, and they kept expanding that business to accommodate their children, of whom there are many.

They set up a limited partnership back in the 1970's to sort of help facilitate that whole deal. Over the years, they accumulated quite a bit of land. It sounds like a lot of land, but out in the old hard part of the world that I live in, it is not as much as it sounds like. But they accumulated enough land to support themselves and their children. Today there are just about 30 of us in the family involved in that business.

In 1976, my dad passed away. We got a pay-out and it took 10 years and several hundred thousand dollars cash to pay his death taxes. Then in the early 1980's, one of the uncles passed away. It took 15 years and another severel hundred thousand dollars to pay off his tax bill. Of course, these tax payments really complicated our business practices. In fact, some of those payments overlapped. That was a pretty rough road that we travelled.

Of course, the result of all of this has been to sap the money out the business. We have got land, we have got cows, and it saps the money right out for the rest of the business. There are things we would like to do to enhance the environment, brush control, wildlife management, those kinds of things, and we simply have not had any cash to pursue those things. We have had to let some of those things just take the back burner.

There are three members of the original partnership who are still living, my mom, an uncle and an aunt, and they are all 80 plus. None of them are in good health. When they are called to their heavenly rest, I really do not have any idea at all how we are going to manage to service the death tax debt on those three estates.

We think the capital gains will come back around and nip us from behind too, because when we sell these assets—and that is what I think we are looking at this next time—we are going to be taxed for that sale too.

On these previous estates we have been pretty fortunate to be able to pay the tax withouthaving to sell some of this real estate. One thing we had to do, we had to lease our land to hunters. We like hunters all right, but the nature of our particular ranching enterprise makes it pretty hard for the two to coexit. But we had no choice at all, because that was a source of revenue.

Additionally, my dad has been dead for 20 years and my mother has only in the last 2 years realized any money from his estate. So, she has helped pay those death taxes. I say again, I really doubt that when she passes we will be able to pay tax debt without selling assets.

The cattle raisers have a survey, which you have a copy of, sir. There may be some things that would be of interest to you. We hope we can. We really feel, of course, ideally, I would love to see the tax repealed. But, if that is not to be, we really do need some help with the lower rates, increased exemptions and indexing estate valuations over time with inflation. I appreciate very much the chance to visit with you, sir.

The CHAIRMAN. Well, thank you very much, Mr. Dudley. We appreciate your taking the time to come to Washington to tell us the problems you and your family have faced.

It is now my pleasure to call on Ms. Ferris, who is from Idaho. Ms. Ferris.

Ms. FERRIS. Good morning.

The CHAIRMAN. Do I understand, are these pictures yours?

Ms. FERRIS. Yes. Those pictures are from our ranch, my father and my brothers, and then a picture of the ranch.

The CHAIRMAN. Magnificent country, no question about it.

Ms. FERRIS. Yes. We love it.

The CHAIRMAN. Please proceed, Ms. Ferris.

STATEMENT OF LEE ANN FERRIS, MEMBER, NATIONAL FEDERATION FOR INDEPENDENT BUSINESS, KETCHUM, ID

Ms. FERRIS. On behalf of the 600 members of the National Federation for Independent Business, I appreciate the opportunity to present the views of small business owners on the subject of estate tax.

My name is Lee Ann Goddard Ferris and I have been a member of the NFIB for more than 10 years. I have come to Washington from Central Idaho, and I have brought with me my mother, Mrs. Hilda Goddard, and my daughter, Natalia Ferris, to represent three generations that are being affected greatly by the estate tax.

The CHAIRMAN. May I just interrupt to say how pleased we are to have all three generations here.

Ms. FERRIS. My family's cattle ranch is 45 miles northeast of Sun Valley, Idaho in a valley called The Lost River Valley, outside of Macke. The ranch consists of 2,600 acres and we are a cow/calf operation. My youngest brother, Ross, lives and manages the ranch right now alongside my mother.

Although I am still involved in the ranching business, I live in a neighboring town called Ketchum, Idaho and my husband and I also rent and operate a small business.

My two brothers, my sister, and I all grew up working alongside my father, my mother, and my grandfather. We worked weekends, holidays, and summers branding, moving cattle, riding the range, and fixing fence. We did not have a lot of material things, but we had our family, we had the land, and we had the lifestyle.

On October 5th, 1993, my father was killed in a farming accident. His clothing got entangled. He was healthy. He was 71 years old. He worked from dawn till dusk. He loved that ranch and he loved his family. We were always a very close-knit family and the hub of our family was my father and the ranch.

My father's death was the most devastating experience that any of us have ever gone through. After the funeral and all that goes with that, the second most devastating experience was sitting down with our estate attorney. I will never forget the words he said: "There is absolutely no way you can keep this place." Like the economist on the last panel, I was like the dazed deer looking into the headlights.

I said, how could this be? We own this land. We paid this land off. How could we not keep this ranch? Our attorney proceeded to pencil out the estate taxes that would be due after my mother's death. It had taken my father and my grandfather their entire lifetimes to build this up, and now we could not continue on and the grandchildren would not be able to enjoy the heritage and lifestyle that we had known all our lives.

It has been three and a half years since my father's death. We have spent thousands of dollars in attorney's fees and we still do not know what we are going to do. But one thing is, if this tax is not changed, we will not be able to keep our ranch.

Our estimated estate taxes on the family ranching assets are $3.3 million. We gross approximately $350,000 from the cattle. Without the land being paid for and tight operating costs, we would not be able to make money from this business. To spread the $3.3 million out over 14 years at 4 percent is of no value to us. That would mean that we would have to pay $241,000 a year, which is virtually impossible for us.

This tax also promotes tremendous debt. My mother and father paid off the final mortgage payment on the property 4 years prior to his death. We were all excited because finally we owned everything free and clear, we owed nothing. But little did we know that we had a silent partner looming out in the air.

Currently, we are selling off some of our most-needed spring ranges in order to buy my mother a $1 million life insurance policy so, in case of her sudden death, we could at least pay off a third of the taxes and not have to have a fire sale.

This tax has been a tremendous strain on my mother. She worries constantly. She has had many sleepless nights, trying to figure out what to do. I do not know if you could imagine how hard it would be to have lost your husband, to have worked your whole life and put all your extra after-tax money back into the land, and then at the end have to think about leaving it and not being able to pass it on to your children.

This scenario is happening to many of the ranchers in our valley. Eighty percent of the ranches are family owned, second and third generation. The land has risen dramatically in the last 5 years. All of these ranchers live on modest incomes and most of them can barely educate their children.

I have heard that the estate tax redistributes wealth, but I feel in my situation it has done just the opposite. For my family, the tax means that we will not be able to run the ranch that has been our heritage for 60 years.

I hear a lot about being pro-family from Congress, from the administration, from our State leaders, but I can say personally that I feel this tax is anti-family. Mr. Chairman, members of the committee, I urge you to ask yourselves, why does this tax exist? Is it worth the great harm that has caused my family and others? If it is not worth the harm, then the tax should not exist. I hope that you will do everything in your power to eliminate the Federal death tax.

Thank you again for the opportunity to let me share my testimony.

The CHAIRMAN. Well, thank you, Ms. Ferris, for an extremely interesting and eloquent statement.

[The prepared statement of Ms. Ferris appears in the appendix.]

The CHAIRMAN. Now we will hear from Mr. Perkins.

STATEMENT OF GORDON PERKINS, PRESIDENT, PERKINS FLOWERS, INC., LaPEER, MI

Mr. PERKINS. Mr. Chairman, members of the committee, I am also pleased to have the opportunity to present testimony today on the issue of estate tax reform. My name is Gordon Perkins. I am president of Perkins Flowers, Incorporated, a retailer and grower of flowers and trees in LaPeer, Michigan.

I am also the president of the Ohio Florists Association, past president of the Michigan Florists Association, and a member of the Society of American Florists. Our National trade association represents our entire industry.

My grandfather started in the flower business in 1903 in Ohio. In 1954, my parents moved the family operation to Michigan by purchasing an existing greenhouse and flower shop.

During the past 43 years in Michigan, our company has grown and now operates our original greenhouse and flower shop, along with an additional flower shop, retail garden center, and a small landscape and tree business.

Upon my father's death in 1981, I took over as president of the company, guiding it through the last 16 years. In 1989, we had the pleasure of my life when my son Chad joined the company. So for the last 7 years, my mother, myself and my son have all had the rare opportunity of three generations working together—my mother managing the flower shop, my son managing the garden center and tree farm/landscaper operation, and me running around somewhere in the middle trying to keep up with those two.

My mother, at the age of 83, still worked a 60-hour plus work week. She arrived every day, 6 days a week, at 6:00 in the morning and left at 5:00 every day. For Valentine's week—of course that is a little bit of an unusual week—she would work in excess of 80 hours that week.

Why I say that she worked, is because four weeks ago yesterday my mother passed away. It has been a very difficult time for us, our family, but also our employees and the whole community, because my mother was something else.

But, even with our estate planning done as recently as 1994 by the experts, the early estimates of $200,000 or more in tax liability could put us out of business. Even if we do survive, as you have heard time and time again, we will have to sell assets to provide income and employment.

With that, all of the comments that I have been sitting back listening to today, I have echoed in the rest of my comments the situation that has been played out to us can be found in relation to the comments that we have had today in my written statement.

However, I jotted down some notes, if I could, as I was going along, of some areas that, to my way of thinking, are very, very important and really have not been covered. You see, the whole business of Perkins Flowers and many small businesses is not the family. It is not just the family.

I have 30 employees, 15 of which have been with me an average of 17 years. I have two employees that have been with the company longer than I have. I have a woman that works in my greenhouse that has been with me 35 or 38 years, that that is the only job she has ever had. The employees are the dedicated work force that makes small families work together for the betterment of their community.

I could not even begin to come to Washington if it was not for those people. This is our busiest time of year. It is crazy. I walk in and I do not know what is going on. In the last four weeks, my people have made this thing happen.

Just some of the comments, if I could, very quickly. One of the women that works for me has worked for us 19 years, and her comments are in my statement. But Saturday, I asked all of my employees that worked that day to write down two or three sentences about why they worked for Perkins Flowers. I have those here, which I am just going to touch on.

I have Regis McQue, at age 56, and employed with me 13 years, a maintenance supervisor, retired Navy. "Why do I work at Perkins Flowers? I work at Perkins Flowers to supplement my Navy retirement pay. This position has been a wonderful opportunity to expand myself in ways unknown through my naval career."

I have the manager of my Metamoire store. It is a lady, 39 years old, employed with me for 5 years. "I chose Perkins Flowers because they have a reputation in the flower business." Skipping on, "I always respected the company and their work. I also was looking forward to, 5 years ago, I felt I would provide the financial forward-looking support I required."

These make very interesting reading for me, because it goes on and on about why they work. They want to work at a small business that they have been working with.

One of the comments from my students was, "I work here so I do not have to flip burgers, but I love the people, too."

The next thing I just briefly would like to expand on that I do not think has been questioned is, as I sit here in front of you today facing the estate tax dilemma and we get through this and we survive, but what, in reality, am I really looking at? If I sit here before you and I die of a fatal heart attack, which, with the stress sitting on this side of the table, it may just happen. [Laughter.]

The CHAIRMAN. We are not as bad as you think.

Mr. PERKINS. This is a very interesting day, really. But if that did happen, the business estate and the stock that I inherited from my mother would be taxed again, and a stock that I had would be, of course, subject to tax.

My personal liquid assets are not as great as my mother's, but now because she was minority stockholder—we took care of that through estate planning—we can take the discount allowed. But now, at 51, I am majority stockholder, so now I get no discount. I have more of the stock.

When I did the projections before I came of what really would happen if I were to die on my way here, the estate tax on my company would be equal or more than the estate tax that I have not even paid yet.

My son says, stay healthy, dad. But in reality, if he is a stockholder and my son meets an untimely death, we still have to go through the whole procedure.

Very quickly, one other point, if I could. The preparation costs. What was it? Estate surprise. I will give you estate surprise. For the last three weeks I have been meeting with my attorneys and my accountants, on a never-ending basis, it seems like, and my estate surprise for the day last week was the quote or the estimate of the cost that it was going to cost my company to appraise our company's stock. Not appraise the land or all the other things, just to appraise my company's stock, is going to cost us between $7,000 and $10,000.

The cost of appraising my business so far, as I have tallied it up through the attorney and CPA's land appraisals and stock appraisals, is $21,000. That is for only the business side of the estate. The other side could cost us $5,000 to $10,000 more. That was my estate tax surprise. I expected some, but not that high.

Life insurance is my last point, if I could, please.

The CHAIRMAN. Please proceed.

Mr. PERKINS. Life insurance. That is right, life insurance. The only problem with using life insurance as a tool to pay Federal estate tax is that, as you acquire life insurance—and I acquired life insurance in 1965, and I bought a brand-new house, and I bought enough life insurance to pay for that house. That house cost me $17,000. I had $25,000 worth of life insurance. Now when I have the heart attack sitting in this chair, my wife can go out and buy a fairly nice car.

My mother had a life insurance policy that she got in 1935. It was $500. On February 28, she paid the $8 per year premium. I called the company and found out what this all was about. In 1935, that was a lot of money. Now it has accumulated all the way up to $2,200, which is about $500 less than her casket was.

We bought life insurance on my mother in order to make sure that we had cash for the springtime, so we had cash flow. Not to pay taxes, so we could have cash flow. You know what it costs me to buy $100,000 or $200,000 on a healthy 78-year-old woman out of my company? $200,000 life insurance cost me over $20,000 a year. Thank goodness I had, because we would not be in business.

Just in closing, I really, really would like to thank you for the opportunity to come and speak. If there are any questions, I would be pleased to respond.

The CHAIRMAN. Thank you, Mr. Perkins, Ms. Ferris, and Mr. Dudley, for very moving accounts as to the impact of the estate tax on, frankly, those who have succeeded. Each of you have an American story of success that has been important not only to you and your immediate family, but, as a number of you have spelled out, to the employees of your farm or of your business.

Let me say that I sympathize very much. We did try to, in a small way, address the problem in legislation we enacted 2 years ago, which was vetoed. We will again try to bring some relief, because there is something wrong with a system that seems to penalize the great American success story.

I only have one question that I would like to ask. The statement was made earlier that people can plan to minimize estate tax liability. Would you agree with that, Ms. Ferris?

Ms. FERRIS. Well, I think planning estate taxes can be a very emotional issue. With my father, he thought he had plenty of time, as we all do. I think it is not a business issue, like it was stated, that if you are a good businessman you would plan.

I think a lot of people avoid it, just for the emotional reason. Not a lot of people like to think about their death. Then there is the issue of how much to give each child, and when do you come up with that. I do not think it is as cut and dry as, you are not a good businessman if you do not plan.

The CHAIRMAN. With that, I would agree.

Mr. Perkins?

Mr. PERKINS. Well, I know that was one of the toughest things I had to do in 1994, is sit in an attorney's office and talk with my mother about death taxes and about it having to be done to transfer stock. It is a very, very difficult, emotional thing to do, especially when you are in the business and you have a brother not in the business and you have to take it on yourself. It is very difficult.

The CHAIRMAN. Thank you.

Mr. Dudley?

Mr. DUDLEY. Yes, Senator. My dad died about 20 years before he planned to. Longevity is a tradition in our family, and he was about the business of trying to plan and think and how to transfer some assets without losing control, which I think is a factor in many minds when it comes to estate planning, and he simply did not make it, and there we were.

In the ensuing years, once you have one of these pay-out estates at work, then you are very limited by what you can do without changing where you have already settled. So that is really what we are looking at, in a family which has so many members, as ours does.

The CHAIRMAN. Senator Moynihan.

Senator MOYNIHAN. Mr. Chairman, first of all I want to wish Mr. Perkins the best of health. [Laughter.]

Mr. PERKINS. Thank you.

Senator MOYNIHAN. I think I had better go home and start thinking about this myself. I just turned 70 and I guess it is time I did, I think. This has been important testimony. Clearly, this is a matter we need to address, and I think we can. I look forward to working with you. Thank you.

The CHAIRMAN. Well, you have made the problem very real and very human. I just want to say how much the committee appreciates your taking the time. I know it is not convenient and it is difficult to talk about these matters.

I have to agree with you, Mr. Perkins, it is a lot easier to sit up here and ask the questions than sit down there and answer them.

But you all did superbly well, and we are indebted to each and every one of you.

Thank you very much. The committee is in recess.

[Whereupon, at 12:27 p.m., the hearing was concluded.]

APPENDIX

ADDITIONAL MATERIAL SUBMITTED FOR THE RECORD

PREPARED STATEMENT OF WILLIAM W. BEACH

My name is William W. Beach, and I am delighted to present the following arguments in support of estate tax repeal to the Committee on Finance of the United States Senate. I am the John M. Olin Senior Fellow in Economics at the Heritage Foundation, a Washington based public policy research organization. The following remarks constitute my own opinions, and nothing in this testimony should be construed as representing the views of The Heritage Foundation or support for any legislation pending before the Congress.

Between 1913 and 1916 the Congress deployed a system of income taxation with two, principal objectives: to raise revenue for the federal government and to contain the economic power of wealthy individuals through taxation. This latter objective dominated Congress's discussion of income taxation and inspired support among political activists during the ratification process for the Sixteenth Amendment to the United States Constitution. In its common translation, Congress intended the "containment" objective to address the following problem: the increasing concentration of wealth in the hands of a few individuals prevents many Americans from enjoying the economic opportunities that this country was founded to provide and that our fundamental law protects.

While revenue requirements were always high on Congress's agenda, especially during the ensuing world war, it is fair to say that the containment of private, economic power was the fundamental public policy goal that Congress intended wealth taxation to achieve. It also is fair to say that, after eighty years of estate taxation, this objective has not been met.

Indeed, intergenerational wealth transfer taxation has produced a set of effects almost completely opposite its original purpose. We now know that the estate tax actually bears down most heavily on the intended beneficiaries of wealth containment, not the tax policy's apparent targets. It places unnecessary and damaging burdens

- on owners of small and medium-sized businesses, often are ethnic or female, who discover too late for remedy that their legacy of hard work and frugality will not pass to their children but instead will fall victim to confiscatory taxation and liquidation;
- on farmers, many of whom are descendants of the Populists who rallied at the end of the nineteenth century in support of wealth taxation and who lose their farms today not because of wealthy agribusinesses or capitalist "robber barons" but because the federal government demands a tax payment upon death from people who have invested their earnings back into their family legacy and have maintained meager liquid savings;
- on workers who suffer when small and medium-sized businesses are liquidated to pay estate taxes and when high capital costs depress the number of new business creations that could offer new jobs;
- and poor people who are harmed by the estate tax, not only because the general economy is weakened by the estate tax's rapacious appetite for family-owned businesses but also because the estate tax discourages savings and encourages consumption (particularly among wealthy individuals), thus undermining the federal income tax from which the funds are raised to support programs for disadvantaged Americans.

If it was Congress's intention to craft a public policy that threatens and destroys small and medium-sized businesses, devastates rural communities, weakens the economy and depresses job growth for new and displaced workers, and makes it more, not less, difficult for poor people to rise up the income ladder and participate more fully in the economic opportunities of American civilization; they could have done little better than the estate tax. But this outcome, of course, was precisely the opposite of Congress's purpose.

U.S. wealth taxation policy surely is a classic instance of unintended consequences. Reversing these perverse results should be the current Congress's principal tax policy program. It is politically unconscionable as well as morally dubious to assert, on the one hand, that a principal objective of U.S. tax policy is to expand economic opportunity for disadvantaged Americans—blacks, Hispanics, women, workers, and poor people—while, on the other hand, vigorously enforcing a part of U.S. tax policy that contracts their economic opportunity.

This dilemma is resolved only by repealing the estate, gift and generation-skipping tax. Reforms that "protect" certain taxpayers from the estate tax (an intriguing admission in itself of the contradictions inherent in the law) through increases in the unified credit do nothing for those Americans above the new taxable threshold but who are no different from their brothers and sisters just below that threshold except that they are modestly more successful.

Reforms do nothing for workers in firms that are not "protected," for farmers whose land values have risen above the new threshold because they abut a new suburb or cross a cellular transmission grid, or for poor people living in an economy still insufficiently robust to lift them out of poverty.

Reforms do nothing to reverse the incentive to consume rather than save or to purchase expensive life insurance, legal and accounting advice that moves resources to sectors of the economy that do little to raise worker productivity and worker wages. And reforms do nothing to resolve the public's increasing demand that Congress enact substantive tax reforms that result in a simpler, flatter, and fairer tax system.

It is ironic but perhaps fitting that most of the energy for estate tax repeal has come from political conservatives. One would think that the rich tradition among American liberals of supporting middle class incomes, jobs for new workers, economic opportunities for disadvantaged groups, and protection of the family farm would have made estate tax repeal a top objective. Surely the objection that repeal would only benefit rich people could be addressed by modest changes to capital gain tax law where, indeed, many wealthy people currently choose to be taxed. And surely the objection that too much revenue would be lost with repeal could be addressed by simple demonstrations that the estate tax currently undermines the income tax directly through legal avoidance schemes that shelter income and indirectly through consumption rather than savings.

Take, for example, the growing evidence of the estate tax's harm to the general economy and to jobs in particular. Economists across a wide political spectrum have produced a rich body of empirical and inferential evidence that the estate tax reduces economic activity and fails to achieve its stated purpose. For example, Alan Blinder, who served in President Clinton's first Council of Economic Advisers and later as Vice-Chairman of the Board of Governors of the Federal Reserve System, argued that "[t]he reformer eyeing the estate tax as a means to reduce [income] inequality had best look elsewhere." [1]

The results of macroeconomic analysis support the conclusions by economists like Professor Blinder. In simulations of estate tax repeal using prominent models of the U.S. economy, analysts are finding that reducing the tax burden on wages and capital leads to significant improvement in job creation and overall economic performance.

An analysis by The Heritage Foundation using the WEFA Group's U.S. Macroeconomic Model and the Washington University Macro Model found that repealing the estate tax would have a large and beneficial effect on the economy.[2] Specifically, the Heritage analysis found that if the tax were repealed this year, over the next nine years:

- the nation's economy would average as much as $11 billion per year in extra output;
- an average of 145,000 additional new jobs could be created;
- personal income could rise by an average of $8 billion per year above current projections; and
- the deficit actually would decline, since revenues generated by extra growth would more than compensate for the meager revenues currently raised by the inefficient estate tax.

The growing interest of academic and policy economists in the estate tax is joined by an emerging focus among political theorists on the policy implications of wealth transfer taxation. Again, the complex estate and gift tax edifice rests on the foundation that taxing intergenerational wealth transfers results in less concentrated wealth holdings and that this leads in turn to greater economic opportunity and a more democratic society. If the tax's supporters cannot sustain the argument that the estate tax improves equality of economic opportunity, then there exists little else (except perhaps inertia) to recommend continuation of this part of U.S. tax policy. Other, simpler taxes could meet revenue objectives far more efficiently and fairly.

