S. HRG. 104-89

SMALL BUSINESS TAX INCENTIVES

HEARING

BEFORE THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

ONE HUNDRED FOURTH CONGRESS

FIRST SESSION

ON

S. 105, S. 161, S. 628, S. 692, S. 867, and H.R. 1215

JUNE 7, 1995

Printed for the use of the Committee on Finance

U.S. GOVERNMENT PRINTING OFFICE

92-446-CC WASHINGTON : 1995

For sale by the U.S. Government Printing Office
Superintendent of Documents, Congressional Sales Office, Washington, DC 20402
ISBN 0-16-047442-6

COMMITTEE ON FINANCE

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SMALL BUSINESS TAX INCENTIVES

WEDNESDAY, JUNE 7, 1995

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

The hearing was convened, pursuant to notice, at 9:30 a.m., in room SD-215, Dirksen Senate Office Building, Hon. Bob Packwood (chairman of the committee) presiding.

Also present: Senators Chafee, Grassley, Baucus, Pryor, Graham, and Moseley-Braun.

OPENING STATEMENT OF HON. BOB PACKWOOD, A U.S. SENATOR FROM OREGON, CHAIRMAN, COMMITTEE ON FINANCE

The CHAIRMAN. The Committee will come to order. As I was telling Ms. Beerbower, at least the hearing this morning concerns simple subjects. It is not hard to understand the issue of the unified credit and expensing for small business. Some of the things we discuss are very complex. At least this is straightforward and understandable. People may have different opinions about it, but it is not complicated.

I am going to put Ms. Beerbower on first this morning, but I am going to switch the order of the second panel, and have Dr. Holtz-Eakin and Dr. Rahn testify first because they are both testifying on expensing.

And then we will hear from Professor Maxfield and Professor McCaffery. They are talking about the estate tax credit, and it makes a little more logic to have the people speaking pro and con on the subjects back to back.

So, with that, we will start with Cynthia Beerbower, the Deputy Assistant Secretary for Tax Policy, who has been in the Secretary's office 17 months. Prior to that, she practiced law with Simpson, Thatcher in New York.

Ms. BEERBOWER. Thank you very much.

The CHAIRMAN. It is good to have you with us. Go right ahead.

STATEMENT OF HON. CYNTHIA G. BEERBOWER, DEPUTY ASSISTANT SECRETARY FOR TAX POLICY, DEPARTMENT OF THE TREASURY, WASHINGTON, DC

Ms. BEERBOWER. Mr. Chairman and Members of the Committee, I am pleased to present the views of the Treasury Department this morning on proposals related to estate and gift taxation, and expensing by small businesses.

The administration has strongly supported, and continues to support, the goal of assisting and strengthening small businesses. We have undertaken a number of legislative and administrative measures for that purpose.

In 1993, we proposed and supported a targeted 50 percent capital gains exclusion for small business stock. We supported a provision that allows gain from selling publicly traded stock to be invested tax free in specialized small business stock, and we supported raising the limit on expensing for small businesses from $10,000 to $17,500.

We have also issued administrative guidance to reduce compliance burdens on small business, and to provide them more flexibility in their business arrangements. My written testimony outlines a number of such administrative guidances. But let me draw your attention to just one of these that has been uniformly praised by taxpayers and practitioners.

This is the so-called "check the box" proposal. The proposal would allow taxpayers to elect to be treated as partnerships simply by checking a box on their tax returns. It would eliminate the complicated and uncertain multi-factor tests of current law, and would reduce needless compliance costs for small businesses.

However, we believe that more can be done to provide targeted, cost-effective incentives for small businesses. And we applaud this Committee for holding these hearings to consider additional proposals.

The administration recognizes the legitimate concern that the amount of the exemption from estate and gift taxes has shrunk in real dollar terms since it was last increased in 1987. We are willing to work with Congress to develop legislation that provides relief for small and medium sized businesses, and helps preserve those small enterprises so that they can be passed on to future generations.

The House-passed legislation, H.R. 1215, would increase the estate tax exemption from its current level of $600,000 to $750,000 by the year 1998. Thereafter, it would be indexed for inflation. The proposal would cost about $20 billion over 10 years. Moreover, it would affect only a limited number of taxpayers. In 1989, which is the latest year for which we have adequate data, the estates of only 1 percent of dying Americans paid any estate tax at all.

In preparing for this testimony, I asked people I know to direct me to individuals who had first-hand experience with the estate tax provisions, and the problems of farmers, ranchers and other small businesses.

I spoke with people in Colorado, Nebraska, Idaho and Iowa. And I wanted to share with you that most of the practitioners, the farmers, ranchers and small business people with whom I spoke believe that there was a greater need to address other specific aspects of the estate and gift tax system than the amount of the unified credit.

For example, they all mentioned that section 2032A, which allows a farm or other real property used in a small business to be valued according to its current use value, rather than its highest and best use value.

This provision offers a substantial benefit to small businesses, especially in combination with section 6166.

The CHAIRMAN. Let me ask you a question, if you do not mind.

Ms. BEERBOWER. That's fine.

The CHAIRMAN. You have a farm in the center of New York, and they would like to continue to value it as a farm. I can understand that.

Ms. BEERBOWER. That is correct. It is the development possibilities that would dictate a much higher value at the time of death.

The CHAIRMAN. Yes.

Ms. BEERBOWER. This provision is used in large measure with small businesses, in combination with 6166, which allows an estate tax on a closely-held business to be paid in installments over 14 years, with no principal payments owing to the first 5 years, and a favorable 4 percent interest rate on the first million dollars in the value of the closely-held business.

Using these provisions, farmers, ranchers, and other small businesses can obtain relief over and beyond the regular estate tax exemption. My written testimony illustrates an example of how a farmer with a gross estate valued at $1.5 million, might use these benefits, and pay an effective estate tax of only 1.6 percent.

However, many of the taxpayers and practitioners with whom I spoke find that it is difficult for taxpayers to take full advantage of these benefits. The special valuation rules, for example, are complex, and many thwart the plans of small families to preserve the family business.

For instance, under section 2032A, the special valuation benefits associated with a farm must be recaptured if the heir cash-leases the farm. This administration has previously testified in support of a proposal similar to that in S. 105 that would modify these rules on a prospective basis, to allow cash-leases of family members in such circumstances, so long as the family members continue to operate the farm.

The administration believes that such targeted measures might address the needs of small business in a more cost-effective manner than raising the unified credit.

The administration also supports increasing, on a revenue-neutral basis, the maximum investment that can be expensed for small business. The administration believes that it is important to encourage small business to invest in capital assets. In addition, increasing the expensing limit would simplify tax reporting for eligible small businesses.

The 1993 Budget Act increased the expensing cap from $10,000 to $17,500. At that time, the administration supported the House version of the Budget Act, which would have raised the maximum to $25,000.

H.R. 1215 would raise the cap gradually to $35,000, at a cost of about $12.5 billion over 10 years. By contrast, raising the cap to $25,000, effective next year, costs less than half as much, about $5 billion over 10 years. In this period of budgetary constraints, we would be willing to work with Congress to develop an appropriate revenue offset, and to help evaluate whether the phased-in increase to $35,000 is likely to meet the best needs of small business in a cost-effective manner.

That concludes my prepared remarks. I will be happy to answer any questions you may have.

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

The CHAIRMAN. Good morning.

Senator MOSELEY-BRAUN. Good morning, Mr. Chairman.

The CHAIRMAN. How are you today?

Senator MOSELEY-BRAUN. Fine, thank you.

Ms. Beerbower, let us work backwards. Let us assume the goal is that we like family-owned businesses, and we especially like them in smaller towns where, frankly, they are the backbone of the leadership in the town. When they get bought out by a bigger company, it is not the same when a manager comes for 5 years and then moves on in the company.

If that is the goal, then what is the best way of going about achieving that? I suggested insurance to somebody, and they said that insurance at that stage is too costly. You have a 65-year-old dad, who has a heart problem. They have a feed and seed business, worth maybe $4 or $5 million. It is not liquid, but it is worth $4 or $5 million, and the insurance is more expensive.

What do we do to make sure that those businesses can stay in the family?

Ms. BEERBOWER. I think we would be willing to work with the Committee. In the discussions that I had with people in just that situation, they said that the hardest aspect of keeping a family business together is when the generations are diverse in the types of activities that they want to do in their lives. For example, the brother wants to stay in the business, but the sister wants to go to Chicago.

The CHAIRMAN. The sister wants the money; the son wants to run the business.

Ms. BEERBOWER. She may want to marry, and she may want the money. And I think, in the case of farmers and ranchers, that is why they stress to me very strongly that the cash-leasing provision, which would allow the farm to stay in the hands of the family, but would allow some type of diversity in life styles among the children of the next generation, would be a very significant measure to keeping the family farms together.

The CHAIRMAN. I am not thinking just of family farms. I think of a business like White Stag, that used to make wonderful sports apparel, headquartered in Portland. It was bought out, and the family is gone. And this was not a small business. It just is not the same when it is bought up by a conglomerate.

I think of Hyster, a company that was founded to make lift trucks in 1932, which was not a great year for founding businesses. It finally sold out about 5 or 6 years ago, when the founder died. But they had several thousand employees at one time. These are not small businesses.

Gosh, the leadership they give is extraordinary. And I doubt if any of us, including the administration, differs with the goal that we would like to keep that kind of business in place.

Ms. BEERBOWER. I agree. And we think that a targeted type of approach is much more likely to be better than one that simply raises benefits for all individuals.

The CHAIRMAN. Senator Chafee?

Senator CHAFEE. Thank you, Mr. Chairman.

We have all seen the examples that you have discussed, with Hyster and so forth. And, Mr. Chairman, in our own towns and

States, I am not sure that the problem is always a tax problem. It is the very situation you pointed out where the family has run out of gas. Nobody really wants to run the business. Somebody wants to be a classics professor, the daughter is married, and the other son wants to be something dissolute like going into politics. [Laughter.]

So there just is not the enthusiasm for running the business, and particularly where you get the situation where some of the children want some cash, which is not an unusual demand. And this does not extend to just small businesses; it applies to the Rockefellers likewise. Why did they sell Rockefeller Center? Because some of the family wanted cash.

So these are not all tax matters. Obviously, the principal owner cannot come along at the age of 65 and say, now I think I will get my estate squared away, because the insurance is too expensive. But if he starts thinking of it at 50, say, there are insurance arrangements he could enter into to get the cash so the business can be liquid to pay the taxes. Am I correct in that?

Ms. BEERBOWER. That is correct. And also, with extended planning, the availability to take the unified credit, the availability to pass along part of the property to the next generation through gift tax exclusions or the special use valuation. In fact, with good planning, a farm of $2 million can be passed along pretty easily without an estate tax. Above that, it becomes more difficult.

Senator CHAFEE. What is the principal problem? Why are you here?

Ms. BEERBOWER. To be supportive, I suppose. I assume that the proposals address a political issue of the numbers of people that are subject to the estate tax, and concerns generally about the estate tax.

Senator CHAFEE. Well, I share the goal that we all have, that the Chairman spoke so well about, which is maintaining these family-owned businesses, particularly because of the leadership that they provide for the community. I do not care whether it is in connection with the school board or the United Way, or the local hospital, that is where the leadership comes from. And it does not come from some conglomerate that, as the Chairman mentioned, sends in a manager who stays for 5 years, and his objective is to make that business as profitable as possible before he moves to Detroit and the next leg upward.

Thank you, Mr. Chairman.

The CHAIRMAN. Senator Moseley-Braun?

Senator MOSELEY-BRAUN. Thank you very much, Mr. Chairman.

Ms. Beerbower, if you were to rate on a scale of 1 to 10 the difficulties that small businesses, family-owned businesses, have with estate taxes versus insurance issues for running the business, how would you come out with that?

Ms. BEERBOWER. I called people that are interested in these provisions, and the primary estate tax concern of the people with whom I spoke was passing a family business along to the next generation, and the cost of doing that when the generation had many diverse interests.

Senator MOSELEY-BRAUN. And if you would rate on a scale of 1 to 10 that issue versus the difficulties that small, family-owned businesses have with obtaining and providing insurance—health insurance specifically—for their employees?

Ms. BEERBOWER. I was talking to them about the unified credit. Insurance did not come up, and you can perfectly well understand why. So I really would not be able to rank their concerns about insurance, since I was talking with them about estate tax.

Senator MOSELEY-BRAUN. Your statement does not really go into detail about your review. Would you tell us a little bit about that?

Ms. BEERBOWER. Clearly. The subject of the hearing was specific in terms of increasing the unified credit from $600,000 to $750,000, and to thereby relieve from estate tax return filing and liability of probably half of the businesses that are currently subject to it. I called people who were lawyers, farmers, and small business owners who were concerned about estate tax. They were uniformly more interested in 2032A and other relief than in the unified credit increase. While we are very happy to work with the Committee to increase the unified credit, and certainly see the reason why the credit might have lagged behind what it would have been if it had been inflation adjusted, we would support more targeted relief to small business. The increasing of the unified credit would be a benefit to all people who die. In talking to small business owners, we talked about an expense of $20 billion over 10 years. These small business people preferred a more targeted approach.

Senator MOSELEY-BRAUN. But how specifically did you go about that in your review?

Ms. BEERBOWER. We talked about the tax issues involved from the tax policy standpoint. I had asked people I knew to put me in touch with practitioners, farmers and ranchers and small business owners that they knew, outside of Washington, so that I could actually talk to them about what they thought the problems were. That is hardly scientific, but I did want to share with the Committee that 2032A in particular did come out of those discussions as something that they cared very much about. And the unified credit increase, when they were aware of its cost, was not as high on their list.

Senator MOSELEY-BRAUN. And in your non-scientific study, you talked to about 10 people, 20 people?

Ms. BEERBOWER. Oh, yes fewer.

Senator MOSELEY-BRAUN. Fewer.

Ms. BEERBOWER. Yes. I assume large interest groups will talk to you plenty, but I was struck by the support for a more targeted approach taken by the people with whom I spoke.

Senator MOSELEY-BRAUN. Thank you very much.

The CHAIRMAN. Senator Baucus?

Senator BAUCUS. Thank you very much, Mr. Chairman.

Ms. Beerbower, you suggested that with careful planning, a farm or ranch of $2 million could basically escape Federal estate tax. Some suggest that, although that might theoretically be true, it requires a lot of gyrations and maneuvering which somewhat exceeds the normal business operation of the farm and ranch. So, in a certain sense, it might be a little unrealistic to bank too much on that.

I hear a lot of this just from my experience, talking to a lot of farmers and ranchers in my State. Somewhat contrary to the words of Senator Chafee, they do want to stay on the farm or the ranch.

The sons and daughters do want to keep operating. And an awful lot of young people want to get into farming and ranching. We have a great State in Montana. Wide open spaces, it is a great life, and people want to stay on the place. And I constantly hear of Federal estate tax law making it very very difficult, particularly when property values are appreciating so much, now that Montana has been discovered.

I know we have a special use provision to somewhat deal with that phenomenon. But I am just curious as to your response to my first point, namely that a planner has to go through a lot of planning. And it somewhat constricts the operation if one wants to make the best use of current law early on, in order to avoid Federal estate taxes.

Ms. BEERBOWER. I think it is a fair point. I will share one comment with you that one fellow made. He said that the only group he hated worse than the Government were lawyers. He did not want to see them in order to plan. And I think that one needs counsel in order to plan.

Senator BAUCUS. And it is your basic point that major change in this area should be increasing the special use exemption?

Ms. BEERBOWER. Targeting.

Senator BAUCUS. Targeting. What does that mean?

Ms. BEERBOWER. Targeting. Well, when I asked the people with whom I spoke about their concerns, obviously the availability of cash-leasing is quite high on the list. And the reforms that they would do would not be chucking the whole system and starting over, but much more targeted to where they see the problems are. And clearly, in terms of cost-effectiveness, capped in terms of their available use for that community.

Senator BAUCUS. So, therefore, you are not very much in favor of raising the $600,000 exemption for everybody?

Ms. BEERBOWER. Well, we would support that, and work with you to do it. I think it could be done in a more targeted way for small business. Raising the unified credit overall would benefit many people who are not small businesses.

Senator BAUCUS. Yes, and I appreciate that. Mr. Chairman, I just want to say that I think it makes sense to try to target this investment.

A lot of people wonder about pharmaceuticals taking advantage of the Puerto Rican situation under Section 936. But Montana's farmers and ranchers and small businesses cannot take advantage of similar tax provisions, so there is no balance in equity here.

The CHAIRMAN. I agree with you on targeting. If all we do is go from $600,000 to $750,000, that does not help most of the estates that you and I are talking about. Maybe it helps a lot of them that do not need as much help as some others who need a lot of help. And, for the same amount of money, you could do this.

Senator BAUCUS. Thank you.

The CHAIRMAN. Senator Grassley?

Senator GRASSLEY. Well, first of all, I would support Senator Baucus on his point, and also the point you made about special use and the cash-lease arrangement.

I am just saying this to inform you, and then I have a couple of questions on another matter. In the 1986 tax bill, as it relates to agriculture, something came out in a way it was not intended. And this involves cash-leasing of land, as a landlord for young farmers versus crop-share, which has the landlord share some of the risk.

We allow passive loss on cash-rent basis, and we do not allow it on crop-share leases. You cannot deduct your loss from non-farm income if you cash-rent. In agriculture, we should want to encourage a close relationship between the landlord and the renter, whether they are in the family or otherwise, because getting young farmers started by having a person crop-share lease, as opposed to a cash-lease, helps the young farmer raise capital because the risk is shared, and they do not have to pay all the rent money up front.

We should allow the same provisions in a family farm for passive loss whether it is from a cash-rent lease or a crop-share lease. And it was never that way until the 1986 tax bill. I was involved in the debate on the 1986 tax bill, but once the regulations came out, you had this difference between cash-rent and crop-share. And that would be one way to help young people too. Also, the way you do it here suggests that it would help as well.

My first question would be, based upon some ideas that were floated early in this administration, not by the President, but someone in the administration thought about taxing capital gains at death. And I saw this as a back door estate tax increase. So my question is, is there any thought of doing this now within the administration, or is this opposed to capital gains at death?

Ms. BEERBOWER. I am not aware of any proposal we have outstanding.

Senator GRASSLEY. All right. Well, thank you. I am glad for that answer but, since the idea was out there, I wanted to make sure if it was still being thought about. And I am glad to hear that it is not.

A witness on our next panel, Professor Holtz-Eakin, states in his written testimony that subsidies to small firms constitute a tax on growth, and that subsidies may hamper the development of small business, due to dependence upon those subsidies.

Do you agree or disagree with that particular point?

Ms. BEERBOWER. I would want to think about it in the context of economic analysis. But, in general, I would disagree. There are many small businesses that have become very thriving, and eventually publicly traded.

Senator GRASSLEY. All right. His opinion is based on the assumption that because small businesses are not truly unique, which could justify preferred tax treatment, and because small businesses do not appear to produce innovations any more than large corporations, there is then no justification for a tax base intervention to aid small business.

I would assume that, with the 1993 tax bill and the increased expensing provisions,

Ms. BEERBOWER. I think we would. And also, there are a number of examples of innovations that have occurred in very small business contexts.

Senator GRASSLEY. Thank you, Mr. Chairman. And thank you, Ms. Beerbower.

The CHAIRMAN. Senator Pryor?

Senator PRYOR. Thank you, Mr. Chairman.

Mr. Chairman, I have a statement I would like to have put in the record at this point, or at the proper place.

The CHAIRMAN. Without objection.

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

Senator PRYOR. I would like to ask a question relative to the tax rate that concerns me and a lot of our people back home. And I know it would apply to Montana, and also to Iowa, and perhaps even Illinois and Oregon.

Once we hit the $600,000 figure, we are looking at about a 37 percent rate. And then it very quickly escalates up to as high as, I think, 55 percent. I wonder if the administration is also looking at rate reduction.

Ms. BEERBOWER. We would be willing to work with you in rate reduction as part of this. Again, I expect our approach would be targeted in some way, rather than a general reduction in the rates.

Senator PRYOR. You would try to target it to, say, small business?

Ms. BEERBOWER. The problem is that it ultimately would become an issue of revenue.

Senator PRYOR. Is the administration looking at rate reduction now?

Ms. BEERBOWER. No. We would be willing to work with the Committee, but the testimony I am giving at the moment is only responsive to the provision in the House bill with respect to increasing the unified credit.

Senator PRYOR. All right. There may be some follow-up questions, Mr. Chairman. But I did want to talk about rate reduction, and I look forward to working with you, Ms. Beerbower.

The CHAIRMAN. Ms. Beerbower, I have no more questions. Does anybody else?

Senator CHAFEE. Could I just ask one question, Mr. Chairman?

The CHAIRMAN. Yes.

Senator CHAFEE. Ms. Beerbower, there is a lot of energy poured into the estate tax, and efforts to avoid it. Yet what strikes me is the modest amount that the estate and gift tax raises. Do you know how much it is? Is it $20 billion or something like that?

Ms. BEERBOWER. I think $15 billion was the number I was given as our most recent.

Senator CHAFEE. What would you think if we just increased the income tax by a percentage point, and just got rid of the estate and gift tax? Just forget it, get rid of them.

Ms. BEERBOWER. I think we would oppose that.

Senator CHAFEE. You would what?

Ms. BEERBOWER. Oppose it. There are reasons.

Senator CHAFEE. You would oppose it?

Ms. BEERBOWER. We would have to look at your alternative proposal very closely, but the estate tax is designed to tax transfers, a very different concept from the income tax. And I think to place the increased burden of estate tax repeal onto the income tax payers might not be appropriate.

Senator CHAFEE. Well, it might be worthwhile looking into.

I understand the social purpose for the tax, that being that we do not want to see great wealth concentrated among a relatively few Americans. But I would suggest that they are probably pretty skillful at keeping it anyway.

Well anyway, brood over it, will you?

Ms. BEERBOWER. Certainly. Thank you.

The CHAIRMAN. Any other questions?

[No response.]

The CHAIRMAN. You have a very disarming manner in answering questions. I told my staff that I think you would say in answer to a question, "Well, that would be war, and we would drop the atomic bomb", with the same aplomb as you do the others. Thank you for coming.

We are going to start on the next panel. We have a vote in about 15 minutes, but we may be able to finish at least two of the witnesses. If I can have the panel come up, Professor Holtz-Eakin, Professor Maxfield, Professor McCaffery and Dr. Rahn, we will take Professor Holtz-Eakin and Dr. Rahn first in testimony.

Professor Holtz-Eakin, would you go right away?

STATEMENT OF DOUGLAS HOLTZ-EAKIN, PROFESSOR OF ECONOMICS, THE MAXWELL SCHOOL, SYRACUSE, NY

Professor HOLTZ-EAKIN. Thank you very much.

Mr. Chairman, Members of the Committee, I am delighted to have the opportunity to share my views with you.

My remarks, and a lot of the discussion today, will center on the desirability of increasing the amount of investment expenses that may be fully deducted in the year of purchase.

I believe that such a proposal is not consistent with sound tax or economic policy. And, in defending this, I would like to divide my thoughts into about five areas.

First, a full deduction or expensing is inconsistent with the appropriate treatment of capital income under an income tax. And we have an income tax in the United States. Under such a system, the accounting matches the annual accrual of income with the annual carrying costs, including wear and tear of the capital itself. A durable piece of equipment is not used up in the initial year and, as such, its costs should not appear only in the first year. Even from the prospect of income accounting, this departure from the standard overstates costs up front, understates capital income, and understates tax.

Is this such a big deal? The numbers often do not seem very impressive, $17,500 or $25,000, $35,000. Well, in fact, information from the 1992 tax returns indicates that the total value of such a deduction that year was $14.5 billion, a number that has surely grown since. So I think that the numbers are significant.

The second point is that such a preferential treatment leads to a misallocation of capital. I think everyone in this room is aware of the fact that the United States is an economy that saves and invests too little. We need to allocate our capital efficiently, given how scarce it is, and our capital is allocated most efficiently among competing uses, when all capital income is taxed at the same rate.

As I noted above, the expensing provides a tax subsidy to particular types of investment, and particular forms. In the process, the economy as a whole sacrifices productive investments in favor of those whose productivity demerits are essentially outweighed by tax subsidy.

The third point I would like to make is that arguments in favor of subsidies to small business are, on the whole, far from overwhelming. One might make the argument that you would willingly incur the subsidy misallocation as a deliberate attempt to foster small businesses. But you have to ask why? You typically hear two arguments—jobs and innovation.

