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CONTRARY TO CLAIMS, ALLOWING ESTATE TAX TO EXPIRE WOULD MAKE FAMILY FARMS AND SMALL BUSINESSES WORSE OFF OVERALL

More People — and More Small Business — Would Face Tax *Increases* Than Tax *Cuts*

By Chuck Marr and Gillian Brunet

While estate-tax opponents have held up family-owned farms and small businesses as "poster children" for the benefits of repealing the tax, such estates would be *worse off,* on balance, if Congress allows estate tax repeal and related tax changes to take effect on January 1, as now seems likely. The estate tax is irrelevant to the overwhelming majority of small farms and businesses because only a tiny number of them have assets worth more than $7 million for a couple ($3.5 million for an individual), the levels below which estates are entirely exempt from the tax. But if repeal advocates have their way and Congress fails to act to extend the current estate tax by December 31, many small businesses and family farms that never would have owed any estate tax will end up with a new capital gains tax burden and will face a sizeable tax increase because of a little-known provision of the 2001 tax-cut law.

Indeed, the number of people likely to face tax increases as a result of congressional inaction on the estate tax far exceeds the number of wealthy people who would secure a tax cut.

Heirs Currently Pay No Capital Gains Tax on Prior Increases in Value of Inherited Assets

Under the estate tax rules in effect for 2009, the first $3.5 million of an individual's estate ($7 million per couple) is entirely free from the estate tax. Amounts above these thresholds are taxed at a 45 percent rate, but because of the tax's high exemption amount and other estate-tax breaks, data from the Tax Policy Center show that the small number of estates that owe any tax pay the tax at less than 20 cents on the dollar, on average (i.e., less than one-fifth of the estate's value is paid in estate taxes).[1]

The current tax treatment of capital gains also is very important — because much of the value of sizeable estates often consists of unrealized capital gains. Consider, for example, a person who bought shares of stock at $10 per share and held them until her death, at which time they were worth $100 per share. Under current law, this $90-per-share capital gain would *never* be taxed. If an heir subsequently sold the stock, he or she would pay capital gains tax only on any increase in the

[1] Tax Policy Center, "$3.5 Million Exemption and 45 Percent Rate: Distribution of Gross Estate and Net Estate Tax by Size of Gross Estate, 2010," November 18, 2009, http://www.taxpolicycenter.org/numbers/Content/PDF/T09-0440.pdf.

value of the stock *above* its value at the time of the decedent's death. In other words, if an heir sold the stock immediately for $100 per share, he or she would pay *no* capital gains tax on it, and if the heir later sold the stock for $110, he or she would pay capital gains tax on only the $10-per-share increase. (In technical terms, when computing the capital gains tax, an heir is allowed to "step up" the "basis" of the assets he or she inherited to their value at the time of the decedent's death.)

These rules for how the capital gains tax applies to inherited assets are particularly important to family farms and small businesses. Often, the primary asset in a family farm or small business estate is the farm or business itself, which has increased substantially in value over time but the owner has never paid capital gains tax on that increase.

If Congress Fails to Act, Many Farms and Businesses Would Face New Capital Gains Tax Liability

Under the 2001 tax-cut law, several major changes related to the taxation of estates are scheduled to take effect (for one year) on January 1, 2010, including:

- As is well known, the estate tax itself will disappear — that is, no estate tax will be levied on the estates of people who die during 2010.

- Less well known is the fact that the tax treatment of unrealized capital gains in estates also will change dramatically — and in the opposite direction. Heirs who sell inherited assets will have to pay capital gains tax on the difference between the *original price the decedent paid to acquire the asset — even if the decedent obtained the asset many decades ago — and the price for which the heir sells the asset now*. For instance, if the heir in the example described above immediately sold the stock that he or she inherited at its value of $100 per share at the time of the decedent's death, the heir would have to pay capital gains taxes on the $90-per-share increase in value that occurred during the decedent's lifetime.

  This effect will be moderated by a provision of the law that exempts the first $1.3 million of unrealized capital gains in an estate from this tax treatment. (An additional $3 million in capital gains is exempt if those assets go to the surviving spouse.) But tens of thousands of estates — many of which include small businesses or farms — include assets with unrealized capital gains of *more than* $1.3 million and go to heirs other than a spouse (especially when there is no surviving spouse). As a result, many heirs of estates that have a total value of less than $3.5 million but contain more than $1.3 million in unrealized capital gains could face large *tax increases*. These heirs would be subject to neither estate nor capital gains taxes if the 2009 estate tax rules were continued. But because Members of Congress who favor estate-tax repeal have blocked efforts to extend the current estate tax rules into 2010, many of these heirs will face hefty tax hikes when they sell assets they have inherited.

Many More Would Face Tax Increase Than Tax Cut

Many more people, and many more family-owned businesses and farms, would face new taxes as a result of the change in the capital-gains treatment of inherited assets that would accompany the disappearance of the estate tax than would benefit from the end of the estate tax itself.

- Few people — and even fewer small farms and businesses — will benefit at all from the disappearance of the estate tax in 2010. Tax Policy Center data show that the estates of only one-quarter of 1 percent of people who die — 5,490 estates nationwide — would owe *any* estate tax if the 2009 estate-tax rules were continued, and thus would benefit from the tax's demise.

  Tax Policy Center data also indicate that only *100 small businesses and farm estates in the entire country* would owe any estate tax in 2010 if the 2009 estate-tax rules were maintained.[2]

- In contrast, the heirs of approximately 71,400 estates could face new capital gains taxes if the estate tax is allowed to disappear for 2010, according to an analysis by John Buckley, chief tax counsel for the House Ways and Means Committee. Moreover, at least 62,500 of these are estates that would not owe any estate tax if the 2009 rules were continued and that thus would be adversely affected by estate tax repeal. Farm and business estates would constitute a disproportionately large share of this group. [3]

Not only would many estates face higher taxes, but nearly all large estates would face new administrative burdens, since their owners would have to know (or estimate) the *original purchase price of every asset in the estate* in order to calculate their capital gains tax liability. Under current law, in contrast, all assets in an estate are simply assessed for their value at the time of the decedent's death.

The bottom line is that family farms and small businesses will, on balance, be much better off if Congress extends the current rules for the estate tax and the capital-gains treatment of inherited assets. If Congress continues to fail to act, many more Americans — and many more family farms and small businesses, in particular — will face tax increases than tax cuts. And the people facing the tax increases will be less affluent than the people who benefit from the tax cuts, since only the country's largest estates owe any estate tax.

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[2] See Tax Policy Center, "$3.5 Million Exemption and 45 Percent Rate: Distribution of Gross Estate and Net Estate Tax by Size of Gross Estate, 2010," November 18, 2009, http://www.taxpolicycenter.org/numbers/Content/PDF/T09-0440.pdf. We follow the Tax Policy Center definition of a small business or farm estate as one in which more than half of the value of the estate is in a farm or business and the farm or business assets are valued at less than $5 million.

[3] See John Buckley, "Estate Tax Repeal: More Losers Than Winners," *Tax Notes*, February 14, 2005. While the Joint Committee on Taxation estimates used in the Buckley paper are several years old, they were accompanied by estimates of the number of estates that would need to file estate tax returns in 2009, and those estimates are not out of line with current estimates. If anything, the 62,500 estimate may be too conservative. The Buckley estimates thus provide reasonable rough estimates of the number of estates that would be affected.