Discussion among political theorists of intergenerational wealth taxation is largely a response to the most important theoretical treatise on liberal egalitarianism, John Rawls's *A Theory of Justice*.[3] Since its publication in 1971, this careful, magisterial presentation of the case for liberal democracy infused with just institutions has permeated thinking on most issues in social and political theory. It is fair to say that no stronger theoretical case for intergenerational wealth taxation exists.

At the center of Rawls's case for wealth taxation is the principle that "[a]ll social primary goods—liberty and opportunity, income and wealth, and the bases of self-respect—are to be distributed equally unless an unequal distribution of any or all of these goods is to the advantage of the least favored."[4] While at first blush this principle would appear to suggest radical egalitarianism in economic and political life, Rawls recognizes the superiority of "free" over socialized markets to produce benefits for the least advantaged citizens, which leads him and many like-minded political theorists to support significant differences in the economic conditions of individuals within a generation. After a century of economic experimentation, there can belittle doubt that everyone achieves greater economic benefit when individuals are allowed to discover their own comparative advantage and focus their labor in the area where they can make the greatest economic difference.

This tolerance for intragenerational differences leads Rawls to oppose all income taxes, since economic income stems from natural differences in talent and from differing propensities of individuals to apply themselves to hard work.[5] However, two principles considerations compel Rawls to take substantial exception to intergenerational differences in economic condition.

First, Rawls opposes the transfer of accumulated property to succeeding generations because it undermines the first principle of a just society: that everyone has "an equal right to the most extensive total system of equal basic liberties compatible with a similar system of liberty for all."[6] Those who begin with a significant unearned endowment of property resources place others not so advantaged in a less equal condition, and this undermines the principle that everyone should have access to the same system of equal basic liberties.

Second, this difference might be tolerated if it produced greater benefits for the least advantaged than for the advantaged. However, intergenerational wealth transfers create benefits that flow in the opposite direction: Over time, they enhance the advantages of inheriting generations and generally degrade the liberties of the unbenefitted. The "[t]he taxation of inheritance and income at progressive rates (when necessary), and the legal definition of property rights, are to secure the institutions of equal liberty in a property-owning democracy and the fair value of the rights they establish."[7]

While Rawls does not advance confiscatory taxation of intergenerational wealth transfers, his argument does imply substantial taxing discretion by the state. In his universe, the state guides the institutions of distribution; should government determine that wealth transfers constitute significant barriers to the equal enjoyment of liberties (as defined by Rawls), it clearly has the power to tax away as much of the wealth that moves between generations as it deems necessary to restore justice.

A number of objections could be raised against the Rawlsian case for wealth transfer taxation, not the least of them being the questionable assertion of government authority over the intergenerational disposition of private property. If wealth is acquired legally and transferred peacefully (that is, in some non-tortious fashion that breaches no contract pertaining to property), government has no ethical standing to interfere with its disposition.

Of course, liberal egalitarians claim a more expansive role for government, a principal element of which is the progressive enhancement of equality of condition among citizens. Thus, it is important first to consider the estate tax within the context of the argument that justifies the tax's existence. If it can be shown that the estate tax does not advance the ethical program of the liberal egalitarians, then other objections to this tax that can be raised without assuming this ethical and moral framework become more compelling.

This approach to analyzing the estate tax was taken in a seminal monograph by Edward J. McCaffery published in *The Yale Law Journal* in 1994.[8] Professor McCaffery comes to the debate over the estate tax with impeccable political credentials. Unlike many critics of intergenerational taxation who frame their objections within a larger, politically conservative analysis of contemporary government, McCaffery formulated his critique of the estate tax within a liberal framework. As he stated last year before this committee:

> I am an unrequited liberal, in both the classical and contemporary political senses of that word, whose views on social and distributive justice might best be described as progressive. I used to believe in the gift and estate tax as a vehicle for obtaining justice. As to the latter belief, only, I am now prepared to confess that I "was blind, but now can see."[9]

McCaffery raises five general objections to the liberal egalitarian argument supporting intergenerational wealth taxation. Each of them assumes the ethical and moral objectives of the liberal program.

(1) *The currently combined income and estate tax system encourages large inter vivos gift transfers, which have the effect of creating a greater inequality of starting points or a less level economic playing field.* This predictable effect of the estate tax law is aggravated further by the fact that high estate tax rates encourage the consumption rather than the transfer of wealth. Purchasing goods and services instead of saving the funds that support that consumption produces larger differences between rich and poor people. Thus, the estate tax is illiberal because it undermines rather than advances the liberal egalitarian objective of equality of economic opportunity.

(2) *While higher wealth transfer taxes might reduce the level of inter vivos gifts, and other tax law changes could be made to penalize the spending behavior of rich families, it currently is both practically and politically impossible to do so.* On the one hand, analysts are becoming increasingly aware of the intergenerational focus of much current saving behavior at all income levels. Liberals should promote the creation of transferable wealth among the less advantaged. On the other hand, politicians are becoming increasingly aware of how much voters want taxes to fall, not rise. The estate or inheritance tax has been repealed in Australia, Canada, Israel, and California; and the movement for tax reform is a spreading, worldwide movement.

(3) *There will always be differences between the starting conditions of people in a non-ideal world.* If liberal egalitarians attempted to eliminate all the differences that stem from intergenerational wealth transfers, they would risk leaving the least advantaged even worse off than they were before. Not only would confiscatory taxation reduce the consumption behavior of wealthy people, thereby also reducing employment and incomes among poorer citizens, but it would depress the amount of economic capital as well, thereby reducing economic expansion and income growth, both of which are central to improving the conditions of the least advantaged.

(4)*"[It] is the use and not the mere concentration of wealth that threatens reasonable liberal values."*[10] Generally speaking, the accumulation of savings and the promotion of earnings that underlie the growth of savings are "goods" that liberals like. Earnings and savings create a "common pool" of resources that can be used to promote improvements in the general welfare through public and private means. Liberals generally regard the consumption behavior of the wealthy as objectionable; thus, wealth transfer taxation, which attacks savings and promotes wanton consumption, is wholly ill-suited to the attainment of an ideal liberal society.

(5) *The best tax policy that liberal egalitarians could pursue, if attaining liberal social and political objectives truly motivates the liberal program, is one that taxes consumption, not savings.* McCaffery writes that "[b]y getting our reasonable political judgments wrong—by taxing work and savings while condoning, even encouraging large-scale use [consumption]—the status quo impedes the liberal project . . . The real threats to liberty and equality from private possession alone turn out, on closer scrutiny, to relate to possession qua potential or actual use, each of which can be addressed—indeed, can best be addressed—in a tax system without an estate tax."[11]

Not only, then, is the estate tax inconsistent with a liberal program of promoting quality of economic condition, but it encourages behavior that works against liberal objectives. It supports consumption and depletion by penalizing savings and earnings. It encourages the kind of strange world where it costs less for a millionaire like Steve Forbes to spend $30 million of his own money on a presidential campaign than to save $30 million for his children's future—an investment upon which he will pay 55 percent transfer tax as opposed to a campaign expenditure upon which no additional taxes are ever levied. How many new jobs and new businesses did Mr. Forbes's campaign create as opposed to the same amount saved in a bank that lends the funds to entrepreneurs and business managers?

Significantly for estate tax repeal, liberals and conservatives are beginning to answer this question in precisely the same way.

ENDNOTES

[1] As quoted in Edward J. McCaffery, "The Uneasy Case for Wealth Transfer Taxation," The Yale Law Journal, Vol. 104 (November 1994), p. 322, note 143. Also see Joseph E. Stiglitz, "Notes on Estate Taxes, Redistribution, and the Concept of Balanced Growth Path Incidence," Journal of Political Economy, Vol. 86 (1978), Supplement, pp. 137-150; Alan S. Blinder, "A Model of Inherited Wealth," Quarterly Journal of Economics, Vol. 87 (1973), pp. 608-626; Blinder, "Inequality and Mobility in the Distribution of Wealth," Kyklos, Vol. 29 (1976), pp 607, 619; Michael Boskin, "An Economist's Perspective on Estate Taxation," in Death, Taxes and Family Property: Essays and American Assembly Report, ed. Edward Halback, Jr. (St. Paul, Minn.: West Publishing Co., 1977); Lawrence H. Summers, "Capital Taxation and Accumulation in a Life Cycle Growth Model," American Economic Review, Vol. 71 (1981); Martin Feldstein, "The Welfare Cost of Capital Income Taxation," Journal of Political Economy, Vol. 86 (1978); and Laurence J. Kotlikoff, "Intergenerational Transfers and Savings," Journal of Economic Perspectives, Vol. 2 (1988).

[2] This study was prepared by The Heritage Foundation and published on August 21, 1996. See William W. Beach, "The Case for Repealing the Estate Tax," Heritage Foundation Backgrounder No. 1091. The methodologies, assumptions, conclusions, and opinions therein are entirely those of The Heritage Foundation. They have not been endorsed by, and do not necessarily reflect the views of, the owners of these two macroeconomic models.

[3] John Rawls, A Theory of Justice (Cambridge, Mass.: Harvard University Press, 1971).

[4] Ibid., p. 303.

[5] Rawls advances a consumption tax to replace income taxes. "For one thing, it is preferable to an income tax (of any kind) at the level of common sense precepts of justice, since it imposes a levy according to how much a person takes out of the common store of goods and not according to how much he contributes (assuming here that income is fairly earned)." Ibid., p. 278.

[6] Ibid., p. 302.

[7] Ibid., p. 279.

[8] Edward J. McCaffery, "The Uneasy Case for Wealth Transfer Taxation," The Yale Law Journal, Vol. 104 (November 1994), pp 283-365.

[9] Edward J. McCaffery, "Testimony before the Senate Committee on Finance, June 7, 1995."

[10] McCaffery, "The Uneasy Case for Wealth Transfer Taxation," p. 296.

[11] Ibid.; emphasis in original.

PREPARED STATEMENT OF HON. JOHN H. CHAFEE

Mr. Chairman, I want to thank you for holding this hearing today on the estate tax. Over the last several years, I have become increasingly concerned with the negative affect that the inheritance tax has on the environment.

The estate tax negatively influences the environment because it precipitates the sale and development of our nation's open spaces. This is a serious environmental problem facing the country today. All across the country, farms, ranches, forests and wetlands are forced to give way to the pressures for new office buildings, shopping malls and housing developments.

America is losing over four square miles of land to development every day. In Rhode Island, over eleven thousand acres of farmland have been lost to development since 1974. More and more frequently, the development pressure comes from the need to raise funds to pay estate taxes.

For those families where undeveloped land represents a significant portion of the estate's total value, the need to pay the tax creates powerful pressure to develop or sell off part or all of the land or to liquidate the timber resources of the land. Because land is appraised by the Internal Revenue Service according to its "highest and best use," and such use is often its development value, the effect of the tax is to make retention of undeveloped land impossible.

In addition, our current estate tax policy results in complicated valuation disputes between the donor's estate and the Internal Revenue Service. In many cases, the additional costs incurred as a result of these disagreements cause a potential donor of a conservation easement to decide not to make the contribution.

These open spaces improve the quality of life for Americans throughout this great nation and provide important habitat for fish and wildlife. The question is how do we conserve our most valuable resource during this time of significant budget constraints.

We need to restructure the nation's estate tax laws to remove the disincentive for private property owners to conserve environmentally significant land. The American Farm and Ranch Protection Act, which I introduced along with Senators Baucus and Gregg, helps to achieve this goal by providing an exemption from the estate tax for the value of land that is subject to a qualified, permanent conservation easement.

This bill is similar to legislation that we introduced during the 104th Congress and was included in the Balanced Budget Act of 1995. It excludes land subject to a conservation easement from the estate and gift taxes. Development rights retained by the family—most frequently the ability to use the property for a commercial purpose—remain subject to the estate tax.

In order to target the incentives under this bill to those areas that are truly at risk for development, the bill is limited to land that falls within a 50mile radius of a metropolitan area, a national park or a national wilderness area, or an Urban National Forest.

Conservation easements, which are entirely voluntary, are agreements negotiated by landowners in which a restriction upon the future use of land is imposed in order to conserve those aspects of the land that are publicly significant. To qualify for the estate tax exemption under this bill, such easements must be perpetual and must be made to preserve open space, to protect the natural habitat of fish, wildlife or plants, to meet a governmental conservation policy, or to preserve an historically important land area.

Prepared Statement of Hon. Susan M. Collins

Mr. Chairman, thank you very much for giving me an opportunity to testify this morning before the Senate Finance Committee in support of S. 482, estate tax relief legislation I was proud to sponsor last month.

It is no accident that S. 482, the Family Business and Family Farm Preservation Act of 1997, was my first bill as a member of the United States Senate, for I fervently believe that small, family enterprises hold the key to our economic growth and prosperity and that government policies must promote and not undermine their continued existence.

Simply put, the extremely high estate tax rates make it very difficult for many families to pass their businesses on to the next generation—the very opposite of what government policy should be. After allowing for what is essentially a $600,000 exemption, an amount which has not been increased in a decade, the marginal rates that effectively apply for estate tax purposes range from 37% to 55%, higher than any other generally applicable federal tax rates. Adding insult to injury, some of what we leave to our children has already been subject to income taxation, and the combined effect of income and estate taxes can be a tax bite as high as 73%.

It should come as no surprise that when a family business or farm is left to the sons and daughters of the owner, the estate often lacks the cash to pay the tax. A 1995 Gallup survey found that one-third of the owners of family businesses expect that some or all of the company will have to be sold to satisfy estate tax liabilities. That this actually comes about is reflected in the experience of the inheritors of such businesses, 37% of whom reported that they had to shrink or restructure the enterprises solely to meet estate tax obligations.

Behind these statistics are the stories of hard working Americans whose life's work is dismantled by a confiscatory tax. One of those stories was recently told to me by Judy Vallee of Cumberland, Maine.

In 1933, her father opened a restaurant in Portland and worked hard over time to expand the business into a chain of 25 restaurants along the East Coast. When he died in 1977, the family was left with a staggering estate tax bill of more than $1 million. Lacking the cash to pay the tax, they had to take on partners outside the family, totally restructure the company, and arrange to pay the tax in installments. Unfortunately, even these measures were not enough, and they ultimately had to liquidate the business at fire sale prices.

Ironically, Ms. Vallee now finds herself in the very same situation, but as a business owner and not a potential heir. When the original business was liquidated, she managed to purchase one of the restaurants in her own name, which she has now developed into a prosperous enterprise. Eager to leave the restaurant to her son and desperate to ensure that history does not repeat itself, her family has spent a small fortune on life insurance to enable her son to enjoy the fruits of her own hard work.

Mr. Chairman, jobs are the primary worry of Maine people, and often overlooked in this debate is the negative effect of the estate tax on employment. A potato bag manufacturer in northern Maine, one of the poorer areas of my state, has told me that he would be able to expand his operation and add jobs were it not for the money he has to spend on estate planning and life insurance.

In another instance, the owner of a Maine trucking company made the painful decision to sell the business to a large, out-of-state corporation rather than leaving it to his children and forcing them to assume a large debt to pay the estate tax. Not only was he compelled to abandon what he and his father before him had spent their lives building, but making matters worse, the new corporate owner moved the administrative operations out of state, costing Maine 50 good jobs.

Maine's experience is common throughout our nation. The Gallup survey found that 60% of business owners reported that they would add to their work forces were it not for the estate tax. Two studies mentioned in a Wall Street Journal editorial in February quantified the job losses caused by this levy—one put it at 150,000 and the other at 228,000. In a word, the harm is widespread.

My bill, S. 482, would give relief to small businesses. It would raise the amount effectively excluded from the tax from $600,000 to $1,000,000, which probably does little more than compensate for inflation during the past decade. While $600,000 understandably seems like a considerable sum, many small businesses require investment in complex or heavy equipment which easily exceeds that threshold.

Referring to a machine essential to his business, the owner of a Maine sawmill recently asked me, "What are my sons supposed to do? Sell the debarker to pay the tax?" There is no Justification for this legal "Catch 22," under which the second- or third-generation business owner can only pay the tax by selling essential assets.

My legislation would also lower the effective tax rate for the next $1.5 million from 55% to 27.5% and would increase from 10 to 20 years the time during which family businesses could pay the tax on an installment basis.

These measures are not designed to provide relief to large enterprises. Rather, the beneficiaries, Mr. Chairman, will be enterprising Americans, many of whom risk their life savings and work at their factories, mills, offices, and farms seven days a week to build a small business, with the reasonable expectation that their government will let them pass it along to their children.

Prior to becoming a member of the Senate, I ran Husson College's Family Business Center in Bangor, Maine. I would share with you two lessons I learned from that experience. First, those family business owners who understand the estate tax cannot comprehend why the federal government imposes a tax that undermines the very type of activity it says it wishes to encourage. Second, many small business owners do not take the extreme measures required to prepare for the estate tax, often with devastating and totally unexpected consequences for their families.

Why do I call these measures extreme? In the Gallup survey, the respondents estimated spending an average of more than $33,000 over 6 and 1/2 years on lawyers, accountants, and financial experts to help plan and prepare for the estate tax. The cost is not only monetary, for the average number of hours spent in the planning process was 167.

As currently designed, the estate tax represents bad public policy. In my state, it is the 30,000 small businesses, many of them family owned, which provide most of the new employment opportunities, and it is these businesses which will account for 2/3 of the new jobs in the future. By discouraging the development and expansion of family enterprises, the estate tax stands as the enemy of job creation and economic growth.

Mr. Chairman, it is time for our actions to match our rhetoric. If we believe in promoting family businesses, as we say we do, and if we believe in promoting family farms, as we say we do, we must change a tax policy which takes the family out of the family business and family farm. Mine is not a call for government assistance or for special treatment. Mine is a call to reform an unfair, destructive, and confiscatory tax.

Again, Mr. Chairman, thank you very much for allowing me to share my thoughts on estate tax relief legislation with the Committee.

KEY PROVISIONS OF THE FAMILY BUSINESS & FAMILY FARM PRESERVATION ACT OF 1997

(1) For family-owned businesses (including farms) the exemption from federal estate taxes is effectively increased from $600,000 to $1 million.

(2) For the next $1.5 million in assets, the top tax rate would effectively be 27.5%—half of the current 55% rate.

(3) Increase from 10 years to 20 years, the time during which family-owned businesses can use an installment payment system to pay estate taxes.

APRIL 10, 1997

STATEMENT OF REP. CHRISTOPHER COX
CHAIRMAN, REPUBLICAN POLICY COMMITTEE
BEFORE THE SENATE FINANCE COMMITTEE

ON THE NEED TO REPEAL THE DEATH TAX

Chairman Roth, I want to commend you for your leadership in holding these hearings today, and I welcome the opportunity to talk about the urgent need for repeal of the death tax.

Mr. Chairman, this tax raises less than 1% of federal receipts. It is not paid by the rich and those who can afford the fancy lawyers and accounts needed to legally avoid the tax. It is paid by the small businessman and the farmer and by those who work for these individuals who pay a 100% tax when they lose their jobs as businesses are liquidated.

Having introduced legislation in each of the last three Congresses to kill the death tax, I am proud to report that support has grown as the American people recognize the danger this most unfair tax poses to them and their families. They realize that the death tax is unfair, confiscatory, and contrary to the values of hard work and saving on which this country built its success. In 1993, when I first introduced the Family Heritage Preservation Act, my bill had only 29 co-sponsors in the House and had not been introduced in the Senate. Today, the same legislation is endorsed by 136 members of the House and 27 members of the Senate.

As far back as 1982, the voters of California sent this message to their state legislature when they overwhelming supported Proposition 6, which repealed the California state inheritance tax. Nearly 65% of the voters in the most populous state in the nation repealed their state inheritance tax by popular initiative. Proposition 6 not only repealed these onerous taxes, but it stipulated that the state legislature could not reimpose this state death tax unless another popular initiative of the people instructed it to do so. Mr. Chairman, the people in my state could have tried changing the details of the law, they could have raised exemptions or lowered rates, but instead they wisely chose to do away with state death taxes completely.

More recently, Iowa has followed the example set by California. By overwhelming margins, the state legislature repealed the state inheritance tax. In New York, Governor Pataki has called on the state legislature to reform its extremely high state death tax rates, and many other states like Pennsylvania are beginning to follow suit. Foreign nations like Israel, Australia, and Canada, which are not considered to be low-tax nations, have repealed their death taxes due to the social and economic harm they cause. My colleague and friend on this panel, Senator Kyl, has with him today thousands of petitions that represent just a fraction of the millions of Americans who, like Californians in 1982, are fed up with the death tax.

Support for repealing the death tax transcends the usual boundaries that often seem to divide us. Democrat and Republican, rich and poor, white and black, people around the county want to kill the death tax. The death tax is not an issue of class warfare or left-leaning versus right-leaning economists--everyone agrees that the death tax seeks to repeal the most basic of human natures, the desire to provide for one's family and loved ones.

We are familiar with the concept of a sin tax, a government levy on goods like cigarettes and alcohol. "If we have to tax something," states the logic behind such taxes, "why not tax behavior that is damaging to society and individuals?" The death tax is the opposite of a sin tax--it is a virtue tax. Self-professed liberal scholar Edward McCaffrey labelled the death tax as a tax on virtue because it taxes exactly the kinds of behavior we consider to be virtuous and want to encourage: savings, investment, and most importantly, work.

After you have worked to put food on the table, clothes on your back and a roof over your head, the most powerful reason to continue to work is to provide for your family and those you care about. You want to work hard to make life easier for your children. Yet the death tax thwarts this basic human instinct. While you may have worked hard, taken risks, built a business, and paid your taxes, you discover that at the end of the line, Uncle Sam stands between you and your loved ones and demands up to 55% of everything you have left.

Senator Kyl has already testified about many of the economic benefits resulting from repeal of the death tax, but I want to take a moment to highlight a few of these, paying particular attention to the erroneous notion that repeal of the death tax will leave the federal government starved of revenue. When we consider the role death taxes play in tax revenues it is important to keep several points in mind:

- Death taxes collect less than 1% of federal receipts, and one study suggests that 65 cents on every dollar is lost through enforcement and compliance costs. Instead of being confiscated or used to build elaborate legal devices to avoid the tax, this money would be used in an economically beneficial way by private citizens, expanding opportunity for all Americans, and therefore, the tax base for the federal government.

- The Clinton Budget calls for an additional $186 billion in spending over the FY 97 Budget Resolution. A small amount of restraint in discretionary spending increases would more than offset any initial loss in revenue from death tax repeal.

- Repeal of the estate tax will lead to increased federal tax collections from income and payroll taxes. According to a Heritage Foundation study, repealing the death tax this year will result in increased annual economic growth by $11 billion, an additional 145,000 new jobs, and increased annual personal income by $8 billion each year. A retrospective study of the economy over the last 20 years showed that net annual federal revenues would have been $21 billion higher if the estate tax had been repealed 20 years ago.