But the notion that small businesses are the dominant, or even the single most important source of job growth has by now been widely discredited. When small firms create this proportionate number of jobs, it is often because they are in emerging industries, not simply because they are small. And even when small firms create a lot of jobs, they destroy nearly as many as these small businesses fail.

Because the failure rate among small businesses is so high, many of the jobs they create today will not survive over a year or so. In the same way, there appears to be little support in the numbers for a disproportionate role played by small firms in product innovation. It is true that there are numerous examples of valuable innovations from small firms. It is equally true that large firms innovate at roughly the same rate.

Moreover, if one cared about innovation per se, it is not obvious that one would prefer a capital equipment expensing provision. You might wish to target research and development or some sort of human capital investments.

The final point with regard to subsidies to small businesses is that you have to ask who really gains? A subsidy will ultimately accrue to the suppliers of capital. And, in this economy, the suppliers tend to be the well-to-do. There is an old adage that firms do not pay taxes, people do. It is equally true, as a result, that firms do not reap the subsidies, people do. And what looks like help to a struggling small business may turn out to be just an unintended windfall to the upper end of the income distribution.

My next point would be that, even if you wished to subsidize small businesses, this might be the wrong subsidy. As I noted earlier, there seems to be little reason to favor a specific subsidy on equipment per se. Indeed, the focus on equipment seems to be misguided from other perspectives. If you look at the 1987 Census document, characteristics of business owners, one finds that 28 percent of business owners reported that they required no capital to start their business. Another 28 percent reported that they needed less than $5,000 to start their business. It may be that there are other investments that would be more helpful to a modern, innovative start-up, and that those start-up ventures would be best in a position to judge what they need.

The second point is that, to the extent small businesses do create jobs, if you base your subsidy to a small business on capital investment, you provide them an incentive to substitute capital for jobs, and essentially undo the job creation tendencies of the firm itself, which seems somewhat perverse.

My final point, focusing on capital in the way that we do with section 179, relates to the phase-outs of the expensing provisions. Essentially, as the firm invests more, the provision to expense investments is phased out. This provides little incentive to undertake more capital investment at the margin, which would seemingly be the goal. Put differently, by phasing out the subsidy, we effectively place a tax on growth, which seems a perverse way to help our small businesses by taxing their success.

My last broad point about these provisions is that the expensing under section 179 complicates enforcement of the Tax Code. The expensing provisions are one example of a hybrid system, in which we attempt to insert into the income tax a consumption tax treatment of investment. As I noted earlier, the expensing deduction amounted to just over $14 billion in 1992. Of this, $10 billion was claimed by sole proprietors on Schedule C.

Given the difficulty of separating business and personal transactions for this group, it is far from unimaginable that the expensing provision was devoted in large part to supporting, for example, the purchase of personal computers that could also be used for personal use. And it strikes me as not exactly our preferred policy to have the Treasury paying 40 cents on the dollar for PC's used in the home.

The CHAIRMAN. Let me ask you a quick question before I go to Dr. Rahn.

PROFESSOR HOLTZ-EAKIN. Yes.

The CHAIRMAN. Whatever other arguments might be made, expensing is not complicated, is it?

PROFESSOR HOLTZ-EAKIN. Expensing per se is not complicated, no.

Senator CHAFEE. What does that mean, per se? I mean, expensing is not complicated, is it?

Professor HOLTZ-EAKIN. Further down the road, in keeping track of the capital assets you have in place, you have to keep track of those which were expensed under section 179 and those which were not. Depreciation allowances will be applied only to those which were not.

Senator CHAFEE. You mean you want the Government to monitor it?

Professor HOLTZ-EAKIN. And it is also more complicated for compliance. A radical fix that I mentioned in my written testimony is to simply rid ourselves of depreciation systems entirely, and go to a consumption-based tax, fully expense all investments. That would be my preferred solution to this problem, place small and large businesses on equal footing in that sense.

The difficulty here is simply running a hybrid system, expensing rules for some investments for some people, income tax rules for other investments and other people. That is where the complications arise.

[The prepared statement of Professor Holtz-Eakin appears in the appendix.]

The CHAIRMAN. Dr. Rahn?

STATEMENT OF RICHARD RAHN, Ph.D., CHIEF ECONOMIST, BUSINESS LEADERSHIP COUNCIL, WASHINGTON, DC

Dr. RAHN. Mr. Chairman, and Members of the Committee, thank you for inviting me to testify today. I am chairman of the board of directors of the Business Leadership Council, and I am testifying on their behalf today.

The Business Leadership Council is an association of entrepreneurial business leaders. We represent businesses of all sizes. I am also president of the Novecon companies. We create joint ventures in Eastern Europe and the former Soviet Union.

Having been a former professor of economics and business, as well as running businesses, I should point out that we are neither a small business nor a large business advocate. We are trying to advocate the best economic policy to maximize economic growth and economic opportunity in this country.

Therefore, we do support the increase in the section 179 expensing allowance from $17,500 to $35,000 because it would reduce some of the existing discrimination against capital investment.

I think everybody realizes that the U.S. taxes capital more heavily than virtually any other country in the world. The result of this taxation of capital is less capital investment. We are forced to import capital, and we end up with slower economic growth, a lower rate of job creation, and all the ills that all of you have heard many times. In fact, I think I have heard all of you make the same points in your own comments.

Clearly, we ought to have a neutral tax system. And I agree with the professor that what we really need to do is change the entire tax system. I think House Ways and Means Chairman Bill Archer perhaps said it best when he said that we need to pull out the existing tax system by its roots.

We are supportive of a totally new tax system, a replacement for the existing tax system. With the existing tax system the cost of compliance has risen; it is a system that nobody understands. Years ago, I used to be the chief economist of the U.S. Chamber of Commerce. With our tax committee, we had many of the country's best tax experts—for instance Ed Cohen, former Under Secretary of the Treasury for Tax Policy, one of the most esteemed tax lawyers in this country. I know of nobody who knew the Tax Code better than Eddie Cohen, and he never claimed to understand it all.

We have an impossible system, particularly for small business. The complexity is overwhelming, and anything we can do to simplify the system, reduce the burden on capital, we ought to do. The Nunn-Domenici, the Armey proposals, the national sales tax proposals, would all be a great improvement over the existing income tax.

Something that has not been realized, is what the new electronic money and smart cards—and I have a demonstration one here—are going to do to the existing tax system. It is going to make it basically unenforceable on the collection of dividends, interest, capital gains in the future. I have more extensive testimony that I will be presenting before the Ways and Means Committee tomorrow on this particular issue.

But you have got a dysfunctional system. I think that within a year you will realize that you have no choice but to replace the existing tax system. And we need to move rapidly ahead.

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So I look at this provision in the House bill as just a small interim step, which will have many more benefits than cost to it. And I would urge you, in the interim, to support it. But, over the next year or two, I think the real focus needs to be on a total replacement for the existing tax system, and getting us to a much simpler system that no longer taxes investment and saving the way the existing system does.

Mr. Chairman, thank you.

The CHAIRMAN. Thank you,

[The prepared statement of Dr. Rahn appears in the appendix.]

The CHAIRMAN. And Professor Maxfield?

STATEMENT OF GUY B. MAXFIELD, PROFESSOR OF LAW, NEW YORK UNIVERSITY LAW SCHOOL, NEW YORK, NY

Professor MAXFIELD. Thank you, Mr. Chairman and Members of the Committee for inviting me. My name is Guy Maxfield. I am a professor at the New York University School of Law, teaching in the Graduate Tax Program.

Let me just make a couple of general observations about the proposal to increase the unified credit. It is certainly true that it has been 8 or 9 years since its enactment. It has clearly the effect, with inflation, of imposing more of a burden on the Internal Revenue Service, in terms of an audit, and an increase in the unified credit would obviously be responsive to these two points.

The real problem though, if we are thinking of granting relief to small businesses, as Ms. Beerbower said, is that it is not targeted. Everyone who has an estate in excess of $600,000—or, under the House bill, $750,000—will get the same benefit. But it would seem to me, if Congress decides to increase the unified credit, it ought to be coupled with a transitional threshold where the credit is phased out.

I would assume, however, that one defines small business. Mr. Gates' Microsoft would probably not qualify. Would it make sense to have that business also get the benefit of an increase in the unified credit? There is obviously statutory authority for this. The personal exemption under section 152 is now gradually phased out as one's income increases, until it is finally eliminated.

I think the real reason the pressure has come to increase the unified credit from small businesses and from others is a real concern about the tremendously high initial estate tax rate. If we look at the Code, ignoring the unified credit, the additional rate begins at 18 percent, which does not look very bad, and gradually increases. But, because of the unified credit, the first dollar in excess of the credit amount is taxed under current law at a 37 percent rate which, as a lot of people noted, is a very high rate, particularly if we contrast the estate tax rate with the income tax rate.

I think the reason for this high estate tax rate is that, even though the aggregate estate gift tax does not raise much revenue for the Government, it nevertheless has a symbolic value to it. If we are going to continue that symbolic value, or end even $10 billion in revenue, it is something that cannot be automatically ignored.

A broadening of the estate tax base could provide a way of financing either the increase in the unified credit and a possibility of some lowering of the rate. My written comments go into more detail on the types of approaches that Congress could take.

Some are hard for me to understand how they could even be viewed as controversial. For example, under present tax law, the gift tax paid by a donor, while the donor is alive, is never going to be subject to any transfer taxes. Yet, if the same donor next door died with the same amount of wealth, the wealth would itself be subject to estate tax. The point is that the gift tax does not include, nor does the estate include, the gift tax paid.

As my paper demonstrates, there is a tremendous built-in bias in favor of the taxpayer paying gift tax. And the larger the gift tax, the more savings comes to the taxpayer. It had been thought that the Government is getting the gift tax dollars earlier, and therefore it is a tradeoff. Yet, as I tried to suggest in my paper, the bias in favor of making taxable gifts and paying a gift tax increases, taking into account the time value of money.

Another broadening of the base of estate tax is doing something with the annual exclusion. The annual exclusion of $10,000 per donor per year, was originally enacted, the Committee reports say, to take away the required record-keeping for birthday presents, wedding presents, Christmas gifts. It is now $10,000. If it is a married couple, it becomes $20,000. With four or five children, it becomes $100,000 a year. In a 20-year period, $2 million totally escapes the transfer tax system.

A variation on the annual exclusion in some case law is that it is now possible to give donees a very limited right to withdraw additions to a trust 15 days after notice. And that has been decided by the courts to be a present interest, and therefore available for the annual exclusion. A cutback on that, extending the period, or some legislative change would overrule that and, again, would have the effect of broadening the base.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you very much, Professor.

And Professor McCaffery?

[The prepared statement of Professor Maxfield appears in the appendix.]

STATEMENT OF EDWARD J. McCAFFERY, PROFESSOR OF LAW, UNIVERSITY OF SOUTHERN CALIFORNIA, LOS ANGELES, CA

Professor MCCAFFERY. I hope Senator Chafee can stay for just 5 minutes here. He might be interested.

I am a liberal. I used to believe in the estate tax.

The CHAIRMAN. You are a what?

Professor MCCAFFERY. I am a liberal

The CHAIRMAN. A liberal?

Professor MCCAFFERY. The "L" word—liberal. I used to believe in the estate tax.

Senator CHAFEE. Is that why you wanted me around?

Professor MCCAFFERY. No, no, no. This is why. As to the latter belief only, I now confess. I was blind, but now can see. The estate tax is a bad tax, even and perhaps especially on liberal grounds. While I support a comprehensive move in the direction of a progressive consumption-without-estate tax, I also believe that simply repealing the estate tax is a step in the right direction.

Somewhat a fortiori, a moderate move to increase the exemption level from $600,000 to $750,000 strikes me as being sensible. Let me explain.

In 1916, it seemed like the estate tax was the best of all possible taxes. The tax only fell on the wealthy, serving the important goal of breaking up concentrations of wealth. It was a classic win-win situation. Unfortunately, times have changed. Over 75 years of experience have produced only a limited, porous, and possibly counter-productive tax system. The current gift and estate tax does not raise much revenue, and may even lose money, all things considered.

It seems to be doing little to break up the concentration of wealth. Most striking, it is not popular. Polls and voting patterns show that people re consistently opposed to taxing inheritance. Canada, Australia and Israel have recently abolished their wealth transfer taxes.

Consider the incentives generated by an estate tax. It encourages large and persistent inter vivos gifts. It discourages work and savings, especially long-term intergenerational savings. It encourages consumption, especially the large-scale consumption of the rich. These hardly seem like good incentives even, and maybe especially, on liberal grounds.

To illustrate these points, let us look at the case of Mr. H. Ross Perot. In 1992, Perot spent about $60 million running for President. Perot often said that this was all his own money, that no taxpayer dollars were at stake. But this is wrong. Under back-ended wealth tax, all consumption shares the structure of a tax expenditure under the income tax. Had Perot not spent the $60 million, either he would have had to give it all to charity—and thus serve a certain public purpose—or the Government would have claimed 55 percent of it, $33 million. We do not have to adjust the sum because the $60 million would have grown along with the social discount rate.

Here is another use of the Perot example, one that might evoke some sympathy for Ross. Assume that Perot does not need any more money for himself. Further assume that he intends to leave his wealth to his children on his death. What tax rate does Perot face on additional income? The perhaps surprising answer is something in excess of 70 percent. Any dollar that Perot earns will first be reduced by the income tax, say 40 percent. The remaining 60 cents will await an ultimate 55 percent estate tax, which will take away another 33 cents, leaving Perot with 27 cents of his original dollar to leave to his heirs, a tax rate of 73 percent. Once again, there is no reason to engage in discounting.

The estate tax discourages behavior that a liberal democratic society ought to like—work, savings and bequests—and encourages behavior that such a society ought to suspect—large-scale consumption, leisure and inter vivos gifts. Our polls and practices show that we like sin taxes, such as 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 and on long-term savings. There is no reason even a liberal populace need support it.

My call for a progressive consumption-without-estate tax obviously goes beyond the narrow question of raising the exemption. If

I had any confidence that the estate tax were doing any good as it is, I might be nervous talking about its repeal or weakening in the current conservative climate. But even without support for my preferred comprehensive reform, nothing is gained by clinging to the estate tax.

The tax fails to raise much, if any, revenue, induces arcane and expensive legal forms of ownership, burdens the work and saving habits of the wealthy, an extremely important class of savers, induces leisure, consumption and large-scale inter vivos gifts, and seems to be playing no role in the breaking up of the concentration of wealth.

If the best defense of the estate tax is as a symbol of our commitment to social equality, we do not need it. We need real answers, not false icons.

Thank you.

[The prepared statement of Professor McCaffery appears in the appendix.]

The CHAIRMAN. Tell me a little bit more about a progressive consumption tax. Is this not unlike Nunn-Domenici?

Professor MCCAFFERY. I think it is very much like Nunn-Domenici. And I think it is like Treasury One. I think it is like the proposals that David Bradford was making for a while.

Basically, my idea is that the conservatives for a long time have had the base issue right—that we should have a consumption tax, which would be a tax on spending, not work or savings. Frankly, I think the Democrats or the liberals have the rate issue right. There is no reason to link a tax on consumption to flat rate taxes, which is sort of the current vogue. So this is very much like Nunn-Domenici, very much like Treasury One.

The CHAIRMAN. You have no objection if somebody is a real miser and makes $100 million, and saves $90 million of it, and pays no taxes?

Professor MCCAFFERY. Absolutely not. And the way the proposal would work, in terms of inheritance, is that on the receipt of money, on the actual transfer, no tax would be levied. It would be on the ultimate expenditure, so we would have zero basis. And there is no problem with passing on wealth. In fact, that is what the miser would have to do. That is what we want Perot to do. We want Perot to earn his $3 billion because, presumably, he served some social good, but we should be nervous about his spending it, so we want him to pass it on. That is what we want him to do.

The CHAIRMAN. Let me ask Professor Holtz-Eakin and Dr. Rahn this. It is not very often that you get statements that are absolutely contradictory that are facts.

Professor Holtz-Eakin, you say, "The notion that small businesses are the dominant or even single most important source of job growth has now been widely discredited." Dr. Rahn says, "Small firms created five times as many jobs as very large firms." Those two seem to be contradictory, or am I not reading them right?

Professor HOLTZ-EAKIN. No. You can count the number of jobs created, and get a number that Dr. Rahn would have. You can have the number of jobs created and subtract off the number of jobs lost as small businesses fail, and you will end up with the picture that I have.

The CHAIRMAN. Dr. Rahn?

Dr. RAHN. Well, I agree with the Professor's analysis. In many ways, this is not the most important issue, what size firm creates the jobs. What we are interested in is maximizing job creation and maximizing the growth in real incomes. And I think everybody who has looked carefully at capital taxation now agrees that it is counter-productive. The costs are greater than the benefits. It slows economic growth.

I was listening to the Assistant Secretary beforehand about the revenue loss numbers. These are totally bogus. This is a static view of the world. And if you treat variables as constants, it will confuse your thinking, and you will come up with the wrong answers.

When we use this kind of static analysis, and say that we cannot go ahead and increase expensing, that is absurd when we already know that the cost of tax on capital reduces the net GNP growth.

The CHAIRMAN. I might suggest to the Committee that a vote has started. If we are all very frugal with our questions, we may be able to finish before we have to go and vote.

John?

The CHAIRMAN. That is enough. [Laughter.]

Senator CHAFEE. Thank you very much. That is real frugality.

Well, Professor McCaffery, I thought that was excellent testimony.

Professor MCCAFFERY. Thank you.

Senator CHAFEE. Usually I find that it is excellent testimony if I agree with it.

Obviously, you have checked and found out that Australia, Canada and Israel—Western democracies all—have abolished the transfer system. There is no transfer tax upon death?

Professor MCCAFFERY. That is correct.

Senator CHAFEE. Or gift?

Professor MCCAFFERY. That is correct.

Senator CHAFEE. I think your point that this thing may be a net cost to the Federal Government is extremely interesting. Have you done anything on that, Dr. Rahn?

Dr. RAHN. On the transfer, no.

Senator CHAFEE. No. The cost to the Federal Government?

Dr. RAHN. No.

Senator CHAFEE. Obviously, we do not want to be involved with a tax that costs us more money than we collect.

The only thing I would question is whether the public would accept it the way you phrased it. The public is very anxious that they do not pay any inheritance taxes, but they want to see the wealthy people pay them. And everybody in the U.S. considers themselves middle-class, I suspect.

Professor MCCAFFERY. Actually, Senator, I am not sure of that. In both the written testimony which you alluded to, and the longer, scholarly pieces that I have written on this—and I have done some research—I cite two interesting historical episodes.

George McGovern proposed a confiscatory inheritance tax above $500,000 in 1972. That is about $2 million in current money, current value. And immediately, the next day, he had to publicly apologize for that. There was large outrage against it.

In 1982, Californians voted something like 64 to 36 percent to repeal the inheritance tax. So I think there is a little bit of public education that would go into this, but I think it is the notion of the Government collecting money at death, the notion of them collecting it from heirs. I do not think that is a popular notion. And further, I think the people are right. I think people have the right instincts here.

Senator CHAFEE. Just one quick question. What do you think the effect would be on charities?

Professor MCCAFFERY. That is interesting. And I address that too in my scholarly work. Clearly, death is a salient point for giving to charities. I think we could make adjustments under Nunn-Domenici, under Treasury One, under a progressive consumption tax. You could exempt charities as well. So I think the question of charities is really independent of it. By the way, charities get about 80 percent as much as the Federal Government gets upon death. Charities get about $6 or $8 billion.

Senator CHAFEE. Well, that should not be controlling, but I think it is interesting.

Professor MCCAFFERY. No. But it clearly has to be considered.

Senator CHAFEE. Libraries and universities, and so forth, would probably lose out. They might and they might not.

Professor MCCAFFERY. They might. I think you could make other adjustments so that they will not. I think it is an important issue, but it can be addressed.

The CHAIRMAN. Senator Baucus?

Senator BAUCUS. I am just curious about this point that maybe it is good to let wealth accumulate. I guess your point is that accumulation would avoid encouraging consumption. Would those taxpayers still pay capital gains taxes on transfer of their property?

Professor MCCAFFERY. Well, right now there is no capital gains on transfer. And under a consumption tax, there would be no capital gains tax.

Senator BAUCUS. So it is your thought that the value, the basis of the property, would be the market value at death.

Professor MCCAFFERY. No. Actually, going back to Treasury One and a consumption tax, you actually have a zero basis. You have no basis in it because you have not paid tax on it yet. Think of it like an IRA or a pension. You save money, you pay no taxes on it, you have zero basis in it. If you die, and you still have money in your pension plan, not having paid any tax on it yourself, you could pass it on to your son or daughter, who would also have a zero basis. When they went to spend it, it would all be taxable. So, under a consumption tax, you actually get rid of the concept.

Senator BAUCUS. What about real estate that is in an estate? You are saying that the basis at death under your proposal would be zero?

Professor MCCAFFERY. If you move all the way to a consumption tax, that is right. Because when you bought the real estate, you would get a deduction. That would be a form of saving.

Senator BAUCUS. And the basis when transferred at death would be zero also?

Professor MCCAFFERY. That is correct.

Senator BAUCUS. And the tax would be paid whenever it was——

Professor MCCAFFERY. If and when somebody cashed out.

Senator BAUCUS. What about income distribution problems in this country? Are you at all concerned about the widening distribution of income in this country?

Professor MCCAFFERY. I am very concerned about that. What I actually believe is that we have gotten the base issue wrong, because we are taxing income and estates, we are constrained in our ability to have progressive rates. So we get arguments like we had in 1981, and again in 1986. We had arguments that high tax rates deter savings and deter earnings, which is correct under an income tax.

Senator BAUCUS. I hear all this, and it is very provocative. The question I keep wrestling with is, how do we make sure we are not buying a pig in a poke here? We know the problems of the 1980's, with the Kemp-Roth supply-side economics. On the other hand, our savings actually declined.

Professor MCCAFFERY. Yes.

Senator BAUCUS. They did not go up. And I am just wondering how we can figure out a way to increase capital in this country but, more importantly, increase jobs.

Professor MCCAFFERY. Yes. That is what I am trying to do too. And partly I look around and think that what we are doing is not working. So we should think about doing something else.

Senator BAUCUS. Thank you.

The CHAIRMAN. Senator Pryor?

Senator PRYOR. Well, I think we are out of time, Mr. Chairman, but I am going to just throw out one question. A moment ago, with our previous witness from the administration, Senator Chafee asked a question, what if we just did away with the estate and gift tax, and substituted a small percentage increase in the income tax? I am not asking that specific question, but what would be an equitable tax to substitute for estate and gift tax, if we had to have the revenue?

Professor MCCAFFERY. My entire package would be to repeal the estate and gift tax, move more squarely to a consumption tax by having, say, unlimited IRA's or family savings accounts, and then maybe raise rates even more than the conservative 1 percent that Senator Chafee mentioned.

Senator PRYOR. So you would favor a consumption tax?

Professor MCCAFFERY. I would say that we are already about halfway there. We should move more, and up the rates.

Senator PRYOR. What would Dr. Rahn say?

Dr. RAHN. I would say move to a consumption tax. I am not in favor of increasing the rates, however. The trouble is, if you start increasing rates too highly on consumption, you will begin to have massive tax evasion. As I just pointed out with electronic money and the smart card, the existing tax system and very high rates are going to be virtually impossible to enforce. We do not have time to go into it today. But if we really want to gain revenue and have a responsible Tax Code by which we could get revenue, and not have massive tax evasion, we are also going to have to keep the rates down, which means downsizing Government.

Senator PRYOR. Well, I think we are out of time, Mr. Chairman.

The CHAIRMAN. We have about 3 minutes to go and vote. I have asked the other Members, and they do not need to come back.

So we want to thank you very much, gentlemen. The panel is excused. We are done, and we will run and vote.

[Whereupon, at 10:33 a.m., the hearing was concluded.]

APPENDIX

Additional Material Submitted

Prepared Statement of Cynthia G. Beerbower

Mr. Chairman and Members of the Committee:

I am pleased to present the views of the Treasury Department on proposals (i) to increase unified estate and gift tax exclusions and exemptions and (ii) to increase the expensing limit for small business.

1. The Administration has strongly supported and will continue to support the goal of assisting and strengthening small businesses.

