



Comments to the U.S. Senate Committee on Finance Individual Income Tax Working Group On Estate Tax Reform and the Step-Up in Basis

Senator Grassley, Senator Enzi, Senator Stabenow and Members of the Senate Committee on Finance Individual Income Tax Working Group, the Small Business Legislative Council (SBLC) appreciates this opportunity to share its insights on estate tax reform and the impact that a repeal of the step-up in basis would have on individuals and businesses alike.

INTRODUCTION:

In recent years there have been a number of efforts to repeal the federal estate tax, increase the federal estate tax exemption or reduce the estate tax rate. A reduction or elimination of the estate tax would certainly prove very beneficial to very high net worth individuals as well as those family-owned small and mid-sized businesses which are very capital intensive, land rich or successful. However, it would be extraordinarily detrimental to many more individuals and *almost all* small businesses if there were to be an elimination, or scale back, of the “step-up in basis” at death. Any attempt to eliminate or scale back the step-up in basis must be vigorously opposed if we are to protect our nation’s small business owners and keep small businesses strong.

The step-up in basis is generally under-addressed in the debate over the estate tax, yet it is sometimes erroneously categorized as a “tax loophole” and looked to as a proposed revenue raiser. The damage that would be caused to almost all small businesses by eliminating the step-up in basis, due to the creation of a new capital gains tax on small businesses at the passing of an owner, would be staggering. While the media attention has focused on proposals to either repeal the estate tax, increase the exemption limit or reduce tax rates, which would certainly be beneficial to some small businesses, there has been very little publicity or awareness of proposals to eliminate the step-up, which is very concerning given the impact that such a change would have on a much broader swath of small businesses.

The most recent proposal to eliminate the step-up in basis came in February in President Obama’s 2016 Budget Proposal.¹ In the context of small business, and the small business growth which, as we are all aware, is critical to the American economy, maintenance of the step-up in basis is imperative. **The SBLC urges the working group to strongly oppose any proposals, related to the estate tax or otherwise, which would reduce or eliminate the step-**

¹ The fact that the President’s Budget calls for a reduction in the federal estate tax exemption which would make the repeal of the step-up in basis even more damaging.



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up in basis. Such a course of action would prove extremely harmful to small businesses across the country and impede the ability of small businesses to grow, create jobs and contribute to the economy.

CONSEQUENCES OF LIMITING OR ELIMINATING THE STEP-UP IN BASIS AT DEATH:

The President's plan, as set forth in his 2016 Budget Proposal, would be to repeal the "step-up in basis" in property that occurs when someone passes away. The step-up in basis provides that property transferred at an individual's death will not be subject to capital gains tax on the appreciation that occurred during the individual's lifetime. The President's proposal refers to the step-up as a "loophole" for high income taxpayers. However, the truth is that this proposal has the ability to force new taxes on many small businesses and their middle class owners.

Under the President's proposal, each individual would be able to exempt up to \$100,000 of any type of capital gain, plus an additional \$250,000 of capital gains on a residence, from being taxed at death. The proposal would also exclude from taxation any capital gains on tangible personal property other than "expensive art and similar collectibles" as well as any capital gains on property that is bequeathed to a charity.

On the business side, the President's proposal would provide that "inherited small, family-owned and operated businesses" would not be subject to the payment of the capital gains taxes until the business is sold and would permit closely held businesses to pay the capital gains taxes due upon death over a period of 15 years. In the past, Congress has struggled with provisions aimed at defining "small, family-owned and operated businesses" and, if this provision were to be enacted, as discussed further below, we would expect to see hundreds of pages of new regulations defining what businesses would be covered by this definition.

A simple example demonstrates just how harmful the elimination of the step-up in basis could be for a family-owned small business. Suppose a small business that is owned by a husband and wife whose basis in the business is \$100,000 and, due to many years of hard work by the owners, is worth \$12 million at the time of their passing. To simplify the example to its barebones, assume that the husband and wife have no other valuable assets, no deductions and that they pass away simultaneously.