Some have suggested that we should merely modify the death tax instead of repealing it outright. But this won't change the underlying incentives against hard work; it will simply add yet another layer of bureaucracy and regulation to what is already one of the most litigated and contentious areas in the entire tax code. Last month, in testimony before the House Ways and Means Committee, one witness testified that this "mend it, don't end it" approach to the death tax would actually add $3 billion in new litigation and accounting costs to the current system as families and businesses try to structure their assets to meet the new standards.

We have the opportunity to simplify the tax code, to cut an entire section of the law that punishes savings and investment, punishes hard work, breaks up family businesses, and makes the next generation keep trying to climb the same rung of the economic ladder. The death tax is contrary to our principles, it is contrary to sound economic policy, and it should die.

I'd like to close with a story that illustrates that the death tax is not merely destructive but immoral. I was talking with a city council representative in one of the cities in my district. The city council is a part-time job, and this man is an estate tax planner and a tax lawyer in his real life outside politics. He came up to me and he thanked me for my efforts to repeal the death tax and shared with me his experience as a tax lawyer. The day before, he said, he spent several hours with one of his clients on his client's deathbed. The man's family was waiting in the next room, but this dying man was forced to give up some of his last hours on earth to sign forms necessary to avoid the death tax. These papers created no new wealth, they were economically useless, except that they allowed this man's family to keep the wealth he had worked for them to have.

So this man signed the papers, but he was deprived of some of his last moments with his family. The government got no money. The tax lawyer got paid, ~~and~~ he came to his Congressman and complained that this is not what the government of the United States of America should do to its citizens during their final moments on Earth. I think that in this we must all agree.

The death tax deserves to die, and I thank the Committee for providing me this opportunity to testify.

# # #

THE FAMILY HERITAGE PRESERVATION ACT
H.R. 902 / S. 75

HOUSE

Nick Rahall (WV)
Robert Andrews (NJ)
James Barcia (MI)
Rick Boucher (VA)
Gary Condit (CA)
Ralph Hall (TX)
Pat Danner (MO)
Tom DeLay (TX)
Bob Livingston (LA)
Tom Bliley (VA)
Jerry Solomon (NY)
Chris Cox (CA)
Susan Molinari (NY)
Joe Pitts (PA)
Steve Largent (OK)
Bill McCollum (FL)
Jim Talent (MO)
Dan Burton (IN)
Spencer Bachus (AL)
Richard Baker (LA)
Bob Barr (GA)
Roscoe Bartlett (MD)
Brian Bilbray (CA)
Sherry Boehlert (NY)
Henry Bonilla (TX)
Sonny Bono (CA)
Ed Bryant (TN)
Jim Bunning (KY)
Sonny Callahan (AL)
Ken Calvert (CA)
Dave Camp (MI)
Chris Cannon (UT)
Charles Canady (FL)
Steve Chabot (OH)
Saxby Chambliss (GA)
Helen Chenoweth (ID)
Jon Christensen (NE)
Tom Coburn (OK)
Mac Collins (GA)
Merrill Cook (UT)
John Cooksey (LA)
Philip Crane (IL)
Mike Crapo (ID)
Barbara Cubin (WY)
Duke Cunningham (CA)
Nathan Deal (GA)
Jay Dickey (AR)
John Doolittle (CA)
David Dreier (CA)
Jimmy Duncan (TN)
Jennifer Dunn (WA)
Robert Ehrlich (MD)
Jo Ann Emerson (MO)
Terry Everett (AL)
Mark Foley (R-FL)
Tillie Fowler (FL)
Michael Forbes (NY)
Jon Fox (PA)
Elton Gallegly (CA)
Jim Gibbons (NV)
William Goodling (PA)
Lindsey Graham (SC)
Kay Granger (TX)
Jim Greenwood (PA)
Dennis Hastert (IL)
Doc Hastings (WA)
J. D. Hayworth (AZ)
Joel Hefley (CO)
Wally Herger (CA)
Rick Hill (MT)
Stephen Horn (CA)
John Hostettler (IN)
Kenny Hulshof (MO)
Duncan Hunter (CA)
Asa Hutchinson(AR)
Bob Inglis (SC)
Sam Johnson (TX)
Walter Jones (NC)
Sue Kelly (NY)
Jay Kim (CA)
Peter King (NY)
Jack Kingston (GA)
Joe Knollenberg (MI)
Jim Kolbe (AZ)
Tom Latham (IA)
Steve LaTourette (OH)
Jerry Lewis (CA)
Ron Lewis (KY)
John Linder (GA)
Frank Lucas (OK)
Jim McCrery (LA)
Joseph McDade (PA)
David McIntosh (IN)
John McHugh (NY)
Buck McKeon (CA)
Don Manzullo (IL)
Jack Metcalf (WA)
John Mica (FL)
Jerry Moran (KS)
Sue Myrick (NC)
Charlie Norwood (GA)
Ron Packard (CA)
Michael Pappas (NJ)
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Ron Paul (TX)
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Richard Pombo (CA)
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Bob Riley (AL)
James Rogan (CA)
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Jim Ryun (KS)
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Jim Sensenbrenner (WI)
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Lamar Smith (TX)
Linda Smith (WA)
Nick Smith (MI)
Robert Smith (OR)
Vince Snowbarger (KS)
Floyd Spence (R-SC)
Cliff Stearns (FL)
Bob Stump (AZ)
Charles Taylor (NC)
James Walsh (NY)
J.C. Watts (OK)
Curt Weldon (PA)
Dave Weldon (FL)
Roger Wicker (MS)
Don Young (AK)

Total: 138

SENATE

Spencer Abraham (MI)
Dan Coats (IN)
Lauch Faircloth (NC)
Phil Gramm (TX)
Jon Kyl (AZ)
Rod Grams (MN)
Jesse Helms (NC)
Tim Hutchinson (AR)
Kay Hutchison (TX)
James Inhofe (OK)
Richard Shelby (AL)
Bob Smith (NH)
Strom Thurmond (SC)
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Conrad Burns (MT)
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Wayne Allard (CO)
Frank Murkowski (AK)
John Ashcroft (MO)
Larry Craig (ID)
Mike DeWine (OH)
Michael Enzi (WY)
Orrin Hatch (UT)
Gordon Smith (OR)
Craig Thomas (WY)
Connie Mack (FL)

Total: 27

KILL THE DEATH TAX

Pass the Family Heritage Preservation Act
H.R 902/S. 75

"One of the most powerful reasons that people work and start businesses is to make life better for their children and loved ones. Rather than seek to repeal this most basic of human natures, a sound tax policy should tap this force as a powerful engine of wealth creation.

–Congressman Christopher Cox

<u>Principle Sponsors:</u>

Rep. Christopher Cox (R-CA)
Chairman, House Republican Policy Committee

Sen. Jon Kyl (R-AZ)
Chairman, Technology, Terrorism, and Government Information Subcommittee

<u>Co-Sponsors:</u>

166 Republican and Democrat, House and Senate members.

<u>The Family Heritage Preservation Act:</u>

- Completely repeals federal estate and gift taxes.
- Estate and gift taxes bring in very little federal revenue–less than 1% of total tax receipts. They are extremely costly to collect: one recent study calculated that enforcement and compliance costs alone ate up 65 cents for every $1 collected.
- Rich people rarely pay this tax. Like Jacqueline Kennedy Onassis, whose state-of-the-art trust arrangement shielded her already wealthy heirs from death taxes, the rich can afford to hire the tax lawyers and accountants who specialize in effective "estate planning." It is the middle class–including small business owners, farmers, and ranchers–who end up paying the tax, because they often are "cash poor" despite the liquidation value of their assets.
- The estate tax often forces family business owners and farmers to liquidate their businesses just to pay the tax. With rates starting at 37% and quickly rising to 55%, it is little wonder that 70% of family businesses don't survive through the second generation and 87% are not passed on to a third.
- Repealing these taxes will spur economic growth and increase the nation's prosperity. According to one study, over the next seven years, the Nation's economic output will increase by $77 billion, over 1 million new jobs will be created, and personal income will increase by $158 billion when these taxes are repealed.

<u>Endorsements:</u>

- Nearly 200 outside groups, including the National Federation of Independent Businesses, the Sixty Plus Association, Americans for Tax Reform, Concerned Women for America, the American Farm Bureau Federation, the National Farmers Union, and the U.S. Chamber of Commerce.
- The editorial pages of Investor's Business Daily, the Orange County Register, the Arizona Republic, and the Wall Street Journal have also endorsed estate tax repeal.
- The people of California, the nation's most populous state, repealed their state inheritance tax by initiative. Proposition 6 passed with nearly 65% approval in 1982, and stipulated that the state legislature could not reimpose the tax unless ordered to do so by another popular initiative.

PREPARED STATEMENT OF HON. BYRON DORGAN

Mr. Chairman, I commend you and the other members of the Senate Finance Committee for holding today's hearing to examine several estate and gift tax relief proposals pending in Congress.

I appreciate the opportunity to share with you a proposal that I have introduced called the "Family Estate Tax Relief Act" (S. 288), which would provide much-needed estate tax relief for our nation's family-owned businesses.

I join my colleagues, many on this Committee, who express real concerns about the impact that our estate tax laws have on the survival of our family farms, ranches and other family-run small businesses. A number of bills have been introduced in Congress to eliminate the estate tax burden imposed on families who are trying to pass along the farm, ranch or other family-run business to their kids or grandkids. Some of these bills would repeal estate taxes entirely, while other bills target their relief in some manner.

Let me say that I'm not among those folks calling for the outright repeal of estate taxes. I'm not troubled by the fact that a handful of the wealthiest Americans—who have prospered greatly in this country—are asked to contribute something back in the form of an estate tax.

However, I do believe that we must remove any impediments in our estate tax laws that hinder the transfer of the family farm or Main Street business to the next generation to operate. And I think our estate tax laws should reflect this simple fact.

Specifically, S. 288 would eliminate estate taxes for the inter-generational transfer of family farms and other family-run businesses valued up to $2 million.

My bill targets $1,000,000 of estate tax relief to help preserve one of our nations most important economic assets—its family-run small businesses. But it also increases the existing $600,000 Unified Estate and Gift Tax exclusion to $1,000,000, which is available to everyone.

In addition, I'm encouraged by the efforts of my colleagues—including Senators Lott, Nickles, Grassley, Baucus and Breaux to try to develop a bi-partisan bill that everyone can support. While I do not agree with every aspect of their bill, I think it shows that significant agreement exists among us that some estate tax changes are long over due, especially as they affect the operation of small, family-run businesses.

In fact, the main thrust of my legislation is the preservation of family farmers and other family-run businesses. These businesses are the major creators of new wealth and jobs in this country. However, they face a number of obstacles to succeeding, ranging from price gouging by tough international competitors to excessive U.S. regulations. That is why it is not surprising to find, for example, that we have lost some 377,000 family farms since 1980, a decline of some 23,500 family farms every year.

Since 1980, we have lost some 9,000 of our family farms in North Dakota. At the same time, we see that only a small fraction of other family-run businesses survive beyond the second generation.

When families have to sell their farms or board up their Main Street businesses, those families lose their very livelihood. Moreover, our communities lose the jobs and services those family businesses provide.

I have been approached on many occasions at town meetings by North Dakotans who say it is virtually impossible for them to pass along their farm or business—which has been the families major asset for decades—to their children because of the exorbitant estate taxes they would pay. They think it is unfair, and I agree.

Unfortunately, our estate tax laws force many family members who inherit a modestly-sized farm, ranch or other family business to sell it, or a large part of it, out of the family in order to pay off estate taxes. This is especially onerous when the inheriting family members have already been participating in the business for years and depend upon it to earn a living.

I think that we must take immediate steps to breathe new economic life and opportunities into our family businesses and the communities in which they operate. It seems to me that a good first step is correcting our estate tax laws so they do not unfairly penalize those working families.

Mr. Chairman, again I want to thank you for examining this important topic. I look forward to working with you and the members of the Committee on this matter.

PREPARED STATEMENT OF HON. CHARLES E. GRASSLEY

I want to thank the Chairman for calling this hearing on estate taxes. Estate taxes once were an atypical tax paid by the affluent to finance wars. Now the estate tax code has launched its own war on American families. The affluent have found their defenses in the law. Farm and small business families remain in the estate tax cross hairs. We are here in this Committee to begin knocking down the estate tax barrier.

Legislators in both chambers of Congress are working to roll back the advancing estate tax. So far in the 105th Congress, there have been more than ten different bills in the Senate to amend or repeal the estate and gift taxes. Similarly, there have been seventeen different bills in the House. In the 104th Congress, there were eighteen bills in the Senate and thirtythree bills in the House. The Senate Committee on Finance has held hearings on the issue. The House Committee on Ways and Means has held hearings. Clearly, there is a consensus that we need to change the law.

Eight of the Members of this Committee have joined to author a bill in this Congress to provide estate tax relief. If you study the legislation you will notice that it is not particularly unique in its approach. In fact, it simply borrows from good legislation previously introduced by others of our friends in the Senate. It is unique because it is a bipartisan commitment to work for immediate estate tax relief. In the last Congress, both chambers passed legislation to provide the same type of relief that we are advancing in our bipartisan bill.

This commitment is consistent with the effort to pass a balanced federal budget. In fact, we intend to work to fit estate tax relief into a balanced budget. Also, those of our friends who support full repeal of the estate tax can feel comfortable and consistent by cosponsoring our bill. Every affordable bite at the estate tax apple is also a positive step towards their repeal goals.

There are two things driving the urgent need for estate tax relief: inflation and demography. Inflation erodes the fixed exemptions in the current code. Our nationally aging population is beginning to throw more Americans into the estate tax problem. Hopefully, we can succeed in our bipartisan relief as soon as possible because both inflation and demography will trend upward. We must remove the estate tax barrier for farm and small business families.

Prepared Statement of John Dudley, Vice President, Texas and Southwestern Cattle Raisers Association *

Good morning, Mr. Chairman and Committee Members. My name is John Dudley. I am a rancher from Comanche, Texas. I appreciate the opportunity to share with you how the estate or death tax has affected me and my family's ranching operation.

I and others in my family run Dudley Brothers Ltd. Ranches, a registered and commercial Hereford operation in central Texas. I am also a partner in 4-J Ranch Co. Ltd. and JJ Ranch—both of which are located in west central Texas.

I am the Second Vice President of the Texas and Southwestern Cattle Raisers Association. TSCRA has a membership of over 14,000 throughout Texas and the southwest. I am also here today on behalf of the National Cattlemen's Beef Association—a group with 230,000 members in all segments of the beef industry.

I am a director of the Texas Sheep and Goat Raisers Association, Southwestern Exposition and Livestock Show, Ranching Heritage Association, American Hereford Association, Comanche National Bank and Roundup chairman for the West Texas Rehabilitation Center.

My wife and I enjoy the ranching business and we would like to recommend ranching to our two college boys. However, it is getting harder each day to do that. The death tax is one of the primary reasons for that difficulty.

My family's history in ranching began with my father, two uncles and their wives, who formed a partnership in 1938. They expanded the business over the years as their families grew. They set up a limited partnership for their children in 1974—my brothers, cousins and I—so that we could continue the family's ranching operation. They accumulated 30,000 acres for the operation to support themselves and their children's families. There are more than 30 of us still involved in the ranching business today.

In 1976, my dad passed away. It took 10 years of payments and several hundred thousand dollars to pay off my father's death taxes. In 1982, my uncle passed away.

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* Texas and Southwestern Cattle Raisers Association is a 120-year-old livestock trade association representing more than 14,000 cattle producers who own or control approximately 1.8 million head of cattle on millions of acres of ranch and pastureland primarily in Texas and Oklahoma. TSCRA's mission is to promote generally the welfare of the cattle industry in the state and nation, for the purpose of mutual protection of its members, and to cultivate a more fraternal feeling among cattlemen generally in the state of Texas and the United States of America.

It took 15 years and several hundred thousand dollars for us to pay off his death tax bill. These individual payments greatly complicated sound business practices, and for four years, those payments overlapped each other, which has put the operation in a tremendous bind.

The result, of course, has been to sap the available cash out of the family business. Any money that could have been spent on conservation efforts, brush control, water development, fence repair and wildlife management has been spent to pay death taxes.

There are three living partners from the original business—my mother, an uncle and his wife. They are all over 80 years old. We will not be able to service the tax debt from three deaths without a sale of property. Then, of course, capital gains will get us on the other end. These three deaths, we believe, will destroy the viability of our family's operation. Speaking of capital gains taxes, I want to address the often missed fact about how interrelated the death and capital gains taxes are to one another. When families are forced to sell assets to pay their loved one's death tax, basically, they give the federal government one-third of the value of the forced asset sale. This gives the federal government an additional check in the amount of half of what their loved one accumulated during his or her lifetime. Today's economic conditions force the linkage of the capital gains and death taxes in ways not foreseen by the original policy makers.

My family was fortunate to have the ability to find the means to pay my father and uncle's death tax debts over the combined 25 years. We were forced to seek other sources of revenue to raise cash. We leased our land and endured outside hunters. Also, it was just two years ago that my mother first used any money from my father's estate. She helped pay his federal death tax. When my mother and the others pass, our family will not be able to accomplish this feat again.

The Texas and Southwestern Cattle Raisers Association recently completed a capital gains and death tax survey of our membership. Over 78 percent of survey respondents said that the current death tax law has affected their farming/ranching operation. If the Congress and Administration do not reduce or repeal the death tax law, 66 percent of respondents say this will affect future plans for their businesses. Finally, 74 percent of respondents favored abolishing death taxes entirely. I have a copy of the survey results for each committee member.

Like all ranching families, we struggle with market forces and climatic conditions—and we are happy to do so. However, the death tax is, in more ways than one, a knock on death's door for many ranching operations. Years of contributions by an operation to the local and U.S. economy through employment, purchases and tax payments contribute nothing toward lessening the death tax. This frustration was expressed by several survey respondents.

To quote another survey respondent, "How will we ever be able to protect our natural resources if every time another generation passes on, the family ranch has to be divided so someone can pay their death taxes by selling their portion of the land? Death taxes are the biggest reason large tracts of land get fragmented into smaller, less manageable tracts."

The justification for estate and gift taxes over the years has been "an appropriate means of recompensing the Government for the protection of property rights," according to the House Ways and Means Committee's 1993 "Overview of the Federal Tax System." Clearly, property rights are of little value if families are being forced to sell assets to pay the death tax.

The death tax is a disincentive for economic success. Each year, the exemption level for the death tax covers fewer and fewer operations. Reform is needed badly and it should come during this Congress. Repealing the death tax is a top priority of the Texas and Southwestern Cattle Raisers Association and the National Cattlemen's Beef Association. If a full repeal is not possible, we strongly urge support of death tax reform efforts through lower rates, increased exemptions and indexing estate valuations over time with inflation.

Thank you again for the opportunity to speak to you today. I am happy to answer any questions you may have.

PREPARED STATEMENT OF LEE ANN GODDARD FERRIS

Good morning. On behalf of the 600,000 members of the National Federation of Independent Business (NFIB), I appreciate the opportunity to present the views of small business owners on the subject of estate taxes.

My name is Lee Ann Goddard Ferris and I have been a member of NFIB for more than 10 years. My family lives in the central part of Idaho. Our family's cattle ranch is 45 miles northeast of the Ketchum/Sun Valley area in the Lost River Valley, outside of Mackay, Idaho. The ranch consists of 2,600 deeded acres and a cow-calf operation with 700 head of cattle. My youngest brother, Ross, lives with and manages the ranch with my mother. Although I am still very involved in the ranch, my husband and I also own and operate a design business in Ketchum.

My two brothers, my sister and I all grew up working alongside my father, mother and grandfather. We worked weekends, holidays and summers branding, moving cattle, riding the range and fixing fences. We didn't have a lot of material things, but we had our family, the land and the lifestyle.

On October 5, 1993 my father was accidentally killed when his clothing got caught in farm machinery. He was 71 and very healthy. He worked from dawn until dusk, and he loved the land and his family. We were always a very close-knit family, and the hub of our family was my father and the ranch. Even though my brother, Jack, my sister, Cary, and I don't live there anymore, we all go home along with the grandchildren to help with seasonal work. My daughter, Natalia, and I take as much time off in the summer as we can and work at our summer cow camp in Copper Basin moving cattle. My mother puts on a lot of church and community picnics and barbecues down by our swimming hole. Every June our family enters the local parade with a float representing our ranch. All of the other ranchers and their families in the valley do the same. Last year the theme for the parade was "Mackay's Heritage-Ranching, Mining and Logging."

My father's death was the most devastating event that any of us has ever gone through. The second most devastating event was sitting down with our estate attorney after his death. I'll never forget his words, "There is no way you can keep this place, absolutely no way." Still in shock from the accident I said, "How can this be? We own this land. We have no debt! We just lost my father, and now we are going to lose the ranch?"

Our attorney proceeded to pencil out the estate taxes that would be due after my mother's death, and we all sat in total shock. It had taken my grandfather and father their entire lifetimes to build up the ranch, and now we can't continue on and the grandchildren will not have the land and rich heritage it provides.

It has been three and a half years since my father's accident, and we still don't know what we are going to do. We only know that we will not be able to keep the ranch unless something is done with the estate tax law now.

The estimated estate tax on our family ranching assets is $3.3 million. We gross approximately $350,000 per year from the cattle. Without the land being paid for and tight operating costs, we would not be able to make money from the business. To spread the $3.3 million out over 14 years at four percent interest is of absolutely no value to us. That would mean that we would have to pay more than $241,650 per year, which is virtually impossible. Currently we are selling off one of our spring ranges in order to buy a $1 million life insurance policy for my mother in the event that she should suddenly die. This would allow us to pay off one-third of the estate taxes and avoid a fire sale.

This tax situation has put a tremendous strain on my mother. She worries constantly and has had many sleepless nights. I don't know if any of you could ever imagine how hard it has been on her. She doesn't have her husband anymore. She worked hard her whole life and gave up a lot of material things to put her after tax dollars back into the land to pay it off. Now unless this tax law is changed or abolished she will have to leave her home, which she loves, and our family will not have a base from which to carry on.

The same scenario is happening to many of the ranchers in our valley. Eighty percent of the ranches have been owned by the same families for two and three generations. The value of the land has risen dramatically in the last five years. All of these ranchers live on very modest incomes, and most of them can barely educate their children. I am certain that none of them will be able to pay this tax. The town of Mackay is almost solely supported by the ranchers who buy feed, gas, food and clothing. The community will not be able to survive without them. What is happening is that these ranches are being bought by wealthy absentee owners who do not run cattle and who fly in only once or twice a year. This has already happened to two neighboring ranches. Both of the owners, both second generation ranchers, were killed in accidents. Their families could not pay the estate taxes and sold the ranches to wealthy southern Californians.

I have heard it said that the estate tax exists to redistribute wealth—to take from the "rich" presumably to benefit others less fortunate. Let me tell you, from where I stand I know that this tax accomplishes the opposite.