The Administration previously has undertaken both legislative and administrative initiatives to achieve the goal of assisting and strengthening small businesses. In 1993, we proposed and supported the 50-percent exclusion for capital gains that result from the sale of small business stock; we supported the enactment of Section 1044, encouraging investment in small businesses by allowing gain from selling publicly traded stock to be invested tax-free in specialized small business investment companies; and we supported the increase in the amount of capital investment that small businesses can expense from $10,000 to $17,500.

Administratively, we issued numerous regulations designed to minimize or eliminate burdensome record-keeping requirements for small businesses. This year, we have reduced the reporting requirements necessary to claim an ordinary loss deduction on the sale of small business stock. Last year, we issued a variety of guidances to reduce compliance burdens on small businesses and to provide them with more flexibility. For example, we issued guidances which:

—simplified the calculation for computing alternative minimum tax liability;

—simplified the determination of depreciation deductions, allowing taxpayers to group certain assets in one or more "general asset accounts;"

—clarified that S corporations may enter into partnerships with partners that could not themselves qualify as S corporations, including nonresident aliens. This guidance gives S corporations flexibility to raise additional capital and structure their business relationships as required;

—clarified that employees did not have any income from the employer's non-deductible portion of business meals and entertainment, so long as there was a business purpose for the expense;

—clarified that small investment partnerships, including family partnerships, can take advantage of a simplified form of accounting for the built-in gains or losses on their securities; and

—provided that the rules governing the timing of hedging gains and losses do not apply to small cash-method taxpayers, even though such taxpayers are given the benefit of the favorable character provisions in those regulations.

Similarly, in 1993, we issued mark-to-market regulations that contain an exception for taxpayers with relatively low levels of sales activity, and we issued uniform capitalization rules that provide a de minimis rule for small businesses.

We expect to reduce needless administrative and compliance costs by proposing that taxpayers be allowed to elect to be treated as a partnership by simply checking a box on a return. This simplified approach would replace the current rules, under which small businesses could get partnership tax treatment only by complying with a multi-factored test that is both complex and uncertain in its application. This check-the-box approach has been uniformly praised by taxpayers and practitioners.

2. *Increase of the Estate Tax Exemption and Addition of Estate and Gift Tax Indexing Provisions*

SUMMARY

The Administration recognizes that the estate-tax exemption has not been increased since 1987. We are concerned, however, that the House-passed proposal to increase the exemption and provide indexing would cost about $20 billion over 10 years and would affect a limited number of taxpayers—less than 15,000 taxpayers per year would benefit from the proposed increase in the exemption. We would be willing to work with the Congress to develop and pay for targeted proposals that would provide benefits for small family businesses.

BACKGROUND

The first estate tax was enacted in 1916. The present gift tax was added in 1932 to prevent avoidance of the estate tax through lifetime transfers. The initial estate tax was progressive, with rates varying from one to ten percent. Over the years, the highest marginal rate was greatly increased, reaching its maximum of 77 percent for the period from 1940 to 1976. At present, the marginal rates range from 18 to 55 percent. The 55 percent rate apples to taxable estates of $3,000,000 or more.

From the outset, a certain amount of property was exempted from the tax. Prior to the unification of the estate and gift tax systems in 1976, each taxpayer was allowed a specific exemption from the estate tax and a separate specific exemption from the gift tax. In 1976, the estate tax exemption was $60,000, and the gift tax exemption was $30,000.

These exemptions were converted into a credit in the Tax Reform Act of 1976. That act made major structural changes in the estate and gift taxes by unifying the estate and gift tax systems, applying a single progressive rate schedule to the aggregate transfers made by gift during life and at death. The exemption was changed to a credit to equalize the benefit received by smaller and larger estates.

The amount of the unified credit has been increased over time to account for inflation (see Chart 1 below). When Congress introduced the unified credit in 1976, it replaced the $60,000 estate-tax specific exemption which had been in effect since 1942. By 1976, the purchasing power of a dollar had decreased to less than one-third of its 1942 value. Under the Tax Reform Act of 1976, the phased-in unified credit effectively exempted from taxation the first $175,625 of an estate (a unified credit of $47,000) in 1981. These exemptions had the effect in 1977 of subjecting only 7.6 percent of decedents to the estate tax.

Congress reexamined the unified credit in the Economic Recovery Tax Act of 1981 (ERTA), again determining that the unified credit had failed to keep pace with inflation. The Senate Report stated:

> Inflation has increased the dollar value of property and, therefore, the transfer tax burdens, without increasing real wealth. With the existing level of unified credit (which permits cumulative tax-free transfers of $175,625), the estate tax is imposed on estates of a relatively small size, including those containing family farms or closely held businesses.
>
> Imposing the tax on these smaller, liquid estates often results in forced sales of family enterprises.

S. Rep. 97–144, 97th Cong., 1st Sess. 124 (1981). ERTA increased the amount of the effective exemption over the five-year period from 1982 through 1987, from $175,625 (a unified credit of $47,000) to $600,000 (a unified credit of $192,800). The unified credit has remained unchanged since 1987.

CHART 1.—HISTORY OF THE UNIFIED CREDIT

Year	Credit Amount	Which Exempts the First
1977	$30,000	$120,666
1978	34,000	134,000
1979	38,000	147,333
1980	42,500	161,560
1981	47,000	175,625
1982	62,800	225,000
1983	79,300	275,000
1984	96,300	325,000
1985	121,800	400,000

CHART 1.—HISTORY OF THE UNIFIED CREDIT—Continued

Year	Credit Amount	Which Exempts the First
1986	155,800	500,000
1987—Present	192,800	600,000

CURRENT LAW

Under current law, the "unified credit" effectively exempts from the federal estate tax the first $600,000 of an estate's value. This credit essentially removes from the estate tax system estates with assets of $600,000 or less. The unified credit can also be used to exempt lifetime gifts from the gift tax, but doing so reduces the amount of the credit available at death. If a married couple plans their estates carefully, both spouses' unified credits can be used to pass $1,200,000 to their children or other persons without imposition of any estate or gift tax. The credit is phased out for estates in excess of $10,000,000. The amount of the unified credit has been unchanged since 1987.

In addition to the amount that can be transferred without tax by gift or bequest due to the application of the unified credit, each taxpayer also may make annual tax-free gifts of up to $10,000 per recipient. A married couple together may make annual gifts of $20,000 per recipient. The annual exclusion does not apply to gifts of future interests (such as reversions or remainder interests). The amount of the annual exclusion has been unchanged since 1982.

A generation-skipping transfer tax ("GST tax") generally is imposed on direct and indirect transfers to a person in a generation more than one generation below that of the transferor. This tax is in addition to the estate or gift tax. Each taxpayer is allowed an exemption from the GST tax of $1,000,000 for generation-skipping transfers occurring during the taxpayer's lifetime or at death. The exemption amount was fixed at $1,000,000 when the GST tax was enacted in 1986 and has remained unchanged.

The estate tax includes relief provisions for farms and family businesses. Under Code Section 2032A, for example, an executor may elect for estate tax purposes to value certain "qualified real property" used in farming or another qualifying closely held business at its current use value, rather than its highest and best use value. When Congress adopted this provision in 1976, it was concerned that a fair market valuation would make "continuation of farming, etc. activities not feasible because the income potential from these activities is insufficient to service extended tax payments or loans obtained to pay the tax. Thus the heirs may be forced to sell the land for development purposes." S. Rep. 94–938, 94th Cong., 2d Sess. 15 (1976). Code Section 2032A is a limited departure from the ordinary estate tax valuation rules, which require that property be valued at its fair market value, that is, the price at which the property would change hands between a willing buyer and a willing seller. The maximum reduction in value of qualified real property resulting from an election under Code Section 2032A is $750,000. This maximum amount has been unchanged since 1983.

Another relief provision is Code Section 6166, which permits an executor to elect to pay the Federal estate tax attributable to an interest in a closely held business in installments over, at most, a 14-year period. When this provision was enacted in 1976, Congress believed that "additional relief should be provided to estates with illiquidity problems arising because a substantial portion of the estate consists of an interest in a closely held business or other illiquid assets. " S. Rep. 94–938, 94th Cong., 2d Sess. 18 (1976).

Under Code Section 6166, for the first five years, only interest is required to be paid; payment of the principal may be deferred for five years. To qualify for the election, the business must be an active trade or business and the value of the decedent's interest in the closely held business must exceed 35 percent of the decedent's adjusted gross estate. Under Code Section 6601(j), a special four-percent interest rate applies to the amount of deferred estate tax attributable to the first $1,000,000 in value of the closely-held business. This $1,000,000 cap relating to the application of the four-percent interest rate has been unchanged since 1976.

Thus, farmers, ranchers and small businesses can obtain relief from the special use valuation and Code Section 6166 deferral over and above the regular estate-tax exemptions. For example, if a farmer who qualifies for the full special use valuation election and Code Section 6166 died with a gross estate valued at $1.5 million, the present value of the estate tax due would be approximately $22,890 (taking into account the value of the deferral of payment). In contrast, the estate of an employed person who had accumulated or inherited wealth of $1.5 million would owe an estate tax of approximately $341,500. The effective estate tax rate on the farmer's estate would be under 1.6 percent, while the effective tax rate on the wage-earner's estate would be 23.6 percent.

H.R. 1215

The House-passed tax legislation, H.R. 1215, would increase the amount of the unified credit against gift and estate tax. The increase would exempt the first $700,000 for decedents dying (and gifts made) in 1996; $725,000 in 1997; and $750,000 in 1998. After 1998, the unified credit would be indexed for inflation. The bill would also index for inflation the $10,000 annual exclusion amount, the $1,000,000 GST tax exemption, the $750,000 special use valuation limitation under Code Section 2032A and the $1,000,000 cap on the four-percent interest rate under Code Section 6601. The indexed annual exclusion amount would be rounded to the nearest $1,000; all other indexed amounts would be rounded to the nearest $10,000.

This proposal, if enacted, would reduce tax receipts by $6.7 billion over the five-year FY1996—FY2000 period, and by $22.6 billion over the ten-year FY1996—FY2005 period.

DISCUSSION

The Administration recognizes that the levels of the unified credit and various other estate and gift tax limitations have not been increased since 1987. We are willing to work with Congress to maintain an estate and gift tax system that exempts small- and moderate-sized estates, and that helps keep intact small and family businesses, so that they can be passed on to future generations.

In addition to considering the proposal contained in H.R. 1215, we believe that it is appropriate to consider other, more targeted modifications to the estate and gift tax system that might provide appropriate relief to small family businesses. For instance, this Administration previously has testified in support of a proposal, similar to S. 105, that would modify, on a prospective basis, the special valuation rules of Code Section 2032A to allow a qualified heir to cash-lease specially valued real property to certain family members of the decedent, who continue to operate the farm or closely held business, without triggering a recapture of special valuation benefits.

Only a small number of the wealthiest taxpayers would benefit from the increase in the unified credit in H.R. 1215. In 1989, for example, 2,150,000 taxpayers died. Less than 25,000 of those decedents had taxable estates in excess of $600,000. Thus, with the unified credit provided by current law, the estates of only one percent of decedents paid estate tax in 1989. If the unified credit had been $750,000 rather than $600,000 in 1989, half of those estates would have paid no tax.

Increasing the unified credit is costly and would benefit not only small businesses, but also the very wealthy. We are willing to work with the Congress to achieve a more targeted way to assist small businesses on a revenue-neutral basis.

3. Increase of Expensing Limit for Small Business

CURRENT LAW

The cost of business or income-producing property that provides service for more than one year generally must be deducted over the recovery period of the property. Under Code Section 179, a taxpayer may elect, however, to deduct currently up to $17,500 of the cost of the property (i.e., "expense" the property). This $17,500 maximum, however, is reduced for each dollar of the total cost of qualified property acquired during the year in excess of $200,000. Thus, if the cost of qualified property placed in service during the year exceeds $217,500, no expensing is allowed.

H.R. 1215

The House-passed bill, H.R. 1215, would increase the maximum investment that may be expensed to $22,500 for 1996, $27,500 for 1997, $32,500 for 1998, and $35,000 for 1999 and thereafter.

The proposal, if enacted, would reduce tax receipts by $8.0 billion over the five-year FY1996—FY2000 period, and by $12.5 billion over the ten-year FY1996—FY2005 period.

DISCUSSION

The Administration supports increasing, on a revenue-neutral basis, the maximum investment that may be expensed for small business. The Administration believes that it is important to encourage small businesses to invest in capital assets.

In addition, increasing the maximum expensing deduction would simplify tax reporting for eligible small businesses.

OBRA 93 increased the maximum investment that may be currently deducted from $10,000 to $17,500. At that time, the Administration supported the House version of OBRA 93, which would have raised the maximum to $25,000. The Administration also testified in support of the original House legislation, H.R. 9, reflecting tax provisions of the Contract with America, which would have raised the maximum to $25,000.

The phased-in increase to $35,000, as contained in H.R. 1215, is substantially more expensive than increasing the limit to $25,000, which is estimated to lose $4.2 billion over 5 years and $5.0 billion over 10 years. In this period of budgetary constraints, we would be willing to work with Congress to develop an appropriate revenue offset and would be willing to evaluate whether, in light of these budgetary constraints, the phased-in increase to $35,000 is likely to best meet the needs of small businesses in a cost-effective manner.

PREPARED STATEMENT OF SENATOR ORRIN G. HATCH

Mr. Chairman, thank you for holding this hearing today on the taxation of estates and the expensing of business equipment in Section 179 of the Internal Revenue Code.

The structure of our current tax code can prevent owners of family farms and businesses from passing the business to their heirs once the owners have passed away. The current unified credit, which allows a $600,000 exemption from estate taxes, is insufficient for many family owned businesses. Oftentimes, due to the high tax rates imposed on these transfers, heirs of family farms and businesses are forced to liquidate part or all of the assets of the business to pay the required tax. I support Senator Dole in his effort to alleviate the difficulties facing these taxpayers.

Mr. Chairman, it is also important that small businesses are allowed to more quickly write off their investment in business equipment. Many small businesses just starting out invest much of their scarce capital in new equipment. In many cases, the current threshold of $17,500 is simply not sufficient to help a small business on its way to becoming a successful job creating company. The expensing of business equipment for these small enterprises goes a long way in increasing cash flow and helping to lower their effective tax rate. This is especially true in the capital intensive early years of the business, which usually define its future.

The two issues we are discussing today are very important to the success of small business. I have long been a supporter of small businesses and look forward to their continued success. Small businesses account for much of the job growth in our economy. I view these issues as complementary to S. 758, the bill Senator Pryor and I recently introduced to assist businesses incorporated as Subchapter S corporations in obtaining needed capital and keeping these businesses in the family.

Mr. Chairman, I applaud you for holding this hearing today and for the opportunity to hear the witnesses before us.

PREPARED STATEMENT OF DOUGLAS HOLTZ-EAKIN

Under Section 179 of the Internal Revenue code, taxpayers may deduct up to $17,500 of annual expenses for capital outlays. This, and other, provisions of the tax code are generally defended as tax preferences necessary to foster an environment conducive to the birth and growth of new businesses. Indeed recent moves to "strengthen" the small business environment include enactment of preferred tax treatment of capital gains from investments in "small" (under $50 million in assets) and proposals to increase the amount of "expensing" permitted under Section 179.

However, when scrutinized carefully from the perspective of sound income tax policy, on economic policy more generally, these tax-based attempts to target small businesses appear to be ill-founded. In general, it is difficult to construct a solid case from the perspective of either economic efficiency or fairness.

Before reviewing the arguments, however, it useful to discuss first several issues that arise in the analysis of the economic role of small businesses.

Who are the small firms? As a practical matter, one must draw a line separating small firms from large firms. But how should it be drawn? There are at least three dimensions along which one might wish to discriminate. The most obvious is revenues, sales or other output-based measures. A firm crosses the line from "small" to "large" when its production or profit reaches becomes sufficiently large. A second candidate is the number of employees. With a focus on job creation (and more recently "good job" creation), it is conventional to divide employers on the basis of the number of jobs. Finally, one could use asset accumulation as the measure of "size." For example, the capital gains tax preference introduced in the Revenue Remuneration Act of 1993 (RRA93) is limited to firms with $50 million or less in assets.

For purposes of this discussion, it is not necessary to take a firm stand on this issue. As noted above, tax treatment of small business has been based on both revenue and asset considerations. And it is equally common to provide differential regulatory treatment to firms on the basis of the number of employees. Regardless of the precise implementation, it is useful to begin with the fundamental objectives and desirability of preferential treatment.

Are small firms entrepreneurial or just small? In descriptive analyses, entrepreneurs are characterized by their daring, risk-taking, animal spirits, and so on. In the words of the path-breaking economist Joseph Schumpeter, "To act with confidence beyond the range of familiar beacons and to overcome that [social] resistance requires aptitudes that are present in only a small fraction of the population and that define the entrepreneurial type . . . " (Schumpeter (1942)). Are these the characteristics of small firms (or, at least, their owner-managers)?

Clearly this notion is central to the issue of preferential treatment. And it is ultimately an empirical issue as well. The empirical literature to date, however, has not provided a clear resolution to this question. In part, this is because empirical analyses have focused on more narrow issues related to small firms such as credit rationing, job creation, and so forth. In part, the question has been avoided; the entrepreneurial virtues of new businesses are often a maintained hypothesis in the analysis. Finally the absence of a clear method and set of criterion for evaluating the contribution of small business per se to productivity growth in the economy has made it difficult to develop an empirical assessment of the role of small business.

Are small firms tax-favored? The tax code contains relatively few provisions that explicitly target small business. In addition to the preferred capital gains tax treatment in RRA93, perhaps the most significant tax advantage conferred on small businesses is the ability to expense up to $17,500 in capital expenditures per year. Expensing reduces the cost of capital and lowers the effective tax rate on the return to small business equity capital. To get a sense of the magnitudes involved, consider a manufacturing sector equipment investment.

Illustrative computations, taken from Holtz-Eakin [1995], are shown in Table 1. Consider the first row of the table, which shows the results of using a 15 percent tax rate (the lowest corporation income tax rate, see below) on the return to capital. Column (1) indicates that the required user-cost is 17.95 percent when it is possible to expense the investment in question. In column (2), however, one finds that the same investment requires a user-cost of 20.23 percent when granted typical tax depreciation. Thus, the option to expense the investment provides an effective subsidy to the required rate of return equal to 2.28 percentage points.

The remainder of the rows show analogous computations using the remaining rates in the corporation income tax schedules; rates of 25 percent and 35 percent, respectively. In each case, the provision of immediate write-off to small business constitutes a substantial subsidy. For a 25 percent tax rate, the hurdle rate of return falls by roughly 4 percentage points, while at the highest tax rate the hurdle rate would be 6 percentage points lower.

Table 1 also embodies the final feature of the tax code directed toward small business. Both small business taxed through the individual income tax (in the form of sole-proprietorships, partnerships, or S-corporations) or those small C-corporations taxed under the corporation income tax face a series of increasing marginal tax rates. In this limited sense, small businesses are ostensibly tax-favored by the lower rates early in the tax schedules.

A glance at down the columns of Table 1, however, indicates that the effective subsidy hardly coincides with the reductions in statutory rates. Because the value of interest deductibility and expensing declines as the tax rate is lowered, the user-cost of capital rises. for example, moving from a 15 percent to a 25 percent tax rate lowers the user cost from 17.95 percent to 17.05 percent. A further increase in the tax rate to 34 percent lowers the user cost again, this time to 16.24 percent. In contrast, the lower value of depreciation allowances for larger businesses (column (2)) results in a steady increase in the user cost as the tax rate rises.

In sum, the current Federal tax code does contain features that favor small business, although in the case of the statutory rate reduction the net effect is not to reduce the effective tax rate. But should it? I turn next to the question of whether steps should be taken to eliminate or expand the preferential treatment of small business.

EQUITY-BASED ARGUMENTS FOR PREFERENTIAL TREATMENT

Income taxes are typically judged in part by the degree to which they satisfy the goals of horizontal and vertical equity. Applying these concepts to the firms, should not small firms get a break? The difficulty is that while appeals to equity carry considerable force with regard to individuals, they are less compelling for firms. An adage as old as the field of public finance is that "firms don't pay taxes, people do." For the same reason, it is difficult to construct a formal, firm-based theory of "fairness" in taxation.

Moreover, applying notions ot fairness to firms may lead to inconsistencies in the treatment of individuals. A dramatic example is the recently enacted preferential treatment of small business-related capital gains, which comes on the heels of a protracted dispute during the Bush administration over the desirability of providing a reduction in the capital gains tax rate. In large part, this debate featured an emphasis on the distributional aspects of capital gains tax reductions. Without taking as stand on the larger issue of the desirability of reducing taxes on capital gains, it is straightforward to note that the implications for the individual income tax distribution of providing preferred treatment to small businesses are the same as providing reduced rates in general. Capital gains accrue to suppliers of capital, and these suppliers occupy a particular strata in the income distribution. From the perspectives of horizontal or vertical equity, the source of the capital gains per se is of no consequence. In short, it is difficult to argue that fairness would lead one to tax small businesses differentially. Indeed, to the extent that issues of equity arise, they seemingly weigh against preferential treatment.

EFFICIENCY AND THE TAX-TREATMENT OF SMALL FIRMS

Lessons from optimal tax theory. The debate over using the tax code to favor small businesses fits uncomfortably into the large, broadly-accepted body of work describing the optimal structure of taxes. An important insight of the optimal tax literature is that tax systems should avoid taxes that distort firms' choices of inputs. Indeed, firm-based taxes are to be exploited only to the extent that (lump sum) taxes may capture pure economic profits. In short, taxes should not distort the production arrangements within firms, and thereby lower the level of production in the economy. A straightforward extension of this line of reasoning is that taxes should not influence the arrangements of firms themselves. To the extent that there is a natural size for a firm or a natural evolution or growth of firms, these should not be altered by the tax code. Thus, an efficiency-based argument for preferred tax treatment requires something "special" with regard to small firms or their inputs. What is potentially unique regarding these enterprises?

Externalities. A standard rationale for a tax-based subsidy to any activity is the presence of beneficial externalities from that activity. Are small firms the source of such beneficial externalities?

Recent years have witnessed a revival of the notion that there are key industries or activities that generate beneficial interindustry externalities. Proponents of activist policies argue that these interconnections are significant, in the same way the proponents of small business argue that they are a unique source of new ideas, products and technological advance. If so, government intervention such as differential tax treatment would be desirable because the private sector is unable to appropriate all of the gains to these activities. Holtz-Eakin and Lovely (1995) examine the optimality of subsidies to firms that generate such spillovers. Interestingly, the results show that policy depends both upon technological linkages and the extent of market power in the target industries. Indeed, it may be the case that the interaction of market forces with technological linkages may require that the government impose a combination of subsidies and taxes on target industries.

The structure of these policies is quite intricate and unlikely to be easily introduced via the corporation income tax code. Moreover, it is an unresolved empirical issue as to whether the small business in the economy provide a disproportionate share of innovations and other activities leading to new processes and products. Finally, even if this is the case, one must demonstrate that these activities have external effects not captured by the firms themselves. While intriguing, this recent research is far from accumulating the weight of evidence sufficient to establish the need to preferentially tax the smaller businesses in our economy.

Capital Market Imperfections. A substantial theoretical literature has demonstrated how credit rationing can emerge even in a world in which all agents are optimizing. That is, it may be the case that two equally promising projects cannot both obtain financing at the same rate of return. Indeed, one of the two projects may not be financed at all.

For this reason, researchers have taken seriously the hypothesis that capital market constraints may be an important determinant of the decision to start a new company and a growing body of literature suggests that capital market constraints may impede the entry into entrepreneurship, the initial capitalization of new ventures, the probability of surviving as a small business, and the growth rate of revenues for entrepreneurial ventures. Thus, there exists both an empirical presumption and some confirming empirical evidence that capital market constraints are reducing the formation of new businesses and lowering the survival rate among the least established firms.

But this literature does not establish the proposition that too few businesses are created each year. Nor does it establish any presumption that a greater fraction of the newly-founded businesses fail each year. In short, the empirical literature to date does not provide a solid foundation for a tax-based (or other) intervention on behalf of small business in general.

In large part, this stems from the informational asymmetries that lie at the heart of the credit market failure. Unless the government has an ability to observe the probability of business success that is superior to that of the financial sector, there is little that it can do to more efficiently allocate credit. The tax code seems an especially unwieldy instrument for this purpose. Indeed, one might wish to evaluate a tax code on the basis of how little individual- or firm-specific information is needed to raise the necessary revenue.