- *Under current law*, there would be no tax on the couple's \$11.9 million capital gains in the business and \$10.86 million of the two estates would be tax exempt pursuant to the federal estate tax exemption. Thus, \$1.14 million of the joint estate would be taxable, which, at a 40% tax rate, would mean that the husband and wife's estates would pay a total of approximately \$450,000 in federal estate tax.
- *If the step-up in basis were eliminated*, assuming no change to the current estate tax exemption, if the family decided to sell the business immediately after the death of the parents, the family would be required to pay capital gains tax on the parents' gains in the business. Under the President's proposal, each individual would be able to

exempt up to \$100,000 in capital gains (or \$200,000 for a couple). Thus, the family would be subject to capital gains tax on \$11.7 million of capital gains in the business, which, at the current top rate of 20%, would mean \$2,340,000 of new capital gains tax.² This would be in addition to the \$456,000 that the family would owe in estate taxes, meaning that the total tax bill for the family would be \$2,696,000. If, however, the President's proposal to reduce the federal estate tax exemption down to \$3.5 million a person and to increase the capital gains tax rate up to 28% were adopted, then again using this simplified example, the family would now owe the government \$2 million in federal estate tax and \$3,276,000 in the new capital gains tax. **The tax cost to the family due to the proposed increase in the federal estate tax and the new capital gains tax is unconscionable.**

If the hypothetical business was a closely held business, rather than a family-owned and operated business, it would still face a similar result. The business would be required to pay the \$2,340,000 (as calculated above) over 15 years, commencing immediately after the parents' deaths. In other words, the business would be required to pay \$156,000 annually in taxes, every year for fifteen years. For most small businesses, \$156,000 annually is a relatively large sum of money and the equivalent of annual pay for up to four employees.

A further concern with the repeal of the step-up as structured in the President's proposal is that it would place regulators in the position of trying to establish what constitutes a family-owned and operated business and distinguishing between family-owned businesses and closely held businesses. If this rulemaking were to take the course we've seen all too frequently, the regulators would spend pages and pages setting forth rules that would attempt to eliminate any possible abuse of the main rule and leave us without any bright line or common sense tests. This process would likely end up following the same course as the old QFOBI (Qualified Family-Owned Business Interest) provisions that were added to the tax code in an attempt to save family-owned businesses from being sold just to pay estate taxes. This provision suffered from one major drawback - the family would not be able to tell if the business qualified for the QFOBI exemption until the owner had passed away. In other words, it gave little, if any, comfort to the family when trying to plan for estate taxes. In addition, the QFOBI suffered from complexity and definitely required specialized lawyers hired to try to wend their way through the maze of regulations in order to assist family-owned businesses to deal with it. It appears that this is the type of exception the President's proposal is trying to resurrect. There is no reason to expect it will work any better the second time around.

PROPOSALS TO REDUCE THE ESTATE TAX BURDEN ON SMALL BUSINESSES:

As can be seen from the above example, the elimination of the step-up in basis could be far more costly for most small businesses than the estate tax currently is (in the example \$2,340,000 in new capital gains tax v. \$456,000 in current estate tax). Thus, SBLC's top priority in this area is to ensure the continued existence of the step-up in basis. There is, however, no

² It is important to note that the President's Budget proposes not only to eliminate the step-up in basis, but also to increase the top capital gains tax rate to 28% (from the current top rate of 20%).



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question that a reduction of the estate tax, without any change to the step-up in basis, would benefit many small businesses and encourage greater growth. The federal estate tax exemption should not be reduced as called for in the President's budget proposals.

Recently, there have been some serious discussions, particularly in the House Committee on Ways and Means, about creating an estate tax exemption for small businesses and farmers. If drafted carefully to avoid the regulatory issues that arose with respect to the QFOBI definition, as discussed above, the SBLC would strongly support legislation to exempt small businesses from the estate tax or otherwise reduce the estate tax burden on small businesses. We applaud the bi-partisan concern about the impact that estate taxes have on small businesses, farms and ranches.