For my family, the tax means we will not be able to continue running the ranch that has been our heritage for 60 years. This Congress says it is pro-family however, I know from personal experience that the current estate tax law is anti-family. The tax will force us to sell the ranch to a wealthy absentee owner who is unlikely to run cattle, or keep the workers employed, or contribute to the community.

Surely if Congress does not provide relief from this tax, many other families will suffer a similar fate. Ultimately, I wonder whether towns like Mackay as we know it will continue to exist.

Mr. Chairman, members of the committee, I urge you to ask yourselves: Why does this tax exist? Is it worth the great harm it has caused to my family and many others like us? If it is not worth the harm, then the tax shouldn't exist, and I hope you will do everything in your power to eliminate the federal death tax.

Thank you again, Mr. Chairman, for the opportunity to testify before you today.

PREPARED STATEMENT OF HARRY L. GUTMAN

Mr. Chairman and Members of the Committee: My name is Hank Gutman. I am a partner in the law firm of King & Spalding. I am pleased to appear before the Committee this morning as an invited witness to discuss federal wealth transfer (estate, gift, and generation-skipping) taxes. The views I express are mine and are not to be attributed to my firm or any client of my firm.

SUMMARY

The federal wealth transfer tax structure is not perfect. Marginal tax rates may be too high, exemption levels may be too low, the tax applies unevenly and it may cause payment problems for estates holding illiquid assets. Despite its structural flaws, the wealth transfer tax plays an important role in the overall progressivity of our tax structure. Unless significant changes are made to the income tax, the wealth transfer tax should be structurally strengthened and retained.

A tax on wealth transfers is, in economic terms, indistinguishable from a tax on income because wealth is simply the capitalized present value of future income. If economic income were fully taxed, wealth would be fully taxed as well and a wealth transfer tax would not be necessary. However, the current income tax system excludes or provides preferential treatment for significant amounts of income. Examples include unrealized appreciation in property held at death, interest income on municipal obligations and the deferral of tax on income earned on life insurance and annuity contracts. The wealth transfer tax serves as a "backstop" to the income tax by taxing the wealth that taxpayers accumulate through excluded or deferred income sources.

The backstop role of the transfer tax may be illustrated by examining the relationship between the transfer tax and the income tax provision (I.R.C. §1014(a)(1)) that permits most property received from a decedent to receive a basis equal to the fair market value of the property at the date of the decedent's death. The effect of this provision is to remove the unrealized appreciation in property held at death from the income tax base. The revenue loss attributable to the failure to tax unrealized appreciation at death is roughly $30 billion annually. Without a transfer tax this appreciation would never be subject to tax.

The transfer tax could be reduced significantly, or perhaps even eliminated, if the unrealized appreciation in property held at death was subject either to income tax at death or preserved for later taxation when the asset is sold by a decedent's heir. However, unless that is done, a wealth transfer tax is a pragmatic alternative to assure that owners of appreciated assets bear a portion of the overall tax burden. If the transfer tax is retained, it should be made to operate more efficiently. In particular, the base should be made uniform, avoidance possibilities eliminated and deferred payment provisions for illiquid estates liberalized.

THE FACTUAL BACKGROUND

Discussion of taxes imposed on transfers at death inevitably engender strong responses, particularly from the small business and farm communities. Thus, it is important to establish the factual context in which the discussion arises. As noted in the Joint Committee pamphlet prepared for this hearing, 31,564 decedents of a total of 2,312,180 in 1995, or 1.37 percent, filed taxable estate tax returns. Transfer tax revenue was $17.2 billion in 1996, representing 1.18 percent of total federal receipts. The Joint Committee estimates that receipts and taxable estates as a percentage of all deaths will continue to increase, the latter reaching 1.97 percent by the year 2000 and 2.64 percent by the year 2005.

These data permit a number of observations. The first is that this tax does not affect a significant portion of the population. The second is that while receipts as a percentage of total federal revenues is small, as an absolute number, it is significant. A modest increase in individual income tax rates could easily offset federal transfer tax receipts. However an income tax rate increase would simply perpetuate the tax preferences that currently exist.

It is illuminating to note the number of taxable estates that contain closely held businesses and farm assets:

ESTATE TAX RETURNS
FILED IN 1995

Size of gross estate			Closely held stock		Farm assets	
	Number	Amount	Number	Amount	Number	Amount
Taxable returns, total	31,564	67,183,128	3,264	4,344,022	2,104	319,256
$600,000 under $1,000,000	13,830	11,195,554	639	82,817	829	44,907
$1,000,000 under $2,500,000	12,710	18,845,531	1,303	439,572	939	109,513
$2,500,000 under $5,000,000	3,298	11,288,768	744	524,608	213	75,324
$5,000,000 under $10,000,000	1,105	7,769,030	320	458,374	55	18,037
$10,000,000 under $20,000,000	390	5,366,395	151	533,855	42	30,821
$20,000,000 or more	231	12,717,850	106	2,304,797	25	40,683

These data, published just a week ago in the Statistics of Income Bulletin indicate that relatively few taxable estates contain farm or closely held business assets. Moreover, farm assets comprised less than .5% of all assets reported on taxable returns. Closely held businesses were 6.5% of the total. This is not to say that estates holding these assets have no problems. It is, however, to emphasize that problems with respect to farms and closely held businesses, should not be used as a rationale for repeal of the transfer tax or major structural changes related thereto.

It is also the case that taxable estates hold most of the nonresidence appreciated assets. This fact illustrates how the transfer tax adds progressivity to the tax system. It also reinforces the notion that if the unrealized appreciation were subject to tax, the transfer tax burden on those assets could be reduced or relieved entirely.

DISCUSSION OF PROPOSALS BEFORE THE COMMITTEE

The proposals before the Committee run the gamut from outright repeal of the transfer tax to reducing its scope by increasing the unified credit, providing exclusions for family-owned businesses, liberalizing the terms of deferred tax payments, reducing the interest rate applicable to deferred tax payments, providing additional incentives for charitable contributions of property and broadening existing special use valuation provisions.

I have already stated why I believe repeal of the transfer tax is inappropriate as a matter of tax structure. However, there are other reasons proffered why the tax should be repealed. For example, some claim that the transfer tax has negative effects on saving and investment. As the Joint Committee pamphlet points out, there is little economic evidence to support that view. Intuition may be at the heart of the assertion. My intuition, however, is that individuals work hard to accumulate sufficient funds for themselves and that they discount the impact of future transfer taxes.

It is also said that the transfer tax causes the break up of family businesses. There is no question that the existence of the tax creates planning needs for businesses that are affected by it. The unified credit, however, effectively shields from tax the first $1.2 million in value of all assets for married individuals. Consequently, many small businesses are not subject to tax. Second, while it is certainly true that many closely held businesses break up after the death of the founder, the reasons are more complex than simply the need to pay transfer tax. In many cases, for example, the key man has been lost. Finally, the need to pay transfer tax is a known fact and liquidity for the payment of tax can be arranged through proper planning. Planning for the payment of tax requires the commitment of resources to quantify the exposure and to determine how to deal with it. Those facts do not lead to the conclusion that no tax should be paid.

I have little to say about the question of the appropriate exemption level. That is a political decision. One can examine the historical data and make a judgment as to the extent to which wealth transfer taxes should apply. The question of rate structure is also a political decision. I note that the transfer tax now effectively starts with a marginal rate of 37 percent and rises rather quickly to 55 percent. It would seem appropriate to reexamine the rate structure both in terms of marginal rates and bracket widths.

The other proposals before the Committee directly or indirectly affect the tax base. In my view horizontal equity is a critically important feature of any tax structure. If a tax is to be imposed on the value of property that is transferred, then all forms of property should be subject to that tax uniformly. There is no structural justification for treating farms or closely held businesses preferentially, either by way of exclusions or favorable tax deferral terms. With regard to the latter, it should be understood that proposals to permit deferred payment of transfer tax attributable to closely held businesses and farms at less than market interest rates are the economic equivalent of an exclusion. A preferential interest rate means that the present value of the deferred tax is less than the tax that would be paid immediately. That reduced tax liability is the equivalent of the normal tax rate applied to property whose valued has been reduced by an exclusion. Thus, exclusions and preferential interest rate tax deferrals are economically equivalent in terms of providing a benefit to the assets for which the privilege is available.

Apart from the horizontal equity issues raised by preferences for closely-held businesses and farms, serious definitional issues abound and statutory complexity issues are inevitable. Those familiar with the tax writing process know the difficulty the draftsmen encounter in attempting to define a closely-held business. This is particularly the case if relief is not to be available for large corporations simply because they are closely held. Defining the scope of the exclusion is difficult.

Proponents of preferential exclusions are correctly concerned that such provisions can be abused. Consequently anti-abuse precautions are necessary to assure that the exclusions are limited to the intended class of recipients. Anti-abuse provisions are also extremely complicated. One need only look at section 2032A of the Internal Revenue Code, permitting special use valuation for certain farmland and real estate used in connection with a closely held business, to understand this point. Thus, the goal of a simplified tax system runs counter to provisions creating preferential tax treatment for certain types of assets.

In conclusion, a matter of horizontal equity and administrability, I do not believe that special provisions for particular assets are appropriate in the transfer tax structure. I might add, parenthetically, that provisions such as those before the Committee today appear to conflict with the goals of those who support a "flat tax." Most of the "flat tax" proposals provide a uniform tax base, recognizing that exclusions and exemptions breed complexity and administrative difficulty.

PROPOSED SOLUTIONS

As I indicated above, I believe that unless and until the income tax base is broadened, the wealth transfer tax should be retained. I have also indicated that in my view the base should be uniform with rates and exemptions levels determined by the political process.

There is no question, however, that the current system is viewed as uneven in its application. That perception is reinforced by articles such as the one that appeared in the New York Times on December 22, 1996. To the extent that avoidance techniques are available to a restricted class of those who would otherwise be subject to the tax, their existence breeds disrespect for the system. Congress should take steps to eliminate selective avoidance opportunities. The fact, however, that the tax may be avoided selectively by planning techniques is not a justification for its elimination. The avoidance techniques should be eliminated instead.

I come finally to what I consider the most difficult issue in connection with the current transfer tax. In general, the transfer tax is due shortly after a taxable transfer occurs. There is no question that an immediate payment requirement would, without relief, severely affect the ability of owners of illiquid assets to pass those assets to their heirs. The tax structure should not force the sale of assets prior to the time market conditions lead the owners of those assets to desire to dispose of them. Thus, the task is to craft appropriate deferred payment provisions to permit those whose estates are comprised of illiquid assets to pay the tax attributable to those assets over time and in amounts that do not force the liquidation of those assets. The interest rate on such deferred payments should be at market so that the present value of the deferred tax payments is equal to the amount of tax that would be due if the tax were paid timely. So long as the interest rate is adequate, the government should be indifferent, apart from cash flow needs, as to whether it receives the tax today or in the future. Appropriate security arrangements must be devised, but that is not an insurmountable task.

REDUCING THE TRANSFER TAX BURDEN

I have previously stated that in my judgment the principal justification for a wealth transfer tax lies in the failure of our current income tax to tax income comprehensively. In my view, it would be entirely appropriate for Congress to reduce, or even repeal, the wealth transfer tax if income tax preferences relating to the taxation of capital income were removed.

In particular, I believe that it would be very worthwhile to study the lock-in, distributional and revenue consequences of treating gratuitous transfers during life and at death as income tax recognition events and reducing significantly or even repealing the current wealth transfer tax. The latter was done in Canada. The details of such proposals have been discussed in the academic literature and have on occasion been mooted by Congressional committees.

Alternatively, but less preferable because of its lock-in and revenue effects, Congress could revisit a carryover basis regime, which has now been adopted by Australia. Many of the difficulties with that system as enacted by Congress in 1976 had, in fact, been identified and proposals to solve them advanced prior to its repeal in 1980.

I would be pleased to answer any questions you may have.

PREPARED STATEMENT OF HON. JON KYL

Mr. Chairman, I want to thank you for scheduling this hearing today to consider whether the federal estate tax should be changed or eliminated. Mr. Chairman, I have concluded that the so-called "death tax" imposes a heavy burden on the nation's economy, that it is beyond repair, and that the best thing Congress could do is simply repeal it outright.

On January 21, I introduced the Family Heritage Preservation Act, S. 75, to do just that. Now cosponsored by 27 Senators—Mr. Chairman, that is more than any other stand-alone estate-tax bill—it would repeal the federal estate and gift tax, and the tax on generation-skipping transfers. Companion legislation in the House of Representatives (H.R. 902) was introduced by Congressman Chris Cox of California, and has about 130 House cosponsors. That is more support than for any other more limited estate-tax reform bills in that body.

I would note that the Kyl/Cox legislation has also been endorsed by the U.S. Chamber of Commerce, the National Federation of Independent Business, the National Association of Manufacturers, and the American Farm Bureau Federation. In all, about 60 family, business, and taxpayer organizations have come out in favor of total repeal. I will submit a complete listing of the groups supporting death-tax repeal for the record.

This mailgram alone—about five inches think—includes the names of 54,858 seniors across the country who support the Family Heritage Preservation Act and want the death tax repealed.

Mr. Chairman, it has been said that only two things in life are certain: death and taxes. And leave it to the federal government to find a way to put them together and create a death tax that can be devastating to families and small businesses. As a good friend and constituent of mine wrote in a letter to me:

> "Since my father died, our lives have been a nightmare of lawyers and trust companies with the common theme, 'you have to protect the family business.' It was hard enough trying to recuperate after my father's long illness, and then adjusting to the reality he was gone."

That's wrong. Most people grieve at the death of a loved one. Because of our budget crunch, many in the federal government merely look upon it as another opportunity to wring money out of hard-working families. What about their budget crunch?

The death tax is not only emotionally destructive, it's economically destructive. The family I referred to built up a printing business from just one employee 38 years ago to over 200 employees today. The founder—the family patriarch—was one of the most generous people I have ever met. He gave to just about every charitable cause in our community, and he made our community a much better place in the process.

Mr. Chairman, contributing to the community and creating badly needed jobs is not something for which hard-working and decent people should be penalized. These are things that should be encouraged.

Let me tell you about another of my constituents in Arizona who knows only too well how devastating this tax can be. I am sure you have heard the same kinds of stories from others all across the country. This constituent's father and uncle started a family ranch back in the 1920s in the small town of Waddell, which is about 20 miles west of Phoenix.

Both the father and uncle died in the 1980s. Like many other families, the surviving brothers put what money and effort they could into the family business, their ranch. Expensive estate-tax planning was the last thing on their minds, so they did not have much money readily available to pay the death tax when the bill came due.

My constituent said the smartest thing to do might have been to walk away—sell the ranch to pay the death tax. But he did not walk away. As he put it, "I've lived here all my life, it was my home. I've got a family, we want to stay here and keep farming and raising cows."

He is still trying to pay off the death-tax bill assessed by the Internal Revenue Service. To add insult to injury, the land is still taxed on its 1985 value even though land prices have plummeted since then.

He wondered what the estate tax is meant to accomplish. "If they're trying to keep the rich from accumulating more," he said, "this isn't the way to do it. When there's a bankruptcy, a family's business or land gets bought up by a big conglomerate. So this isn't preventing large concentrations of wealth." Of course, he is right.

At one time, the death tax was required of only the wealthiest Americans. Now inflation, a nice house, and a good insurance policy can push people of even modest means into its grip. The estate tax is applied to all of the assets owned by an individual at the time of death. The tax rate, which starts at 37 percent, can quickly rise to a whopping 55 percent—the highest estate tax rate in the world.

It is true that each person has a $600,000 exemption, but that does not provide as much relief as one might expect. Unless a couple goes through expensive estate-tax planning so that trusts are written into their wills and at least $600,000 of the assets are owned by each spouse—that is, not held jointly—the couple will end up with only one $600,000 exemption.

So while the wealthiest Americans may have the resources to plan ahead to minimize their tax liability, up-and-coming and hard-working entrepreneurs often do not. Therefore, the burden of death taxes falls mostly on those with newly acquired, modest wealth, or families like the two I mentioned who have much of their assets invested in the day-to-day operation of the family business itself. The death tax does not hinder concentrations of wealth. What the tax really hinders is new American success stories.

The respected liberal Professor of Law at the University of Southern California, Edward J. McCaffrey, observed that, unlike taxes on alcohol and cigarettes, the estate tax "is an anti-sin, or a virtue, tax. It is a tax on work and savings without consumption, on thrift, on long term savings." Even a scaled back death tax will continue that bias against savings, entrepreneurship, and job creation.

The death tax it is probably one of the most complex and inefficient taxes on the books today, despite the fact that there have been nine attempts to reform it during the last 50 years. It is so complex that when Congress tried to exempt small businesses in 1995, the final product would have helped only about 400 businesses nationwide, according to a Price-Waterhouse analysis. So obviously, if the goal is to maximize relief, particularly for small family-owned businesses, we need to ensure that relief is effectively provided.

Mr. Chairman, the need for death-tax relief is clear. According to a 1993 study by Prince and Associates—a Stratford, Connecticut research and consulting firm—nine out of 10 family businesses that failed within three years of the principal owner's death said that trouble paying estate taxes contributed to their companies' demise.

In fact, six out of 10 family-owned businesses fail to make it to the second generation. Nine out of 10 never make it to the third generation. The estate tax is a major reason why. The tax costs many people their jobs. It deprives our communities of valuable expertise.

Probably the best thing we can do is repeal the estate tax altogether, as I have proposed.

The push for repeal received a significant boost last year when it was endorsed by the National Commission on Economic Growth and Tax Reform, which studied ways to make the Tax Code simpler. The Commission, which was chaired by former HUD Secretary and vice presidential candidate Jack Kemp, concluded that "[i]t makes little sense and is patently unfair to impose extra taxes on people who choose to pass their assets on to their children and grandchildren instead of spending them lavishly on themselves."

Repeal of the estate tax would encourage people to save more and would promote economic growth. A recent study by the Heritage Foundation estimated that if the death tax were repealed this year, over the next nine years the economy would average as much as $11 billion per year in extra output, an average of 145,000 additional new jobs could be created, and personal income could rise by an average of $8 billion per year above current projections.

The budget deficit would decline, according to Heritage's review, since revenues generated by extra growth would more than compensate for the meager revenues currently raised by the inefficient death tax.

Mr. Chairman, I look forward to working with you and the members of the Finance Committee to push for repeal of the onerous death tax.

Prepared Statement of Hon. Richard G. Lugar

Mr. Chairman, thank you for holding this hearing today and for allowing me to testify. I am honored to participate in your committee's work on this very important issue.

As Chairman of the Senate Agriculture Committee, I recently held hearings on the impact of the estate tax on farmers and ranchers. The effects of inheritance taxes are far reaching in the Agricultural community and justified our Committee's study. The Committee heard from many insightful witnesses from the farming and small business communities. Citing personal experiences, witnesses described how the estate tax discourages savings, capital investment and job formation.

One such story came from a Hoosier, Mr. Woody Barton. He is a fifth generation tree farmer living in the house his great grandparents built in 1885. I visited his 300 acres of forested property last October and can attest to its beauty. Typical of many farmers, Mr. Barton is over 65 years old and wants to leave this legacy to his four children. But he fears that the estate tax may cause his children to strip the timber and then sell the land in order to pay the estate tax bill. His grandmother logged a portion of the land in 1939 to pay the debts that came from the death of her husband. How many generations must buy back the hard work and dedication of their ancestors from the federal government? Mr. Barton believes, and I agree, that the actions of Congress have more impact on the outcome of his family's land than his own planning and investment. Mr. Chairman, this should not be the case.

Although the estate tax hinders entrepreneurial activity and job creation in many sectors of our economy, the estate and gift tax falls disproportionately hard on our agricultural producers. Ninety-five percent of farms and ranch operations are sole proprietorships or family partnerships, subjecting a vast majority of these businesses to the threat of inheritance taxes. According to USDA figures, farmers are six times more likely to face inheritance taxes than other Americans. And commercial farm estates—those core farms that actually produce 85 percent of our nation's agricultural products—may be fifteen times more likely to pay inheritance taxes than other individuals.

This hardship will only get worse as the agricultural community gets older, with the average farmer about to have a 60th birthday. Many farmers will shortly confront either capital gains taxes when they retire or estate and gift taxes when they pass their farm onto the next generation. Recently, the USDA estimated that between 1992 and 2002, more than 500,000 farmers will retire. Only half of those positions will be replaced by young farmers. During the last 15 years, the number of farmers under the age of 44 has decreased by nearly a third. Demographic studies indicate that a quarter of all farmers could confront the inheritance tax during the next 20 years.

The capital-intensive nature of farming and ranching makes the payment of inheritance taxes exceedingly difficult. Although the paper value of farm producers may be high, their assets are largely tied up in farm production and their return on farm investment is low—approximately 4 percent on a well managed farm. The average farm consists of 75 percent non-liquid assets such as land and equipment. Raising cash while still maintaining a farm's integrity is extremely difficult. Estate tax bills often require a fire-sale of integral farm capital, threatening the farm's very existence.

Inflation contributes to the harmful effects of the estate tax on farmers, eroding the vast majority of the gain on farm property and subjecting the farm estate to the taxation of illusory gains. Census figures indicate that farmers own their land for long periods of time—estimated at around 30 years. Chief Economist of the USDA, Mr. Keith Collins, testified in the Agriculture Committee that over the last thirty years the average acre of farm land has increased in value from about $158 to $890. Three-fourths of this $732 increase is the result of 30 years of inflation, not real appreciation of land values. In essence, although the farmer is only slightly better off than he was thirty years ago, the paper-value of the farm is significantly higher and the estate tax, which is blind to inflation, is levied on this imaginary wealth. I point this out because this goes to the heart of the agricultural tax problem, both for capital gains and estate taxes. A great majority of what a farmer saves is reinvested back into the land. For most farmers, the land is their total savings—there are no pensions or retirement accounts to speak of. To tax not only real gains, but inflationary buildup, is devastating to farmers. Mr. Chairman, this policy is unfair and should be addressed in your reform considerations.

I know first-hand about the dangers of this tax to agriculture. I have a 604 acre corn, soybean and tree farm in Marion County, Indiana. My father died when I was 24. I helped manage the farm, which had incurred substantial debt during my father's illness. Fortunately, after a number of years, we were successful in working out the financial problems and repaying the money. We were lucky. That farm remains in our family because I have been practicing active estate planning and execution of the plan along with profitable farming for each of the last 40 years. But many farmers and small business owners are not so fortunate.

The estate tax began as a temporary tax in 1916, limited to 10 percent of one's inheritance. The tax was intended to prevent the accumulation of wealth in the hands of a few families. Journalists and social commentators frequently lament the death of thousands of family farms and the substantial concentration of land ownership. The estate tax literally forces many family-owned farms and small businesses to sell to larger corporations.

Mr. Chairman, death should not be a taxable event, both for economic and moral reasons. With the highest marginal rate at 55 percent, the estate tax has mushroomed into an exorbitant tax on death that hinders our country's economic growth. It thwarts families' efforts to save, invest, and provide for their children. By the time the inheritance tax is levied on families, many of their assets have already been taxed at least once. This form of double taxation violates perceptions of fairness in our tax system.