Risk-taking. Businesses, large and small, face risks of financial loss and insolvency. However, the risk of failure is higher for small businesses. Does this risk lead to an inadequate formation of new businesses in risky areas? Should tax policy offset this risk?

The interaction of taxes and risk have been closely linked to arguments in favor of a lower capital gains tax rate. The Economic Report of the President, 1990 argues (page 115) "Much of the return to entrepreneurs and their backers who bring new products to market particularly through startup ventures comes through increasing the value the business. Reducing the tax rate on capital gains will provide a climate that encourages businesses to invest in new technologies and products." And sentiments of this sort presumably lay behind the RRA93 provisions regarding capital gains.

But the case in favor of preferential treatment of small business capital gains is far from clear-cut. First, a canon of personal investment strategy is the desirability of diversifying away the idiosyncratic risks associated with a single project or firm. That is, in a sufficiently diversified portfolio, one should not "count" the firm's specific risks at all. Thus, from this perspective, there appears to be little case for the need to subsidize financial backers in the form of a tax cut on capital gains.

But what of undiversifiable, systematic risks? One possibility is that tax policy should lean against the wind of cyclical movements in the economy, especially in light of the frailty of smaller businesses. Regardless of the merits of the argument, it appears infeasible in practice. The appropriate policy would necessarily treat small businesses differently during economic upturns and downturns. Given the demonstrated inability of the government to use fiscal policy to "fine-tune" the macroeconomy, the prospects for timely and appropriate treatment of the small business sector appear nil.

Of course, the individual owner-entrepreneur may hold a highly specialized portfolio the business that cannot take advantage of the risk-reduction offered by diversification. Even so, however, the case for preferential treatment is far from clear. Standard economic reasoning does not demonstrate that increased taxation reduces the willingness of individuals to undertake risky investments. Moreover, to date there is no consensus in the empirical literature regarding the relationship between higher tax rates and the propensity to incur risk.

What sort of magnitudes are involved. To gain a feel for this, consider the simulation results presented in Table 2 and drawn from Holtz-Eakin [1995]. The simulations compute the probability of success needed to induce an individual earning $100,000 to undertake a risky business startup. Thus, the fifth entry in the first row indicates that the break even probability when 40 percent of capital gains are excluded from tax is 0.987. The row beneath labeled "Change" shows that this represents a 0.013 reduction in the probability from that needed with an exclusion of 30 percent.

As the table shows, the capital gains exclusion represents a compensation for the risk associated with the business start-up. However, the magnitudes are not enormous. For example, consider the first row that gives the results for a $60,000 investment. A 50 percent capital gains exclusion reduces the probability of success from 1.0 to only 0.973, a change in the probability of success of only 0.027. For lower amounts at risk, the results are more dramatic. The remaining rows show that for a smaller, $50,000 investment the reduction in probability amounts to only 13 percentage points for a 50 percent exclusion. Or, if the required investment falls to $40,000, the 50 percent exclusion is equivalent to permitting the probability of success to be 22.5 percentage points lower. In short, while the tax exclusion does reduce the risk facing the individual, the effect is not large for those projects that represent a very large commitment of annual consumption opportunities. The effects are more dramatic as the initial outlay declines, but the difficulty in targeting these types of investments for subsidy is daunting.

Phase-outs and implicit taxes. A final argument against preferential treatment of small firms rests on the disincentive effects of eliminating the preferences as the firm grows. In this way, subsidies to small firms constitute of "tax" on growth. To be concrete, consider the phase-out of Section 179 expensing provisions. Effectively, as the firms success and capital needs grow, the tax code raises other things being equal the cost of capital. To the extent that the goal is to encourage robust business enterprises, a policy of inducing the entry of more firms through subsidies may come at the expense of hampering the development of these same firms at a later time. While one could possibly concoct a situation in which this was an appropriate strategy, it is difficult to defend this as the optimal current policy.

CONCLUSIONS

There is seeming widespread support for special help to small businesses and this support has manifested itself in preferential tax treatment of these enterprises. However, consideration of the standard equity and efficiency criteria for such a subsidy does little to support the current tax-based subsidies and does not support the expansion of further aid.

Table 1.—ILLUSTRATIVE USER-COST OF CAPITAL CALCULATIONS*

(In percent)

Tax Rate	Expensing	Depreciation	Subsidy
15%	17.95	20.23	2.28
25%	17.05	21.13	4.08
34%	16.15	22.40	6.25

*Author's calculations based on equation (1). Computations assume that the interest rate is 9 percent, inflation is 3 percent, and the rate of economic depreciation is 13.3 percent. Computations for firms using "Depreciation" assume that z=0.2814.

Table 2.—EFFECT OF CAPITAL GAINS EXCLUSION ON NEW BUSINESS START-UP: PROBABILITY OF SUCCESS REQUIRED TO INDUCE START-UP

Amount of Investment	Percent of Capital Gains Excluded From Tax					
	0%	10%	20%	30%	40%	50%
$60,000	1.000	1.000	1.000	1.000	0.987	0.973
Change		0.000	0.000	0.000	-0.013	-0.027
$50,000	0.962	0.940	0.920	0.902	0.886	0.871
Change		-0.022	-0.042	-0.060	-0.076	-0.091
$40,000	0.874	0.850	0.828	0.808	0.790	0.775
Change		-0.025	-0.047	-0.066	-0.084	-0.100

*See text for description of simulations.

ENDNOTES

1. The Office of Advocacy, Small Business Administration frequently uses an employment criteria to identify small businesses.
2. In the case of S-corporations, the measure of "size" is the number of shareholders. See Plesko (forthcoming) for a discussion of the rules associated with S-corporations.
3. I focus here on explicit preferential treatment of small businesses. A broader definition might include as well the fact that small businesses are less likely to be corporate entities, and thus do not pay the corporation tax, or that the mix of debt and equity may yield a lower effective. tax rate on small businesses.
4. The limit increased from a limit of $10,000 in 1993. Section 179 expensing provisions are limited by taxable income in any year and are phased out by the amount of qualified investment in excess of $200,000.

5. In column (2), z=0.2814, the 1988 value taken from Cummins, Hassett, and Hubbard [1994], Table 1, page 8. Increasing the value of z modestly to account for the slightly lower inflation in recent years has little effect on the results.
6. The use of these rates ignores the 5 percent surcharge on corporate revenues between $100,000 and $335,000. In this range, the marginal tax rate is 40 percent.
7. In addition, the 1991 Statistics of Income, Corporation Income Tax Returns indicates that the ratio of net depreciable assets to business sales is 50 percent lower (0.128 versus 0.256) for firms with under $100,000 of assets than for all firms. The lower capital intensity of these firms implies that the effective output subsidy is smaller than that suggested by the cost of capital computations alone. I thank Eric Toder for emphasizing this feature.
8. Due to the preferential treatment embodied in large, negotiated tax deals with influential employers, states' tax treatment probably favors large over small businesses. I thank James Papke for this insight.
9. See, for example, Holtz-Eakin, Joulfaian, and Rosen (1994a, 1994b).
10. This reasoning does not apply to credit market discrimination (or the spillover of product market discrimination into credit markets); see, e.g., Bates (1991). In these instances there is a direct rationale for government intervention.
11. Poterba (1989) indicates that a large fraction of venture capital is supplied by tax-exempt entities such as pension funds, making the likely impact of preferential treatment much smaller than even the analysis of individual behavior would suggest.

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PREPARED STATEMENT OF PROFESSOR GUY B. MAXFIELD

No doubt many of the comments suggesting an increase in the unified credit which now exempts $600,000 from the transfer taxes, stem from the very high rate structure of the gift tax and estate tax. (The rates begin at 37% and increase sharply to 55%).

A reason for the high rates of the transfer tax is because the base subject to tax is too narrow. A broadening of the base would permit a lowering of the rate and/or an increase in the unified credit without any revenue loss.

The following comments suggest some possibilities for change.

1. INCLUDE GIFT TAX IN TRANSFER TAX BASE.

The estate and gift taxes are calculated using the same rate schedule and the same unified credit. The tax is determined by taking into account all prior transfers. The unification of the estate and gift tax was intended to unify the two taxes and to minimize the influence of taxes in determining whether a lifetime gift will be made.

Despite the fact that the same rate schedule and same unified credit is used for both the gift tax and estate tax, the "ideal" neutralizing feature between the gift and estate taxes is not realized for the reason that the estate tax is imposed on the value of the estate (including the assets used to pay the estate tax) while the gift tax is imposed on the value of the gift without inclusion of the assets used to pay the gift tax. The inevitable result of not including the gift tax paid in the transfer tax base is a savings to the taxpayer in an amount equal to the marginal estate tax rate times the gift tax paid*

As a justification for the current law's bias in favor of making inter vivos gifts subject to gift tax, it has been suggested that since the government receives the gift taxes early it is made whole because of the value of the receipt of the gift tax. However, taking time value of money into account the savings from making inter vivos gifts subject to the gift tax increases!**

The gift tax should be imposed on a tax-inclusive basis so that the net after tax transfer would be the same whether or not the transfer was inter vivos or at death. This result could be accomplished most simply by amending section 2035(c) to eliminate the three year period with the result that payment of gift taxes whenever paid would be included in the gross estate.

2. AMEND GIFT TAX EXCLUSION.

Section 2503(b) provides for a $10,000 per donee annual exclusion for gifts of present interests in property. This exclusion is justified on the grounds of administrative convenience so that neither the taxpayer or the government would have to account for relatively modest transfers. Indeed the Committee Reports in discussing the former $3,000 exclusion stated that the purpose was to eliminate the need for record keeping for birthday and wedding presents and Christmas presents.

Assuming a married couple with a $20,000 exclusion per-donee, per year, it is clearly possible to transfer very large sums of money without any tax. A couple with five children could transfer $2,000,000 in 20 years without utilization of the unified credit. One may certainly question whether this result is required by administrative convenience.

A second, separate issue involving the exclusion is the use of trusts where the beneficiary is given a limited time to withdraw additions to the trust. While the original stated reasons for the exclusion were premised on administrative convenience, counts have upheld the use of the exclusion in circumstances were the beneficiary is given a 30-day or even a 15-day time period within which the donee must exercise the power of withdrawal. Crummey v. Commissioner, 397 F.2d 82 (9th Cir. 1968) and Estate of Cristofani, 97 T.C. 74 (1991).

If these two uses of the annual exclusion seem to go beyond the original reason for the exclusion, then a cap could be imposed per year. For example, in any one year the donor could not claim more than three exclusions. Second, in the case of gifts to trusts, the exclusion could be denied unless the donee had an unlimited time within which the power of withdrawal could be exercised.

3. VALUATION OF MINORITY INTEREST.

It is a very difficult job to determine the fair market value of property which is not publicly traded. The test is determining the price at which a willing seller and willing buyer would arrive at, neither being under any compulsion to buy or sell and

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*Assume a taxable estate of $1,500,000 and death in 1995. The estate tax payable would be $363,000. However, if the taxpayer made a gift of $750,000 (ignoring the annual exclusion of $10,000) the gift tax would be $55,500. If death occurred more than three years later (in order to avoid section 2035(c)), the estate tax on the assets remaining (viz. $750,000 less $55,000 of gift tax paid) would be $283,635. Thus, a savings of $23,865 in tax by paying the tax gift. Note the 43% marginal estate tax rate x the $55,500 gift tax equals $23,865.

**See attached calculations.

both have reassurable knowledge of all relevant facts. See Regs. §20.2031-1(b) and -3 and 25.2512-1.

The problem becomes more acute when the interest being valued is a fractional interest in the property. Under current law it is clearly established that a non-controlling interest in a business should be valued at less than a controlling interest. Furthermore, a donor who has a controlling interest (including owning 100%) makes gifts of non-controlling interest, the value of all of the separate minority interests is less than the value as a whole. See, e.g. Estate of Bischoff, 69 T.C. 32 at 49 (1977) and Estate of Campanari, 5 T.C. 488 at 492 (1945).

For a time the Internal Revenue Service asserted that family attribution should be relied upon to prevent a minority discount in family gift situations. Rev. Rul. 81-253, 1981-2 C.B. 187. The courts have consistently rejected this approach. See, e.g. Estate of Bright v. U.S., 658 F.2d 999 (5th Cir. 1981) and Propstra v. U.S., 680 F.2d 1248 (9th Cir. 1982). The Service has now given up on the argument. Rev. Rul., 93-12, 1993-1 C.B. 202.

No doubt the enactment of sections 2701-2704 has dealt with many valuation problems including typical "estate freeze" transactions. Nevertheless, current law continues to permit minority discounts in transaction involving family business.

To prevent a discount involving transfers within the family, the adoption of a family attribution rule would broaden the base subject to the transfer tax.

4. DEDUCTION FOR INTEREST.

Under current law it is clear that interest paid by an estate on estate taxes (Rev. Rul. 79-253, 1979-2 C.B. 333 and Rev. Rul. 80.250, 1% 0-2 C.B. 278), on gift tax deficiencies (Estate of Webster, 65 T.C. 968 (1976), acq. 1977-2 C.B. 2) and on income tax deficiencies (Rev. Rul. 69-402, 1969-2 C.B. 176) is deductible as an administration expense pursuant to Section 2053(a)(2).

It seems difficult as a matter of tax policy to justify the interest deduction. For example, if a donor pays interest on a gift tax deficiency the interest is not deductible for income tax purposes. (Section 163) However, it becomes deductible for estate tax purposes if paid after death.

Since the estate tax is imposed on fair market value of the estate at the time of death, what is the reason for allowing the deduction for interest paid after death? Certainly income earned post death is not subject to tax. The deduction for estate tax purposes of the interest paid clearly reduces the effective interest cost. This may have the effect of providing for incentives to prolong estate tax controversies as long as possible.

Finally, as a small step to reduce complexity in the Code, the repeal of the interest deduction would eliminate the involved calculation of, the amount of the interest since it is a function of the amount and time when the estate tax is paid and the determination of the proper amount of estate tax is a function of the amount of interest.

5. EXTENSION OF TIME FOR PAYMENT.

Under current law, the executor may apply for an extension of time to pay the estate tax for a period of up to ten years upon a showing of "reasonable cause."* Section 6161. Interest is computed using the normal rates. Also under current law, Section 6166 provides for an automatic extension of time to pay for a period of up to 15 years for the estate tax attributable to certain interests in closely held businesses. Furthermore, interest is charged at a 4 percent rate on the first $1 million of tax. This extension may be elected if the value of the active business assets in a "closely held business" exceeds 35% of the value of the adjusted gross estate. (Further, details of section 6166 are discussed in Stephens Maxfield and Lind, Federal Estate and Gift Taxation,]2.02[3][c]. Warren Gorham & Lamont, 6th Edition, 1990)).

If the reason given for a proposed increase in the unified credit is based on the difficulty for some estates in paying the estate tax nine months after death, then a liberation of section 6161 and 6166 could be more cost effective in meeting the objective. If interest in the unpaid tax was not deductible as an administration expense and unpaid with a requirement of posting a bond, there would be no real reason not to increase the reasons for granting an extension of time to pay the tax.

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*Reasonable cause includes situations where the state has no substantial assets consisting of rights to receive payments in the future, estates not having sufficient funds (without borrowing at a high rate of interest) and estates having claims to substantial assets which cannot be ———————— until after litigation. Reg. Sec. 20.6161-1(a)(1).

6. APPRECIATION AT DEATH.

The most controversial issue involving transfers of property at death does not involve the transfer tax but is the income tax treatment at death of assets which have appreciated in value. Under current law, in general, assets owned at death receive a basis equal to the fair market value at death. Section 1014. This result is unchanged even if the assets did not contribute to any estate tax because, for example, of the marital deduction.

There is considerable debate about the wisdom of treating death as a taxable event. What is inescapable is that the current law provides for very different results for taxpayers in substantially similar positions. Assume an asset held at death and sold shortly thereafter at $1,000 but having a cost basis to the descendant of zero would incur an estate tax of $370 (assuming a 37% bracket) and no income tax on the sale. The beneficiary of the estate would "net" $630. If instead, the asset was sold shortly before death there would be a capital gain tax of $280 (28% rate) and a net at death of $720 which would generate an estate cost of $266.20. This would leave a beneficiary a net of $453.60 to be contraseal with the net of $630.

In general, there are several possible changes from current law to overrule the result discussed above. First, a carryover basis would leave the two beneficiaries in the same position. This approach was attempted in 1976 when Congress enacted Section 1023. It was repealed retroactively in 1978!

A second approach would be to tax the appreciation at death. This approach, especially if it also provided for a generous exception from tax of smaller estates (viz. less than $2 million for example) could raise significant revenue which could be used to lower the rate of tax or increase the unified credit.

There are at least two variations on taxing all appreciation at death. One approach would limit the basis increase under Section 1014 to assets that gave rise to estate tax liability. Thus, assets equal to the unified credit and deductions (including the marital deduction) would not receive a new basis at death. To take care of household items and the like, the law could exempt some amount (such as $50,000) for household goods. A second, but more roundabout approach, would be to provide for a higher rate of estate tax on the amount by which the fair market value exceeds the adjusted basis of the assets.

7. INCREASE UNIFIED CREDIT.

Section 2010 presently provides for a unified credit of $192,000 which is the amount of estate tax on taxable estates of $600,000. Thus, the first $600,000 of an estate is not subject to tax.

There have been suggestions in the past year or so to increase the credit by some amount such as the past $750,000. Thus, a married couple would pay no estate tax on transfers amounting to $1,500,000. The credit have some useful functions. It eliminates the need for smaller estates from even filing an estate tax return. Also the credit provides for some relief from the steep transfer tax rates. (The first dollar in excess of the unified credit amount is taxed at a 37 percent rate.) An increase in the unified credit should be coupled with a reduction of the credit for very large estates. For example, a estate of $3,000,000 could be the threshold ———— for the beginning of a reduction in the credit. An approach such as section 151(d)(2) could be the tax mode.

In conclusion, a broader tax base would permit either a lowering of the rate of tax or an increase in the unified credit. The changes discussed herein would have the effect of taking some of the estate planning tools away which would have the effect of making the transfer tax system less "elective" in the sense that the tax is to be paid by those who do not carefully plan.

Attachment.

Considering the time value of money:

Part (a):

1990 assets of $1,500,000 grow in four years, at 5% after tax, compounded annually, to	$1,823,259
Estate tax on $1,823,259 in 1994	508,466
Total to heirs in 1994	$1,314,793

Part (b)

Gift in 1990 of $750,000 grows in four years in hands of donees to	$ 911,630

Gift tax on $750,000 = $55,500
Remaining assets = $694,500
(i.e., $1,500,000 - $750,000 gift - $55,500 gift tax).

Value of $694,500 in four years = $844,169

Estate tax per § 2001(b)

Unified transfer tax base = $1,594,169 ($844,169 + 750,000)	
Tax on $1,594,169 =	$598,176
Less gift tax paid on $750,000	55,500
Gross estate tax	542,676
Less § 2010	192,800
Net estate tax	$349,876

Net to heirs ($844,169 - 349,876) =	$ 494,243

Total to donees in four years	$911,630
Total to heirs	494,243
Total to transferees	$1,405,923
Total to heirs if no gift	1,314,793
Improvement due to gift	$ 91,130

PREPARED STATEMENT OF EDWARD J. MCCAFFERY

I begin with a few confessions. 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." I now believe that the gift and estate tax is a bad tax, even and perhaps especially on liberal grounds, and serious thought should be given to repealing it.

While my own specific further beliefs on tax reform, documented in several recent scholarly pieces,[1] would be to move comprehensively in the direction of a progressive-consumption-without-estate tax, I also believe that simply repealing the estate tax would be a step in the right direction. Somewhat a fortiori, a moderate move to increase the exemption level from $600,000 to $750,000 strikes me as being sensible. I shall take the rest of this brief statement to explain what may at first seem like these puzzling views.

In 1916, when the estate tax was first put in place, it may have seemed like the best of all possible taxes—as it had, indeed, to Jeremy Bentham and John Stuart Mill in the 19th Century. The tax would only fall on the very wealthy, and would serve the important social goal of breaking up large concentrations of wealth. It would not penalize lifetime earnings or accumulation. If it would hurt anyone, this could only be the putative heirs, but since such heirs could not bank on any inheritance, anyway, under the Anglo-American property system, their incentives would not be skewed. It was a classic win-win situation.

Unfortunately for this happy tale, times have changed since 1916. Over 75 years of experience with the estate tax, which was permanently supplemented with a gift tax in 1932, have produced only a limited, porous and possibly counter-productive tax system. The current gift and estate tax does not raise much revenue, and may even lose money, all things considered.[2] It seems to be doing little to break up the concentration of wealth in this country. A more sophisticated understanding of savings behavior has cast doubt on the "life cycle" theory of savings that underlay the 1916 world-view.[3] More striking, the tax is not popular. Polls and voting patterns show that people are consistently opposed to taxing inheritance. Canada, Australia and Israel—Western democracies all—have recently abolished their wealth transfer tax systems. Americans reacted with outrage to Presidential candidate George McGovern's call to abolish inheritance over $500,000 in 1972 (the equivalent of nearly 2 million 1995 dollars), and Californians solidly voted to repeal an inheritance tax in 1982 that applied to a small fraction of them. I shall return, in a moment, to this question of why the estate tax may not be popular.

First, let's pause and look at some of the incentives generated by the estate tax, which is a back-ended wealth tax. The tax encourages large and persistent inter vivos gifts, often made in complex and costly legal forms. Even without the inducements generated by the $10,000 annual per donor per donee exclusion, and categorical exemptions for certain medical and educational payments, the mere fact of inflation counsels for an early and aggressive use of the unified credit equivalent amount: This is the distilled essence of the popular "estate freeze" device. Using up one's exemption earlier in life gets both that exemption amount and all subsequent growth of it out of one's estate: this effect can, of course, be substantial over time. Thus, the gift and estate tax is in some ways more easily circumvented by the very rich, who can afford to get wealth out of their estates on an ongoing basis, than by the merely rich who wait until death to transfer assets.[4] An estate tax also discourages work and savings, especially long-term, intergenerational savings, and encourages consumption, especially the rapid and large scale consumption of the very rich. These hardly seem like good incentives, even and maybe especially on liberal grounds.

As I have in my published work, I shall use the example of H. Ross Perot to illustrate my points. Perot's personal wealth is estimated at something like 3 billion dollars. In 1992, Perot spent $60 million running for President. Perot was fond of making the claim that this was all his own money, that it came out of his own pocket, that no taxpayer dollars were at stake. But this is wrong. Under a back-ended wealth tax, all consumption shares the structure of a "tax expenditure" under the income tax. Had Perot not spent the $60 million, either he would have had to leave it all to charity, and thus serve a certain public good explicitly sanctioned by the tax laws,[5] or the government would have claimed 55% of it, $33 million. These are the only choices for someone, like Perot, deep into the estate tax's range. There is no reason at all to engage in complex present value discounting and speculation and so forth, because the $60 million, had it sat in Perot's estate, would have naturally grown along with the discount rate.

This $33 million has, as I have said, the same accounting or financial structure as a tax expenditure under the income tax. What does this mean? We have now grown accustomed to thinking that, if a taxpayer in the 30% bracket, say, makes a $1000 contribution or other deductible expense, the government "really" kicks in 30% of this, via the value of the tax deduction. In other words, but for the taxpayer action, the government would collect $300. So it is appropriate, in a sense, to see the government as paying that amount. From this straight accounting and "but for" logic of tax expenditures, I believe that we should simply ask an instrumental question about the wisdom or desirability of that expense—that is, I would divorce all tax expenditure talk from any formal or essentialist belief in some innate meaning of "income."[6] It is simply a matter of whether or not it is a good idea—in terms of equity or efficiency or some other policy basis—to allow the deduction.

Now, this very same logic applies to Perot. But for his $60 million expense, the government would collect 55% of that wealth. Looked at another way, all personal consumption is a deduction from the estate tax base, which is wealth left over after a taxpayer dies. Perot's presidential run was a very large tax expenditure, with the government kicking in $33 million.

