

Small Business Council of America



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Small Business Council Of America Warns That Repeal of the Estate Tax in 2010 and Beyond will Harm Many Small Business Owners

The Small Business Council of America ("SBCA") warned today that more small business owners would be hurt if the estate tax were to be permanently repealed in 2010, than if the law were frozen in 2009. "Proponents of repeal tout the benefits of estate tax repeal to the small business owner when, in fact, repeal will actually harm most small business owners because of the loss in the step-up in basis." said Paula Calimafde, Chair of the SBCA.

In order to protect small businesses, the SBCA called for immediate reform of the estate tax system. The following steps should be taken immediately in order to protect small businesses from estate tax:

- Increase the estate tax exemption amount *immediately* to \$3.5 million and then increase it gradually over a number of years until it reaches *at least* \$5 million and thereafter have it increase by COLA
- Preserve the step-up in basis at death for simplicity and fairness
- Reunify the estate and gift tax exemptions, increasing the gift tax exemption to immediately equal the estate tax exemption, for simplicity and flexibility
- Exempt retirement plan assets from the estate tax in an amount up to an additional \$1 million if assets are going to a surviving spouse and up to an additional \$500,000 if the assets are going to other heirs
- Reduce the top estate tax rates, particularly if an interest in a closely held or small business is subject to the tax.

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By implementing these steps, small business owners who have worked a lifetime to build their companies will be virtually exempt from the estate tax system which is the professed goal of Congress. Additionally, by implementing these proposals, many small business owners will find themselves in a better tax position than they would if the proposed repeal were to take place as scheduled in 2010. This is because total repeal would be accompanied with a loss of the step-up in basis and a continuing \$1 million cap of the gift tax exemption. Further, exempting a certain portion of retirement plan assets from the estate tax would promote retirement plan savings.

Under the estate tax law today, any assets that a person receives from another person's estate receive a "step-up" in basis - this means that the person receiving them gets them with a tax basis increased to fair market value as of date of death. Thus, when the person decides to sell the property, he or she would be taxed on the difference between the sales price and the date of death fair market value (this gain would be subject to either income tax or capital gains tax depending upon the asset).

A step-up in basis is contrasted to a "carry-over" basis where the heirs receive the assets with the same basis that the deceased owner had. For example, assume a father bought an investment property for \$20,000 and did not improve it in any way and that 35 years later at his death, the property is valued at \$200,000. If the son received the property with a "carry-over" basis, his basis in the property would be \$20,000. If the son then sold the property for \$200,000, he would have \$180,000 of gain which would be subject to tax. If instead the son received the property with a stepped-up basis, his basis in the property would be \$200,000 and there would be no gain subject to tax when he sold the property for \$200,000.

Under current law, upon the full repeal of the estate tax in 2010, the current rule providing for a step-up in basis (or receiving the asset with a tax basis equal to its fair market value) is repealed. Instead, the heirs will have the basis that the decedent had in those assets. The heirs will be entitled to an aggregate basis increase of \$1.3 million (adjusted for inflation after 2010). In addition, the decedent's surviving spouse will be entitled to an additional aggregate basis increase of \$3 million (adjusted for inflation after 2010). So, if estate taxes are repealed and a decedent is survived by the decedent's spouse and the value of the decedent's estate is \$4.3 million, the full amount of the estate will pass to the spouse free of any estate tax and the surviving spouse will have a stepped-up basis for the entire estate. If there is no surviving spouse, then only \$1.3 million of assets will receive the step-up in basis.

Example – Why Making Repeal Permanent in 2010 Would Be a Tax Increase on Many Small Businesses

Assume there is a small business owner who has \$3.5 million of assets and no surviving spouse. He (or rather his heirs) are much better off under the 2009 law rather than total repeal of the estate tax because of the loss in the step up in basis. This is how this works:

Under total repeal: \$1.3 million of the assets receive a step-up in basis to the fair market value of those assets at date of death. The remaining \$2.2 million of assets will have the basis that the decedent had in those assets. Imagine if the decedent were an 85 year old man who acquired many of these assets more than 40 years ago... it is beyond us how the heirs will even be able to even figure out the carry over basis of those assets. The burden is on the heirs to prove any basis, and many will fail to have enough records, resulting in a zero basis. (The step-up in basis was repealed back in 1976 and was then reinstated in 1980, though the carry-over

rules never became applicable during that period, because Congress learned from attorneys and accountants who handled the probate process that it was almost impossible to determine the carry-over basis for many assets.)

Now when the heirs of this decedent sell this \$2.2 million of assets, they will be subject to income tax on the difference between the then fair market value of the assets and any basis they can prove the decedent had in those assets. For example, let's assume that the heirs are able to prove that the carry-over basis in the assets is \$1 million - then the heirs will be taxed on \$1.2 million (assuming the fair market value of the assets was still \$2.2 million).

Under an immediate \$3.5 million exemption:

All \$3.5 million of assets receive a step-up in basis to the \$3.5 million level (this is the fair market value of his assets as of his passing). Now when the heirs sell any of these assets (assuming the fair market value of the assets was still \$3.5 million), there would be no income tax and no estate tax.

Basically, a single person with assets greater than \$1.3 million up to \$3.5 million is better off under the estate law as it stands in 2009 and does much worse under total repeal of the estate tax. Similarly, a decedent who is married with assets greater than \$4.3 million up to \$7 million does better under the law as it would stand in 2009 than he would under total repeal. This covers a significant amount of taxpayers based on the data that illustrates how many taxpayers drop off of the estate tax rolls as the exemption amount increases.