Fortunately, our country has rediscovered the necessity of saving and investment if we are to enjoy better jobs. The inheritance tax punishes the behavior we should be encouraging—hard work, thrift, and family. The estate tax, by definition, blocks the accumulation of entrepreneurial capital and breaks up the businesses and farms for which families have sacrificed. Only 30 percent of businesses are transferred from parent to child, and only 12 percent of businesses make it to a grandchild. The estate tax directly contradicts the American dream of handing down an individual's life work to one's children and grandchildren.

A Heritage Foundation study estimates that eliminating this tax would have the equivalent effect of increasing individuals' lifetime earnings by 18 percent. The same study asserts that abolishing this tax on death would expand the nation's economy by as much as $11 billion per year, create an additional 145,000 jobs, and increase personal income by an average of $8 billion annually.

Although I advocate complete repeal, I support all good-faith efforts, including those put forth by members of this Committee, to raise the unified credit and focus estate tax relief on small business owners and farmers. I have introduced a set of three bills aimed at minimizing the impact of inheritance taxes on the American economy. My first bill would repeal the estate tax entirely upon enactment. The second bill would phase it out over six years. The third bill would raise the exemption amount of the unified credit from $600,000 to $5 million. This increase would represent the first adjustment of the exemption amount since 1987. It would free 96 percent of farm estates and 90 percent of closely-held business estates from the inheritance tax burden.

Today I have introduced two pieces of legislation to provide additional relief in this area and I want to mention them briefly. The first bill would provide Americans with a powerful estate tax planning tool by raising the tax-free gift limit to $25,0000 from $10,000. Inflation has eaten into this amount, which has not been adjusted since 1982. I am confident that this change will assist Americans in their efforts to effectively plan for the passing of their estate. The second bill would correct a long-standing agriculture problem that disqualifies farm heirs for special use valuation when they cash lease their farm to other members of their family. Section 2032A of the tax code provides farm heirs with a special valuation of their farm property if it remains in family farm production after the death of the decedent. The courts have held that the cash lease of farm property to members of the decedent's family triggers a recapture tax intended to recoup this farm tax benefit. Although Congress partially fixed the problem regarding spouses in 1988, other family members remain unable to cash lease farm property to their family. This runs contrary to the intent of Section 2032A and my legislation would fix this predicament.

As this committee considers repealing or reforming the estate tax, I contend that the estate tax is a prime example of how our income-based tax system has become divorced from the most fundamental needs of our economy. We have forgotten that taxation, like surgery, is at best, a necessary evil. Just as a surgeon seeks to minimize damage to a patient during an operation, our goal when constructing a tax system must be to raise the necessary revenue in a manner that does the least violence to productive, job-creating resources. I do not believe that the estate tax is in the best interest of our economy or our values. Repealing it, or at least reforming it, would be a boost for job creation, investment and savings. Such a step would end the disproportionate estate tax burden on farmers and small business owners, and perhaps begin the process of refocusing tax policy on the needs of our economy.

Mr. Chairman, I thank the Committee for this opportunity to testify.

Prepared Statement of Drew Mendoza

INTRODUCTION

Mr. Chairman and Members of the Committee, my name is Drew Mendoza. I am the founding director of the Loyola University Chicago Family Business Center. The Center's mission is to further the understanding, growth and development of responsible family-owned businesses in the Chicagoland area. Our day-to-day focus is through research and programming, the study of and development of solutions to the unique and distinct opportunities presented in family business. In addition I am a lecturer in the Graduate School of Business on the subject of family business as well as an advisor to family firms. My advisory work is conducted through the Family Business Consulting Group based in Marietta, Georgia.

I was honored to receive the phone call six days ago, inviting me to address this body on the subject of transfer taxes and family business. The family business is the back bone of the American economy as well as a precious component of the communities in which we live and work. Based on the research of Shanker and Astrachan (1996), and depending on the breadth of the family business definition used:

- There are 10–20 million family businesses in the United States
- Family Businesses make up 91 percent of all U.S. businesses
- 60 percent of all privately owned businesses are family firms
- 49 percent of the gross domestic product is generated by family businesses
- Family businesses employ 59 percent of the US workforce
- Family firms created 78 percent of all new jobs between 1977 and 1990

Ours is a society which places high value on the concept of family. We encourage family unity. We praise family contributions to our communities. Ironically transfer taxes—and the too low level of relief provided to family firms—challenge and make it extraordinarily difficult for many business-owning families to achieve those values we hold most dear by confiscating their business assets at the time of generational transfer. And clearly, from the above statistics, we have to admit that family firms play an important role in our economy. I care that something which is so good for our society has so intense a disincentive to continue from one generation to the next, and that the disincentive comes of our own doing—from our own government—is remarkable. On the contrary, it seems logical that we put in place incentives to keep the family business as a significant portion of one or a few peoples estates within a given family.

The historical literature which trace the genesis of transfer (estate and gift) taxes indicate they were designed and implemented for these reasons:

- they were seen as a vehicle to prevent the undue concentration of wealth at a time when a few family names such as Carnegie, Morgan and Rockefeller controlled fantastic amounts of wealth and shares of the nation's assets (railroads, bank, communications, etc.); and,
- the revenues generated to the American treasury could be used to fund a significant portion of the activities of government. For example, revenues from transfer taxes were relied on as far back as 1797 to capitalize the development of a navy due to strained trade relations with France. More recently, transfer tax revenues were relied on to fund the Page Three Senate Finance Committee Testimony of Drew Mendoza—April 10, 1997 Civil War, Spanish American War, World War I and to help us through the economic miseries of the great depression. Research by Foster and Fleenor reports that transfer tax revenues accounted for as much as 9.7 percent of total federal revenue in 1936. According to data from the Internal Revenue Service, transfer taxes now generate only 1 percent of the federal government's revenues.
- Precedence exists to imply that the United States estate tax law is designed to provide for the continuity of the family business as well as acknowledgment that business-owning families tend to have the bulk of their estates tied up in

the business. IRS code Section 2032A limits the value placed on certain assets used in the business, thereby reducing the amount of taxes. Section 6166 of the tax code allows the estate tax to be paid in installments over about 15 years if a significant portion of the decedent's estate, 35 percent, is interest in the family or closely held.

TRANSFER TAXES AND THE AMERICAN FAMILY BUSINESS

Although I am generally uncomfortable discriminating among assets when it comes to taxes, I can support—in the absence of a broader full repeal of estate taxes—the notion of having some sort of special treatment for family firms and their liabilities vis-a-vis transfer taxes. Speaking solely from the viewpoint of someone who assists business-owning families consider and prepare for the successful continuity of family firms across multiple generations, the transfer taxes do not achieve their goals on a number of tangible levels.

- Transfer taxes are catching many much smaller fish in its nets than was ever intended. The majority of family firms in the U.S. are not the giant conglomerates transfer taxes were intended to financially humble and downsize. Based on IRS 1995 Statistics of Income about 84 percent of Federal transfer tax returns were from taxable estates of under $2.5 million.
- According to the National Federation of Independent Businesses, citing data released by the IRS 1994 Income Statistics, less than one-seventh of one percent of total federal revenue comes from the collection of death taxes on closely-held family businesses and farms. If research findings reported by J.C. Payne in Tax Notes Today (1991) are correct that the government and taxpayers collectively spend $0.65 for each dollar of tax collected for enforcement and compliance activities, than the net effect of the 1/7 of 1% just noted becomes even smaller.
- With a base of $600,000 few business-owning families can escape the transfer tax. Particularly in smaller family firms, the bulk of the owner's estate are tied up in the assets of the business—in the plant, equipment and real estate on which the business operates. With the lowest estate tax rate pegged nearly as high as the highest income tax rate therefore, many family firms report having to sell off assets, parts or all of the business, to pay estate taxes. This conclusion is supported by a recent finding of family firms with revenues in excess of $1 million in which half of the respondents reported having at least 60 percent of their family's net worth tied up in the business.
- Transfer taxes to not help family firms continue cross-generationally. Research conducted at Kennesaw State University (1996) asked family business owners how the payment of estate taxes will affect their businesses. The results are alarming.

Effect on Business Future	Size of Business		
	<$5mm	5–10	>$10mm
Paying estate taxes will limit business growth	61%	67%	67%
Paying estate taxes will threaten business survival	64%	65%	72%
Paying estate taxes will require selling all or part of the firm	36%	39%	41%

- This same research found that looming estate tax liabilities reduced the acceptable risk associated with business investments in the eyes and minds of family business owners.
- A recent survey of over 3,000 American family firms found they plan to use ongoing operating profits as one of the top two ways to meet their expected tax obligations. This is not, in my opinion, a good use of working capital.
- In a comparison of the maximum estate taxes due at death we find that the United States is highest (Attachment A):

Country	Maximum estate tax rate
Germany	35 percent
Belgium	30 percent
Spain	38 percent
U.S.	55 percent
France	40 percent
Italy	27 percent
Portugal	24 percent

FAMILY BUSINESS BEHAVIORS

Family firms often rely on life insurance to pre-fund part or all of their expected tax liability. For 67 percent of the respondents to a survey of family firms in the U.S. (conducted by Loyola University Chicago in conjunction with Kennesaw State University, Arthur Andersen Center for Family Business and MassMutual) life insurance represents the primary source of funds to cover estate and gift taxes. In addition, more than one-third (36 percent) of the respondents depend on life insurance to cover more than 75 percent of the death-tax tab. The expectation may be unrealistic because more than half of the respondents do not have regular formal valuations of company share value and, therefore, may not know or at least underestimate their estate tax liabilities.

A tax criterion which would seem reasonable is that the tax, and its reliefs, be easily understood. The Payne research referenced earlier also references a General Accounting Office study which estimated that 44 percent of the penalities assigned by the IRS in 1990 were wrong. Payne concluded the complexity of the system and its rules are responsible for much lost time and money. Taxpayers should be able to not only easily comprehend what is expected of them but also fulfill their legal tax obligations without extraordinary expense being incurred. Family firms must invest a considerable amount of capital, which otherwise could be used for investment purposes, to plan for how they will fulfill their pending estate tax liabilities. The Kennesaw research above found that family firms spend in the area of $35,000 for legal and financial council associated with estate planning. In addition I have attended scores of workshops, attended by thousands of family business owners who, for the price of admission, hope to gain an understanding of the estate and gift tax law and how a family business can protect itself from having to dismantle a life's work to pay that expected tax obligation. The look in the eyes of the attendees generally go from keen interest, to dazed confusion much like that of a deer caught in a car's headlights—they know something is coming but seem unable to act. Perhaps this is why one in four family firms have little or no understanding of their estate tax liabilities.

One of the more common methods used to protect the family business assets or minimize the estate tax burden is to transfer, using legal means, the equity of the asset to the next generation but retain control of the organization in the hands of the parent generation—the control being transferred at some later date *(note: this is an overly simplified explanation of an estate tax planning technique. The Senate Finance Committee should confer with a professional estate tax attorney for a fuller, detailed discussion of this techniques).* On the one hand, this is a reasonable maneuver but, in my opinion, it too often serves to postpone the inevitable decisions which have to be made in any family business intent on continuity: who will run and/or control the business in the next generation. This is a highly charged, divisive and emotional issue which—perhaps more so than any other issue—kills family firms. It can best be dealt with through planning processes which address the future needs of the business, the owners and the competencies and skills of the next generation. Such plans would include estate plans, strategic plans, financial plans and succession plans.

A strong case can be made for a logical progression of these plans beginning with the estate plans of the senior generation of owners. By knowing what the estate tax liabilities are going to be, a business owner can plan for what sort of performance the business will have to achieve in order to fulfill those liabilities and still make and sell its products. Perhaps family firms would be less planning avoidant if the tax planning they were required to undertake were not so confusing. Or perhaps a case can be made to support the repeal of gift taxes leaving the estate tax in place. Doing so might create a suitable incentive for family business owners to plan for the transfer of ownership and management, prepare the next generation and pass ownership of the family business to the next generation all in increments which permit the senior generation leaders/owners to test the worthiness, competency, passion and interest of the next generation while the predecessor is still alive. If it turns out the next generation isn't right for the job, the business can be sold in a fashion which doesn't force a discounted value due to the fire sale nature of having to sell to pay the tax.

CONCLUSION

Family businesses are good for the nation and its economy and I urge this Committee to take what steps it can to help promote the continuity of family firms across generations.

For a variety of reasons, family firms can be fatally affected by transfer taxes. We cannot actually foresee what will happen if these taxes are completely repealed.

Richard Wagner, Professor of Economics at George Mason University in Fairfax, Virginia in his article *Federal Transfer Taxation: A Study of the Social Cost* (1993), calculated the number of new jobs that would have been created over 20 years from 1971 to 1991 if federal estate and gift taxes had been eliminated in 1971. According to his article, 262,000 more jobs would have been created that actually were. In another published extrapolation, Dr. Craig Aronoff writing in Family Business Advisor, estimated that without estate taxes $100,000 spent in a year to pay a life insurance premium (to pre-fund the estate tax liability) would in that same year produce:

- $500,000 more in taxable sales per year;
- Create 5 new jobs paying $25,000 each at a 12% tax rate yielding $15,000 more in
- personal income tax revenue annually;
- Produce $8,750 more in corporate tax revenues assuming a 5% profit margin and a 35% corporate tax rate;
- In 20 years yield $4.75 million in additional revenues to the federal government.

Finally, I believe family businesses are critical to our nation because of their commitment to their employees and the communities in which they operate. I know of no better, more compelling evidence of this than the Feuerstein family's well publicized decision to continue to pay workers after the plant had been destroyed by fire in the 4th generation family business, Malden Mills in Lawrence, Massachusetts. Had Malden Mills been a non-family owned and managed company, I doubt whether management, faced with rebuilding the charred remains of the factory in the rust-belt north, would have elected to keep idle workers on the payroll. The question before the Committtee today is this: *Do we stand to gain more as a nation by preserving the American Family Business? Should our tax policies encourage appropriate planning for family business continuity or rob families of the opportunity to continue the legacy and all the economic and societal benefits these firms bring with them?*

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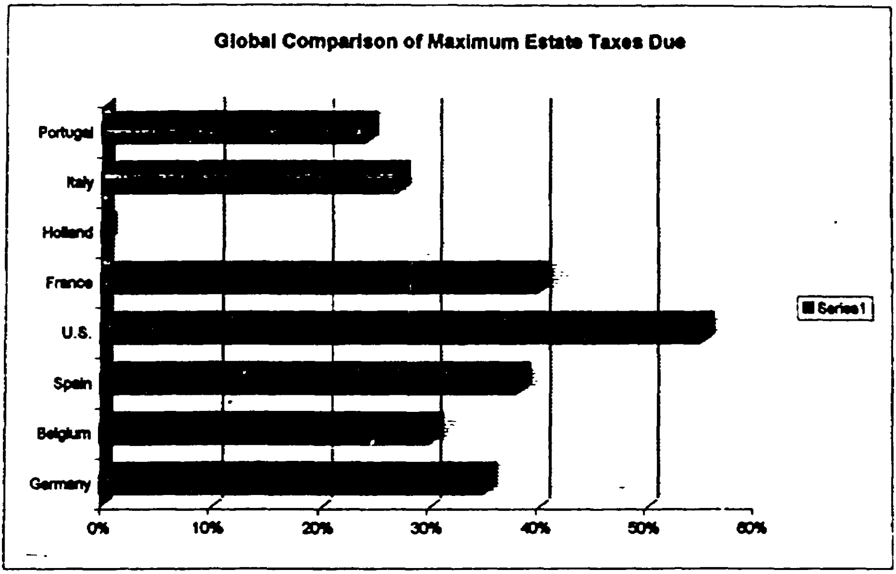

Source: Instituto de la Empresa Familiar, Comparitive Contributions of Family Business.

Prepared Statement of Hon. Frank Murkowski

Mr. Chairman, I commend you for scheduling this hearing on the various estate tax proposals pending in Congress.

As you know, Mr. Chairman, I am a co-sponsor of your bill S.2 and Senator Grassley's bill (S.479). And looking to the future, I am cosponsoring Senator Kyl's bill (S.75), which entirely repeals the estate tax.

Mr. Chairman, I think the effective question that must be asked about our estate tax is: Does the United States government have the right to take away 55 to 60 percent of the assets that an individual or a family business has built over a lifetime? Although some might view this as a moral question, I look at the realities of estate planning and conclude that when confronted with an unfair and confiscatory tax system, Americans overwhelming reject the idea that the government has such a right.

With proper estate planning, it is clear that many Americans can structure their affairs in such a way that they can entirely avoid paying any estate taxes. In fact, of the estates valued at more than $600,000, more than half, 55 percent, paid not a single dollar of estate tax. And of the returns of the richest Americans, those with estates valued over $20 million, nearly a third owed no estate tax.

It seems to this Senator that what the estate tax has become is a bonanza for estate planners and tax accountants, and an unfair and onerous burden to the small businesses and farmers of America who do not have the resources nor the time to take advantage of sophisticated estate planning schemes. As a result, more than 60 percent of the burden of the estate tax falls on estates valued at $5 million or less.

As my colleagues know, the primary asset of many of these smaller estates is the family businesses, whether a small retail or wholesale operation, or a family farm. And when it comes time to pay the estate tax, many of these family businesses are forced to liquidate a portion of the business or even the business itself. The other option for many of these businesses is to saddle itself with debt to pay the tax. This only heightens the cash flow problems that many small businesses confront.

Of course with sophisticated estate planning, many of these small business estate problems would go away. But then we, as policy makers, should ask ourselves: What is the sense in constructing a tax that primarily provides a livelihood to those who can advise others on how to avoid the tax?

Mr. Chairman, if we do not repeal the estate tax, we ought to make certain that it is not a trap for the unwary and an avoidable loophole for the sophisticated.

Prepared Statement of Gordon Perkins

Mr. Chairman, Members of the Committee, I am pleased to have the opportunity to present testimony today on the issue of estate tax reform.

My name is Gordon Perkins. I am the President of Perkins Flowers, Inc., a retailer and grower of flowers and trees in LaPeer, Michigan. I am also President of the Ohio Florists Association representing 3,200 members, primarily floriculture growers. In addition, I am a member of the Society of American Florists, the national trade association representing the entire floral industry, and speak today on behalf of that organization and its members.

The Society of American Florists is the only national trade association representing the interests of all segments of the floral industry. Our membership includes nearly 20,000 small businesses nationwide: growers, wholesalers, retailers, suppliers, educators and affiliated organizations located in every state and Congressional district.

Despite the industry's large size and economic strength, it is made up largely of small, family-owned businesses. As I do, many floriculture growers, wholesalers and retailers own businesses which have been in their families for several generations.

PERSONAL STORY

I greatly appreciate the opportunity to appear before the Senate Finance Committee to discuss the estate tax issue. Estate tax reform is extremely important to the future of small businesses in this country and to me personally, because of the death of my mother less than a month ago.

With the death of my mother, Ella Perkins, on March 12, 1997, at the age of 83, and the preceding death of my father, Dana Perkins in 1981, my son and I find our family business in jeopardy because of federal estate taxes.

My family's flower business was founded in Ohio in 1903 by my grandfather, C.R. Perkins. Moving to Michigan in 1954, my parents purchased an existing greenhouse and flower shop. I have been in the business all my life, and in 1989 my son, Chad

Perkins, joined the company. For the past seven years we have enjoyed the rare opportunity of three generations working together along with more than 30 full-time employees. My mother, Ella, even at the age of 83, still worked more than 60 hours a week starting at 6 a.m. and ending at 5 p.m., six days a week.

Let me describe my business. What began in 1954 as a small greenhouse and retail flower shop, has grown substantially over the past 43 years. Perkins Flowers, Inc. now includes the wholesale greenhouse, a retail garden center, a landscape tree farm, and 2 retail flower shops. The greenhouse grows plants for wholesale in my retail garden center and in other retail garden centers. The primary customers of the greenhouse, are community fundraising groups such as churches, schools and girl scout troops. They buy plants at wholesale to re-sell as part of their fundraising activities. Or retail garden center sells bedding plants, nursery stock and landscape plants directly to retail customers primarily in our community . Finally the retail flower shops sell flowers and floral arrangements. My mother ran the original retail flower shop right up until the week before she died. My son Chad manages the tree farm and the retail garden center.

My mother had met with estate planners as recently as 1994, taking measures to become a minority stock holder. But even though I have only one sibling, who is not in the business, and even with no one contesting my mother's will, we were still not prepared for the early estimate of $200,000 or more in tax liability after my mother's death. This could put us out of business. The $200,000 will be due in 9 months. $200,000 represents a huge outlay. How can this situation have happened even with all of our estate planning?

ESTATE TAXES DESTROY FAMILY-OWNED BUSINESS

First, as in many family-owned businesses, the senior member of the family often works beyond normal retirement age. My mother worked every day up until the week before she passed away at age 83. In fact, she was presented with the Michigan Florists Association, "Retailer of the Year" award on March 1 which, as it turned out, was her last day at work. She wanted to work because her work and her business was her life. Handing down control was a slow, cautious process for my mother. Many parents prefer to will company stock and assets upon their death. Our company is not an isolated case; this situation is being played out every single day with the loss of a parent or family member. My family has spent its entire life working, building and expanding Perkins Flowers. I was looking forward to watching my son and grandchildren grow into the business. But that is now all at risk. Because my mother stayed active in the business, and retained control of her own property, all of those assets are now included in her estate to be taxed at a high rate after her death.

Secondly, floriculture is very capital intensive, requiring higher capital investments than any other type of agriculture. For example, it costs at least $175,000 per acre to build a greenhouse, and costs can run to as much as $800,000 per acre. Many of the other capital investment costs associated with a floriculture business are similarly very high. And as with many family businesses, we have not taken much money out as salary, preferring to reinvest profits into the business. The timing of my mother's death is unfortunate in view of the fact that we have made major capital improvements and investments in the past 10 years. We still have mortgages on a lot of that investment. But now there is not enough time for that investment to begin paying for itself before we start being taxed on it.

Finally, my brother wants no part of the business, but he inherits half of the estate. His share of my mother's estate will be a considerable portion of her liquid assets and a portion of the land on which we operate the greenhouse. That cash up until my mother's death, was being used as part of the business to guarantee loans and operate the business. Because my brother doesn't want to be involved in the business, we lose part of our working capital. This is not the fault of the estate tax but two "people" need to be paid cash—my brother and the federal government. In addition, I will have to buy my brother out of the land on which the greenhouse sits. This creates another cash demand. The loss of these cash resources hits the business at a critical growth stage and could in effect cripple the business permanently.

So the only alternative will be to sell assets to generate cash to pay the estate tax. What will I sell? Most likely it would be our new retail floral shop. About 6 years ago, I purchased an old landmark building built in 1928. We gutted the building and restored it from the ground up. In fact we won the National Builder's Award for remodeling. The building could be valued at $375,000 for estate purposes. I have invested $175,000–$200,000 into it in capital improvements. If I do manage to sell the building, I would probably only break even and I would have to let go two full-time and two part-time employees.