Here's a second use of the Perot example, one that should evoke some sympathy for Ross. Let's assume that Perot does not need any more money for his purely personal wants; his $3 billion stock of wealth secures his and his wife's immediate needs. Further assume that he intends to leave at least his residual wealth to his children or other individuals on his death. What, then, are Perot's incentives to work and save? Put another way, what tax rate does he face on additional income? The perhaps surprising answer is something in excess of 70 percent. The reason is that any dollar that Perot earns will first be reduced by income and other lifetime taxes, which I will conservatively take to be 40%. So he is left with 60 cents. But then this 60 cents will just sit in his estate, awaiting an ultimate 55% estate tax levy. This tax will take away another 33 cents, leaving Perot with 27 cents of his original dollar to leave to his heirs—a tax rate of 73%. Once again, as with the tax expenditure example, there is no reason to engage in any complex discounting, because the 60 cents can be expected to grow along with the social discount rate.

Now, the last time we saw income tax rates of 70% and higher was before ERTA, in 1981, and I do not need to remind this audience that we reduced rates then and further reduced them in 1986. Even liberals, I believe, have come to accept that overly high tax rates are inefficient and probably unfair.[7] My ultimate liberal claim is that this seems right as long as high tax rates are applied to work and savings, which are objective goods. We should be placing the burden of progressivity on the act of private preclusive use, that is, consumption. But the estate tax does the opposite: It burdens savings, and rewards consumption.

Let me go back, now, and pick up the question of popularity. The estate tax discourages behavior that a liberal, democratic society ought to like—work, savings, bequests—and encourages behavior that such a society ought to suspect—the large-scale consumption, leisure, and inter vivos giving of the very rich. Our polls and practices show that we like sin taxes, such as 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. There is no reason even a liberal populace need support it.

What would I do? I would move to a progressive-consumption-without-estate tax. That is, I would move the current "income" tax further in the direction of a consumption tax, repeal the gift and estate tax, and then increase, perhaps steeply, the progressivity of the system. Such a plan would then consistently exempt work and savings from taxation, and levy a tax only on the act of consumption, or private preclusive use, whether by initial earners or subsequent heirs (my scholarly work suggests the possibility of a higher rate schedule on spending by heirs out of inherited wealth).[8] The role of progressivity would be to place a greater burden on large scale rapid consumption. Such a tax system, which I believe has long been at least implicit in the work of David Bradford and others,[9] would consistently implement the logic of a social concern with high end consumption. In my scholarly work, I have addressed other related issues, such as what to do about the problem I call "consumptive investment," or possession qua use—that is, the use of savings to exercise power. We think of William Randolph Hearst buying up newspapers, say. I shall not go into those details in this forum, but I do think that this problem can be met.[10]

My call for a progressive-consumption-without-estate tax obviously goes beyond the narrow question of raising the unified credit equivalent amount from $600,000 to $750,000. If I had any confidence that the gift and estate tax were doing any good as it is now, I might frankly be nervous about talking about its repeal or weakening in a climate that I feel, again quite frankly, is insufficiently sensitive to the liberal and humane concerns of justice. My scholarly work, for example, attempts to sever the link between the cases for consumption taxation and flat rates, a link that I find to be neither ethically nor logically compelling. If social conservatives really believed in the value of work and long term savings, they should be suspicious of the large scale, non-charitable consumption of the very wealthy. The moral component of the conservative call for tax reform leads, to my mind and heart, towards a progressive, perhaps steeply progressive, consumption-without-estate tax.

I began with a confession; I shall end with a sermon. Alas, I feel and fear that no one wants to hear any message about social justice at all right now; that an ideology of the supply side and productivity and wealth maximization is masking the purely private activity of greed. A progressive-consumption-without-estate tax would only burden the work and savings efforts of those citizens who insist on lavish spending on their own account—and I submit that that is an appropriate point to place a larger social burden. It would not burden those who, in a classic American spirit, work hard and save wisely, living well but not extravagantly, providing for future emergencies (expenditures on which could be deductible) or their own posterity, all the while allowing the whole community to benefit from their industry and thrift.

But even without the climate for my preferred comprehensive reform, I believe that nothing is gained by clinging to the gift and estate tax. This tax fails to raise much if any revenue; induces arcane and expensive legal forms of ownership; burdens the work and savings habits of the very wealthy, an extremely important category of savers; induces leisure, consumption and large scale inter vivos gifts; and seems to be playing no role in the breaking up of the concentration of wealth in this country. If the best defense of the gift and estate tax is as a symbol of our commitment to social equality, we don't need it. We need real answers, not false icons.

FOOTNOTES

[1]: See Edward J. McCaffery, *The Uneasy Case for Wealth Transfer Taxation,* 104 Yale Law J. 283 (1994) and *The Political Liberal Case Against the Estate Tax,* 23 Philosophy & Public Affairs 281 (1994). See also Edward J. McCaffery, *Tax Policy Under a Hybrid Income-Consumption Tax,* 70 Tex. Law Rev. 1145, 1211-14, 1218 (1992).

[2]: Estate and gift taxes raised a gross of 11.5, 11.1, 11.1, 12.6 and 15.2 billion dollars for the years 1990 to 1994, respectively. Historical Tables, Budget of the United States Government, Fiscal Year 1996, Table 2.5 (1995). From this we ought to subtract the expenses of administering the tax. I have been unable to get a specific figure for gift and estate tax administration from the government, but I suspect that it is large: estate tax returns have high audit and litigation rates, and the matters are often expensive to adjudicate. The IRS maintains a separate gift and estate tax examination unit in each of its district offices. In addition, the economist Douglas Bernheim has argued that the type of transactions induced by the gift and estate tax (trusts, life insurance, certain charitable gifts, etc.) lose the government income tax revenues; Bernheim concludes that the net yield of the gift and estate tax might be negative. B. Douglas Bernheim, *Does the Estate Tax Raise Revenue?,* in 1 Tax Policy and the Economy 113 (Lawrence Summers, ed., 1987). I personally suspect that Bernheim's figures are overstated, but it should be clear that the estate tax does not net all that much revenue. Further, this analysis does not take into account any longer term dynamic effects, such as work and savings behavioral incentives, that would also almost certainly reduce the effective yield of the tax, here quite possibly into negative territory. There are also, of course, high private transaction costs associated with the tax.

[3]: See generally Laurence J. Kotlikoff, What Determines Savings? (1989); McCaffery, *Hybrid, supra* note 1, at 1175-79.

[4]: This point also casts some doubt on the inflation indexing rationale for increasing the exemption level, however; individuals who use their unified credit early in their lives are able to see its effective value fully indexed. It is only those who wait who suffer from the ravages of inflation.

[5]: I discuss charitable contributions in McCaffery, *The Uneasy Case, supra* note 1, at 356-58.

[6]: An objection to my tax expenditure analogy is that tax expenditure talk is only about deviations from a "normative" concept of income. But I take it as one of the many legacies of the great Boris Bittker that we should be skeptical of such semantic distinctions. All definitions of "income," and even the very commitment to an "income" ideal (if we have such a commitment at all —see my *Hybrid and Political Liberal Case,* supra note 1, in which I question this commitment) must be justified on independent normative or policy grounds. See Boris I. Bittker, A *'Comprehensive Tax Base' as a Goal of Income Tax Reform,* 80 Harvard Law Review 925 (1967), and *Accounting for Federal 'Tax Subsidies' in the National Budget,* 22 National Tax Journal 244 (1969), collected with many other essays in Boris I. Bittker, Collected Legal Essays (1989). For example, my use of the tax expenditure concept would initially bring all § 162 business deductions under scrutiny, but most would readily pass muster under a straightforward efficiency analysis; the government ought to be pleased to let profit-maximizing expenses be made. Conversely, we should be suspicious of even business deductions that combine elements of personal consumption, or reflect timing distortions, etc. I mean simply to point out that, in a certain logical and accounting sense, the government lost $33 million dollars when Perot spent $60 million running for president. Now we can ask whether or not that is an appropriate "normative refinement of the estate tax base," if we want to phrase things that way. Just as "income" is not necessarily either self-defining or

normative, neither is "wealth left over" as the estate tax base. It calls for independent justification.

[7]: See generally Joel Slemrod, *Optimal Taxation and Optimal Tax Systems,* 4 J. Econ. Persp. 157 (1990).

[8]: See *Uneasy Case,* supra note 1, at 352-53; Political Liberal Case, supra note 1, at 301-02.

[9]: See David F. Bradford at al., Blueprints for Basic Tax Reform, 2d ed., revised 122-25 (1984). See also William D. Andrews, *A Consumption-Type or Cash Flow Personal Income Tax,* 87 Harv. Law Rev. 1113 (1974). Andrews' piece is of course the classic statement of the nature of and case for a cash flow consumption tax, the form of tax that I favor. I disagree with Andrews' call for a supplementary gift and estate tax, which I believe undercuts the best spirit of the proposal, and my own work advocating a progressive consumption tax rests on different normative grounds. Whereas Andrews sees the best argument for a consumption tax being the preservation of the pre-tax equality between savers and spenders—an argument that runs into some tension with the case for progressivity —I rest the case on objective, political liberal values, that support work and savings but question at least large-scale consumption. I draw heavily on the philosophical work of John Rawls and Thomas Scanlon in making these claims. But I share much in common with Andrews, to whom I also owe a great personal debt as a devoted former student.

[10]: The essence of my proposal in this regard is to have the kind of loose social oversight over nominally "private" investments that we now have over the massive pension and charitable institutional investment areas—allowing menus of approved investment vehicles, say. See *Uneasy Case,* supra note 1, at 349; *Political Liberal Case,* supra note 1, at 311-12.

PREPARED STATEMENT OF SENATOR DAVID PRYOR

Mr. Chairman, I want to commend you for holding this very important hearing to discuss issues relating to small business—namely the estate and gift tax and "expensing" by small businesses.

Also, I would like to thank the Chairman and my friend, Senator Hatch, for scheduling a hearing on the S Corporation Reform Act of 1995, introduced by Senator Hatch and myself. I realize the initial hearing had to be postponed because of a busy Committee schedule on Welfare Reform, but I very much look forward to participating in a future hearing on issues effecting S Corporations.

Mr. Chairman, I believe these 3 areas—expensing, estate and gift tax, and S Corporation Reform—are primary areas of focus to give small business a boost.

In 1993, we increased the expensing provision from ($10,000) to $17,500. At that time, I supported going higher, as did the Administration. So, I believe it is appropriate, at this time, to consider an increase in the expensing provision.

Over the past months, I have also been working with several of my colleagues on both sides of the aisle and with small business and agriculture groups in order to target estate and gift tax relief to family-owned small business and farms. The estate and gift tax laws often force family businesses and farms out of business—many times resulting in the loss of jobs and goods and services to a community. Quite frankly, the estate tax rates are too high (55%) and the payment comes due so abruptly its more than any business could take.

I look forward to our hearing today to discuss these issues, and I sincerely hope we can continue to work in a bipartisan manner to address this problem for one of our country's most valuable assets—small business.

PREPARED STATEMENT OF RICHARD W. RAHN

Mr. Chairman and Members of the Committee, thank you for this opportunity to present our views on proposals to increase the amount of investment that may be expensed, including the provision included in the recently passed House tax bill. As Chairman of the Board of Directors of the Business Leadership Council, I am testifying on their behalf. The Business Leadership Council is an association of entrepreneurial business leaders who are committed to working to limit the size of government and to expand economic growth. I also serve as President of the Novecon companies, which were established to create and operate joint ventures in the former Soviet Union and Eastern Europe.

The Business Leadership Council believes that the central purpose of all economic policy should be to promote a higher standard of living for the American public. Among the most important means of achieving this goal is the adoption of sound tax policies. Two primary issues must be addressed. First, we must decide what level of federal taxation and spending maximizes economic growth. Second, we must decide what is the best means of raising the revenue required by the federal government. It is in this context that we would like to address the issue of expensing for small businesses.

HOW MUCH REVENUE IS THE RIGHT AMOUNT OF REVENUE

By the early 1980s, it was evident that the small-government economies of some Southeast Asian countries were enjoying sustained economic growth rates higher than conventional economic theory deemed possible, while growth in a number of large-government economies had been anemic at best. As a result, a number of economic researchers began looking at the relationship between the size of government and economic growth. Rather than the relationship being positive as was the conventional view, studies increasingly showed a negative relationship. In an attempt to understand what was the optimum size of government (ie. the size which maximizes economic growth), several of us who were economists at the U.S. Chamber of Commerce at that time (1986), analyzed the relationship between rates of economic growth and government spending as a percentage of gross national product (GNP) for twenty-two countries for which there was adequate data. We found that a reduction in the rate of economic growth was significantly correlated with the growth in the government share of GNP. Our best estimate, given the data, was that government maximized economic growth when it was between 15 and 25 percent of GNP.

In the years since, many more studies using both much more extensive time series and cross sectional data have been completed. The conclusions in this subsequent work have both confirmed our early work and been more precise. For instance, in November 1994, the distinguished economist Gerald W. Scully, produced a study for the National Center for Policy Analysis in which he concluded that to maximize economic growth, the average rate for federal, state and local taxes combined should be between 21.5 percent and 22.9 percent of GNP. Currently in the U.S., total government taxation is approximately 31 percent of gross domestic product (GDP) and spending is about 34 percent of GDP. Scully concluded that if the tax burden had been at the optimal level, economic growth would have averaged about two percent higher per year and the "average American family would have had twice as much real income today as it actually has." Finally, he concluded that given the much higher rate of economic growth, even with the lower tax rate "government at all levels would have collected $11.6 trillion more in taxes" since 1949.

We know that if government took one-quarter or less from the private sector rather than the current one-third, we would be a much more prosperous nation with higher levels of employment, better jobs and lower levels of poverty. In short, high tax rates and high levels of government spending are demonstrably counterproductive.

THE EXISTING DYSFUNCTIONAL INCOME TAX SHOULD BE REPLACED

Most thoughtful observers understand that the present income tax system is dysfunctional and must be replaced. Both the rising administrative costs and adverse economic effects of the existing tax system have made it not only unfair but uneconomic. Complexity and ever more burdensome regulations have caused private compliance costs to soar. Furthermore, the present system is biased against productive savings and investment which in turn has sharply reduced our rate of capital formation and hence the standard of living for most Americans. New technologies, such as electronic money and the "smart card," will make the existing tax system increasingly easy to evade for those who so choose. Finally, the existing system is intrusive, subject to abuse by government officials, and not compatible with a free society in which citizens should be considered innocent until proven guilty and not have to fear their own government.

In a May 11, 1995 presentation at the National Press Club, Harvard Professor Jorgenson estimated that the marginal efficiency cost of the present tax on capital income costs us 68 cents in lost economic output per dollar of revenue raised. This means that for every dollar the federal government raises in taxes, it reduces the Gross National Product by 68 cents. Existing individual capital income taxes cost us $1.02 in lost economic output per dollar raised in taxes. Corporate income taxes cost us 45cents* in lost economic output per dollar raised. These astounding figures show how high a price we are paying in terms of lost economic opportunity for American citizens for indulging in the liberal policies of punitive taxation of capital income. It also illustrates the tremendous opportunity that Congress has to improve the living standard of working Americans. If the existing income tax is repealed and replaced with a system that is neutral with respect to investment, the United States will enjoy sustained economic growth rates unseen for decades.

There are three politically viable and economically sound alternatives that could replace the existing income tax. A so-called consumed income or cash flow tax (with a tax base similar to that in the legislation introduced by Sens. Nunn and Domenici, but with a lower tax rate); a national sales tax; and a Hall-Rabushka type flat tax (introduced by Rep. Armey). Each of these proposals would simplify the existing tax system, eliminate the tax bias against savings and investment, reduce the disincentive to work and promote economic growth and a higher standard of living for the American people.

Each of these proposals has distinctive advantages and disadvantages which this Committee must address as it meets the challenge of developing a replacement for the income tax. The Business Leadership Council is establishing a Tax Alternatives Working Group to work systematically through these issues and we look forward to working with this Committee as the debate unfolds.

EXPENSING CAPITAL INVESTMENTS

Each of the three major alternatives to the existing tax system would provide businesses with full expensing (Nunn-Domenici or Armey) or complete exemption (a sales tax) for their capital investments.

The House bill passed early this year would increase the section 179 expensing allowance for small firms from $17,500 to $35,000 for firms investing less than $200,000 per year. Firms would be able to deduct their expenditures for capital equipment rather than having to depreciate them over various periods. The House bill is an incremental move in the direction of needed fundamental reforms. The House bill would promote investment, increasing the productive capital base in the U.S., by reducing the tax bias against investment and reducing the cost of capital. The larger and more modern capital stock that would result would improve the living standard of working Americans. It would help capital-starved small businesses invest to create jobs. It would reduce the cost of complying with the existing income tax to some degree. Finally, it would improve the competitiveness of small U.S. businesses in the international marketplace. This economic improvement resulting from the House bill would be measurable and important but is quite small when compared to the promise of the three major tax alternatives being debated in the Congress.

EXPENSING ALLEVIATES THE TAX BIAS AGAINST INVESTMENT

The present tax system is extremely biased against investment and capital income. Instead of providing a deduction for investment, taxpayers must make an investment out of after-tax dollars. Capital costs are recovered over an extended period (as long as 31 years for some structures, but typically five to seven years for equipment). The return to that investment is taxed even before the capital cost is recovered. If the investment has higher than expected returns or if interest rates drop, then the investor will sell the asset for more than he paid for it. The capital gains tax thus taxes both the increased present value (capitalization) of the future income stream as well as the future income stream itself and is therefore literally taxing the same income twice. Moreover, the investor is taxed on purely inflationary gains. He may have lost money after adjusting for inflation but he will still be taxed. Similarly, part of any interest or dividend received is simply compensation for the decline in the value of money. It is not a real return. Nevertheless, our present system taxes the inflation. Further, if the business making the investment is a corporation and decides to pay dividends to its owners, the income is taxed still more.

A truly neutral tax system would not alter the relative cost of savings and investment on the one hand and consumption on the other. Savings and investment may be thought of as deferred consumption. The return on the investment compensates the investor for deferring his consumption. The rate of return to investment is the price that investors require to defer consumption. When that return is taxed, the investor will demand more return to compensate for the tax. The borrower or business seeking capital will be required to pay more and be able to afford less capital for investment because the cost of capital is increased by taxes on capital income. Taxes on capital income alter the relative price of consumption and investment. Taxes on capital income make consumption more attractive and ,conversely, make investment less attractive than they would be in a neutral tax.

Expensing of capital investment is a big part of the equation when it comes to transforming the tax system to a neutral system. A move in that direction, such as contemplated by the House bill, will make the tax system more neutral and reduce the cost of capital.

EXPENSING WILL REDUCE THE COST OF CAPITAL AND PROMOTE INVESTMENT AND ECONOMIC GROWTH

Expensing reduces the cost of capital by increasing the present value of tax allowances provided by law. By reducing the relative cost of investment relative to consumption and reducing the tax disincentive to invest in modern plant and equipment embodying the latest technological advancements, expensing will promote investment. Investment will provide firms with lower cost means of production, make their employees more productive, and enable them to compete in markets where they previously could not effectively compete. Productivity and economic growth will increase, and as labor productivity increases, so will wages and the standard of living. Professor Jorgenson in his recent book Productivity, Volume 1, Postwar Economic Growth (1995) estimates that capital investment was the largest single factor determining the rate of economic growth from 1948-1979.

Similar conclusions have been reached by Bradford De Long and Lawrence Summers (President Clinton's Under Secretary of the Treasury for International Economic Affairs) published in the Quarterly Journal of Economics. A lower cost of capital will, over time, increase the capital stock. A larger capital stock (more and better equipment per worker) improves productivity, economic growth and living standards.

EXPENSING WILL HELP SMALL FIRMS CREATE JOBS

Small businesses are the primary job creation engine in the United States. Most studies have shown that small businesses have created the bulk of new employment opportunities in the United States for at least a decade. Recent figures released by the U.S. Small Business Administration's, Office of Advocacy, for example, show that between 1989 and 1991, firms with less than 100 employees created 1,066,894 jobs, while those with 100 or more employees lost 379,726 employees. In a reversal of previous trends, firms with more than 2500 employees actually gained employees (177,947), but small firms still created more than five times as many jobs as very large firms. Expensing will provide small firms with the means to provide their employees with the machinery and equipment necessary to become more productive and compete for new markets in a highly competitive and increasingly global marketplace.

EXPENSING WILL REDUCE COMPLIANCE BURDEN ON SMALL FIRMS

Some commentators estimate that the cost to the private sector of complying with the income tax approaches two percent of GNP. This figure does not include the adverse economic effects of the distortions and disincentive effects of the present tax system, but simply accounts for the man-hours involved in accounting for and figuring one's tax liability. No single provision is the cause of the tremendous compliance burden that businesses experience. Instead, it is the confluence of dozens of complex and time-consuming regulations that together constitute an intolerable burden. But certainly for small businesses, keeping track of depreciation allowances is an onerous task. In many cases, they must maintain two or sometimes three depreciation schedules for a particular asset: for example, one for regular tax, one for the alternative minimum tax, and one for purposes of presenting statements (typically to their bank) in conformance with generally accepted accounting principles (GAAP). Expensing, particularly if coupled with appropriate reforms in the alternative minimum tax (AMT), would at least remove this headache from the long list of tax compliance headaches.

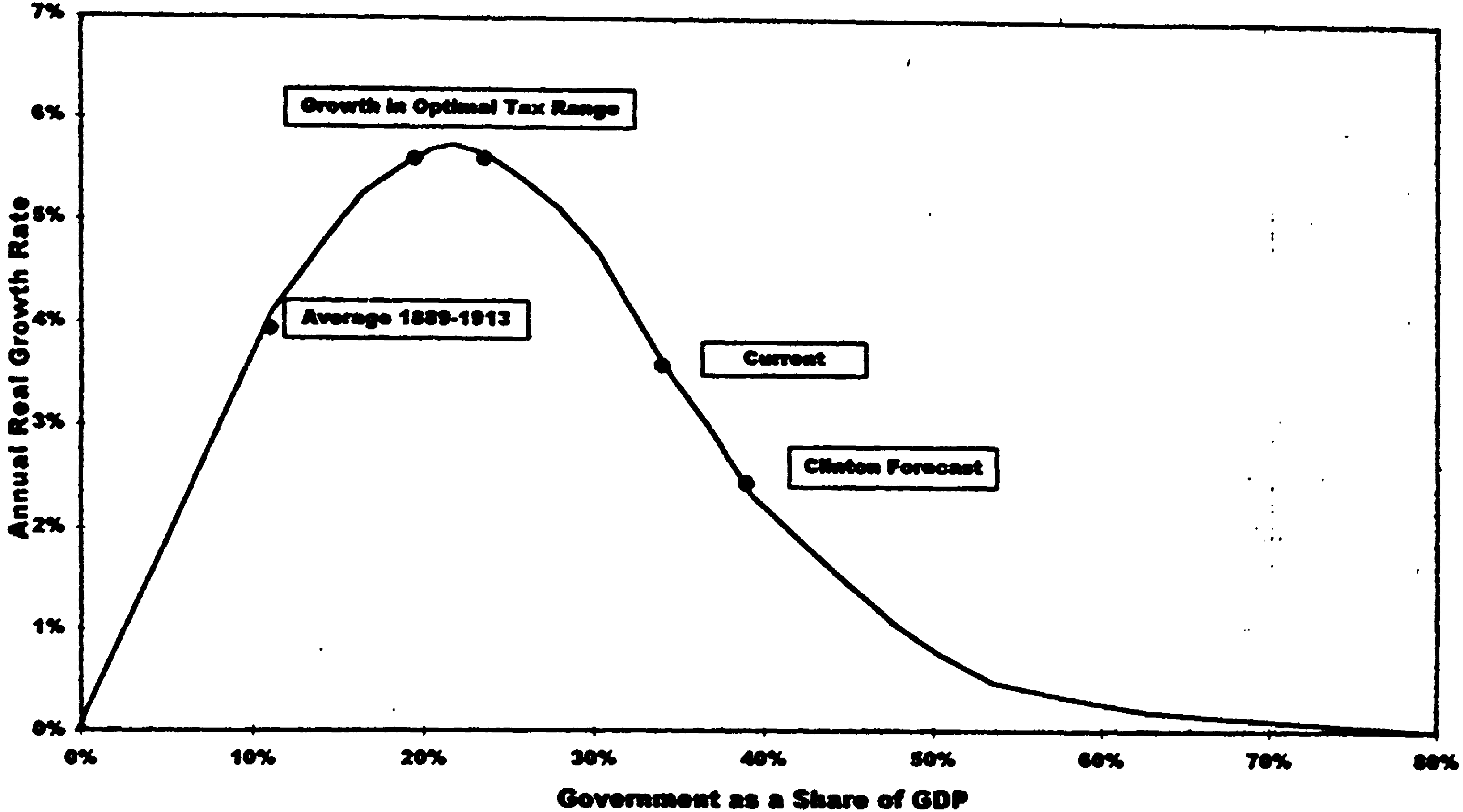
THE DANGER OF THE ALTERNATIVE MINIMUM TAX

When Congress enacts a higher section 179 expensing threshold, it needs to be certain not to take away with one hand what it is giving with the other hand. The AMT must not treat section 179 deductions as a tax preference item. An AMT that does so will obviate much of the economic advantage of a higher expensing allowance and it will eliminate much of the reduced compliance costs associated with an increase as well, since even firms that are not, in the final analysis, subject to the AMT will have to do the calculations to determine whether they indeed are subject to the AMT. This effect will be most pronounced in the case of start-up or marginally profitable firms, precisely those firms least able to afford needless compliance costs or unfairly high taxation.