Based on data set forth in a March 16, 2005, issue paper from the Center on Budget and Policy Priorities:

- If the estate tax exemption were \$1 million in 2011, then 53,800 estates would be subject to the estate tax (this represents about 2% of the 2.6 million people expected to die in that year). Of the 53,800 estates that would be taxable, nearly half (46%) would have assets of less than \$2 million and nearly three-fourths would be valued at less than \$3.5 million.
- If the exemption level in 2011 were \$2 million instead of \$1 million, then the number of taxable estates would shrink to 21,000. This is a reduction of 61% in the number of estates that would face the estate tax.
- **If the exemption amount in 2011 were \$3.5 million instead of \$2 million, then the number of taxable estates would drop to 8,500 (84% of the estates would be exempt compared to the number that would have been subject to estate tax if the exemption amount were \$1 million in 2011). This amount represents about 0.3% of all the people who are expected to die in 2011.**

The reason why most small businesses owners (particularly where they have assets which under repeal will have a carry over basis versus a stepped up basis if the \$3.5 million exemption were in effect) do not

understand that they are worse off under repeal, is that they do not understand the impact of the carry over basis and the ultimate imposition of income tax on those assets.

At the end of the day, the proponents of repeal have won over the small business community with flashy slogans - "Kill the Death Tax" or "Is it fair that you have to pay taxes when you die?" (Of course, most of the owners did not realize that the estate tax never would have applied to them in the first place because the estate tax exemption is higher than their total assets.) **Nor has anyone explained to them that a great number of small business owners will be worse off if repeal is enacted and only an extraordinarily few will be better off.**

Small business are being used to make repeal "respectable" - it is far easier to talk about how outrageous it is for a farmer to lose his farm to pay estate taxes than to talk about how unfair it is that a billionaire will have to pay a portion of his assets to the government and/or charities. Small businesses would be far better off to have the dollars that would be "saved" by the 2009 estate tax law being enacted with our changes instead of estate tax repeal¹ on a total repeal of AMT which really does hurt small businesses. By enactment of our estate tax proposals, virtually all small businesses will be removed from the reach of the estate tax. It is time for small business owners to understand how estate tax repeal could adversely impact them and to walk away from it. Proponents of repeal have used small business as the straw man to push for estate tax repeal when, in fact, many small business owners and their families will be harmed by estate tax repeal. Repeal will only help the extraordinarily rich.

Despite attempts by Representative Pomeroy and others, who understand how repeal actually hurts small business owners, the House yesterday voted for permanent repeal (even though in reality this is a tax increase on small businesses). The SBCA urges the Senate to proceed with more deliberation in light of harm that can be done to the most vital segment of our economy - small business.

The Small Business Council of America (the SBCA) is the only national organization whose sole purpose is to represent the interests of private and family owned businesses in federal income and estate tax, pension, health care and other employee benefit concerns. The SBCA, through its members, represents well over 20,000 enterprises in retail, manufacturing and service industries, virtually all of which sponsor retirement plans and provide health insurance for their employees. The primary goal of the SBCA is to enact favorable federal tax and employee benefit laws for small businesses. The SBCA supports legislation which creates important economic incentives, and opposes burdensome and oppressive laws and proposals.

¹ The March 16, 2005, Center on Budget's paper referred to above states that if the exemption were set at \$3.5 million and the top tax rate were 45% (i.e., this is the 2009 law), the total estate tax revenue raised would be \$17 billion in 2011 according to the Tax Policy Center. Even at the \$3.5 million exemption level, which would exempt 84 % of taxable estates from estate tax in 2011, 44% of the revenue that would be lost under total repeal would still be preserved. These numbers reflect the fact that some of the taxable estates remaining would have enormous wealth which would generate significant estate taxes.

Who Gets Harmed by Repeal of the Estate Tax and Why

- **Any single person with assets greater than \$1.3 million up to \$3.5 million is better off under the 2009 estate law and does much worse under total repeal of the estate tax.**
- **Any married decedent with assets greater than \$4.3 million up to \$7 million does better under the 2009 estate law than he would under total repeal.**
- **The assets between those dollar ranges will have the basis that the decedent had in those assets (this is called a carry over basis) and the burden is on the heirs to prove the decedent's basis. For those who cannot find enough records, they will end up with a zero basis. Under the 2009 law, the assets would receive a step up in basis to fair market value.**
- **If the estate tax exemption were \$1 million in 2011, then 53,800 estates would be subject to the estate tax (this represents about 2% of the 2.6 million people expected to die in that year). Of the 53,800 estates that would be taxable, nearly half (46%) would have assets of less than \$2 million and nearly three-fourths would be valued at less than \$3.5 million.**
- **If the exemption amount in 2011 were instead \$3.5 million, then the number of taxable estates would drop to 8,500 (84% of the estates would be exempt compared to the number that would have been subject to estate tax if the exemption amount were \$1 million in 2011). This amount represents about 0.3% of all the people who are expected to die in 2011.**
- **Many small business owners fall in this gap between \$1 million and \$3.5 million and thus, will be harmed by the repeal of the estate tax.**
- **It is ironic that while repeal is touted as helping small business, it will actually end up hurting them by the imposition of additional income tax.**