Another option is to sell the tree farm, My son Chad has been general manager of the garden center and operations manager for our tree farm for the last five years. We bought this 45-acre farm about 8 years ago. I got a bargain at $750 per acre. The land was undeveloped and hadn't been farmed for many years. We made capital improvements, such as clearing the land and adding an irrigation system. We planted ornamental shade trees which eventually which will grow into trees large enough to sell to landscape and other customers. However, trees take several years to mature. After planting trees six years ago, they are just now grown enough to begin to sell. If we sold this farm my son would be losing six years of hard work. In addition the land could be appraised as high as $2,500 per acre and we will have to pay estate taxes on that valuation. If we then sell the land, we will have to pay income taxes on the proceeds.

Five years ago, my mother, myself, my son, and Robin, my chief operational officer, sat down and did a long range strategic plan. It was based on capital improvements to meet the demands of our customers in order to survive in today's highly competitive market. Those goals have all been met and now we are just beginning to see the benefits. We now find ourselves with possibly all those plans being set back to square one.

LOSS OF JOBS AND REVENUE

The second point I want to make is that the current estate tax law affects not only me and my family but my employees as well.

In our case, as in thousands of others, family members are just a small percentage of those affected when a business faces an estate tax crisis. Of our 30-plus employees, 15 have worked with us for an average of 17 years. All of our full-time employees' wages exceed the Federal minimum wage. They are as much a part of our company as any family member, compensated equally, and in some cases more. My estate tax liability will take a toll not only on my family but on my employees because it looks like I may have to lay off loyal employees. If I sell the garden center to pay my estate tax bill, who will I let go? If I sell only the greenhouse, who will be put out of work? These are choices I shouldn't be forced to make.

I have many loyal and dedicated employees. Two of the employees have been working here longer than I have. The manager of my greenhouse has been with me for over 35 years—it's the only job he has ever had. Robin Axsom, my Chief Operational Officer, started 19 years ago transplanting seedlings into flats. Robin is not a member of my family but she is as much part of my business as my son is. It is not just the family that makes the business grow, but everyone working with me.

To grieve over the loss of my mother is a luxury I cannot afford. Almost every day for the last four weeks I have been meeting for hours with lawyers and accountants, in order to begin the filing process. All of this is happening at our busiest time of year. If it hadn't been for our dedicated employees greeting the customers, transplanting the seedlings and overseeing the operation these last four weeks, I would have had to close the doors until I could get my affairs in order. The strength of the business is my employees.

Perkins Flowers has flourished for 93 years, continually paying taxes year after year. Shouldn't I be encouraged to continue to grow and develop and provide opportunities for people in my community? Our company taxes, including Local, State and Federal Income Tax, FICA, FUTA, Sales Tax, Licensing, Road and Gas Taxes, Property Tax and Unemployment Taxes totaled $133,900 in 1996. The reality is, the death of our business represents a far greater loss in revenue to the federal government over the long term than the one-time gain to the federal government from the estate tax. Instead of paying taxes year after year, creating jobs and investing in our community through a productive business, we will be paying approximately $200,000 one time to the Federal government.

THE ESTATE TAX IS AN UNFAIR TAX

The final point I want to make is that the estate tax is unfair.

Not only do we find ourselves confronted with paying the estate tax itself, but I am faced with other sizable costs including the estimates for the preparation of property appraisals and company stock estimates. The CPA and attorney's fees could cost us as much as $35,000 or more. This amount of money is a sizable cash outlay when cash is at a premium. How could I now be faced with the possibility of selling the family business or assets after having done so much planning with experts?

As I stated earlier, some of the capital improvements in my business were made a few years ago, and many others twenty years ago or more. Yet everything must be appraised as of March 12, 1997, inflating the values beyond their value to the company. Is this fair?

Let me just point out that when my mother died, our attorney informed me the estate taxes were due in nine months. To lessen the burden on a family, some estate tax proposals include a deferral provision. Our bank has told me that this possibly could place our business in a tax lien position. As long as a federal lien is in place, banks will be reluctant to lend us capital improvement loans. As a small business, I operate on a very small and frankly sometimes negative cash flow. If our lenders lose confidence in our ability to regain financial stability, they will also be reluctant to give us critical operating loans which we need each spring for inventory. Is this fair?

During her lifetime, my mother paid income taxes and now her business assets are being taxed again at her death at a very high rate. To pay the estate tax, I will need to sell assets. If I want to continue the business, and I do, our CPAs have informed me that the gains from any sale of assets will also be subject to State and Federal income tax. The taxing never ends.

Furthermore, without estate tax relief this ordeal could repeat itself. Think about it—if we do survive this current estate tax ordeal and in five or ten years are able to regain a strong financial condition, what if I, or for that matter my son, dies an untimely death? Without relief it is obvious at this point, that I would be foolish to continue to build capital assets. That would be self-defeating. How can I structure my own estate planning knowing that my son could be faced with this same scenario down the road? When you are trying to maintain a business as a family business, there seems to be no way to shelter the assets from the estate tax.

Under the current system, the voracious estate tax will tax again and again and again until nothing is left. The tax is never-ending.

CONCLUSION

I have read and heard comments that estate tax reform is a "tax cut for the wealthy." The estate tax may have begun as a tax on wealthy Americans but I can hardly believe an estate of $600,000 can today be defined as wealthy. Even the smallest businesses and family farms own capital assets and land worth well over this level. Often these assets were accumulated through frugality, entrepreneurship and plain hard work. The last time the unified credit was increased was in 1987. A decade of inflation has completely eroded the current exclusion.

As you can see, the federal estate tax makes it very difficult to pass on a family business to the next generation. The current system may force me to liquidate a business in which I've worked my whole life. Moreover, the costs of estate planning alone retard economic growth. The money I spent just to try to stay in business, could turn what was once profitable into a marginally successful business or maybe the business will fail.

I believe strongly that the Congress should reevaluate this punitive tax which defies logic, and instead encourage family businesses to expand and grow. The best incentive for that goal would be to allow me to pass my business down to my son. If my son is able to continue to operate the business, he will create more jobs and ultimately contribute to a healthy economy for our community.

For the last 93 years my family has chosen to make a modest income in order to reinvest into the business in the form of capital improvements and maintenance. We have worked hard to make the business a success. The ultimate American dream is to be able to pass on a lifetime of work to your children. The death of the owner should not be the death of the business. From where I sit now, it seems like all of my efforts to expand and improve the business over many years of hard work will be wiped out in one instant.

In closing, I would like to thank the Senate Finance Committee for the opportunity to tell you my experience with the estate tax. I would be pleased to answer any questions.

COMMUNICATIONS

STATEMENT OF THE AMERICAN BANKERS ASSOCIATION

The American Bankers Association ("ABA") is pleased to have an opportunity to submit this statement for the record on reformation of estate and gift taxes.

The American Bankers Association ("ABA") brings together all elements of the banking community to best represent the interests of a rapidly changing industry. Its membership—which includes community, regional, money center banks and holding companies, as well as saving associations, trust companies and savings banks—makes ABA the largest banking trade association in the country.

The American Bankers Association strongly supports a change to the current estate tax system which will allow more of our customers who own small businesses and farms to hand down that business or farm from one generation to the next. The selling of family businesses and farms has occurred many times in order to raise the funds necessary to pay estate taxes.

Our view of the estate tax system has been shaped by the experiences of our members who are routinely engaged as corporate fiduciaries for trust administration or as personal representatives for estate administration. Consequently, they have seen, many times, how families struggle to pay the taxes due when a death occurs, particularly when those deaths are unexpected. There are approximately 2,700 financial institutions that are engaged in trust activities which include estate administration. Those institutions hold approximately $21 billion in estate assets in either a discretionary or non-discretionary capacity, according to the 1995 *Trust Assets of Financial Institutions* issued by the Federal Financial Institutions Examination Council. This represents approximately 49 million estate administration accounts.

In addition to the laudable goal of helping small business owners and farmers as well as many others, any proposal to change the estate tax system should not add to the existing complexities of the Internal Revenue Code. Simplicity and understanding of the tax code are important to our customers as well as our members. Any proposed change should ease the estate tax burden without adding complexity to the tax code.

Bank trust departments are intimately familiar with the problems caused by the current estate tax system, because they provide personal fiduciary services such as settling estates. In estate settlement, the bank's role is that of the personal representative. This means the bank could be either the executor or the administrator. There are many steps to the estate settlement process from the admission of the will to the court to the final distribution of the estate assets to the beneficiaries. The bank begins its duties with an appointment as personal representative. The bank's responsibilities in this position include giving notice to heirs, beneficiaries, and interested persons; collecting and appraising assets; drawing up a budget for payment of estate obligations and perhaps selling some assets to meet any outstanding debt; safekeeping assets; making tax elections; settling all tax obligations (income taxes and state and federal estate taxes); assessing claims filed against the estate; making a final accounting to the probate court; and finally, distributing the assets to the beneficiaries.

THE CURRENT SYSTEM NEEDS TO BE REFORMED

The White House Conference on Small Business Commission in 1995, published *Foundation for a New Century—A Report to the President and Congress.* The report contains the 1995 Conference delegates' action agenda for small business. The agenda, as the Commission describes it, contains "60 public-policy recommendations that will further shape small businesses' role as the nation's job creators, innovators and risk takers." Tax relief for small businesses dominated the final recommendations.

Repeal of the estate tax was the fourth most popular recommendation, garnering 1,385 votes. The tax has drawn repeated fire from small business groups who say it is a threat to family-owned inherited businesses. The message that the conference sent to Congress was that the negative effect of the estate tax on small businesses and others far exceeds the revenue to the government. There are high administrative costs associated with the estate tax which affects individuals, small businesses and the government.

Clearly, the Small Business Commission hit upon an issue that generates extreme concern, anger and worry for many small business owners across the country. It is natural for those who have worked long hours and sacrificed much to grow a business, to hope that their lifelong achievement will be passed on, intact, to the next generation.

The same natural desire is felt by many of our nation's farmers. The impact of estate taxes on farmers was recently discussed in a hearing held by the Senate Committee on Agriculture, Nutrition and Forestry on February 25, 1997. At that hearing, the witnesses declared the current estate tax rules were impeding the transfer of farms from one generation to the next. This is due to the liquidity problem that estates containing farm assets face. In such cases, a sale may have to be conducted quickly to raise cash, which in many cases will result in low sale prices. These "distress sales" are likely to result in family farm land being sold to developers of commercial property at a fraction of its true value.

The concern over the estate tax does not stop with small business owners and farmers. Many other citizens worry about the payment of estate taxes. The continued growth of the equities market and the greying of the baby boomer generation has caused many to consider whether the accumulation of their savings, insurance, home and other property will result in the payment of estate taxes at rates as high as 55%. These rates may go higher than 55%, due to any applicable generation skipping tax with rates that begin at 55% after a one time $1 million exemption.

THE PROPOSED REFORMS

Currently, the estate tax attributable to certain interests in closely held businesses may be paid in installments over 14 years. Code section 6166 allows a special four percent interest rate on a portion of the deferred tax. An estate is eligible for the installment payment provision if the value of the business included in the estate equals at least 35 percent of the value of the adjusted gross estate. These rules, while providing a benefit for many small businesses, may not be widely used because the businesses are unable to obtain credit needed for day to day operations as the property is subject to an IRS tax lien. The Internal Revenue Code requires that such a lien be placed when the election is filed. The lien exists until the estate tax has been paid in full. During the period of installment payments, money that otherwise could be used to expand or invest in new operational technologies is instead being paid to the government in installments, lasting up to 14 years. This leaves the small business at a competitive disadvantage. Difficulties also arise when the value of the property or business drops during the period of installment payments. A bankruptcy may be inevitable. Such a situation can cause difficulties for the bank, who is closely involved with the estate during this long period of installment payments. Even with a bankruptcy, the estate tax is still due and the bank as the "fiduciary" may still be required to make the payments even though the estate no longer has the ability to generate cash. Of course, the fees that the bank would normally receive for the services it has performed are also not paid in these situations. Another possible reason for the lack of popularity of the installment proposal is that the rules are very complicated and the estate cannot be closed quickly and simply.

The Administration has proposed to expand the installment payment provision in order to address the liquidity problems of estates holding farms and closely held businesses. Under the proposal, the cap on the special low interest rate would be available on the first $2.5 million of value of the closely held businesses. In addition, the 4 percent rate would be reduced to 2 percent. The types of businesses eligible for the installment payment provision would be expanded by making the form of business ownership irrelevant. The proposal would also authorize the Internal Revenue Service to accept security arrangements in lieu of the special estate tax lien.

Another potential solution to the estate tax problems of small business owners and farmers is the family-owned business interest estate tax cut. These proposals (S.2—"The American Family Tax Relief Act" and S. 479—"The Estate Tax Relief for the American Family Act of 1997") would provide special estate tax treatment for qualified "family-owned business interests" if such interests comprise more than 50 percent of a decedent's estate. Subject to certain requirements, the first $1,500,000 in value of qualified family-owned business interests from the decedent's estate would not be subject to the estate tax, and 50 percent of the remaining value of qualified family-owned business interests would be excluded (S. 479 would exclude 50 percent of the next $8,500,000 in value of qualified family-owned business interests).

In order to meet the definition of a qualified family-owned business, the business would have to be any nonpublicly-traded interest in a trade or business (regardless of the form in which it is held) with a principal place of business in the United States if ownership of the trade or business is held at least 50 percent by one family, 70 percent by two families, or 90 percent by three families, as long as the decedent's family owns at least 30 percent of the trade or business. To qualify for the beneficial treatment, the decedent (or a member of the decedent's family) must have owned and materially participated in the trade or business for at least five of the eight years preceding the decedent's death, and each qualified heir (or a member of the qualified heir's family) would be required to materially participate in the trade or business for at least five years of each eight-year period ending within ten years after the decedent's death. Due to its long-term nature, these proposals may generate the same types of problems associated with the current installment method available for closely held businesses.

While these two proposals would appear to address some of the problems of small business owners and farmers, they do nothing to simplify the estate tax rules and, in fact, would add to the existing complexity. Substantial estate planning will still be necessary for small business owners and farmers. The administration of the estate will become increasingly complex since there are many conditions extending over a period of years that must continue to be met by the estate in order to keep the benefit of these provisions. In addition, these proposals do not address the question as to how qualified family-owned business interests are treated if they are held within a trust, which is very common and provides many estate planning benefits for family businesses.

REPEAL OF ESTATE AND GIFT TAX

Repeal of the current estate and gift tax system would certainly solve the concerns of small business owners, farmers and those middle class Americans who wonder whether the totality of their savings and possessions will create a steep estate tax bill. Repeal also achieves the goal of simplifying the tax code. The ABA, however, is mindful of the revenue implications of such a proposal.

INCREASING THE UNIFIED CREDIT OR LOWERING THE ESTATE TAX RATES

The central factor of the current federal estate tax system is the unified credit, which provides an exemption from estate tax for most estates. The unified credit was increased substantially in 1981 to a credit of $192,800 that was phased-in through a gradually increasing credit each year until 1987, when it became fully effective. The current credit is equal to $192,800 which, under the current tax rate structure, exempts the first $600,000 of estate assets. Using minimal estate planning, married couples can transfer $1.2 million of assets to their heirs without the payment of federal estate or gift taxes.

Do most Americans have a basic understanding of the unified credit? The answer would have to be yes. The basis for that statement would lie in the past. In 1992, there was a rumor, apparently arising in California, which swept the country. The rumor alleged that Congress was about to pass a bill that would reduce the unified credit equivalent from $600,000 to $200,000. Congressional committees, financial planners and the news media were deluged with calls and faxes about the bill, primarily from people anxious to put a stop to the bill's passage. The bill was of special interest to older, middle income people, since it would mean a sharp increase in taxes on their medium sized estates. The bill that was introduced was a long-term care package. The goal of the legislation was to begin a discussion of long-term care and how to pay for it. While that goal was not accomplished, it certainly highlighted the concern that many people had regarding estate taxes.

What many have begun to realize is that a family with a home, a lifetime accumulation of personal property, pension benefits and average savings, which would make up their total estate, add up rather quickly. Moreover, although life insurance payouts aren't subject to income taxes, the face amount of life insurance, including employer paid policies, is subject to estate tax, which is a liability many families overlook. The estate tax exemption level hasn't been increased since 1981. If it had been indexed to inflation it would now be worth approximately $838,000. The payment of estate taxes are more of a burden on some families even though there may be an equivalent amount of estate tax due. In one situation, a family may have a

Monet hanging in their living room which can be sold to pay the estate tax. In another circumstance, where an equivalent amount of estate tax is owed, the family business may have to be sold or workers laid off in order to meet their estate tax obligations.

An increase in the unified credit or a significant reduction of the current estate tax rates would achieve both the goals of simplification and a reduction of estate tax for small business owners and farmers. The various proposals on the increase in the unified credit are supported by the American Bankers Association. The ABA would also support legislation which would significantly reduce the current estate tax rates.

CONCLUSION

The banking industry has always been familiar with the problems that its trust department customers face when a death occurs. It is because of this exposure of our members that the ABA has developed its position that any changes to the current estate tax system should be both beneficial to our customers from the reduction of their estate taxes and also should avoid adding additional complexity to an already overly complex Internal Revenue Code. The American Bankers Association is willing to offer assistance in fashioning a solution that meets both of these concerns.

STATEMENT OF THE AMERICAN FARM BUREAU FEDERATION

Production agriculture is a capital intensive industry with total assets of more than $1 trillion. Yet, despite its size, it is an industry dominated by family businesses, many of which are multi-generational. Estate taxes greatly impact the efficient use of farm capital and the transfer of assets from one generation to the next. When you consider that 47 percent of farm and ranch operators are 55 years or older and that they own or rent over half the assets held by farmers and ranchers, it is not hard to understand the importance of estate tax relief to farmers and ranchers.

Farm Bureau's position on estate taxes is straightforward. We recommend repeal. Farmers and ranchers work long, hard hours over a lifetime to build their businesses. Along the way they paid income taxes on their earnings and it is wrong to tax those earning again at death. Farmers and ranchers should be able to save for the future without having to worry about sharing the outcome of their efforts with the federal government after already paying a lifetime of income taxes. Family farms and other family businesses should be passed from generation to generation without complex and costly estate planning.

Until repeal is possible, Farm Bureau supports increasing the exemption to $2 million and cutting the tax rate by half for assets over $2 million. We also believe that estate taxes should be deferred until a farm is sold outside the family or to non-heirs. In addition, the gift tax should be increased from $10,000 to $50,000 per year. These changes would lift the burden of estate taxes for thousands of farmers and ranchers.

Internal Revenue Service figures show that by increasing the estate tax exemption to $1 million, over 37,000 estates, 54 percent of the returns filed, would no longer have to file estate tax forms.

A $2 million exemption would eliminate the tax on most farms and ranches. Failure to increase the exemption discourages the continuation of family farms. Often, farm heirs must sell business assets to pay estate taxes. When taxes drain capital from a farm business, the profit-making ability of the farm is destroyed and the farm business dies.

The story of a Missouri farmer makes clear the need for estate tax reform. The family farm was purchased in 1919 for $3.50 an acre. Today, three generations later, the farm has an appraised value of $1.7 million. The land now planted to trees, happens to be located near the city of Branson, with its value based on commercial development and not agricultural use. This family can donate the property to a church or even a university with little or no tax liability. However, if the land is passed to their children, the estate tax has been estimated at more than half a million dollars. Their heirs would be forced to sell a large portion of the farm just to pay the tax, bringing into question the economic viability of the smaller farm operation. The estate tax has essentially precluded this farm from being passed on to a fourth generation and will simply accelerate its transition to development.

The estate tax exemption hasn't been increased since 1987. Since then, average prices in the U.S. economy have increased by 35 percent. Farm Bureau believes that the exemption should be increased to $2 million and indexed for inflation. This would provide the same protection from inflation as is provided by the adjusting of income tax brackets, personal exemptions and the standard deduction.

Two million dollars may seem like a lot of money to some. But for many farmers and ranchers, it is simply a family business. According to Purdue University, good Indiana farmland sells for $2,300 an acre. A multi-generation family farm may involve 1,000–2,000 acres, with half the land owned and half rented. One thousand acres of land at $2,300 per acre is worth $2.3 million. That doesn't include buildings, livestock, farm equipment and other assets whose value would easily be worth another third of a million dollars on a 1,000-acre farm.

Some people argue that estate taxes do not impact small business if estate planning is effectively used. While sometimes effective at protecting farm businesses from estate taxes, estate planning tools and life insurance are costly and constantly drain resources that could be better used by farmers and ranchers to upgrade and expand their operations.

The situation of an orchard and farm market operation in Allegheny County, Pennsylvania, illustrates the burden placed on many farm and ranch families. Knowing that the estate tax burden will be great, this family operation of a mother, father and four children has developed an estate plan requiring money to be set aside for estate taxes. The amount of money that the business puts into a trust each year is almost as great as the individual earnings of each of the children. According to the family, this significantly reduces funds for things that the farm could use to operate more efficiently, like equipment purchases and building improvements.

The Indiana and Pennsylvania examples show that the estate tax is not a tax on the rich, as opponents of estate tax cuts argue, but rather a penalty on middle-class men and women who chose to make their living by operating their own businesses. Internal Revenue Service data from 1995 clearly shows that those with the greatest worth are also the best at using estate tax planning to reduce or eliminate taxes at the time of death.

While farmers spend hundreds of hours and thousands of dollars for estate plans and life insurance, relatively little revenue is generated for the federal government. In fact, Internal Revenue Service figures for 1995 show 54 percent of returns (37,000 estates) had assets of less than $1 million and generated only $650 million. The estate tax raised a total of about $17.2 billion in fiscal year 1996, as reported by the Office of Management and Budget. But, the estate tax can also cause huge revenue losses. People who believe they will be subject to the estate tax seek ways to transfer assets to avoid the tax. That often includes investing in less productive assets that reduce taxable income in the short term.

It follows that one of the reasons that revenue collected from the estate tax is low is that not very many people pay the tax. During 1995, 31,565 estates paid estate taxes. This is roughly 1.4 percent of the estimated 2.3 million adults who died that year. Opponents of estate tax reform say there is no reason to change a tax that affects so few middle income Americans. But each death affects children, grandchildren and other close family members. The impact is greatest for multi-generation family farms and ranches and other family businesses.

At a recent hearing on estate taxes before the Senate Agriculture, Nutrition and Forestry Committee, the U.S. Department of Agriculture (USDA) reported that only about five percent of U.S. farms and ranches are affected by estate taxes, claiming that only those farm operators with assets of more than $1.2 million would be impacted. It arrived at this conclusion because current estate tax law allows a unified tax credit equal to a $600,000 per person exemption. Since most farm operators are married, USDA assumed that the two together would have combined exemptions of $1.2 million. A closer look shows a much larger percentage of production agriculture is at risk.