CONCLUSION

The House bill provision to increase the section 179 expensing allowance for small firms should be enacted. The House bill would promote investment, increasing the productive capital base in the U.S., by reducing the tax bias against investment and reducing the cost of capital. It would help capital-starved small businesses invest to create jobs. It would modestly reduce the cost of complying with the existing income tax. It would improve the competitiveness of small U.S. businesses in the international marketplace. In fact, the expensing principle should be generalized and made available for all businesses as part of a replacement to the existing dysfunctional income tax.

Big Government Hurts Economic Growth



COMMUNICATIONS

STATEMENT OF THE AUTOMOBILE MANUFACTURERS ASSOCIATION

The American Automobile Manufacturers Association (AAMA) appreciates the opportunity to submit this statement for the record of the Senate Finance Committee hearing on section 352 of H.R. 1215, a provision that has important economic implications for countless small firms that purchase motor vehicles for use in their businesses, as well as for the domestic automobile industry. The issue is first-year expensing, which is currently available for all business assets except motor vehicles. H.R. 1215 proposes that the current expensing limit be raised from $17,500 to $35,000.

AAMA is the trade association for the domestic automobile manufacturing industry. Our members are Chrysler Corporation, Ford Motor Company, and General Motors Corporation. Together, our members employ more than 600,000 workers directly and account for another 1,500,000 jobs through their dealers and suppliers.

Internal Revenue Code section 179 allows small businesses to expense up to $17,500 of the cost of most depreciable assets. However, section 280F of the Code limits to $3,060 the amount a small business can deduct for a business-use passenger car or light-duty truck in the first year through either depreciation or expensing. Thus, small businesses that purchase a car or light-duty truck during a year are unfairly denied the benefits of section 179. The proposal to raise the section 179 limit to $35,000 would not alleviate this disparity.

AAMA urges extending the applicability of Code section 179 to purchases of business-use automobiles and light-duty trucks by amending the cap imposed by section 280F of the Code. In recent testimony before the House Committee on Small Business, The Small Business Survival Committee and the National Association of Manufacturers both supported making section 179 expensing available to purchasers of motor vehicles.

The businesses directly affected by this limitation are those small businesses whose only asset purchase for a tax year is a motor vehicle. They are the truly small businesses in America—the local carpenters, plumbers, grocers, florists—businesses so small that they often are not well represented before Congress. If the only significant asset purchased by such a business in a year is a motor vehicle, the business receives no benefit from section 179 expensing. This increases the after-tax cost of the purchase of a motor vehicle relative to other business assets.

For example, a business asset costing $20,000 and not subject to the section 280F limits would be allowed $17,500 first-year expensing under section 179, plus full first-year depreciation on the remaining cost of $2,500. In contrast, a business-use motor vehicle costing $20,000 would be limited to first-year depreciation of $3,060 with no section 179 expensing. Thus, section 280F not only limits ordinary depreciation deductions for so-called "luxury" vehicles," but also effectively disallows section 179 expensing of the "non-luxury" cost (i.e. $15,300, the amount of non-luxury depreciation allowable under section 280F over a vehicle's five year recovery period). No other business asset is subject to a so-called "luxury" cap. Moreover, to call $15,300 a "luxury"cap is a misnomer.

The current rules, thus, discriminate against small firms who invest in business-use vehicles as compared to small firms who make non-automotive investments. A simple and more equitable solution would be to allow for expensing of motor vehicles, at least up to the five year "luxury" depreciation limit, currently $15,300. This would reduce the discrimination against the small firms that invest only in business-use vehicles during a tax year, without changing the "luxury" depreciation limits. In other words, small businesses purchasing cars or light-duty trucks should be allowed to benefit from enhanced expensing rules, at least to the extent of the "non-luxury" content of the purchased vehicles. This would place all small businesses on a more equitable footing, whether they invest in motor vehicles or in non-automotive business assets. We believe such improved neutrality is essential to effective, efficient and equitable tax law.

Whether or not a motor vehicle qualifies for additional first-year expensing has important cash flow implications for small firms. This is because qualifying for expense treatment would lower the present value of a vehicle's after-tax purchase cost by varying amounts, depending on the price of the vehicle and the purchaser's marginal tax rate. For example, the after-tax cost of a vehicle costing $20,000 could be reduced by more than 7% (assuming a 35% marginal tax rate for the purchaser).

The purchasers of motor vehicles, especially small businesses, are very responsive to price changes. It is estimated that a 7% price decrease could bring about a 7% increase in vehicle purchases by affected small businesses. Thus, current law not only adversely impacts the cash flow of small businesses, it is also harmful to the interests of the automobile industry. The lower sales level resulting from this discriminatory provision costs automobile industry jobs. Industry economists estimate allowing additional first-year expensing for motor vehicles could increase industry sales by 15,000 to 20,000 units per year, supporting an additional 2,500 to 3,500 jobs in auto and auto related industries.

The limitation on small business expensing is only one of a number of provisions in the Code that discriminate against purchasers of automobiles. The so-called "luxury" depreciation cap cited above is an example, as is the five year class life, when three years more appropriately reflects economic life for business-use automobiles according to a 1991 Treasury study. We hope that Congress will address these inequities in the future, but, above all, we hope future legislation does not exacerbate the existing discrimination. It should be noted that, as passed by the House, the proposal to increase the section 179 expensing limit, as well as the Neutral Cost Recovery proposal, would improve cost recovery rules for business assets generally, but would not benefit businesses that purchase motor vehicles. Thus, Congress is currently considering proposals that would worsen the cost recovery rules for motor vehicles relative to other business assets. We respectively request that any bills reported out of the Committee treat purchasers of business-use motor vehicles equitably vis-a-vis purchasers of other business assets.

In summary, AAMA urges the Committee to allow purchasers of business-use passenger cars and light-duty trucks the benefits of the section 179 additional first-year expensing, at least up to the luxury depreciation cap of section 280F.

STATEMENT OF THE AMERICAN FARM BUREAU FEDERATION

The America Farm Bureau Federation is the nation's largest general farm organization with a membership of 4.4 million member families in 50 states ad Puerto Rico. Farm Bureau members produce virtually every commodity grown commercially in this country. Policy is developed by producer members at the county, state ad national levels of organization.

Farm Bureau applauds the efforts of this committee to hold hearings focusing on changes needed in estate tax law. Reform of our nation's estate taxes has been at the top of Farm Bureau's agenda for may years.

Farmers ad ranchers have a vital interest in estate taxes because production agriculture remains a family enterprise based industry. According to the 1992 Census of Agriculture, 85.9 percent of the farms ad ranches are individual or family proprietorships ad 9.7 percent are partnerships. Of the 3.4 percent that are family corporations, most have 10 stockholders or less. Only 0.4 percent of the farms ad ranches are corporations that are not family held. Farms ad ranches that have incorporated have done so for tax ad financial planning reasons, not because they are large business enterprises.

While some farms ad ranches stay in the family for generations, the actual operators of farm ad ranch enterprises are constantly changing. The U.S. Department of Agriculture estimates that between 1992 ad 2002 about 500,000 older farmers will leave production agriculture to be replaced by about 250,000 new, young farmers. This is partly happening because the average age of farmers in 1992, according to the census, was 53.3 years. For these retiring farmers ad ranchers ad the new ones who would like to tax their place, now is a important time to make changes in the federal estate tax laws.

Without estate tax law changes the next generation of farmers will find it more difficult to begin farming. According to a USDA analysis of census data collected in 1988, roughly 45 percent of the young farmers who had obtained land had either purchased it from a relative (29 percent) or had received it as an inheritance or gift (15 percent). What those numbers would be without estate taxes ad capital gains taxes, we will never know. What we do know is that multi-generation farms ad ranches are a fact of life. How viable they will remain will be partly determined by the estate tax load they must carry.

Even though lad prices declined in may are as of the country during the 1980's, in both real and nominal terms, they have recovered in recent years in most areas. As a result may farmers ad ranchers are facing far higher lad prices today than when they purchased the lad 30 or 40 years ago. Much of this gain is due to nothing more than inflation. For example, the average price of farmland in Illinois was $234 per acre in 1965; now it is close to $1,500 per acre, over six times what it was in 1965. All portions of the country face the same problems.

Farm Bureau has advocated for many years that the estate tax be abolished. Elimination of the estate tax should not be a major budget issue. Last year, total estate and gift tax revenue came to about $13 billion. While $13 billion is still a considerable amount of money even by today's standards, it is not such a large amount to prevent its phase-out over a number of years.

The unified credit which effectively exempts from taxes the first $600,000 of value of a estate was last increased in 1981. Due to gradual inflation and pressure from land development, the current $192,800 unified tax credit and allowance for farm use valuation are not sufficient to allow may family farm businesses to pass from one generation to the next.

Farm Bureau supports increasing the estate tax exemption from $600,000 to $2 million and indexing the exemption for inflation. Exact numbers are not available, but this level would likely exempt may farms and ranches from estate taxes ad allow them to be passed from one generation to another, unencumbered by federal taxes. If the exemption is not increased and a large portion of farm business assets must be sold to pay the tax, the economic viability of the operation can be destroyed and family members would be forced to abandon the farm.

The impact of an increase in the exemption to $2 million would be significant. For example, the current exemption would exclude 400 acres of average priced Illinois farmland from the estate tax. Again using Illinois as an example, family farms are now more than 400 acres and at least half the land is valued at more than $1,500 per acre. This means the total value of the farming enterprise would be more than $600,000 when the value of equipment, livestock and other assets are considered. Increasing the exemption would allow may farms to be passed tax-free to the next generation of farmers.

Another way to provide needed estate tax relief to farmers would be to lower estate tax rates. High estate tax rates are nothing more than a penalty on individuals who save ad reinvest in their businesses. The current maximum rate of 55 percent is exorbitant when compared to tax rates that would be applied to business assets if they had been liquidated and the money spent during the owner's life. Reducing rates would have the same beneficial result for farmers as increasing the unified tax credit. The lowered tax burden will allow more farms to pass from one generation to the next without threatening the farm's economic viability by forcing asset sales to pay estate taxes. The cost of lowering tax rates could be reduced by targeting rate relief to small businesses.

An additional estate tax issue of importance to farmers ad ranchers is the $750,000 ceiling allowed under Internal Revenue Code 2032A for valuing land at its agricultural productive value. Farm Bureau supports elimination of the $750,000 limit to the adjustment in value that can be made when farmland is valued at its actual use rather than its highest and best use under Section 2032A. Legislation is also needed to clarify section 2032A so that an heir who rents property to another family member is not subject to recapture provisions.

This changes are especially important in areas faced with urban growth. Land values for development in these areas are much higher than for agricultural use, rendering the $750,000 cap ineffective in preserving farmland. If this cap cannot be eliminated it should, at the very least, be increased and indexed for inflation.

Farm Bureau also supports increasing the annual gift tax exemption per donee from the current $10,000 to $20,000. This would provide another tool to ease the estate tax burden and help keep farms and ranches in the family.

Keeping farms and ranches in the family has never been an easy task. The tax changes we have proposed today are a significant part of making that task just a little bit easier. We urge the committee to work for swift implementation of these measures.

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Committee on Finance
United States Senate

Hearing on Small Business Tax Incentives
(held June 7, 1995)

STATEMENT OF ALBERT HALE
PRESIDENT
THE NAVAJO NATION
ON

INCENTIVES FOR INDIAN RESERVATION INVESTMENT AND CAPITAL FORMATION

I am Albert Hale, President of America's largest Indian tribe, the Navajo Nation. The purpose of my Statement is to urge the Committee to include -- within the tax and job creation provisions that it will mark-up later this year in connection with its consideration of budget reconciliation legislation -- two vitally-needed measures to help induce private sector businesses to make investments on Indian reservations (the most disinvested geographic locations in America), and to facilitate the availability of capital toward that end.

Specifically, the Navajo Nation requests that the Committee, as a sensible, meaningful and necessary follow-up to the reservation-based "Indian Investment and Employment Tax Incentives" (i.e., accelerated depreciation for property on Indian reservations, and an Indian employment credit) that were established in the Omnibus Budget Reconciliation Act of 1993, now adopt the following two complementary investment mechanisms:

1. The Indian Reservation Investment Tax Credit ("IRITC"), a powerful investment incentive that is needed to supplement the less-valuable accelerated depreciation, and which was previously: (i) passed by the Senate with bipartisan support and enacted in 1992 within a major tax bill (H.R. 11) that was subsequently vetoed, (ii) passed again by the Senate with bipartisan support in 1993 in its version of the Budget Reconciliation Act, but (iii) removed in conference in favor of the less-valuable accelerated depreciation incentive.

2. Enhanced Tax-Exempt Bond Authority -- Indian tribal leaders should be provided the tools to attract and raise capital to facilitate those sought-after investments through expanded opportunities for tribes to issue bonds, the interest on which is exempt from federal taxation ("tax-exempt bonds").

I appreciate the opportunity to provide this Statement for the hearing record, and thank the Chairman and the Members of the Committee for their consideration of our position.

INTRODUCTION

In January of this year, thousands gathered in Window Rock, Arizona, the capital of the Navajo Nation, to join me on a special day -- my inauguration as President of the Navajo Nation. Our all-day ceremony was a joyous celebration, honoring our past and our sacred traditions, yet at the same time mindful of the enormous challenges in our future. Underlying the happiness, joy and unity of thousands of Navajo people that day was the stark reality of the challenges ahead.

Regrettably, the challenges of our future -- a new generation of Navajo leadership -- are in large measure the identical challenges that have confronted and defined the futures of generation after generation of our ancestors: devastating poverty, unconscionable unemployment, lack of infrastructure. Whether it is a "Contract With America" or a new covenant with the people, that contract will be illusory and the covenant will be broken unless dramatic action is taken now to improve the lives and living conditions on Indian reservations that are located in 32 different states across America.

Though the challenges are great, they in turn offer opportunities -- to this Committee and this Congress -- to provide the leadership that can help transform the present reality into a future of investment and jobs in Indian country.

BACKGROUND

I have the unique responsibility for improving the lives and prospects of the poorest of America's poor. Across the Navajo Nation -- which is larger than the states of Connecticut, Delaware, Maryland, Massachusetts and Rhode Island combined -- our people live in conditions of economic deprivation virtually unknown in those states.

At a time when the average unemployment rate in America is 5%, the **unemployment rate in the Navajo Nation averages 38% to 50%**, depending on the season. Over 56% of the Navajo people live in poverty. Per capita income averages $4,106, less than 1/3 of that in the surrounding states. Only a very few Navajos enjoy certain "luxuries" that are taken for granted elsewhere in the United States -- 77% of Navajo homes lack plumbing, 72% lack kitchen facilities, and 76% lack telephone service. Though the Navajo Nation is slightly larger than West Virginia, our 2,000 miles of paved roads equate to barely 11% of West Virginia's 18,000 miles. Until recently, we had just three banking facilities within our entire 28,500 square mile area.

Ironically, the Navajo Nation is perceived as one of the more prosperous of Indian tribes. Tragically, these types of living conditions are mirrored at hundreds of other Indian reservations throughout the United States, with the nationwide Indian reservation unemployment rate averaging 56%. Not in the most destitute non-Indian rural areas, nor in the most decayed urban inner cites, nor in the Third World countries to which the United States generously provides foreign aid can the Members of this Committee observe chronic impoverishment and infrastructure shortfalls rivaling that found at Indian reservations in the states of:

Alabama	Iowa	Montana	Oregon
Alaska	Kansas	Nebraska	Rhode Island
Arizona	Louisiana	Nevada	South Dakota
California	Maine	New Mexico	Texas
Colorado	Massachusetts	New York	Utah
Connecticut	Michigan	North Carolina	Washington
Florida	Minnesota	North Dakota	Wisconsin
Idaho	Mississippi	Oklahoma	Wyoming

Listen to the words of several of your own colleagues, from both parties, who were among the bipartisan coalition that championed the Indian Investment and Employment Tax Incentives in 1993 (and who supported adoption of the more powerful IRITC):

Senator John McCain: "I challenge those Members who say they want to help the poor to remember the Indian people, perhaps the poorest members of our society."

Senator Pete Domenici: "American Indians are by far America's poorest ethnic group."

Senator Daniel Inouye: "The unemployment rate on the majority of Indian reservations is simply incomprehensible to the average American."

Representative Bill Richardson: "Nowhere -- I repeat nowhere -- in the United States can you find adverse economic conditions that rival those found consistently throughout Indian country."

And, as correctly summed-up in 1993 by my predecessor, former President Peterson Zah:

> Stated simply, there is no single group of U.S. citizens that -- uniformly -- is more economically-deprived than American Indians living on reservations; there is no classifiable set of locations that -- uniformly -- is more deficient in infrastructure and job opportunities than Indian reservations.

INCENTIVES TO FACILITATE RESERVATION INVESTMENT AND CAPITAL FORMATION

The IRITC:

The IRITC is a powerful investment incentive for the private sector, and one that can truly influence business to consider Indian country for new or expanded investment. The Navajo Nation strongly recommends that, subject to a modification explained below, the Committee incorporate into its upcoming mark-up of budget reconciliation legislation the identical IRITC that Congress enacted in 1992 in the vetoed H.R. 11, and that the Senate re-adopted in 1993 in its version of the Budget Reconciliation Act. See: (i) 1993 Senate-passed IRITC (139 CONG. REC. S8027-28 (daily ed. June 24, 1993)), (ii) excerpts from 1993 Budget Reconciliation Act Conference Report

(H.R. REP. NO. 213, 103d Cong., 1st Sess. 718-23 (1993)), and (iii) excerpts from 1992 Conference Report on H.R. 11 (H.R. REP. NO. 1034, 102d Cong., 2d Sess. 45-49, 715-16, 721-23 (1992)) (submitted as exhibits). Four current Members of this Committee -- from both sides of the aisle -- were among the bipartisan cosponsors of the 1993 bill (i.e., S. 211, introduced by Senator John McCain) that contained the IRITC provisions which the Senate passed in its reconciliation legislation that year.

Among the positive features of that twice-passed IRITC legislation are: (1) tax credits for Indian reservation personal property, new reservation construction property and, significantly, reservation infrastructure investment; (2) full credits available for qualified investments on all reservations where Indian unemployment exceeds the national average by at least 300%; (3) partial credits (1/2) on any reservations where Indian unemployment is between 150% and 300% of the national average; and (4) restrictions prohibiting availability of the credits for property used in connection with gaming activities. Significantly, the IRITC can encourage both small and large businesses, and promote both new investments and expansion of existing businesses. And, unlike appropriations, which inevitably shrink by the time they actually reach the reservations, the IRITC can potentially leverage much higher amounts of private sector dollars flowing to Indian country.

The Navajo Nation recommends an important modification to the IRITC. The tax credit percentages previously acted upon by the Congress (i.e., 10% for reservation personal property, 15% for new construction property and 15% for infrastructure investment) should be made even more generous -- 20%, 25% and 25%, respectively. This is truly the type of powerful encouragement that will be required to help effectuate the reversal of decades of experience in which the private sector has virtually ignored Indian reservations as places to locate new investment and jobs.

Enhanced Tribal Tax-Exempt Bond Financing:

Although the Congress in recent years has cut back on the types/amount of tax-exempt bond financing that can be undertaken by state and local governments (including restrictions on issuance of private activity bonds), the limitations imposed on tribal issuance of tax-exempt bonds have been even more restrictive (in contrast to state and local governments) due to 1987 amendments to the Indian Tribal Governmental Tax Status Act of 1982. As a result, despite the fact that Indian reservations are the most disinvested, capital-poor locations anywhere in America, tax-exempt bond authority has had little, if any, positive impact in addressing those circumstances.

The 104th Congress should move dramatically not only to loosen those restrictions, but also to authorize expanded tribal tax-exempt bond issuance authority that can have an immediate effect in providing the capital -- for business formation and job creation -- that has been unavailable at Indian reservations historically. Toward that end, the Navajo Nation intends to forward to the Committee legislative language that will allow this useful economic development tool to make a real difference on Indian reservations.

THIS INVESTMENT INCENTIVE AND CAPITAL FORMATION PACKAGE IS ESSENTIAL FOR INDIAN COUNTRY ECONOMIC DEVELOPMENT

While it would be convenient simply to dismiss these proposals by saying that it is too soon to create another set of federal tax incentives for Indian country, that response would be inappropriate, short-sighted and self-defeating. Indian country cannot afford to wait for ten years while Congress gauges the private sector's response to the accelerated depreciation incentive. To help resolve at last the extraordinary economic deprivation that has perpetually characterized Indian country and plagued the people who live there, nothing short of these meaningful and effective new incentives will suffice.

Indeed, the principal weakness of the Indian Investment and Employment Tax Incentives was the substitution, in conference, of the less-valuable accelerated depreciation incentive for the more-potent IRITC. That compromise resulted in an investment incentive that in all likelihood is not valuable enough, standing alone, to counter the inherent disincentives (primarily the lack of infrastructure) to Indian country investment. Adding a powerful new investment incentive to the existing accelerated depreciation incentive, however, will allow both to be used hand-in-hand as tools to attract the attention of a national business community that -- by reasons of unfamiliarity, misimpressions, misunderstanding or worse -- has been blind to the potential advantages of locating in Indian country. The IRITC will enhance the effectiveness of the accelerated depreciation incentive, not to mention the Indian employment credit, as an attractive draw to Indian country. (An added benefit is that the IRITC can be partially "paid for" to the extent of the savings from that portion of the value of property against which the credit is taken, and for which accelerated depreciation cannot be taken.)

One historic argument against an investment tax credit generally is that it provides benefits to investors for investments that would otherwise have been made even in the absence of the incentive. Of course, that argument fails miserably when applied to an IRITC targeted solely to Indian country and its 56% average unemployment rate.

As the Navajo Nation has repeatedly explained, Indian country is always at a significant disadvantage when competing -- even against the most financially-strapped non-Indian distressed communities -- for new private sector investment and jobs. This unlevel playing field that has perpetually confronted and confounded tribal economic development leaders is caused, most prominently, by the shocking lack of infrastructure that burdens reservation inhabitants everywhere. The increased non-wage business costs resulting from these unique infrastructure deficiencies can only be mitigated by availability of incentives that comprise or contain added benefits for Indian country in comparison to non-Indian areas (i.e., the so-called "Indian differential"). The proposed IRITC plainly meets this test.

That a powerful new incentive is needed cannot be subject to dispute. As explained above, <u>the economic deprivation characteristic of Indian reservations and their inhabitants is unique within United States borders, and should be viewed -- with considerable alarm and discomfort -- as an embarrassment to all Americans</u>. Rather than minimizing the scope of incentives targeted for encouragement of Indian country investment and jobs, a maximum, sustained effort should be directed -- not toward addressing, but actually to resolving -- this crisis for U.S. citizens living on reservations throughout America. The IRITC, when added to the accelerated depreciation incentive, can provide a powerful magnet to the private sector, and modification and enhancement of tribal authority to issue tax-exempt bonds can help bring about the capital formation to enhance the potential effectiveness of those investment (and the existing employment) incentives. NOW is the time to make the commitment to resolve the problem of Indian reservation unemployment and poverty.

Indeed, targeting a separate program of federal tax incentives to Indian reservations in order to encourage badly-needed economic development and jobs is fully consistent with, and in furtherance of, the treaty obligations, trust responsibilities and laws of the United States. Moreover, such targeting is consistent with the unique legal and political status of Indian tribes and their government-to-government relationship with the federal government, and has been upheld by the Supreme Court (Morton v. Mancari, 417 U.S. 535 (1974)).