In the event that reform of the estate tax system is under consideration, the SBLC urges the Finance Committee and its members to focus, not necessarily on the biggest changes to the estate tax, but the changes most likely to become law and provide meaningful relief to small businesses. Proposals to repeal the estate tax have been widely discussed. However, there is also another option that should be considered which would reduce the estate tax burden for many small businesses and individuals but would be more likely to gain bi-partisan support. Specifically, this would be to create a two tier rate system for the application of estate taxes over the exemption limit. In other words, maintain the current estate tax exemption (which today is \$5.43 million per individual), then tax the first \$5 –10 million over the estate tax exemption at a lower rate of say, 20%, and anything beyond the first \$5 million (or perhaps \$10 million) over and above the federal estate tax exemption level would then be taxed at the current estate tax rate of 40%.

Applying this proposal to an example, suppose that the business described in the earlier example had a value of \$25 million rather than \$12 million.

- *Under the current estate tax system*, the first \$10.86 million (\$5.43 million per parent) would be exempt from estate tax and the remaining \$14.14 million would be taxed at a rate of 40%. Under the current system, the total estate tax bill would be \$5.656 million.
- *Under the tiered estate tax proposal*, the first \$10.86 million (\$5.43 million per parent) would be exempt from estate tax, the next \$10 million (\$5 million per parent) would be taxed at a rate of 20% (\$2 million), and the remaining \$4.14 million would be taxed at a rate of 40% (\$1.656 million). Under the tiered estate tax proposal, the total estate tax bill would be \$3.656 million or \$2 million less than the bill under the current system. This would significantly assist those small businesses who have higher values due to being land rich, capital intensive or just simply very successful. Of course if the 20% rate extended to an estate valued at \$15.43 million per individual that would be even more helpful for these types of family-owned businesses.

Even though the value of many small businesses does not exceed the federal estate tax exemption there are still many small and family-owned businesses that have a fair market value



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that does exceed that level. As we have identified above, those most likely to exceed the exemption level (even the joint exemption level of a couple – and of course, many small business owners are not married) are those businesses that are capital intensive, land rich (but often income poor), or are just plain successful, which means they are generating jobs – mostly jobs for Americans. It is interesting to note that under the U.S. Small Business Association (SBA) standards, a service business with annual receipts of up to \$21.5 million (depending on the type of service) may be classified as a small business and a retail business with annual receipts of up to \$21 million (depending on the product) may be classified as a small business. Of course, one cannot determine the fair market value of a business based solely on annual receipts, but it is highly probable that a business generating annual receipts in this amount would have a value in excess of the federal estate tax exemption.

The introduction of a tiered estate tax system, as outlined above, however, would reduce the estate tax burden on small family-owned businesses that has proven harmful to the growth and success of many of these businesses. On the other hand, the tiered proposal would not be as costly as a proposal to eliminate the estate tax all together.

CONCLUSION:

The SBLC strongly opposes any proposals to eliminate the step-up in basis. The loss of the step-up in basis would be devastating for many small family-owned or closely held businesses. The SBLC urges the Finance Committee to consider the tiered estate tax proposal set forth above, as well as an exemption for small and family-owned businesses which is easy to understand and apply. Ensuring that small family-owned businesses can grow and succeed over multiple generations should be a priority and these proposals would help do just that.

The SBLC thanks this Committee for its consideration of these issues and would welcome the opportunity to discuss these comments further.

The SBLC is a 35 year old permanent, independent coalition of over 50 trade and professional associations that share a common commitment to the future of small business. SBLC members represent the interests of small businesses in such diverse economic sectors as manufacturing, retailing, distribution, professional and technical services, construction, transportation, and agriculture. SBLC policies are developed by consensus among its membership.

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