The combined exemption only applies if each spouse holds $600,000 of assets and the assets from the first spouse to die do not transfer to the remaining spouse. Unless substantial estate planning has been performed, a farm operator with $1.2 million of assets could face a $200,000 estate tax bill.

The total value of agricultural assets held by the estimated two million farm and ranch operators was $716.6 billion in 1995. The 122,000 operators, 6 percent of the total operators, with assets of $1.2 million or more held farm assets of $200.8 billion, 28 percent of total farm assets. Using USDA's definition of farm operators at risk to estate taxes, over one-fourth of the assets of farm operators are held by operators that are at risk to estate taxes.

If the more appropriate $600,000 of assets per operator is used to access the impact of estate taxes, in 1995 there were 408,000 farm and ranch operators, 20 percent of the total operators, with farm assets of $389.4 billion at risk to estate taxes. This is 54 percent of the assets held by the two million farm and ranch operators, a figure 10 times higher than the USDA estimate of about five percent of farm and ranch operators.

Farm Bureau supports changes in Section 2032A of the tax code that allows land to be appraised at its agricultural value for estate tax purposes. While beneficial to farms that operate near towns and parks, the amount that land value can be reduced is limited to $750,000. Use valuation is sound public policy and the limit should be removed so that the program can be applied to all farm and ranch land.

In addition, Section 2032A requires that the land be kept in agricultural production and "operated" by the heirs for 10 years. The rules have become so complex that some choose not to use the program because they fear they may not be able to comply with all the rules. Farm Bureau recommends improvements in the law so that cash leasing to family members and the harvest of timber does not trigger the recapture of estate taxes.

Farm Bureau also supports the deferral of estate taxes until a farm is sold outside the family. In addition, land protected by a conservation easement or participating in a farmland preservation program should not be subject to estate taxes.

American farmers and ranchers are the most productive in the world, producing 16 percent of the world's food on just 7 percent of the land. Farm and ranch productivity allows U.S. citizens to spend only 9.3 percent of their income on food, the lowest percentage in the world.

Agriculture and related industries provide jobs for more than 21 million people. Nearly 3.5 million people operate farms or work on farms. Another 3.6 million produce the machinery and inputs used on the farm or process and market what farmers produce. More than 14 million work in wholesale or retain businesses helping get farm products from the farm to consumers.

In order for farmers to continue this high level of productivity, reform of estate tax laws is needed without delay. The results will benefit farmers, consumers and the economy.

STATEMENT OF THE INDEPENDENT BANKERS ASSOCIATION OF AMERICA

Mr. Chairman, Members of the Committee: The Independent Bankers Association of America (IBAA) appreciates the opportunity to submit its views to the Senate Finance Committee on pending estate and gift tax proposals, which are of vital importance to our customers, our banks and the communities where they live and do business.

IBAA represents more than 5,500 locally-owned banks nationwide, and is the only trade association that exclusively represents the interests of such independent community banks. Our median bank holds assets of $50 million (about 25 employees) and has two branches. The core business of these banks is financing small businesses, farms, ranches, and local consumers.

Our Association wishes to commend the Leadership of both parties in the Senate for making estate tax reform a part of their Leadership tax packages in this 105th Congress (S. 2 by Majority Leader Lott and S. 20 by Minority Leader Daschle). We also thank the leadership of this Committee for working out agreement on the broad, bipartisan estate and gift tax bill introduced on March 19th (S. 479). That bill seems to signal a large measure of agreement between the major parties on a framework for prudent and effective estate tax changes, and IBAA was proud to attend the press announcement on S. 479 as an indication of our support. We also commend the Chairman and Ranking Minority Member of this committee for conducting public hearing to explore the implications of the various proposal on family business continuity, and the Administration for acknowledging the problems in this area.

We hope these legislative and executive initiatives offer avenues to common ground that could promote enactment of critical and long-delayed relief in the estate tax area, which we believe would benefit the U.S. economy as a whole over the long term.

OVERALL CLIMATE FOR SAVINGS SHOULD BE IMPROVED

IBAA agrees with the Treasury Department's warning before this committee in March, that our personal savings rate—critical for the retirement security of an aging American population is disturbingly low—having declined from 7.7 percent over the 1960-86 period to 4.9 percent in 1996 (Statement of Deputy Secretary Summers before the Senate Finance Committee, March 6, page 2).

We also recall the conclusion of Federal Reserve Chairman Alan Greenspan before the Way and Means Committee in 1991, that increasing individual savings and national investment are the highest economic priorities. IBAA testified before both tax-writing committees in the 104th Congress, advocating the enhancement of tax-advantaged savings products. Since then, bipartisan efforts, spearheaded by Chairman Roth, succeeded in enacting the Spousal IRA provision in 1996. However, Secretary Summers confirmed that the U.S. savings rate remains significantly below the average of industrialized countries with which the U.S. competes.

In this context, we feel the renewal of the Super-IRA bills introduced by Senators Roth and Breaux (S. 197) and Representatives Thomas and Neal (H.R. 446), as well as the Clinton Administration's multifaceted proposals, are most constructive. IBAA strongly supports these proposals. Improving IRAs has a respectable lineage for both Democrats and Republicans—before it was a Lott-Roth bill, it was Roth-Breaux bill, and, before that, a Bentsen-Roth bill.

We believe opening the most attractive type of Individual Retirement Account (deductibble) investment to a larger population would be a powerful incentive to not only to prospective savers, but to the institutions holding, administering (and marketing) these funds.

The statistics reflect that three-fourths of all U.S. banks (7,400) hold IRA or other retirement accounts.

We have noted in our association's education programs that only about 10 percent of the workers in companies with less than 100 employees, for which community banks are primary financial advisors, now have any type of retirement plan. So, the banking system, among other service providers, is ready, willing and able to promote and perform retirement account services to the general public.

Before IRAs were cut back in 1986, they were attracting more than $38 billion of retirement savings. In the past few years, the annual total has hovered below $10 billion. So, there appears to be a sizable potential savings increases via IRA-type vehicles.

CAPITAL GAINS PROPOSAL ADVANCES THE DISCUSSION

In the capital gains area, the Clinton Administration, which advanced a proposal favoring small business and venture capital in 1993 (that became law), has taken another worthwhile initiative with its proposal to exempt $500,000 of value in the sale of a residence.

We believe the homeowner exemption has merit, based upon three principles: (1) the value of a residence accumulates over a long period, (2) it is often a family's primary retirement asset, and (3) it seems unfair to most Americans to tax a family on a reasonable amount of retirement savings.

What seems most promising to us is that these principles also apply to family farms and small businesses. One problem in cross-applying this limitation directly was discussed at the Senate Agriculture hearings of February 26 by IBAA witness John Dean. Most farmers live modestly, and would not be able to take full advantage of a residence exemption at that level. However, if such a concept can be applied generally to the build-up of farm and small business assets, there appears to be a significant opportunity to make progress in the closely related areas of capital gains and estate taxes, the interaction of which does much to determine whether farms and small businesses pass from one generation to another.

ESTATE TAX PRESENTS SERIOUS PROBLEMS

Despite the American Dream of family business succession, a minority of U.S. businesses (30 percent) are passed down to a second generation and only 13 percent make it to a third generation, according to the SBA. Federal estate taxes, that rise steeply to 55 percent and were last adjusted by 1981 legislation, are a prime cause of this attrition.

We believe the evidence is overwhelming that the existing federal estate tax is basically unfair to family and small commercial and agricultural enterprises.

Importantly, the income tax exemption is adjusted for inflation every year, but the estate tax exemption is not, and has not been adjusted legislatively since 1981.

Also, as federal estate taxes are structured, the most enterprising elements of our population are frequently taking a triple-hit. First, all business income is taxed as it is earned. Second, business assets are subject to tax again at death, at a very high rate. Third, many farm and business estate must sell part of the enterprise to pay these taxes, often at distressed prices because the are "forced sales." Others heirs must mortgage their farms or businesses heavily for 20 or more years to literally buy them back from the federal government.

The maximum estate tax rate was scheduled to fall from 55 percent to 50 percent in 1993, but the reduction was postponed to raise more revenue. Some argue that estate tax reductions should not take place until the budget is balanced. It is encouraging that the budget deficit has been declining steadily, but nobody is predicting that budget will be in balance until 2002, five years from now. For that result, however, we are somewhat at the mercy of general U.S. and world economic conditions beyond our control. Family farmers and small business owners should not be asked to wait indefinitely; half of U.S. farmers are age 57 or older.

BALANCING THE BUDGET IS COMPATIBLE WITH ESTATE TAX REFORM

The entrepreneurial community has something tangible to contribute to balancing the budget. At the beginning of this year, there seemed to be agreement in concept between the Executive and Legislative Branches that the budget should be balanced within the next five years in a way that would accommodate tax reductions that were decided to be most in the public interest.

Effective reform of estate tax, as well as savings and investment enhancements, would strengthen the foundations of the American economy. These are the kind of tax reductions that can help to promote budget balance two reasons. First, both objectives are long-term providing for some flexibility. Estate tax relief, especially, can be phased in over a considerable length of time, as was done with the last two major estate tax adjustments (1976–1981 and 1981–1986).

Tax planning for intergenerational transfer of family farms and small businesses is a long-term process, In our view, it is more important to get a really effective family business transfer provision in the law than to deliver large amounts of instant tax relief. In this regard, IBAA recommends that the tax reductions proposed in S. 479 not be front-loaded. Front-loading adds to the cost because the larger benefits are in effect for more years. IBAA would prefer to see any and all reductions phased in gradually, particularly so ample latitude is left for favorable treatment for long-held "family business assets."

Second, lightening the tax on investment in family enterprise will certainly encourage more investment in this economically significant segment of our economy. In turn, these investments, will boost federal and state tax revenues, to an unknown extent. However, if IRA, capital gains and estate tax provisions are reported from the Ways and Means Committee, there will be an opportunity, under the new House rules, to obtain a "dynamic revenue estimate," of how much revenue are expected to be generated over the next five years. Whatever the numbers show could be factored into the "fiscal dividend," so that tax changes that are widely regarded as desirable, do not need to be financed solely from cutting other federal programs.

ESTATE TAX STRUCTURE PROBLEMS GROW WORSE WITH TIME

Moreover, to freeze the estate tax structure for the indeterminate future would compound the problems for farm and business owners, and be, literally, counterproductive for communities across the country, and for our national economy.

The problems created by federal and state death taxes are a very serious and legitimate set of problems for the American small business community that need to be addressed on long-term basis. They need to be addressed sooner rather than later.

IBAA FAVORS BALANCED REFORM OF ESTATE AND CAPITAL GAIN S TAXES

Our bankers have a world of first-hand experience with the adverse impact of federal estate on small and family firms. This experience has impelled our association, for several years, to express strong support for substantial reform of federal estate taxes.

We also support further reduction of capital gain taxes, but in ways that promote long-term investment in community businesses. To fulfil these objectives, we believe that capital gain tax reductions should be done in tandem with estate tax reduction and near-term achievement of a balanced budget, which is also a forceful form of public saving.

IBAA believes estate taxes and capital gains are linked. The relative levels of these two sets of taxes pervasively influence the decisions of small businesses and farmers about whether to sell out or to keep their enterprises in the family.

The current maximum federal rates are 28 percent for capital gains and 55 percent for estate taxes. So, despite the possibilities of complex estate planning, there can be as much as a 2:1 financial advantage in selling a business property. If the maximum capital gains tax is reduced, say to 20 percent, the differential will increase—unless comparable adjustments are made in federal estate taxes.

THE ROLE OF FAMILY FARMS AND BUSINESSES

For more than 200 years, entrepreneurs in this country have been able to start farms and businesses and pass them along from one generation to another. These enterprises put down roots in their communities. Their owners come to know and care about their employees, their customers, their schools, churches and hospitals. They and family members volunteer at local charities and are a significant part of the cement of American life. Family stewardship of the land and other productive assets has worked well in this country.

Because of the fixed threshold of federal estate taxes, and the steeply graduated rates above that threshold, there is a real threat that federal estate taxes will destroy the system of existing family farms, businesses, and banks by taxing it out of existence. Giving substance to this threat is the fact that, since reductions in federal estate taxes were last legislated in 1981, revenues from this tax have increased 150 percent, from $6.389 billion in 1980 to an estimated $15.924 billion in 1996. This increase vastly outpaced inflation, an indication that estate taxes are a growing source of revenues for other federal expenditures.

Even more startling is the most recent estimate by the Joint Tax Committee that estate tax revenues will reach $19 billion this year and then double again to $35.6 billion in 2007. This revenue picture dramatically illustrates that rising asset values are causing increasing problems for ordinary Americans who have spent a lifetime building up modest nesteggs in farms, small businesses, retirement accounts, mutual funds, or rental properties.

So, in our view, the estate tax, which is justified by theorists as breaking up great concentrations of wealth by the super-rich, is evolving into a tax that increasingly promotes concentration of wealth by the super-rich at the expense of the middle class.

LIMITED VALUE OF A DEFERRAL PROVISION

When a farm or small business owner dies, typically federal estate taxes are due, within 9 months. IBAA believes that the estate tax installment payment privilege, under section 6166, is of very limited value, because the Internal Revenue Service acquires a "special lien" on the farm or business until the tax is fully paid. Conventional lenders are wary of extending credit to a business where the federal government is a senior creditor.

For this reason, section 6166 is little used now, and extending it to somewhat larger estates, as the Treasury Department recommends, would be almost entirely symbolic.

THE FUTURE OF MANY COMMUNITIES IN PERIL

Community bankers tell us that, in most cases, farm acreage or business assets must be sold off to pay the taxes, or the heirs must take out a mortgage, payable over 20 or more years.

The U.S. Department of Agriculture has estimated that 500,000 farmers over the age of 57 will retire in the next 10-20 years. That total could represent as much as one-quarter of U.S. family farms. How many of these farms and small businesses are going to make it over the next estate tax hurdle?

Two types of commercial businesses predominate in this country—local, family businesses (including farms) and chain stores (e.g. Wal-Mart, K-Mart, Sears). The former pay estate taxes; the latter do not. So, across the economy, taxes discourage family ownership, pushing enterprises toward larger units that often are transferred to absentee owners who have few ties to the communities in which they operate.

Today, community banks with less than $100 million in assets—typical IBAA banks—make more small business loans than any other size category of bank. Studies show that these financial institutions (which hold about 10 of U.S. deposits) make almost 30 percent of small business loans of less than $100,000. Often, a community bank is the only financial institution in a small town or rural area. Unfortunately for small business, there has been an overall decline of almost one-third in U.S. banks in the past decade, and all of that decline has been in the under-$100 million category.

Full interstate banking takes effect in the U.S. on June 1, 1997. Banks across the country must develop strategic plans that include whether they wish to continue as independents or whether they will seek to sell their franchise to another financial institution. Federal and state death taxes occupy a very significant role in this decision.

Banks as small as 8 employees and $15 million in assets have experienced estate tax problems. Should current IBAA owners plan to increase their investment, to better serve their customers, and incur greater estate tax risks, or should they plan to sell out? If owners are replaced with less experienced branch managers, business and farm loan applications may be sent to distant cities for evaluation by specialists who are probably not well acquainted with either the owners or their communities.

ESTATE AND GIFT TAX STRUCTURE SHOULD BE MODIFIED

IBAA urges, in the strongest terms, that the current grim reaping machine of the federal estate tax be thoroughly reexamined, for both economic and social reasons.

These taxes discourage investment where we need investment to remain world-competitive. They separate our most enterprising people from the enterprises their families have built, where our nation needs to preserve traditional family enterprise.

An extensive study by the Heritage Foundation in Washington, D.C. concluded as follows: "the economic cost of the estate tax is many times greater than the revenue it produces, and its reach into American households extends far beyond those few who pay it . . . The hardest hit by the tax are small businesspeople who work hard to pass on an enterprise of value to their children. And its bias against saving and wealth generation is the antithesis of the American Dream." (August 21, 1996, pages 3, 29).

Fortunately, estate tax problems are increasingly being recognized. In Iowa, Governor Branstad, on February 17, signed into law a bill that abolishes the state inheritance tax for lineal descendants. The combined vote of the Iowa House and Senate was 137-9 .

The federal thresholds, rate structure and the gift tax limits also need to be modified to bring them from the 1981 environment into the modern era.

EXISTING SENATE BILLS EXCELLENT DEPARTURE POINTS

Now that there is broad recognition of the problems, there should be action. On the federal level, IBAA supports the increase in the filing threshold ofa the Unified Credit from current $600,000 as a desirable first step. But, we would like to emphasize that this will not help many farmers, ranchers or treegrowers—or community banks. In IBAA's view, increasing the Unified Credit alone is not a cost-effective way of assuring the transfer of farms and businesses from one generation to another. It is also more expensive, because it applies to all assets, including securities and collectibles, rather than being focused on family farms and small businesses.

To get the job done, recognition needs to be given to the family and small business character of these assets, and the fact that they build up over a lifetime of effort, and the continuous risk of the market. The Senate Leadership bills, authored by Majority Leader Lott and Finance Committee Chairman Roth (S. 2), and by Minority Leader Daschle (S. 20), and the bipartisan Finance Committee bill (S 479) are excellent points of departure for crafting appropriate legislation.

As noted above, President Clinton's proposal for a homeowners' exemption for the first $500,000 of value in a residence may provide an avenue toward common ground. since the same principles apply to a farm and a small business. We therefore hope, as Senator Lott has indicated, that there can be a convergence of interest that can lead to bipartisan legislation that will really work to permit the transfer of family owned enterprises, while guarding against abuse.

IMPORTANCE OF ENACTING LEGISLATION THAT IS EFFECTIVE

It is thus vital that this Congress get estate tax reform right. If the 1997-98 legislation falls short, there will be many more horror stories from farm and small business families before Congress comes around to this issue again. And, in the meantime, the character of American life may be changed permanently for the worse.

We hope that a bridge can be built between the President's proposals and the House and Senate Leadership proposals, so that legislation bringing about both a balanced budget and needed tax reductions can be enacted during the 105th Congress.

Thank you again for this opportunity to express our views. IBAA would be pleased to work with the Finance Committee to improve these areas of the tax laws, so they can truly promote the economic well-being of small independent enterprises, their communities and the national economy.

STATEMENT OF MARYVILLE UNIVERSITY

SUBMITTED BY KEITH LOVIN, PRESIDENT

I am the President of Maryville University, a school of approximately 3,200 students located in St. Louis County, Missouri. I have been involved in the administration and financial workings of higher education for twenty-seven years in colleges and universities in Texas, Pennsylvania, Colorado and Missouri. We face a constant challenge to finance our schools. It is well known that the tuition charges only pay a fraction of the true cost of operating a university. So we need extra financial support not only to make ends meet in our everyday operations, but especially to enhance the quality of the educational experience we can offer our students.

Maryville is and expects to continue to be the beneficiary of charitable trusts. These sources of support have directly helped us add a new gymnasium and library to our campus among other things.

I am not a tax expert; however, I have been advised that due to changes made in the generation skipping tax in the mid 80's, and particularly the "predeceased parent exclusion," people whose children have predeceased them are put at a death and gift tax disadvantage if they set up charitable trusts which go to their grandchildren after the period of charitable use. The rate of tax apparently can be as high as almost 80% as compared to a direct gift of their assets to their grandchildren which would bear only a 55% tax. There would appear to be no reason for this difference. The same is apparently true for those who have no lineal descendants surviving them and who might leave their property to grandnieces and grandnephews who are their closest living relatives.

I have been involved with financial affairs for colleges long enough, and have seen enough contribution situations, to know that if persons were faced with a confiscatory tax at these percentages, most would probably not be so generous with our University.

I am also advised that the imposition of this generation skipping tax was aimed at those who were skipping generations of live people, which is not the case in either situation earlier described. These persons are not skipping anyone; they are merely leaving their assets to their closest living relatives. They just happen to be collateral descendants, in the one case, rather than lineal descendants. And the fact that they would choose to let our University enjoy the trust income for awhile, would put them in this penalizing tax situation all by itself, in the other case.

So here we have the anomaly of an unintended tax which would discourage such gifts.

We are very fortunate to have our new gymnasium and library. If the gifts that made these possible were being considered today, they might not have been made.

The tax laws of our country have been designed to encourage charitable donations. This is a policy deeply rooted in our system. For this, we are extremely grateful, to be sure. We could not exist without this encouragement. But in the midst of this lies a happenstance discouragement which needs to be removed. As I stated earlier, I am not a tax expert. However, one does not need to be a tax expert to see that these provisions are working opposite from what they were intended to accomplish—all to our detriment.

We strongly urge the passage of S.479 which contains a provision broadening of the "predeceased parent exclusion" to cover trust gifts where consistent with the intent and purpose of the generation skipping tax law and to cover collateral descendants for those who have no children or grandchildren.

STATEMENT OF JOHN S. NOLAN, MILLER & CHEVALIER

Dear Mr. Chairman: Pursuant to your announcement of April 7, 1997, I write this letter to offer my views as to an element of estate tax relief for family-owned, closely-held businesses that is critical to the fairness of the federal tax system.

As currently drafted, and under some current proposals, section 6166 of the Internal Revenue Code, which allows for installment payments of federal estate tax attributable to a closely-held family business or farm, is unavailable to some businesses merely because of the structure in which the owners of the business choose to operate. This is particularly true of business corporate structures in which some of the stock is owned and traded by the public, but the closely-held character of the business is retained. I believe that fairness requires that those distinctions based solely on form of ownership be eliminated.

MY BACKGROUND

I am a member of the law firm of Miller & Chevalier, Chartered, in Washington, D.C., where I have practiced law from 1951 to 1969 and from 1972 until the present. An important part of my practice has been advising family-owned businesses and the families that own them regarding federal estate tax issues. From April 1969 to February 1972, I served as Deputy Assistant Secretary of the Treasury for Tax Policy, with responsibility for formulation and execution of United States domestic and international tax policies. I have also served as Chairman of the Section of Taxation of the American Bar Association (1981-1982), a member of the Advisory Group to the Commissioner of Internal Revenue (1967-1968, 1983-1984), President of the

American Tax Policy Institute (1990-1991), and a member of the Board of Trustees of the American Tax Policy Institute.

BACKGROUND OF ESTATE TAX RELIEF FOR FAMILY BUSINESSES

The 55% federal estate tax on owners of closely-held businesses is a huge burden. Closely-held businesses include not only private businesses and family farms, but even publicly-traded companies where one person owns such a substantial portion of the outstanding shares that, for estate tax purposes, the burden of paying the estate tax threatens the continuing existence of the company.