Finally, the IRITC in particular is a perfect fit with the times. It is available directly to the private sector taxpayer, and is not dependent upon creation of a new government bureaucracy for implementation. Unlike appropriations, the IRITC can serve to leverage larger sums of private sector dollars flowing to reservations. Unlike the current expensing provisions under consideration (which are available only to small business), the IRITC can appeal to large and small business alike, and can serve to attract the focused attention of labor-intensive, factory-type facilities that to date have ignored Indian country. Unlike some other provisions currently on the table, the IRITC has twice enjoyed bipartisan support -- from the immediately preceding two prior Congresses. Today, the 104th Congress should at last make this twice-passed Indian country objective a reality, and should include expanded tax-exempt bond authority to enhance its potential.

CONCLUSION

Importantly, the IRITC is consistent with, and a tool that can effectively facilitate, "local empowerment." As I explained in my inaugural speech in January:

> The centerpiece of the Hale/Atcitty campaign, and now the Hale/Atcitty administration, is local empowerment. More than 52% of the Navajo voters endorsed local empowerment.
>
> * * *
>
> [L]et us release our people from the bondage of dependence by empowering them to decide for themselves and set the course and future for their communities and the Navajo Nation.

Mr. Chairman, nothing is more basic yet more essential to empowering people to lead successful, productive lives than having a job. Apart from the obvious economic benefits, having a job -- providing for a family and contributing to one's community -- empowers a person in untold psychological and spiritual ways that enrich and ennoble that person's life and the lives of their families.

If you are born an Indian, and you desire to remain on your reservation to live with your family and contribute to your community, you have less than a 50% chance of finding employment. This is a shameful, counterproductive set of circumstances that must be recognized immediately, addressed expeditiously, and resolved before the turn of the 20th century for the people who have inhabited this land for centuries past.

The IRITC and the enhanced tribal tax-exempt bond authority discussed herein properly look to the private sector to provide the investment dollars and job creation urgently needed throughout Indian country. These powerful incentives can work; half-way measures will not.

Passage of these measures can put this Committee in the forefront toward helping to correct the tragic circumstances of Indian reservation unemployment, poverty, infrastructure deficiencies and overall economic deprivation that scar the American landscape. On behalf of the Navajo Nation, I urge the Committee to make this issue one of your highest priorities as you mark-up the tax and job creation provisions of the budget reconciliation legislation.

NORTH AMERICAN EQUIPMENT DEALERS ASSOCIATION

Serving Farm, Industrial and Outdoor Power Dealers

John J. Mullenholz, Legislative Director
(202) 296-8000

June 12, 1995

The Honorable Bob Packwood
Chairman, Senate Finance Committee
219 Dirksen Senate Office Building
Washington, DC 20515

Dear Senator Packwood:

I am writing on behalf of the over 5,500 U.S. members of the North American Equipment Dealers Association to urge your support of legislation to increase the estate tax exemption, or eliminate it completely for small family-owned businesses.

NAEDA's members are the farm, industrial and outdoor power equipment dealers located throughout the nation. With an average of 17 employees per dealership, they are often among the largest employers in their communities. Many of NAEDA's members are operating family businesses which have been passed down through several generations. These are true family businesses with the husband, wife, and children working long hours alongside their employees to make the business succeed. The current estate tax jeopardizes the future of those businesses.

The majority of dealers have virtually all of their assets tied up in the business. Passing on the business is not the same as passing on cash. There is not the liquidity available to pay large estate taxes. It may be difficult for the heirs to obtain loans to pay off an estate tax debt and they may be forced to liquidate the business in order to pay the tax. The business is lost, jobs are lost, and the local source of equipment and service is lost.

You can help correct this problem. We urge your committee to increase the exempt amount, as the House did in its tax bill, H.R. 1215, or eliminate the estate tax altogether for businesses handed down to family members who keep it in operation for at least ten years.

Sincerely,

John J. Mullenholz
Legislative Director

STATEMENT OF THE SMALL BUSINESS COUNCIL OF AMERICA (BY HAROLD I. APOLINSKY)

Mr. Chairman and Members of the Committee, I am Harold I. Apolinsky, Past Chair of the Small Business Council of America (SBCA) and currently Vice President—Legislation. I am also a practicing tax attorney (over 30 years) who specializes in estate planning and probate. For over 18 years, I have taught estate planning and estate, gift and generation skipping taxation as my avocation to law school seniors at both the University of Alabama School of Law in Tuscaloosa, Alabama and the Cumberland School of Law in Birmingham, Alabama. I am here to present our views on estate, gift and generation skipping taxes.

SBCA is a national nonprofit organization which represents the interests of privately-held and family-owned businesses on federal tax, health care and employee benefit matters. The SBCA, through its members, represents well over 20,000 enterprises in retail manufacturing and service industries, which enterprises represent or sponsor over two hundred thousand qualified retirement and welfare plans, and employ over 1,500,000 employees.

The time has come for Congress to repeal the estate, gift and generation skipping taxes.

An estate tax due nine months after death is imposed on the transfer to children or other heirs of the taxable estate of every decedent who is a citizen or resident of the Unite States ($600,000 of assets are exempt). Tne graduated estate tax rates begin effectively at 37% and increase to a maximum rate of 55% (see Exhibit "A" for how the tax is calculated). Taxes on bequests to spouses may be deferred until the last-to-die of husband and wife.

A gift tax is levied on taxable gifts (excluding $10,000 per donee per year) as back-stop to the estate taxes. The graduate rates are the same. (The $600,000 exempt amount may be used during life for gifts or at death.)

An extra, flat 55% generation-skipping tax is imposed on gifts or bequests grandchildren ($1,000,000 is exempt).

The 1986 White House Conference on Small Business recommended eliminating estate and gift taxes on the transfer of small business assets to family members. Legislation has been introduced in prior years to accomplish this (Exhibit "B" attached).

With a new entrepreneurial voter wave shifting control of both the House and Senate to Republicans, it is time to repeal these transfer taxes. President Clinton has expressed the desire to retain and increase jobs. Repeal would do this!

- Only 30% of family business make it through the second generation. Seventy percent (70%) do not. Only 13% make it through the third generation. Eighty-Seven (87%) do not. The primary cause of the demise of family businesses, after the death of the founder and the founder's spouse, is the 55% estate tax. It is hard for the successful business to afford enough life insurance. (Premiums are not deductible and deplete working capital.)
- A recent study by Prince and Associates (research company) for National Life of Vermont reviewed the history of 749 family businesses which failed within three years after the death of the founder. The Prince study reinforced and supported the conclusion of the deadly effect of estate taxes. The businesses could not continue as a result of the tax drain on working capital needed to effectively compete and cover errors in judgment made by new and younger management. Jobs were lost in the communities.
- The estate tax took its present form primarily in the early 30's. The express purpose was to "break-up wealth." Is this consistent with a free enterprise economic system and a very competitive world economy? In 1992, the estate, gift and generation-skipping taxes accounted for only 1.1% of revenue. For 1995, the figure is closer to 0.8%. The expense of administering this system probably offsets 75% or more of the revenue when you factor in IRS, Treasury and costs of litigation.
- The transfer tax provisions represent 82 pages of the Internal Revenue Code and 289 pages of Regulations issued by the Internal Revenue. The transfer tax system forces many estates, the Internal Revenue Service, and the Department of Justice to expend funds in court. The number of transfer tax cases now total 10,247 representing some 13,050 pages of the Commerce Clearing House Tax Publication.
- Australia repealed their. estate and gift tax laws in the mid-1970's. It was felt that these transfer taxes were an inhibitor on the growth of family businesses. The legislative body of Australia sought more jobs which they believed would come if family businesses grew larger and were not caused to sell, downsize, or liquidate at the death of the founder to pay estate taxes.

The President has expressed concern about children inheriting appreciated assets from deceased parents and selling them without paying income taxes on the profits. This is the result of the step-up in basis to the value as shown in the estate tax return. If the transfer tax laws were repealed, there would be no step-up in basis. At the time assets were sold, gain would be taxed and funds available to pay the tax. The fair market value of assets sold would be fixed.

- If you factor the significant expense in collecting these taxes and the income tax when—assets were sold, the repeal may be revenue neutral.
- Combined income and estate taxes frequently consume 75% or better of retirement plan accounts at death (see chart attached as Exhibit "C").

A very few of our most wealthy citizens have elected to give up their citizenship, become citizens of foreign countries, and avoid the 55% transfer taxes. The cover story of Forbes, November 21, 1994 (attached as Exhibit "D"*), was devoted to "Expatriation—As the Ultimate Estate Planning Technique." What a loss of available capital! These are the people who may give the most to charity and have the resources to seed new businesses.

This should be a wake-up call that this tax is no longer appropriate. We have the highest transfer taxes in the world. Instead of reacting to this by an "exit tax"—Congress should step back, study the issue, and then repeal these taxes to promote jobs and the growth of family capital.

It is contrary to the best interest of my tax practice, my teaching, and my firm (we have 6 lawyers out of 94 doing estate planning, administration and probate) to urge repeal of these transfer taxes. It is the right thing to do to help grow family businesses, provide jobs and encourage the entrepreneurial spirit needed for small businesses to become large businesses.

EXHIBIT "A"

CALCULATION OF ESTATE TAXES

A. Gross Estate (fair market value at death of all assets, including real estate, stock, cash, life insurance, retirement accounts, etc.).
B. Deductions:
   1. Debts and expenses.
   2. Marital (assets left to spouse if citizen).
   3. Charitable.
C. Taxable Estate.
D. Add Prior Taxable Gifts.
E. Total transfer to heirs (life and death).
F. Apply Rates: 18% to 55%.
G. Less credit ($192,800*)
H. Net tax (effective 37% to 55% (plus 5% for larger estates] due 9 months after death.
I. Extra 55% tax for bequests to grandchildren in excess of $1 million.

*This is tax on $600,000 taxable estate.

EXHIBIT "B"

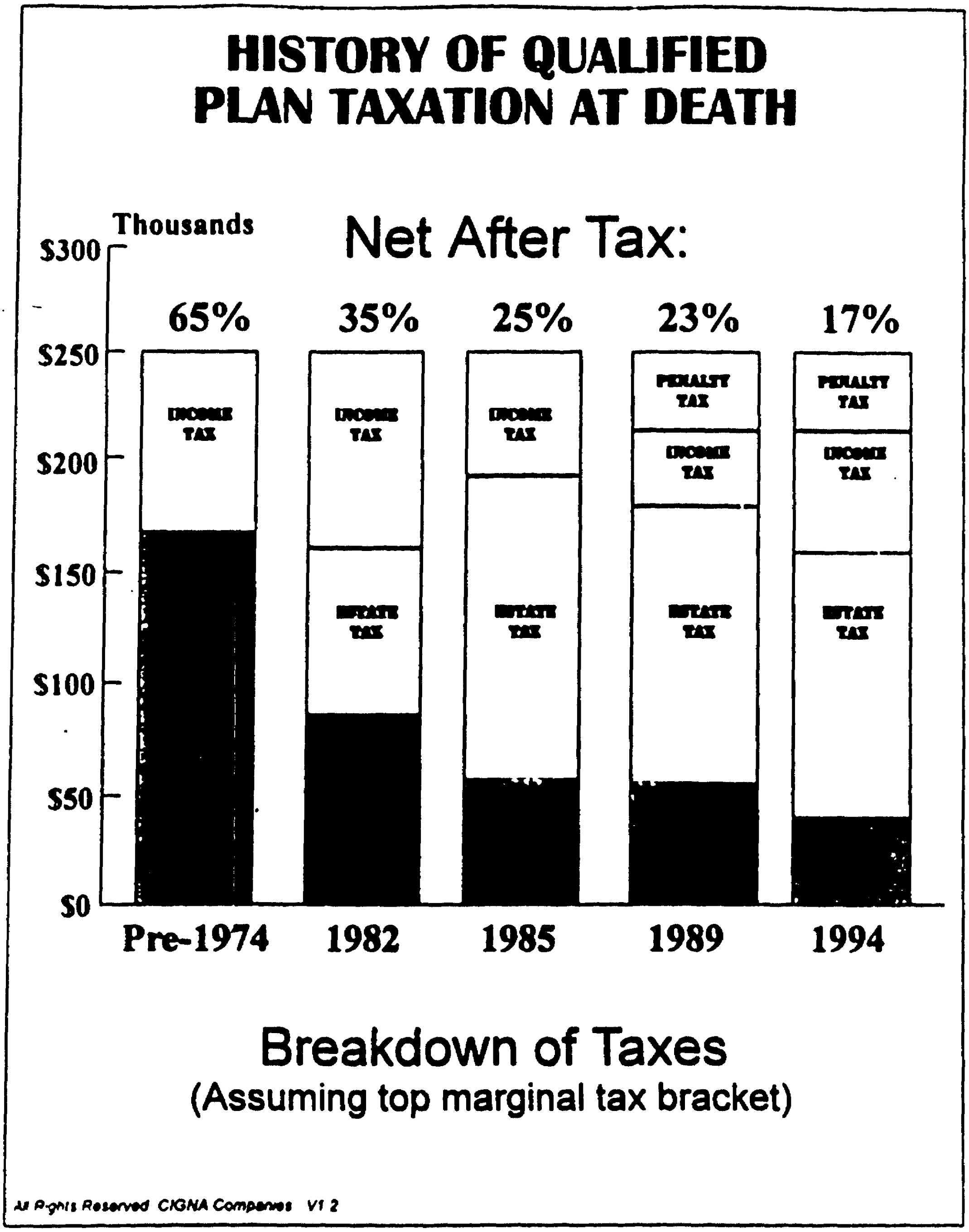
PERTINENT LEGISLATION

A. Legislation was introduced in July 1993 (H.R. 2717) to repeal estate, gift and generation-skipping taxes.
B. Legislation was also introduced but not enacted in the 102nd Congress would have allowed heirs of small business owners to defer the estate tax owed on a farm or business until it was sold outside the family. In order to take advantage of this deferral, the following requirements would have to be met:
   (1) The business must be worth less than $50 million.
   (2) The business must comprise at least 40 percent of the decedent's estate.
   (3) The person inheriting the business must have actively participated in the running of the business prior to the owner's death.
C. A provision in separate legislation also introduced in the 102nd Congress would have reduced the amount exempt from estate and gift taxes from $600,000 to $200,000. This provision of the bill was subsequently withdrawn.
D. Legislation introduced in the 103rd Congress included bills that would increase the estate and gift tax exemption to $770,000 plus cost-of-living adjustments

*Exhibit D was made part of the official files of the committee.

(H.R. 567), $850,000 plus cost-of-living adjustments (H.R. 1475), $1 million (S. 531) and $1.2 million (H.R. 1110).
E. H.R. 784 was introduced on February 1, 1995 to repeal estate, gift and generation-skipping taxes. H.R. 1039 was introduced on February 27, 1995.
F. S. 628 was introduced on March 27, 1995 to repeal estate, gift and generation-skipping taxes.

EXHIBIT "C"



STATEMENT OF CHESTER THIGPEN

My name is Chester Thigpen. My wife Rosett and I are Tree Farmers from Montrose, Mississippi.

I appreciate the opportunity to submit my statement to this Committee. You are debating an issue that is very important to more than 7 million people who own most of the nation's productive timberland. Most of us have been at it for a long time. Professor Larry Doolittle of Mississippi State University published a paper in 1992 that suggested half the Tree Farmers in the Mid-South were 62 years old or over. This pattern holds true in other parts of the country as well. So it should come as no surprise to the Committee that, when Tree Farmers gather, one of the things we discuss is estate taxes.

Estate taxes matter not just to lawyers, doctors and businessmen, but to people like Rosett and me. We were both born on land that is now part of our Tree Farm. I can remember plowing behind a mule for my uncle who owned it before me. My dream then was to own land. I bought a little bit in 1940 and inherited some from my family's estate in 1946, and then bought some more. Back when I started, the estate tax applied to only one estate in 60. Today it applies to one in 20—including mine. I wonder if I would be able to achieve my dream if I were starting out today.

You will no doubt hear from folks who will talk about the technical details of estate tax reform. They know far more about it than I do. I'd like to talk to you about what I do know: what estate tax reform will mean in places like Montrose, Mississippi and to Tree Farmers like me and Rosette.

We first got started in forestry in 1960. Much of our land was old cotton and row crop fields, so early on I spent 90 percent of my time trying to keep it from washing away. We developed a management plan and started growing trees. Today, we manage our property for timber, wildlife habitat, water quality and recreation. We have built ponds for erosion control and for wildlife. Deer and turkey have come back, so we invite our neighbors to hunt on our land. It took us half a century, but Rosett and I have managed to turn our land into a working Tree Farm that has been a source of pride and income for my entire family.

Our Tree Farm made it possible to put our five children through college. It made it possible for Rosette and me to share our love of the outdoors and our commitment to good forestry with our neighbors. And finally, it made it possible for us to leave a legacy that makes me very proud: beautiful forests and ponds that can live on for many, many years after my wife and I pass on. We wanted to leave the land in better condition than when we first started working it. And we will.

We also want to leave the Tree Farm in our family. But no matter how hard I work, that depends on you.

Right now, people tell me my Tree Farm could be worth more than one or two million dollars. All that value is tied up in land or trees. We're not rich people. My son and I do almost all the work on our land ourselves. So, under current law, my children might have to break up the Tree Farm or sell off timber to pay the estate taxes. Today I wish to endorse a proposal which was introduced by Senator Thad Cochran called the National Family Enterprise Preservation Act, S. 867, which would totally exempt over 98.5 percent of all family enterprises, not just Tree Farms, from the Federal estate tax. A summary of the bill is attached to this statement.

Giving up the Tree Farm we worked fifty years to create would hurt me and my family. I don't think it would be good for the public either. If the Tree Farm had to be sold or the timber cut before its time, what would happen to the erosion control programs we put in place, or the wildlife habitat? Who would make certain that the lands stayed open for our neighbors to visit and enjoy? I know my children would. And I hope their children will have an opportunity after them.

I think too often people focus on just the costs of estate tax reform and not the benefits. In forestry, the benefits will be substantial. I mentioned earlier that most of the 7 million landowners in this country are close to retirement age or, like me, way past it. Without estate tax reform, many of their properties will be broken up into smaller tracts or harvested prematurely. Some may no longer be economical to operate as Tree Farms and will perhaps be converted to other uses or back into marginal agriculture. Other properties may become too small or generate too little cash flow to support the kind of multiple use management we practice on our property. Healthy, growing forests with abundant wildlife provide benefits to everybody. Without estate tax reform, it will become harder and harder for people like me to remain excellent stewards of our family-owned forests.

A few months ago, Rosett and I were named Mississippi's Outstanding Tree Farmers of the Year. It was a great honor to be selected from among the thousands of excellent Tree Farmers in Mississippi. I'm told one reason we were recognized was because Rosett and I have been speaking out on behalf of good forestry for almost four decades.

That's why I am submitting this statement today: to remind the Committee that estate tax reform is important to preserve family enterprises like ours. It is also important for good forestry. We just planted some trees on our property a few months ago. I hope my grandchildren and great-grandchildren will be able to watch those trees grow on the Thigpen Tree Farm—and I know millions of forest landowners feel the same way about their own Tree Farms. We applaud estate tax reforms that will make this possible.

THE NFEP

1. Increase In the Unified Estate and Gift Tax Credit

The current unified credit of $192,800 would be increased to $314,600 in the case of family enterprise property. This would be an increase from $600,000 to $1 million in the amount of property that may pass free of Federal estate and gift taxes.

2. Increase In the Annual Gift Tax Exclusion

The current annual gift 'tax exclusion of $10,000 would be increased to $20,000 in the case of gifts to qualified family members of family enterprise property. Qualified family members are individuals who are members of the same family within the meaning of section 2032A(e)(2) of the Internal Revenue Code.

3. Special Use Valuation Changes

Currently, special use valuation cannot reduce the gross estate by more than $750,000. This amount would be increased to $1 million.

4. Family Enterprise Interest

The value of the gross estate shall be reduced by 5% for each taxable year in which a qualified family member participates in the active management of the family farm or business following the decedent's death. The estate will be credited with the maximum deduction at the time of the decedent's death. The qualified family member must continue in the active management of the family farm or business for 10 years following the decedent's death, otherwise appropriate recapture provisions would apply. The term active management means the making of the management decisions of a business other than the daily operating decisions. In no event shall the value of the decedent's gross estate be reduced by more than the lesser of 50% or $1 million by reason of this family enterprise interest.

As I stated, this proposal will totally exempt over 98 percent of our nation's family owned enterprises from the heavy burden of the current estate tax laws. This proposal has been estimated by the Joint Committee on Taxation to cost $415 million over a five year period. This proposal will allow the backbone of our nation's economy, family owned enterprises, to continue to grow from generation to generation and provide jobs for millions of Americans. This proposal will provide a tremendous bang for the buck in estate tax reform.

STATEMENT OF THE WASHINGTON FARM FORESTRY ASSOCIATION

(SUBMITTED BY CHAN NOERENBERG)

My name is Chan Noerenberg. I am Vice President of the Washington Farm Forestry Association. Our association represents non-industrial tree growers throughout the State of Washington. I am also a timberland owner myself. I wish to thank you for providing me with the opportunity to submit this statement to the Committee today concerning legislation which is vitally important to the seven million non-industrial, private landowners throughout the United States. The legislation addresses one of the most pressing issues that affects individual tree growers—the federal estate and gift tax laws.

Something has to be done about laws that force inheritors of a family farm or business to sell that enterprise in order to pay estate taxes on it. A family farm or business is not only an extremely productive component of our economy, it also provides a quality of life which millions of Americans cherish.

Forty or fifty years ago productive agricultural land could be purchased for less than $100 per acre. Today, the national average price per acre is over $750. Inflation has made estate taxes a major burden on family farms and businesses. Independent companies are being forced to merge into large corporations because marketable stock can be acquired tax free and many estate tax problems associated with a family farm or business can be avoided.

In 1942, the estate tax applied to only one estate out of 60. Today, this number has increased to one out of 20, significantly broadening the application of the law. The sad fact is that inflation has pushed family farms and businesses that were too small to pay estate taxes into extremely high tax brackets. The result has been that heirs of these enterprises have been forced out of business because they must pay stiff Federal estate taxes.

Inflation has seriously imperiled the maintenance of family farms and businesses of all kinds. What we are witnessing today is a major threat to the very survival of our free and independent enterprise system.

Family owned farms and businesses are an integral and vital component of our economy and society. As a source of entrepreneurial spirit, family owned farms and small businesses must be preserved and protected. These enterprises give the family a personal sense of freedom, accomplishment, and pride in ownership. The perpetuation of the family business in America is of significant importance to the survival of free enterprise that is the foundation of our economy.

I am pleased to note that the tax reduction bill which the House passed, H.R. 1215, contains a provision which is a step in the direction of meaningful estate tax reform. This proposal would increase the unifiede state and gift tax credit over a three year period to the equivalent of a $750,000 exclusion from estate and gift taxes. This would be an increase of $150,000 over the current level of $600,000. This proposal would apply to all taxpayers. As a result, the Treasury Department has stated it would lead to a $20 billion revenue loss over the next ten years. Despite this rather high price tag, we wholeheartedly support the thrust of this proposal.

There are other options for estate tax reform which we also support. One approach would significantly reduce the estate tax rates for qualified family businesses. Another would eliminate the estate tax rate entirely for qualified family business interests. We support all of these approaches and indeed have been working with a coalition of small business groups whose primary goal is to achieve significant estate tax reform for the sector of our economy which needs it most—independently owned family enterprises. The approach the coalition has taken is to target estate tax reform to family businesses. This clearly keeps the cost of the -various proposals within our current budgetary framework. I wish to discuss one such option which we believe will provide the most significant amount of estate tax relief for family enterprises and the lowest amount of revenue loss of any of the proposals of which I am currently aware.

The National Family Enteprise Preservation Act of 1995, S. 867, introduced by Senator Cochran (the "NFEP") will provide estate tax relief to more than 98.5 percent of our Nation's family owned farms and businesses, allowing them to continue their many contributions to the economy, creating more jobs, advancing technology and innovation, and increasing our productivity. The proposal also recognizes the importance of children and other heirs who work in a family enterprise.