Although ostensibly imposed in a neutral manner on assets, the estate tax actually is different in character and incidence when applied in the case of a closely-held business owner. In general, the executor of an estate of the owner of other assets, such as stock in widely-held public companies, is able to sell some of those assets in order to raise cash to pay the estate tax without any effect on the underlying assets that are sold. In contrast, however, when the owner of a closely-held business dies, there is no satisfactory way to raise cash to pay estate taxes without experiencing severe adverse effects on the business itself. Sale of the decedent's entire interest in the business would destroy its character and deny the decedent's family the opportunity to continue the family inspiration and creativity that led to its success. The alternative, immediate redemptions of the decedent's shares, would strip the business of its cash resources, and often would require heavy borrowing by the business, crippling its continued success and growth.

In my experience, owners of such businesses have typically invested their entire lives and financial resources in their family businesses. They often do so with a view to passing on ownership and control to their family, just as they may have received the business from their ancestors. The principal stockholder generally does not have other assets to pay the large estate tax that would be imposed on the value of a successful business. In these cases, the only source of payment of the estate tax (other than a forced sale of the business to outsiders, usually at a distressed price) is generally, as I have said, the business itself, through redemptions of the principal owner's stock. Therefore, in the case of a family-owned business, the estate tax, in effect, is often a tax on the business itself-a tax not incurred by widely-held public companies. But for the proper application of section 6166, this burden on the closely-held business would cause severe harm to the business, the decedent's heirs, and even to unrelated investors in the business.

I know that the Committee and the Congress agree that family-owned businesses in this country contribute invaluably to job creation, inventiveness, and economic growth. In my experience, this is an asset of the United States which we must preserve. The break-up of these businesses by the estate tax is not in the public interest.

APPLICATION EVEN THOUGH SOME STOCK IS OWNED BY THE PUBLIC

The burden of the tax on closely-held businesses is not necessarily relieved when some of the stock or other ownership interest in the business is owned by the public and traded in an established market. Indeed, the estate tax burden can be even worse in such a case. Efforts to sell the decedent's stock (if even allowed by securities laws) in what is typically a thin market, in the quantities necessary to pay estate tax, can severely depress the traded value of the stock and thus hurt the investments of both the estate and unrelated public stockholders. The result can be very much the same as a forced sale of the business to a public company, a result which I believe tax policy should not encourage or welcome. For all practical purposes, the family's stock is nonmarketable, even if some of the other stock is held by the public.

THE ESSENTIAL ROLE OF SECTION 6166

I believe that it is largely in recognition of these circumstances that Congress has provided self-defensive measures in the form of estate tax relief for businesses which to a substantial extent are closely-held. One of the most important of these relief provisions is the ability of an executor under section 6166 of the Internal Revenue Code to defer payment of the federal estate tax attributable to the decedent's interest in a closely-held business, if at least 20 percent of the value of the voting stock of a corporation is included in determining the value of the decedent's gross estate and the value of that stock included in determining the decedent's gross estate exceeds 35 percent of the decedent's adjusted gross estate. If this election is made, (1) no amount of that part of the tax need be paid with the estate tax return due nine months after the decedent's death, (2) only interest on the tax is payable until five years after that date, (3) the interest on a portion of the tax is calculated at a favorable rate, and (4) beginning five years after the regular due date of the tax, the principal amount of the tax, with interest, is payable in up to ten annual installments. This deferral of the estate tax enables closely-held businesses to survive and prosper by providing funds to the decedent's estate to pay the estate tax gradually, over a reasonable period of time.

The relief of section 6166 is extended to stock held directly by the decedent even if up to 80 percent of the stock is held by the public. Under current law, as long as the decedent's ownership interest in a business is a sufficiently substantial portion of the decedent's adjusted gross estate (35 percent), and a sufficiently substantial portion of the voting interests in the business (20 percent), the decedent's estate is allowed deferral under section 6166, irrespective of whether the interest is publicly-held in part or entirely privately-held.

Section 6166 serves a vital purpose in beginning to redress the unfair burden of the estate tax on some of the country's closely-held businesses by allowing the business some breathing room in which to recover from the effect of the decedent's death and raise the money needed to pay the tax in an orderly way. The hope is that this opportunity will avoid the need to immediately liquidate the business and will permit the business to remain healthy and competitive.

SHORTCOMINGS OF SECTION 6166

Unfortunately, section 6166 does not effectively address the variety of modern business structures.

Before 1984, the relief of section 6166 in general was available only with respect to stock (or partnership interests and sole proprietorships) owned directly by the decedent. Thus, before 1984, a decedent's estate might have been unable to elect deferral under section 6166 merely because of the form in which an otherwise qualified business was held-for example, as the operating subsidiary or subsidiaries of a holding company. In the Deficit Reduction Act of 1984, Congress addressed that problem by adding paragraph (8) to section 6166(b) to provide that certain holding companies could be looked through in applying section 6166. The stated purpose and intended effect of the 1984 legislation was that "interests in active closely held corporations may be considered for purposes of the installment payment provision provided the indirectly owned interest would meet the requirements of that provision were it directly owned." H.R. REP. NO. 98-861, 98th Cong., 2d Sess. 1236 (1984) (conference report) (emphasis added). This new provision was well-conceived because modern business practices often require use of a holding company for non-tax business reasons.

The commendable stated purpose of that change was to remove mere form (ownership of the interest through a holding company) as a determinant of the tax consequences of this vital estate tax relief provision. Unfortunately, however, for no apparent reason, the effectiveness of the 1984 amendment is limited by sections 6166(b)(8)(A)(ii) and (iii), which deny the initial five-year deferral of principal payments of tax and the preferential interest rate, and by section 6166(b)(8)(B), which provides that "[n]o stock shall be taken into account for purposes of applying this paragraph unless it is non-readily-tradable stock (within the meaning of paragraph (7)(B))." The legislative history gave no explanation for these limitations, imported into the new provision for holding companies from section 6166(b)(7), a completely different rule which had been added in 1978 to permit the 20-percent test to be met by all the stock held by the decedent's family if it were not met by the decedent's stock alone. The section 6166(b)(7) rules serve entirely different purposes in the application of that provision. They have no place in section 6166(b)(8) where they cripple its application even though the decedent's indirectly-owned interest (through the holding company) would meet the requirements of section 6166 if it were directly owned.

This improper limitation in the scope of section 6166(b)(8)(B) forces the principal owner of a closely-held business to forego what may be very important non-tax reasons for using a holding company structure. Such a structure often facilitates operations of a multi-faceted business. If the decedent's interest in the business meets the basic threshold tests of section 6166, there is no reason why the application of section 6166 should be denied simply because that interest is held in the most efficient manner through a holding company.

THE COMMENDABLE CURRENT INTEREST IN ESTATE TAX RELIEF FOR FAMILY BUSINESSES

I applaud the current bipartisan interest in making the estate tax relief for family-owned, closely-held businesses and farms more effective, reflected both in the Administration's budget proposals released in February and in S. 2, S. 20, and S. 479.

The Administration's proposal appears at first reading to be particularly laudable. It states, under the heading "Reasons for Change," that "the estate should not be forced to forego the benefits of the five-year deferral and lower interest rate *simply because of the structure of the business entity.*" It then explains its intended objective, under the heading "Proposal," as "providing the same relief to closely held businesses *whether owned directly or through holding companies.*" DEP'T OF THE TREASURY, GENERAL EXPLANATIONS OF THE ADMINISTRATION'S REVENUE PROPOSALS, ch. IV, at 26-27 (February 1997) (emphasis added).

Unfortunately, the Administration's proposal may fall short of these worthy objectives, because, although it addresses the discrimination with respect to the five-year deferral provision and the preferential interest rate, it appears to retain the troublesome and unnecessary "non-readily-tradable stock" limitation. As I have earlier indicated, section 6166 applies even if some of the stock of the family-controlled business is owned by the public, and the result should not be different simply because non-tax reasons require the interposition of a holding company.

The Administration's proposal resembles an amendment offered by Senator Bradley to the 1995 budget act, except that Senator Bradley's amendment would have completed the elimination of discrimination based on form of structure by repealing section 6166(b)(8)(B). Amendment 3031 to S 1357, 141 CONG. REC. S16028-29 (Oct. 27, 1995). The brief floor debate in 1995 suggests that Senator Bradley's amendment was tabled by the Senate primarily because of what it sought to replace, not on its own merits. There is no apparent reason why the Administration's proposal should have departed from the approach of Senator Bradley's amendment.

CONCLUSION

Mr. Chairman, there are a host of sound business reasons why a family-owned business would raise supplemental capital through public equity markets, and not exclusively through debt financing, while still retaining its essential character as a family-owned business. Wisely, section 6166 in general does not insist on a "non-readily-tradable" requirement for interests is such businesses held directly by the decedent. Similarly, however, there are a host of good business reasons why a family might choose to conduct a business through a holding company structure, rather than through direct ownership of an operating company. Denial of relief under section 6166 solely on that basis is unfair, particularly where, in terms of the purpose of the 1984 legislation (though not its precise provisions), the indirectly-owned interest would meet the requirements if it were directly owned.

I urge the Committee on Finance to welcome the Administration's stated commitment to the extension of the benefits of section 6166 and the elimination of distinctions based on form of ownership, but to make sure that the legislation it recommends to the Congress lives up to that commitment by including the repeal of section 6166(b)(8)(B).

STATEMENT OF THE U.S. CHAMBER OF COMMERCE

SUBMITTED BY WILLIAM T. SINCLAIRE, SENIOR TAX COUNSEL & DIRECTOR OF TAX POLICY

The U.S. Chamber of Commerce appreciates this opportunity to express its views on the federal estate and gift tax. The U.S. Chamber is the world's largest business federation, representing an underlying membership of more than three million businesses and organizations of every size, sector and region. This breadth of membership places the U.S. Chamber in a unique position to speak for the business community.

INTRODUCTION

The U.S. Chamber believes that public policies should not only improve our current economic environment but also ensure our future prosperity. The key to a stronger economic future is simple to define, i.e., a high rate of economic growth, but difficult to achieve. It is strong economic growth that will allow us to maintain our position of world leadership, increase our domestic standard of living, and meet the daunting demographic challenges that will begin to present themselves early in the next century.

But economic growth does not occur by accident. Just as our farmers do not rely on good luck for bountiful harvests, neither can we rely on chance or the momentum of the past to propel us in the future. The seeds of tomorrow's economic success must be planted today, and so, when evaluating economic policies, we must ask how they would cultivate long-term economic growth.

By definition, economic growth is simply the product of growth in the labor force (i.e., the number of hours worked) and growth in productivity (i.e., output per hour). With growth in hours worked largely determined by demographics, sensible economic policy must emphasize strong productivity growth.

This is a crucial issue because productivity growth has been languishing for the past quarter-century or so. After expanding at a healthy 2.7 percent rate during the 1960's, for example, productivity growth has slowed to an anemic one percent rate so far in the 1990's. With growth in hours worked hovering a little below 1.5 percent, long-term economic growth is thus limited to 2.5 percent—well below the average of the post-World War II era.

While measurement problems related to productivity have expanded with the growing share of the economy devoted to service-producers rather than goods-producers, the decline in economic growth over the same period confirms that we are suffering a decline in the underlying growth rate in productivity. The question then becomes: What can we do to raise productivity growth?

Like the farmer who sows the seed corn and cultivates the soil, households and businesses must also prepare for the future. Virtually all economists agree that this is done by saving and investing in capital—both human capital (education) and physical capital (plant and equipment). Thus the issue of long-term productivity growth and, in turn, economic growth becomes one of fostering additions to, and improvements in, capital. Consequently, the U.S. Chamber believes that today's economic policies must be targeted toward improving economic growth by fostering saving, investment, and capital formation. Only through such pro-growth policies can we lay the foundation of prosperity and security for our children into and beyond the 21st century.

To boost productivity, the federal government must end its misdirection of resources and curb its appetite for borrowing so that national savings and investment can be increased. This will yield stronger productivity growth, which in turn will propel the economy on a higher growth track. Besides balancing the budget, other policy elements that would aid long-term economic growth include overhauling our regulatory and tort systems, enhancing education and job training programs, reducing the tax burden, and reforming the tax code.

The estate and gift tax is a tax on accumulated savings and entrepreneurship. It imposes a financial disincentive and a psychological barrier to capital accumulation and investment. The tax begins as a threat and then becomes a punishment to taxpayers who save their entire lives, or who have developed successful and valuable businesses.

BACKGROUND OF THE ESTATE AND GIFT TAX

Federal death taxes in this country, for most of our history, were imposed primarily to finance wars or threats of war. The first federal death tax in the United States was a stamp tax imposed in 1797. The first progressive estate tax—similar to that imposed under current law—was adopted in 1916. Estate tax rates have varied over the past 81 years, ranging from a 10-percent maximum rate in 1916 to a 77-percent maximum rate in 1941. The first gift tax was imposed in 1924. Although the gift tax was repealed in 1926, it was reinstated in 1932 and has continued ever since. In 1948, Congress provided the first marital deduction, allowing 50 percent of any property transferred to a spouse to be transferred on a tax-free basis.

Before 1976, estate taxes were imposed on those transfers occurring at death, while gift taxes were imposed on transfers during a taxpayer's life. In 1976, the estate and gift tax structures were combined and a single unified graduated tax rate came into being. This unified tax system has since applied to the cumulative taxable transfers made by a taxpayer during his or her lifetime and at death.

Under the current estate and gift tax rate structure, rates begin at 18 percent on the first $10,000 of cumulative transfers and reach 55 percent on transfers exceeding $3 million. However, a unified nonrefundable tax credit is available to offset the first $192,800 of estate and gift taxes. This credit effectively exempts the first $600,000 of cumulative transfers from tax. Therefore, the initial tax rate at which lifetime and death transfers become subject to the tax is 37 percent. A 5-percent surtax is also imposed upon cumulative taxable transfers between $10 million and $21,040,000, to phase-out the benefits of the graduated rates and the unified credit. Furthermore, a taxpayer may exclude $10,000 of gifts made to each donee during a calendar year and gifts between spouses are generally tax-free.

WHAT CAN BE DONE TO REFORM THE ESTATE AND GIFT TAX

The best approach to relieve those small business owners and others from the burdensome and inefficient estate tax and gift would be to repeal it outright. However, if outright repeal is not feasible in the near term, there are reforms which would make the tax less harmful to small business owners and their workers, and they should be implemented.

First, the unified credit—which currently provides a nonrefundable credit of up to $192,800 against the estate tax and gift—should be increased and indexed. This credit effectively exempts up to $600,000 of lifetime transfers from the unified estate and gift tax and has not been changed since 1987. If the credit had been indexed since 1987, it would now effectively exempt approximately $838,000 in lifetime transfers.

Second, overall estate and gift tax rates—which effectively begin at 37 percent and rise to 55 percent (without taking into account the 5-percent surcharge)—should be significantly reduced. The value of an individual's lifetime transfers, including his or her business, only has to exceed $2 million before it becomes subject to a 49-percent rate, and $3 million before it is subject to the maximum 55-percent rate. These rates are excessive and need to be significantly lowered in order to promote business and job growth.

Third, in order to promote continuation of small and family businesses, their value should be excluded from their owners' lifetime transfers. When a substantial portion of an individual's wealth is invested in one enterprise, payment of transfer taxes is generally impossible without selling the business or borrowing against its assets to pay the estate and gift tax.

ESTATE AND GIFT TAX LEGISLATIVE PROPOSALS

President Clinton proposed some estate tax modifications in his FY 1998 budget. In addition, various estate tax legislation has been introduced in the 105th Congress by both Republicans and Democrats. These proposals vary in terms of relief from mere modification of payment terms to outright repeal. A summary of the more significant proposals follows.

President Clinton's Fiscal Year 1998 Budget Proposal

Unfortunately, the President's proposal would not provide individuals or business owners with any significant estate tax relief. His proposal would merely modify the interest rate provisions as it relates to the deferred estate tax liabilities of certain closely-held businesses. It would not reduce the underlying estate tax liabilities of these or any other types of businesses.

Under the President's proposal, the amount of value in a closely-held business that would be eligible for a special low interest rate on its deferred estate tax would be increased from $1,000,000 to $2,500,000. The special 4-percent rate would be reduced to 2 percent; however, interest paid on the deferred estate tax would no longer be deductible for income or estate tax purposes. The deferred estate tax on any value of a closely-held business exceeding $2,500,000 would be subject to interest at a rate equal to 45 percent of the usual rate applicable to tax underpayments.

The American Family Tax Relief Act (S. 2)

Introduced by the Senator Roth (R-DE) and others, this bill includes the following estate tax relief provisions:

- The unified credit would be ratably increased over an eight-year period beginning in 1997 from an effective exemption amount of $600,000 to $1 million. The full $1 million would be available for decedents dying, and gifts made, after December 31, 2003.
- The first $1.5 million in value of a "qualified family-owned business interest" of a decedent's estate, and 50 percent of the excess value, would be excluded from federal estate and gift tax. To qualify, certain ownership and participation requirements would have to be met (i.e., such interest must comprise more than 50 percent of the decedent's estate and be a non-publicly-traded interest). In addition, the exclusion would be subject to recapture if the "qualified heirs" do not "materially participate" in the business for at least ten years after the decedent's death.
- The maximum period for which federal estate tax installments could be made under a special provision of the Internal Revenue Code would be extended from 10 to 20 years. In addition, no interest would be imposed on the amount of deferred estate tax attributable to the first $1 million in value of a closely-held business.

The Targeted Investment Incentive and Economic Growth Act of 1997 (S. 20)

Introduced by the Senator Daschle (D-SD) and others, this bill includes the following estate tax relief provisions:

- The first $900,000 in value of a "qualified family-owned business interest" of a decedent's estate would be excluded from federal estate and gift tax. To qualify, certain ownership and participation requirements would have to be met (i.e., such interest must comprise more than 50 percent of the decedent's estate and be a non-publicly-traded interest). In addition, the exclusion would be subject to recapture if the "qualified heirs" do not "materially participate" in the business for at least ten years after the decedent's death.
- The 4-percent interest rate imposed on installment payments attributable to the first $1 million in value of a closely-held business would be increased to the first $1.6 million in value.

The Family Heritage Preservation Act (S. 75 and H.R. 902)

Introduced by Senator Kyl (R-AZ) in the Senate, and Representative Cox (R-CA) in the House, these companion bills would completely repeal the federal estate and gift tax upon the date of enactment.

The Estate Tax Relief for American Family Act of 1997 (S. 479)

Introduced by Senators Grassley (R-IA), Baucus (D-MT), Lott (R-MS), Nickles (R-OK), Breaux (D-LA), Dorgan (D-ND), and others, this bipartisan bill includes the following estate tax relief provisions:

- The unified credit would be increased over a six-year period beginning in 1997 from an effective exemption amount of $600,000 to $1 million. The unified exemption equivalent would be increased to exempt an additional $100,000 in each of the first two years, and $50,000 in each of the following four years.
- The first $1.5 million in value of a "qualified family-owned business interest" of a decedent's estate, and 50 percent of the next $8.5 million, would be excluded from federal estate and gift tax.
- The maximum period for which federal estate tax installments could be made under a special provision of the Internal Revenue Code would be extended from 10 to 20 years. In addition, no interest would be imposed on the amount of deferred estate tax attributable to the first $1million in value of a closely-held business.

The Family Business Protection Act (H.R. 1299)

Introduced by Representatives McCrery (R-LA), Dunn (R-WA), Christensen (R-CA), Herger (R-CA) and Condit (D-CA), this bill includes the following estate tax relief provisions:

- The unified credit (which currently exempts up to $600,000 of a decedent's assets from tax) would be replaced with an actual exemption that would reach $1 million by 2002 and be indexed for inflation thereafter.
- The first $1.5 million in value (which would be indexed for inflation), and 50 percent of the excess value, of a "qualified family-owned business interest" would be exempt from the federal estate and gift tax.
- Various rules relating to special use valuations for farms and ranches, conservation easements, and historic property would be modified.

Other Proposals

A variety of other estate tax relief bills have been introduced in the 105th Congress, including those by Senators Lugar (R-IN), McCain (R-AZ) and Dorgan (D-ND), and Representatives Crane (R-IL), Livingston (R-LA), Solomon (R-NY) and Stump (R-AZ). These bills would either repeal the estate tax, increase the unified credit, reduce the estate tax rates, or provide family-owned businesses with tax relief to varying degrees.

CONCLUSION

The U.S. Chamber believes the estate and gift tax can deplete the estates of taxpayers who have saved their entire lives, or can force successful family businesses to liquidate or take on burdensome debt to pay the tax. Taxpayers should be motivated to make financial decisions for business and investment reasons, and not punished for individual initiative, hard work, and capital accumulation. The estate and gift tax law should be completely repealed, however, if outright repeal is not feasible in the near term, it should be reformed or simplified to reduce or eliminate its negative effect on individuals and the owners of family businesses.

Statement of the University of Arkansas

SUBMITTED BY A.H. EDWARDS, VICE CHANCELLOR FOR UNIVERSITY ADVANCEMENT

Mr. Chairman: I am A.H. "Bud" Edwards and I am currently the Vice Chancellor for University Advancement at the University of Arkansas. I have held this position since August 1989. As a member of the Chancellor's Cabinet, I participate in the overall management of the University. In my role as Vice Chancellor I plan, organize, schedule, coordinate, report, and budget in the areas of alumni programs, creative services, development, public information, and major university events. My objectives include the development and implementation of a communications plan to promote and establish public perceptions of the University of Arkansas as a center of academic excellence and a valuable asset to the State of Arkansas; the planning and implementation of a total development program; the development of alumni programs; and the maintenance and improvement of high-quality University of Arkansas publications.

The University of Arkansas is located in Fayetteville, Arkansas. It is the flagship campus of the University System.

Like most, if not all, public universities, we are challenged constantly to supplement our public financial support with private contributions from friends of the University who are anxious for us to maintain our program at the highest possible level. We have needed and enjoyed the tax policies of this nation which foster charitable giving in these efforts.

However, we have become aware of estate and gift tax issues which need to be re-examined because of some inadvertent effects on our private financial support.

We wish here to express the University of Arkansas' strong support, in particular, for that portion of Senate bill, S.479, which amends the Generation Skipping Transfer (GST) tax to expand the predeceased parent exclusion (1) to include taxable terminations and distributions from a trust and (2) to cover collateral descendants where the transferor has no lineal descendants.

By making the predeceased parent exclusion inapplicable to anything other than a direct gift to a qualifying beneficiary, the GST tax as presently structured effectively prohibits donations through the use of a charitable lead trust where the predeceased parent exclusion would otherwise apply. No matter how strong the donor's charitable interest, the donor is unlikely to be willing to suffer an additional fifty-five percent tax on the bequest to his descendants.

Charitable lead trusts are a very important source of contributions to the University of Arkansas and charities of all kinds. It makes no sense to discourage their use where there is plainly no attempt at tax avoidance whether the gift is made directly to the beneficiary or after an intervening charitable trust.

We also believe that it is unfair to limit the predeceased parent exclusion to lineal descendants. A donor who happens to be without children and grandchildren should not be treated differently from a donor who has grandchildren. Assessing the GST tax on the bequest of the childless donor to his collateral descendants reduces the estate significantly and discourages charitable giving, as well.

We hope that this amendment can be accomplished.

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