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PRESENT LAW AND PROPOSALS RELATING TO ESTATE AND GIFT TAXATION AND EXPENSING BY SMALL BUSINESSES

Scheduled for a Hearing

Before the

SENATE COMMITTEE ON FINANCE

on June 7, 1995

Prepared by the Staff

of the

JOINT COMMITTEE ON TAXATION

June 6, 1995

JCX-23-95

CONTENTS

INTRODUCTION

The Senate Committee on Finance has scheduled a public hearing on June 7, 1995, on issues relating to small business tax incentives. Specifically, the hearing will examine estate and gift taxation and expensing of equipment for small businesses under section 179 of the Internal Revenue Code of 1986 and will analyze proposed changes to these present-law provisions. The proposed changes to the estate and gift taxes are contained in section 351 of H.R. 1215 (the "Tax Fairness and Deficit Reduction Act of 1995") as passed by the House of Representatives on April 5, 1995; S. 105; S. 161 (the "American Family Business Preservation Act"); S. 628 (the "Family Heritage Preservation Act"); S. 692 (the "Family Forestland Preservation Tax Act of 1995"); and S. 867 (the "National Family; Enterprise Preservation Act of 1995"). The proposed change to section 179 is contained in section 352 of H.R. 1215. This document,[1] prepared by the staff of the Joint Committee on Taxation, describes the present-law estate and gift tax and section 179 and the applicable provisions of proposed legislation that would amend present law.

Part I of the document is an overview of present-law estate and gift taxation and equipment expensing and the legislative proposals that would amend these present-law rules. Part II is a description of estate and gift tax provisions of present law, H.R. 1215 as passed by the House, and Senate bills. Part III is a description of expensing provisions of present law and H.R. 1215.

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[1] This document may be cited as follows: Joint Committee on Taxation, Present Law and Proposals Relating to Estate and Gift Taxation and Expensing by Small Businesses (JCX-23-95), June 6, 1995.

I. OVERVIEW

<u>Estate and gift taxation</u>

A gift tax is imposed on any transfer of property by gift. The gift tax is imposed on the donor and is based on the fair market value of the property transferred. Deductions are allowed for certain gifts to spouses and to charities. Annual gifts of $10,000 or less per donor per donee generally are not subject to tax.

An estate tax also is imposed on the "taxable estate" of any person who was a citizen or resident of the United States at the time of death, and on certain property belonging to a nonresident of the United States that is located in the United States at the time of death. The estate tax is imposed on the estate of the decedent and generally is based on the fair market value of the property passing at death. The taxable estate generally equals the worldwide "gross estate" less certain allowable deductions, including a marital deduction for certain bequests to the surviving spouse of the decedent and a deduction for certain bequests to charities.

Since 1976, the gift tax and the estate tax have been unified so that a single graduated rate schedule applies to an individual's cumulative taxable gifts and bequests. Under this rate schedule, the unified estate and gift tax rates begin at 18 percent on the first $10,000 in cumulative taxable transfers and reach 55 percent on cumulative taxable transfers over $3 million. A unified credit of $192,800 is available with respect to taxable transfers by gift and at death, which effectively exempts a total of $600,000 in cumulative taxable transfers from the estate and gift tax. The benefits of the unified credit (and the graduated estate and gift tax rates) are phased out by a 5-percent surtax imposed upon cumulative taxable transfers over $10 million and not exceeding $21,040,000.

A separate transfer tax is imposed on generation-skipping transfers to a beneficiary of a generation more than one generation below that of the transferor. The generation-skipping transfer tax is imposed at a flat rate of 55 percent on cumulative generation-skipping transfers in excess of $1 million.

Section 351 of H.R. 1215, as passed by the House, would increase the present-law unified credit of $192,800 (i.e., the amount that effectively exempts $600,000 in taxable transfers from the estate and gift tax) to $248,300 (i.e., the amount that would effectively exempt $750,000 in taxable transfers from the estate and gift tax) over a three-year period beginning in 1996. After 1998, the unified credit amount would be indexed for inflation. The bill would also index the following amounts for inflation beginning after 1998: (1) the $10,000 annual exclusion for gifts; (2) the $750,000 ceiling amount on special use valuation under Code section 2032A; (3) the $1,000,000 generation-skipping transfer tax exemption; and (4) the value of a closely-held business (i.e., $1,000,000) eligible for the special 4-percent interest rate on deferred payments of estate tax liability under Code section 6601(j).

S. 105 would provide that the cash lease of specially valued real property by a qualified heir to certain family members would not cause the qualified use of such property to cease for purposes of imposing the additional estate tax under Code section 2032A(c). S. 628 would repeal the Federal estate and gift tax and the Federal generation-skipping transfer tax. S. 692 would provide special estate tax treatment for qualified conservation easements, and special estate tax valuation for qualified forest lands. S. 161 and S. 867 would make certain changes to the estate and gift tax treatment of certain family-owned businesses.

Equipment expensing for small businesses

Taxpayers generally recover the cost of tangible property placed in service in a trade or business over time through annual depreciation deductions. Under present-law section 179, in lieu of depreciation, a taxpayer with a sufficiently small amount of annual investment generally may elect to deduct up to $17,500 of the cost of tangible personal property (i.e., generally, machinery and equipment) placed in service for the taxable year. The $17,500 amount is reduced by the amount by which the cost of qualifying property placed in service during the taxable year exceeds $200,000.

Section 352 of H.R. 1215 would increase the amount allowed to be expensed under section 179 to $35,000 for taxable years beginning after 1998. The increase to $35,000 would be gradually phased in from 1996 to 1999.

II. ESTATE AND GIFT TAXATION

A. Present-Law Rules

Application of the estate and gift tax

A gift tax is imposed on lifetime transfers and an estate tax is imposed on transfers at death. Since 1976, the gift tax and the estate tax have been unified so that a single graduated rate schedule applies to cumulative taxable transfers made by a taxpayer during his or her lifetime and at death.[2] Under this rate schedule, the unified estate and gift tax rates begin at 18 percent on the first $10,000 in cumulative taxable transfers and reach 55 percent on cumulative taxable transfers over $3 million (sec. 2001(c)).

The amount of gift tax payable for any calendar year generally is determined by multiplying the applicable tax rate (from the unified rate schedule) by the cumulative lifetime taxable transfers made by the taxpayer and then subtracting any gift taxes payable for prior taxable periods. This amount is reduced by any available unified credit (and other applicable credits) to determine the gift tax liability for the taxable period.

The amount of estate tax payable generally is determined by multiplying the applicable tax rate (from the unified rate schedule) by the cumulative post-1976 taxable transfers made by the taxpayer during his lifetime or at death and then subtracting any gift taxes payable for prior calendar years (after 1976). This amount is reduced by any available unified credit (and other applicable credits) to determine the estate tax liability.

Unified credit

A unified credit is available with respect to taxable transfers by gift and at death. Since 1987, the unified credit amount has been $192,800 (sec. 2010), which effectively exempts a total of $600,000 in cumulative taxable transfers from the estate and gift tax. The benefits of the unified credit (and the graduated estate and gift tax rates) are phased-out by a 5-percent surtax imposed upon cumulative taxable transfers between $10 million and $21,040,000 (sec. 2001(c)(2)).[3]

The unified credit originally was enacted in the Tax Reform Act of 1976. As enacted, the credit was phased in over five years to a level that effectively exempted $175,625 of taxable transfers from the estate and gift tax in 1981 (i.e., a unified credit of $47,000). The Economic Recovery Tax Act of 1981 increased the amount of the unified credit each year between 1982 and 1987, from an

[2] Prior to 1976, separate tax rate schedules applied to the gift tax and the estate tax.

[3] Thus, if a taxpayer has made cumulative taxable transfers exceeding $21,040,000, his or her average transfer tax rate will be 55 percent under present law.

effective exemption of $225,000 in 1982 to an effective exemption of $600,000 in 1987. The unified credit has not been increased since 1987.

Annual exclusion for gifts

A taxpayer may exclude $10,000 of gifts made to any one donee during a calendar year (sec. 2503). This annual exclusion does not apply to gifts of future interests (e.g., reversions or remainders). Prior to 1982, the annual exclusion was $3,000.

Valuation

Generally, for Federal transfer tax purposes, the value of property is its fair market value, i.e., the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant facts. Fair market value is determined as of either (1) the time of the decedent's death, or (2) the "alternate" valuation date of six months after the decedent's death (sec. 2032).

Under Code section 2032A, an executor may elect for estate tax purposes to value certain "qualified real property" used in farming or another qualifying closely-held trade or business at its current use value, rather than its highest and best use value. Currently, the maximum reduction in the value of such real property resulting from an election under Code section 2032A is $750,000.

An estate may qualify for current use valuation if: (1) the decedent was a citizen or resident of the United States at the time of death; (2) the value of the farm or closely held business assets in the decedent's estate, including both real and personal property (but reduced by debts attributable to the real and personal property) is at least 50 percent of the decedent's gross estate (reduced by mortgages and other secured debts); (3) at least 25 percent of the adjusted value of the gross estate is qualified farm or closely held business real property;[4] (4) the real property qualifying for current use valuation must pass to a qualified heir;[5] (5) such real property must have been owned by the decedent or a member of the decedent's family and used or held for use as a farm or closely held business ("a qualified use") for 5 of the last 8 years prior to the decedent's death; and (6) there must have been material participation in the operation of the farm or closely held business by the decedent or a member of the decedent's family in 5 years out of the 8 years immediately preceding the decedent's death (Code sec. 2032A (a) and (b)).[6]

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[4] For purposes of the 50-percent and 25-percent tests, the value of the property is determined without regard to its current use value.

[5] The term "qualified heir" means a member of the decedent's family, including his spouse, lineal descendants, parents, and aunts or uncles of the decedent and their descendants.

[6] In the case of qualifying real property where the material participation requirement is satisfied, the real property which qualifies for current use valuation includes the farmhouse, or

If, after an election is made to specially value property at its current use value, the heir who acquired the real property ceases to use it in its qualified use within 10 years (15 years for individuals dying before 1982) of the decedent's death, an additional estate tax is imposed in order to "recapture" the benefit of the special use valuation. Some courts have held that the cash rental of specially valued property after the death of the decedent is not a qualified use and, therefore, results in the imposition of the additional estate tax under section 2032A(c). Martin v. Commissioner, 783 F.2d 81 (7th Cir. 1986) (cash lease to unrelated party); Williamson v. Commissioner, 93 T.C. 242 (1989) (cash lease to family member).

Contributions for conservation purposes

A deduction is allowed for estate and gift tax purposes for a contribution of a qualified real property interest to a charity (or other qualified organization) exclusively for conservation purposes (secs. 2055(f), 2522(d)). Qualifying conservation purposes are: (1) the preservation of land areas for outdoor recreation by, or the education of, the general public; (2) the protection of a relatively natural habitat of fish, wildlife, or plants, or similar ecosystem; (3) the preservation of open space (including farmland and forest land) where such preservation will yield a significant public benefit, and is either for the scenic enjoyment of the general public, or pursuant-to a clearly delineated governmental conservation policy; or (4) the preservation of an historically important land area or certified historic structure (sec. 170(h)(4)). For this purpose, a qualified real property interest means the entire interest of the transferor in real property (other than certain mineral interests), a remainder interest in real property, or a perpetual restriction on the use of real property (sec. 170(h)). Also, a contribution will be treated as "exclusively for conservation purposes" only if the conservation purpose is protected in perpetuity.

Generation-skipping transfer tax

A generation-skipping transfer tax ("GST tax") generally is imposed on transfers, either directly or through a trust or similar arrangement, to a "skip person" (i.e., a beneficiary in a generation more than one generation below that of the transferor). Transfers subject to the GST tax include direct

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other residential buildings, and related improvements located on qualifying real property if such buildings are occupied on a regular basis by the owner or lessee of the real property (or by employees of the owner or lessee) for the purpose of operating or maintaining the real property or the business conducted on the property. Qualified real property also includes roads, buildings, and other structures and improvements functionally related to the qualified use.

skips, taxable terminations and taxable distributions.[7] The generation-skipping transfer tax is imposed at a flat rate of 55 percent on cumulative generation-skipping transfers in excess of $1 million.

Installment payment of estate tax

Under Code section 6166, an executor generally may elect to pay the Federal estate tax attributable to an interest in a closely held business in installments over, at most, a 14-year period. To qualify for the election, the business must be an active trade or business and the value of the decedent's interest in the closely held business must exceed 35 percent of the decedent's adjusted gross estate.

If an election is made, the estate pays only interest for the first four years, followed by up to 10 annual installments of principal and interest. Interest is generally imposed at the rate applicable to underpayments of tax under Code section 6621 (i.e., the Federal short term rate plus three percentage points). Under Code section 6601(j), however, a special 4-percent interest rate applies to the amount of deferred estate tax attributable to the first $1,000,000 in value of the closely-held business. The maximum amount that may be subject to the 4-percent rate is the lower of (1) $345,800 (i.e., the amount of estate tax on the first $1,000,000), less the amount of allowable unified credit, or (2) the amount of estate tax attributable to the closely-held business that is being paid in installments pursuant to Code section 6166.

B. Description of Provision in H.R. 1215

Description of Provision

Increase in unified credit

Section 351 of H.R. 1215, as passed by the House, would increase the present-law unified credit of $192,800 to $248,300 over a three-year period beginning in 1996. For decedents dying and gifts made in 1996, the unified credit would be $229,800 (i.e., the amount that would effectively exempt $700,000 in taxable transfers from the estate and gift tax). For decedents dying and gifts made in 1997, the unified credit would be $239,050 (i.e., the amount that would effectively exempt $725,000 in taxable transfers from the estate and gift tax). For decedents dying and gifts made after 1997, the unified credit would be $248,300 (i.e., the amount that would effectively exempt $750,000 in taxable transfers from the estate and gift tax). After 1998, the unified credit would be indexed for

[7] For this purpose, a direct skip is any transfer subject to estate or gift tax of an interest in property to a skip person (e.g., a gift from grandparent to grandchild). A taxable termination is a termination (by death, lapse of time, release of power, or otherwise) of an interest in property held in trust unless, immediately after such termination, a non-skip person has an interest in the property, or unless at no time after the termination may a distribution (including a distribution upon termination) be made from the trust to a skip person. A taxable distribution is a distribution from a trust to a skip person (other than a taxable termination or a direct skip).

inflation each year by multiplying the applicable exclusion amount of $750,000 by a cost of living adjustment. The indexed exclusion amount would be rounded to the nearest $10,000.

To reflect the increase in the unified credit, the provision also would make conforming amendments to (1) the 5-percent surtax in order to permit the proper phase out of the increased unified credit, (2) the general filing requirements for estate and gift tax returns under Code section 6018(a), and (3) the amount of the unified credit allowed under Code section 2102(c)(3) with respect to nonresident aliens with U.S. situs property who are residents of certain treaty countries.

Indexing of certain provisions

In addition to increasing and indexing the unified credit, the H.R. 1215 would index the following amounts for inflation beginning after 1998: (1) the $10,000 annual exclusion for gifts; (2) the $750,000 ceiling amount on special use valuation under Code section 2032A; (3) the $1,000,000 generation-skipping transfer tax exemption; and (4) the value of a closely-held business (i.e., $1,000,000) eligible for the special 4-percent interest rate under Code section 6601(j). Indexing of the annual exclusion would be rounded to the nearest $1,000 and indexing of the other amounts would be rounded to the nearest $10,000.

Effective Date

The provisions relating to the increase in the unified credit would apply to the estates of decedents dying, and gifts made, after December 31, 1995. The indexing of the other provisions would apply after December 31, 1998.

C. Descriptions of Other Bills

1. S. 105 (Senators Daschle, Conrad, Dorgan, Kassebaum, and Baucus)

Description of the Bill

The bill would provide that the cash lease of specially valued real property by a qualified heir to a "member of the family" (who continues to operate the farm or closely held business) does not cause the qualified use of such property to cease for purposes of imposing the additional estate tax under Code section 2032A(c).

Effective Date

The bill would apply to rentals occurring after December 31, 1976.

2. S. 628 (Senators Kyl and Helms)

Description of the Bill

The bill would repeal the Federal estate and gift tax and the Federal generation-skipping transfer tax.

Effective Date

The bill would apply to decedents dying, gifts made, and generation-skipping transfers occurring the date of enactment.

3. S. 867 (Senator Cochran)

Description of the Bill

The bill would provide three special rules applicable to "family enterprise property." For purposes of the bill, family enterprise property generally would mean any interest in real or personal property devoted to use as a farm or use for farming purposes or that is used in a trade or business, if at least 80 percent of the ownership of the farm or trade or business is held by five or fewer individuals or by members of the same family.

First, in addition to the unified credit of $192,800 allowed under present law, the bill would grant an additional unified credit amount of up to $121,800 with respect to gifts and bequests of "family enterprise property." Thus, the bill would increase the amount of property that can be transferred free of estate and gift tax as a result of the unified credit from $600,000 to $1 million, provided that at least $400,000 of such transfers were gifts and bequests of family enterprise property.[8]

Second, the bill would allow an exclusion for annual gifts of up to $10,000 of family enterprise property per donee, in addition to the $10,000 annual exclusion for gifts allowed under present law.

Third, under the bill, a decedent's gross estate would be reduced by 50 percent of the value of any family enterprise property included in the gross estate. The maximum reduction under this provision would be $1 million. Any reduction in value would be subject to recapture of estate tax if the family member(s) cease active management of the property or dispose of the property within ten years after the decedent's death. The amount of recapture would depend upon when the recapture

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[8] As presently drafted, the bill literally only requires $121,800 of family enterprise property to qualify for the maximum additional credit of $400,000. The Joint Committee on Taxation staff understands that the intent, however, is that the additional credit apply only to family enterprise property and not be available to offset the tax attributable to other property.

occurs during the ten-year period. For this purpose, the term active management means the making of the management decisions of a business other than the daily operating decisions.

In addition to the special rules applicable to family enterprise property, the bill would increase the $750,000 ceiling amount on special use valuation under Code section 2032A to $1 million.

Effective Date

The bill would apply to the estates of decedents dying, and gifts made, after December 31, 1995.

4. S. 161 (Senator Murray)

Description of the Bill

The bill would make several changes to the estate and gift tax applicable to qualified "family-owned business interests." For purposes of the bill, a qualified family-owned business interest would mean any interest in a sole proprietorship, a partnership carrying on a trade or business with 15 partners or less, and a corporation with 35 shareholders or less.

First, in certain cases, the bill generally would reduce the estate tax rate on qualified family-owned business interests to either 15 or 20 percent. To qualify for this reduction and tax rates, the value of the qualified family-owned business interest must exceed 50 percent of the value of the adjusted gross estate. In addition, during five of the eight years preceding the decedent's death the qualified family-owned business interest must have been owned by the decedent or a member of her family and the decedent or a member of her family must have materially participated in the business. Any reduction in tax rate would be subject to recapture if certain disposition events occurred or the heirs ceased to materially participate with respect to the qualified family-owned business interest within ten years following the decedent's death.

Second, if the estate tax is deferred under section 6166, the special 4-percent interest rate available under section 6601(j) generally would apply to the tax imposed on the value of the qualified family-owned business interest without regard to the $1 million limitation.

Third, the bill would allow an alternate valuation date of 40 months after the decedent's death (rather than six months after the decedent's death as provided under present-law sec. 2032) to be used with respect to estates that qualify for the reduced tax rates.

In addition to the special rules applicable to family-owned businesses, the bill would change the annual exclusion for gifts such that the annual exclusion cannot be less than 15 percent of the donor's earned income during the calendar year. Finally, the bill would index the applicable unified credit for inflation and would make conforming amendments to the unified credit to reflect the other changes made by the bill.

Effective Date

The bill would be effective with respect to the estates of decedents dying, and gifts made, after December 31, 1995.

5. S. 692 (Senator Gregg)

Description of the Bill

a. Special treatment for conservation easements (sec. 101 of the bill)

The bill would provide that an executor may irrevocably elect to exclude from a decedent's gross estate the value of any land subject to a qualified conservation easement. The amount excluded would be the value of any qualified conservation contribution (within the meaning of sec. 170(h)) of a qualified real property interest (as generally defined in sec. 170(h)(2)(C)) made by the decedent or a member of the decedent's family. A qualifying conservation purpose would be any of the purposes defined in present-law section 170(h)(4), except that the preservation of a historically important land area or a certified historic structure would not be a qualifying conservation purpose under the bill. The basis of such land acquired at death would be a carryover basis (i.e., the basis would not be stepped-up to its fair market value at death). A member of the decedent's family would include his or her ancestors, his or her spouse, a lineal descendant of the decedent, the decedent's spouse or the decedent's parents, and the spouses of any of the foregoing lineal descendants (sec. 2032A(e)(2)).

Effective Date

The provision would apply to the estates of decedents dying after December 31, 1995, with respect to qualified conservation easements granted after December 31, 1995.

b. Special estate tax valuation of certain forest land (sec. 102 of the bill)

In general, the value of certain forestland (called "qualified forestland") for Federal estate taxes purposes would be its value for use as a timber operation. "Qualified forestland" would be real property which either (1) qualifies for a State differential use value assessment plan or (2) is forestland with a minimum size of 10 acres that is subject to a forest management plan. The proposal is similar to the special valuation rules of present-law section 2032A with the following major differences:

(1) In order to qualify for the new valuation rules, the value of the forestland must be more than 25 percent of the adjusted value of the gross estate (i.e., there also is not a 50 percent test as with present law special valuation rules)

(2) Heirs would be required to perform "active management" with respect the property (instead of "material participation");

(3) The estate tax value of forestland would the lowest of: (a) its State assessed value; (b) the sales value of comparable rural forestland; (c) the capitalized value of expected income from timber operations; or (d) any other factor which fairly values the timber value of the property;

(4) There would be no limit on the amount that the value of the forestland could be reduced by the provision (i.e., there would be no $750,000 limit);

(5) Continued forestland use would be required for 25 years (instead of the 10 years provided by the sec. 2032A special valuation rules);

(6) A qualified heir can dispose of the forestland to any other person before 25 years without recapture tax if the transferee agrees to continue use of the property as qualified forest use;

(7) In addition to cessation of forestland use, recapture would occur if any depreciable improvements are made to the property (other than those relating to qualified forestland use);

(8) A qualified heir can make a contribution of a conservation easement without recapture tax; and,

(9) Recapture from involuntary conversion or exchanges would be avoided to the extent conversion proceeds or replacement property are invested in property to be used for qualified forest use.

<u>Effective Date</u>

The provision would apply to the estates of decedents dying after December 31, 1995.

III. EXPENSING BY SMALL BUSINESSES

Present Law

Taxpayers generally recover the cost of tangible property placed in service in a trade or business over time through annual depreciation deductions. In lieu of depreciation, a taxpayer with a sufficiently small amount of annual investment may elect to expense and deduct up to $17,500 of the cost of qualifying property placed in service for the taxable year (sec. 179).[9] In general, qualifying property is defined as depreciable tangible personal property that is purchased for use in the active conduct of a trade or business. The $17,500 amount is reduced (but not below zero) by the amount by which the cost of qualifying property placed in service during the taxable year exceeds $200,000. In addition, the amount eligible to be expensed for a taxable year may not exceed the taxable income of the taxpayer for the year that is derived from the active conduct of a trade or business (determined without regard to this provision). Any amount that is not allowed as a deduction because of the taxable income limitation may be carried forward to succeeding taxable years (subject to similar limitations). The $17,500 and $200,000 amounts are not indexed for inflation.[10]

Description of Provision

Section 352 of H.R. 1215, as passed by the House, would increase the $17,500 amount allowed to be expensed under Code section 179 to $35,000. The increase would be phased in as follows:

Taxable year beginning in--	Maximum expensing
1996	$22,500
1997	$27,500
1998	$32,500
1999 and thereafter	$35,000

[9] The amount permitted to be expensed under Code section 179 is increased by up to an additional $20,000 for certain property placed in service by a business located in an empowerment zone (sec. 1397A).

[10] The Omnibus Budget Reconciliation Act of 1993 increased the amount allowed to be expensed under section 179 from $10,000 to $17,500. The $10,000 amount had been provided by the Tax Reform Act of 1986 ("1986 Act"). Prior to the 1986 Act, taxpayers were allowed to expense up to $5,000 of the cost of qualifying personal property. The $5,000 limit had been scheduled to rise to $7,500 for taxable years beginning in 1988 and 1989, and $10,000 thereafter. The 1986 Act also instituted the present-law $200,000 phaseout and taxable income limitation.

Effective Date

The provision would be effective for property placed in service in taxable years beginning after December 31, 1995, subject to the phase-in schedule set forth above.

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